

ROSETTA STONE INC
Form 10-K
March 03, 2014
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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, 2013
Commission file number: 1-34283

Rosetta Stone Inc.
(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

1919 North Lynn St., 7th Fl.
Arlington, Virginia
(Address of principal executive offices)

043837082
(I.R.S. Employer
Identification No.)

22209
(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

Common Stock, par value \$0.00005 per share

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 No

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

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 No

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 No

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.

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

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

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The aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$281.1 million as of June 30, 2013 (based on the last sale price of such stock as quoted on the New York Stock Exchange).

As of February 21, 2014, there were 21,110,250 shares of common stock outstanding.

Documents incorporated by reference: Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2014 Annual Meeting of Stockholders to be held on May 20, 2014 are incorporated by reference into Part III.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the federal securities laws. The forward-looking statements included herein or incorporated herein by reference include or may include, but are not limited to, (and you should read carefully) statements that are predictive in nature, depend upon or refer to future events or conditions, or use or contain words, terms, phrases, or expressions such as "achieve," "forecast," "plan," "propose," "strategy," "will," "continue," "potential," "expect," "believe," "anticipate," "project," "estimate," "predict," "intend," "should," "could," "may," "might," or similar words, terms phrases, or expression or the negative of any of these terms. Any statements in this Form 10-K that are not based upon historical fact are forward-looking statements and represent our best judgment as to what may occur in the future. These forward-looking statements include, but are not limited to, statements regarding: our business strategies; information regarding our future financial performance; our projected plans and objectives; our development of new products, the integration and expansion of the products we have acquired through mergers and acquisitions; international expansion in certain markets and contraction in other markets, including our plans to substantially reduce our Japanese and Korean operations; our development of a business model to drive growth; expected market competition and continuation of certain market trends; the sufficiency of our cash flows from operations and available sources of funds; the impact of inflation on our financial position and results of operations; our technology and product development initiatives; and our intellectual property strategy and protection. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included throughout this filing and particularly in Item 1A: "Risk Factors" section set forth in this Annual Report on Form 10-K. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to revise or publicly release any revision to any such forward-looking statement, except as may otherwise be required by law.

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PART I

Item 1. Business

Overview

Rosetta Stone Inc. ("Rosetta Stone," "the Company," "we" or "us") is dedicated to changing the way the world learns. Our innovative, technology-driven language-learning solutions have been purchased by millions of individuals and used by thousands of schools, businesses, and government organizations around the world. Rosetta Stone Inc. is a corporation incorporated in Delaware in 2005. Founded in 1992, Rosetta Stone's predecessor pioneered the use of interactive software to accelerate language learning. Today we offer courses in 30 languages across a broad range of formats, including online subscriptions, digital downloads, mobile apps, and CD packages. Rosetta Stone has invested more in language learning and expanded into education-technology with its acquisitions of Livemocha Inc. ("Livemocha") and Lexia Learning Systems Inc. ("Lexia") in 2013 and of Vivity Labs, Inc. ("Vivity"), and Tell Me More S.A. ("Tell Me More") in January 2014.

Livemocha has developed one of the world's largest online language-based communities. The acquisition brought us a cloud-based platform, enabling us to accelerate our transition to cloud-based learning solutions. By combining the Livemocha community with Rosetta Stone's own innovative product development and marketing capabilities, we are positioned to meet the changing needs of learners around the world.

The acquisition of Lexia, a leading reading-technology company, marked our first extension beyond language learning and expanded our footprint in the education-technology industry. We are leveraging Lexia's expertise in children's reading to deepen our engagement with schools and deliver digital literacy solutions to young learners in the United States ("U.S.") and international consumer markets.

The purchase of Tell Me More, headquartered in France, significantly strengthens Rosetta Stone's Global Enterprise & Education business. Tell Me More is a global language-learning software company with significant presence throughout Europe, as well as sales in the U.S., Latin America and China. Tell Me More offers a robust suite of Software-as-a-Service ("SaaS") based language learning products and services that provide intermediate, advanced and business language solutions in nine languages. We plan to introduce Tell Me More's products into our Consumer business to increase the options provided to customers, and we believe that with Tell Me More, we will be able to offer the most comprehensive suite of products and services--with the broadest number of languages, greatest depth of content and largest geographic reach-- in the industry.

Vivity is the creator of the Fit Brains brain-training product portfolio, and this acquisition continues Rosetta Stone's expansion beyond language learning and into adjacent categories of education-technology. Underscoring the connection between brain fitness and language learning, Vivity's mobile applications are localized in multiple languages to serve customers around the world. Vivity's emphasis on mobile solutions is especially compatible with our focus on cloud-based technology to enable on-the-go learning.

Rosetta Stone's management team has communicated a strategic business plan designed to guide the Company through 2015. The key areas of focus are:

- 1.leveraging the brand;
- 2.innovating the platform; and
- 3.expanding distribution.

In pursuing these priorities, we plan to grow the business by continuing to invest in research and development of new products while focusing on maintaining costs and margins at appropriate levels.

Business Segments

During 2012, we instituted a change in our chief operating decision maker ("CODM"), which led to a fourth quarter change in what our CODM uses to measure profitability and allocate resources. Accordingly, beginning with the fourth quarter of 2012, we have three operating segments, North America Consumer, Rest of World ("ROW")

Consumer and Global Enterprise & Education (previously referred to as Institutional). From the first quarter of 2011 through the third quarter of 2012, we had two operating segments, Consumer and Global Enterprise & Education. Prior to 2011 we operated as a single segment.

The North America Consumer and ROW Consumer segments derive revenues from sales to individuals and retail partners. The North America Consumer segment includes sales made within the U.S. and Canada; the ROW Consumer segment

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includes sales made in countries other than the U.S. and Canada. The Global Enterprise & Education segment derives revenues from sales to educational institutions, government agencies and corporations worldwide.

For additional information regarding our segments, see Note 16 of Item 8, Financial Statements and Supplementary Data. Prior periods are presented consistent with our current operating segments and definition of segment contribution.

Products and Services

Consumer:

Rosetta Stone offers a broad portfolio of technology-based learning products. Powered by our widely recognized brand, and building on our 21-year heritage in language-learning, our portfolio now extends into reading and brain fitness. In addition to our computer-based interactive learning solutions for adult consumers, Rosetta Stone also offers a suite of games, mobile apps, and a growing selection of learning products for kids.

Learning Solutions: Rosetta Stone provides intuitive, easy-to-use learning programs that are available online and via digital download or CD. Our language-learning suite offers courses and practice applications in 30 languages, each leveraging our proprietary immersion methodology and innovative technology features. Strengthened by the acquisition of Livemocha, Rosetta Stone offers an online, world-wide community of learners that is open to language-learners around the world.

Games & Apps: Rosetta Stone mobile apps are available for both tablet and smartphone use to enable learners to continue their lessons on the go. Our current suite of apps includes companions to our language-learning solutions, as well as a series of introductory language apps for travelers and a high-tech Spanish language-learning game called Rosetta Stone Arcade Academy. Developed by Vivity Labs, Fit Brains Trainer and Sparky's Adventure are brain-training solutions for adults and children. The mobile apps are available through the Apple AppStore and Google Play.

Rosetta Stone Kids: Our Rosetta Stone Kids products provide technology-based learning solutions for children that focus on early childhood language and literacy. In 2013, we launched Rosetta Stone Kids Learning Games, with a small suite of apps for children aged 3-6 that provides blended learning solutions to introduce kids to both basic literacy skills and a foreign language.

Enterprise & Education

Rosetta Stone offers a series of technology-based learning products for schools, businesses and organizations. With the acquisition of Lexia, our Enterprise & Education portfolio now extends into reading and literacy. In addition to our technology-based interactive learning solutions, Rosetta Stone also offers administrator tools for performance monitoring, and custom solutions to ensure that organizations achieve desired outcomes.

Learning Solutions: Rosetta Stone provides cloud-based learning programs that are available online or in a variety of digital formats. Our core language-learning suite offers courses and practice applications in 30 languages, each leveraging our proprietary immersion methodology and innovative technology features.

Our newly acquired Lexia Learning solutions provide explicit, systematic, personalized reading instruction for students in grades pre-K to 5. Lexia's solutions deliver norm-referenced performance data and analysis to enable teachers to monitor and modify their instruction to address specific student needs.

With the acquisition of Tell Me More, we also now provide intermediate, advanced and business language instruction in nine languages. Tell Me More's offering is built on a SaaS platform that includes up to 2,000 hours of instructional content with over 35 learning activities per language, including assessment, placement and certification testing.

Administrator Tools: Our Global Enterprise & Education learning programs come with a set of administrator tools to measure and track learner progress. Administrators can use these tools to access real-time dynamic reports and identify areas where learners may require additional attention.

Custom Solutions: Rosetta Stone offers tailored solutions to help organizations maximize the success of their learning programs. Our current custom solutions include curriculum development, global collaboration programs that combine language education with business culture training, and language courses for mission-critical government programs.

Our Advanced English for Business solution serves multinational companies seeking to build their employees' English language proficiency so they are able to communicate and operate in a global business environment.

Product Developments

Our product portfolio is a result of significant investment in product development. Our product development efforts include design and build of software solutions across a variety of devices, pedagogy and curriculum development, and the

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creation of language learning content. Our development team builds new solutions and enhances or maintains existing solutions. We have specific expertise in speech recognition technology, iterative and customer-focused product development, instructional design and language acquisition.

Our research and development expenses were \$34.0 million, \$23.5 million, and \$24.2 million for the years ended December 31, 2013, 2012 and 2011, respectively.

We continue to evaluate changes to our products to strengthen our brand and improve the relevance of our offerings. We are developing our first set of products for children, including several mobile applications that were released in 2013. In addition, we are enhancing our offering for educational organizations to expand our Global Enterprise & Education business. We intend to make our products more modular, flexible and mobile.

Distribution Channels

Our global consumer distribution channel comprises a mix of our websites, call centers, third party e-commerce websites such as Digital River and Apple iTunes, select retail resellers, such as Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Staples, Costco, daily deal partners such as Groupon, home shopping networks such as GS Home Shopping in Korea and consignment distributors such as Speed Commerce and third-party resellers of Lexia Core5. We believe these channels complement each other, as consumers who have seen our direct-to-consumer advertising may purchase at our retailers, and vice versa.

Direct to consumer. Sales generated through either our websites or call centers.

Indirect to consumer. Sales generated through arrangements with third-party e-commerce websites.

Retailers. Our retailers enable us to provide additional points of contact to educate consumers about our solutions, expand our presence beyond our own websites, and further strengthen and enhance our brand image. Our retail relationships include Amazon.com, Barnes & Noble, Best Buy, Books-a-Million, Costco, Groupon, Staples, and others in and outside of the U.S.

Home School. We promote interest in this market through advertising in publications focused on home schooling, attending local trade shows, seminars and direct mailings.

Rosetta Stone Kiosks. On April 4, 2013, we announced the closure of our entire kiosk sales channel in the U.S. and the United Kingdom. As of December 31, 2013, we operated three retail kiosks in Japan that were subsequently closed in the first quarter of fiscal year 2014.

Our Global Enterprise & Education distribution channel is focused on targeted sales activity primarily through a direct sales force in five markets: K-12 schools, colleges and universities, federal government agencies, corporations, and not-for-profit organizations. We also have relationships with third-party resellers focused primarily on the sale of Lexia products and services.

Educational Institutions. These customers include primary and secondary schools and colleges and universities.

U.S. Federal Government Agencies and Not-for-Profit Organizations. These customers include government agencies and organizations developing workforces to serve non-native speaking populations, offering literacy programs and preparing members for overseas missions.

Corporations. We promote interest in this market with onsite visits, trade show and seminar attendance, speaking engagements and direct mailings.

Third-party Resellers. A significant portion of our sales of Lexia Core 5 are generated through our relationships with third-party resellers.

Sourcing and Fulfillment

Our strategy is to maintain a flexible, diversified and low-cost manufacturing base for our prepackaged products. We use third-party contract manufacturers and suppliers to obtain substantially all of 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.

Competition

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Rosetta Stone competes in several categories within the technology-based learning industry, including consumer and institutional language learning, literacy and reading for students, brain fitness and kids-focused learning solutions. The language-learning market is highly fragmented globally and consists of a variety of instructional and learning modes: classroom instruction utilizing the traditional approach of memorization, grammar and translation; immersion-based classroom instruction; self-study books, audio recordings and software that relies primarily on grammar and translation; and free online and mobile offerings that provide content and opportunities to practice writing and speaking. Within consumer-focused language learning, our competitors include Berlitz International Inc., Simon & Schuster, Inc. (Pimsleur), Random House Ventures LLC (Living Language), McGraw-Hill Education, Duolingo, Fluenz, Busuu, Babbel.com and many other small and regionally-focused participants. In the institutionally-focused language market, we compete with EF Englishtown, Global English, Wall Street Institute, Inlingua, Imagine Learning as well as many private language schools and other classroom-based courses. In the literacy and reading category, we compete primarily in the K-12 Digital Reading space in the U.S. with Scholastic, Inc., Imagine Learning, Achieve 3000, Scientific Learning, Odyssey (Compass Learning), Waterford Early Reading (Pearson), Renaissance, and MindPlay. In the brain fitness and training category, the market is new and highly fragmented. We compete with Lumosity and Posit Science as well as many online and digital app providers.

Seasonality

Our business is affected by variations in seasonal trends. 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, due to the timing of when these organizations receive annual funding. In particular, we generate a significant portion of our consumer sales in the fourth quarter during the period from Black Friday to Cyber Monday. We sell to a significant number of our retailers, distributors and enterprise and education customers on a purchase order basis and we receive orders when these customers need products and services. As a result, their orders are typically not evenly distributed throughout the year and generally are highest in the third and fourth quarters.

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 six U.S. patents, eight foreign patents and several U.S. and foreign patent applications pending. This includes patents held by Tell Me More (Auralog) acquired in January 2014 and a patent issued in the U.S. in February 2014.

Many of the pending patent applications 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, Rosetta Course, The Blue Stone Logo, Adaptive Recall, TOTALe, Livemocha, Lexia Learning, Lexia, Tell Me More, Auralog and Talk to Me. All of these trademarks are the subject of either registrations or pending applications in the U.S., as well as numerous countries worldwide where we do business. We have applied to register our yellow color as a trademark with the U.S. Patent and Trademark Office. We intend to continue to strategically register, both domestically and internationally, trademarks we use today and those we develop in the future. 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 are registering or have registered copyrights in the U.S. all editions of our Version 3 and TOTALe languages. We have registered copyright for the refreshed Rosetta Stone Blue Stone Logo artwork in the U.S. We intend to continue to strategically register copyrights in our various products. 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.

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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, 2013, we had 1,313 total employees, consisting of 921 full-time and 392 part-time employees. In connection with our acquisition of Tell Me More, we have employees in France, Spain and Italy who are represented by a collective bargaining agreement. We believe our employee relations are good.

Financial Information by Segment and Geographic Area

For a discussion of financial information by segment and geographic area, see Note 16 to the consolidated financial statements contained in this Annual Report on Form 10-K.

Available Information

This Annual Report on Form 10-K, along with our Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), are available free of charge through our website as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission ("SEC"). Our website address is www.rosettastone.com. The SEC maintains a website that contains reports, proxy statements and other information regarding issuers that file electronically with the SEC. These materials may be obtained electronically by accessing the SEC's website at www.sec.gov.

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 represents 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 in the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate

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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.

We may not be able to utilize all of our deferred tax assets.

At December 31, 2013, we had gross deferred tax assets of \$36.0 million which was offset by a valuation allowance of \$33.9 million for certain jurisdictions. We recorded the valuation allowance to reflect uncertainties about whether we will be able to realize some of our deferred tax assets before they expire. The valuation allowance is based on our estimates of taxable income for the jurisdictions in which we operate and the period over which our deferred tax assets will be realizable. We could in the future be required to increase the valuation allowance to take into account additional deferred tax assets that we may be unable to realize. An increase in the valuation allowance would have an adverse impact, which could be material, on our income tax provision and net income in the period in which we record the increase.

Risks Related to Our Business

Because we generate a significant majority of our revenue from language-learning solutions in the U.S., a decline in demand for our language-learning solutions or for language-learning solutions in general could cause our revenue to decline.

We generate a significant majority of our revenue from our language-learning solutions, and we expect that we will continue to depend upon language-learning solutions for a significant majority of our revenue in the foreseeable future. In addition, a substantial portion of our language-learning revenue is from customers in the U.S. 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; and

- changes in U.S. or international laws or policies making it more difficult for foreign persons to visit or take up residence in the U.S.

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 brands, 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;

- provide appealing solutions that engage our customers;

- anticipate and meet consumer demand for additional languages, learning levels and new platforms for delivery;

- effectively position and market our products and services;

- identify and secure cost-effective means of marketing our products to reach the appropriate consumers;

-

identify cost-effective sales distribution channels and other sales outlets where interested consumers will buy our products;

- anticipate and respond to consumer price sensitivity and pricing changes of competitive products;
and

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identify and successfully implement ways of building brand loyalty and reputation.

We may be unable to develop new solutions or solution enhancements in time to capture market opportunities or achieve sustainable acceptance in new or existing markets. In addition, our solutions may become less appealing to consumers due to changes in technologies or reduced life cycles of our solutions. A decline in consumer demand for our solutions, or any failure on our part to satisfy such changing consumer preferences, could harm our business and profitability.

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

The success of our business depends to a significant extent upon discretionary consumer spending, which is subject to a number of factors, including general economic conditions, consumer confidence, employment levels, business conditions, interest rates, availability of credit, inflation and taxation. Adverse trends in any of these economic indicators may cause consumer spending to decline further, which could hurt our sales and profitability. For our retail business, we depend on the continued popularity of physical stores and malls to generate customer traffic for retailers. Decreases in physical store or mall retail traffic may adversely affect our consumer sales 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.

Because a significant portion of our sales come from sales of our Version 4 TOTALe product, pricing declines of this product could negatively impact our revenue and profitability.

Historically, reduced pricing of our Version 4 TOTALe product has resulted in increased unit sales volume in the direct-to-consumer web channel of our North America consumer segment, which has offset the impact on sales from lower prices. We expect that the trend of lowering prices resulting in increased unit volume and overall increased sales will continue in the direct-to-consumer web channel. However, given the scale of our business, if this trend does not continue and lowering prices does not result in increased units sales volume, our overall profitability could be negatively impacted.

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 and profitability.

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers and distributors are highly concentrated on a small group and comprises a mix of websites such as Digital River and Apple iTunes App Store, third party e-commerce websites, select retail resellers, such as Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Staples, Costco, daily deal partners such as Groupon and consignment distributors such as Speed Commerce. Sales to or through our retailers and distributors accounted for approximately 18% of our revenue for the year ended December 31, 2013, compared to 17% for the year ended December 31, 2012.

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

As evidenced by the bankruptcy and liquidation of Borders in 2011, book stores and other traditional physical retailers are experiencing diminished foot traffic and sales. Reduced customer foot traffic in these stores is likely to reduce their sales of our products. In addition, if one or more of these bookstores or other retailers or distributors are unable

to meet their obligations with respect to accounts payable to us, we could be forced to write off such accounts. Any bankruptcy, liquidation, insolvency or other failure of any of these retailers or distributors could result in significant financial loss and cause us to lose revenue in future periods.

Product returns and pricing concessions could exceed our estimates, which would diminish our reported revenue. In the U.S., we offer consumers who purchase our packaged software and audio practice products directly from us a 30-day, unconditional, full money-back refund. We also permit some of our retailers and distributors to return packaged products,

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subject to certain limitations. We establish revenue reserves for packaged product returns based on historical experience, estimated channel inventory levels, the timing of new product introductions and other factors. If packaged product returns exceed our reserve estimates, the excess would offset reported revenue, which could hurt our reported financial results.

We continue to test changes to the pricing and delivery methods of our products. If we reduce our prices or our method of delivery as a result of successful tests in an effort to increase sales volume and overall market penetration, we may provide our retailers and distributors with price protection on existing inventories, which would allow these retailers and distributors a credit against amounts owed with respect to unsold packaged product under certain conditions. These price protection reserves could be material in future periods. It is uncertain whether these strategies will prove successful or whether we will be able to develop the necessary infrastructure and business models. The intense competition we face in the sales of our language learning solutions and general economic and business conditions can put pressure on us to change our prices. If our competitors offer deep discounts on certain products or services or develop products that the marketplace considers more valuable, we may need to lower prices or offer other favorable terms in order to compete successfully. Any such changes may reduce margins and could adversely affect operating results. Any broad-based change to our prices and pricing policies could cause our revenues to decline or be delayed as our sales force implements and our customers adjust to the new pricing policies. If we do not adapt our pricing models to reflect changes in customer use of our products or changes in customer demand, our revenues could decrease.

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 competition to persist and intensify. Increased competition could cause reduced revenue, price reductions, reduced gross margins and loss of market share. 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 in select local markets. 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-learning 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 have also seen increased competition from imitation products which are lower priced, lower quality products that attempt to capitalize on the popularity of our products by utilizing similar packaging and marketing materials. In addition, we see increased competition from community practice providers which provide low priced entry points for consumers interested in learning languages. 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.

We have seen an increase of language-learning applications on mobile platforms, such as iPhones and iPads, that are offered at extremely low prices and, while they are currently limited in scope and ability to teach languages, they may present a threat as they develop.

As we continue to expand into foreign markets both directly and indirectly through resellers, 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-learning applications and websites offering limited vocabulary lists, grammar explanations and tips, and crowdsourced text translations. 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 and applications 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 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, distribution channels and retail partners; 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.

Some 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 it cannot be assured that we can increase the amount of remnant advertising at the discounted prices we have obtained in the past. If any of these events occur, we may be forced to purchase time slots and publication dates at higher prices, which will increase our costs.

We also seek new customers through our online marketing efforts, including paid search listings, banner ads, text links and permission-based e-mails, as well as our affiliate and reseller programs. We engage in an active public relations program, including through social media sites such as Facebook and Twitter.

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

A significant portion of 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 U.S. 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 our business, 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 must continue to update our marketing communications in order to maintain and enhance our brand awareness and the value of our brand. Failure to do so may result in a decrease in brand value and related sales.

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 stabilizing the losses we have experienced in international markets in order to prepare for future growth and expansion into international markets. We are currently augmenting and optimizing certain of our website direct sales channels in Europe, Asia and Latin America. In addition, we are continuing to selectively expand and optimize our indirect sales channels in Europe, Asia and Latin America through retailer and distributor arrangements with third parties. If we are unable to stabilize losses in our international operations successfully and in a timely manner, our ability to subsequently pursue our growth strategy will be impaired. Such stabilization and 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 to the extent we expect.

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 effectively managing third-party e-commerce resellers of our products and services;

- difficulty in establishing and maintaining financial and other internal controls over geographically dispersed operations;

- competition from local language-learning 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;

- inability to drive traffic to our websites, call centers, and distribution channels;

- inability to register domain names in Country Code Top Level Domains in order to operate country specific websites to permit consumers to easily locate our products in other countries due in large part to cybersquatting;

- difficulties with providing appropriate and appealing products to suit consumer preferences and capabilities in these markets, such as the potential need to customize English-based language-learning software solutions for local markets;

- difficulties with establishing successful 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;

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

• 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.

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

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

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

Included within our Global Enterprise and Education 2013 bookings is \$2.0 million related to a Lexia pilot program with a state school system. Typically, Lexia sales are with single schools or local school systems. If this arrangement is not renewed we may not be able to achieve the projected growth in our Global Enterprise and Education segment. Some of our enterprise and education business faces a lengthy and unpredictable sales cycle, which could delay new sales.

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

• customers' budgetary constraints and priorities;

• the timing of our customers' budget cycles;

• the need by some customers for lengthy evaluations that often include both their administrators and faculties; and

the length and timing of customers' approval processes.

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.

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We need to anticipate, develop and introduce new products, services and applications on a timely and cost-effective basis that keeps pace with technological developments and changing customer needs. The process of developing new high technology products, services and applications and enhancing existing products, services and applications is complex, costly and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our market share and results of operations. For example, the number of individuals who access the internet through devices other than a personal computer, such as tablet computers, mobile devices, televisions and set-top box devices, has increased dramatically and this trend is likely to continue. Our products and services may not work or be viewable on these devices because each manufacturer or distributor may establish unique technical standards for such devices. Accordingly, we may need to devote significant resources to the creation, support and maintenance of such versions. If we fail to develop or sell products and services that respond to these or other technological developments and changing customer needs, such as the demand for products designed for children, cost effectively, we may lose market share and revenue and our business could suffer. We offer our software products and services primarily on Windows and Macintosh platforms. To the extent that there is a slowdown of customer purchases of personal computers on either the Windows or Macintosh platform or in general, to the extent that we have difficulty transitioning product or version releases to new Windows and Macintosh operating systems, or to the extent that significant demand arises for our products or competitive products on other platforms before we choose and are able to offer our products on these platforms, our business could be harmed. To the extent new releases of operating systems, including for mobile and non-PC devices, or other third-party products, platforms or devices make it more difficult for our products to perform, and our customers are persuaded to use alternative technologies, our business could be harmed.

If we fail to manage our expansion 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 are currently involved in efforts to stabilize losses in our international business and aim to ultimately expand our operations internationally, grow our Global Enterprise & Education business, and move our business more online, which has strained our managerial, operational, financial and other resources.

We anticipate that continued expansion of our operations will be required to satisfy consumer and enterprise and education demand and to avail ourselves of new market opportunities. The expanding scope of our business 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 expansion and move our business more online 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 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.

A transition to more online offerings may not be successful, if we are not able to attract and retain customers, which could adversely affect our business and financial performance.

Our ability to attract customers to online offerings will depend in part on our ability to consistently provide our customers with a valuable and quality experience for learning languages. Usage of our product varies by individual consumer. If consumers do not perceive our service offering to be of value, or if we introduce new or adjust existing features or change the mix of content in a manner that is not favorably received by them, we may not be able to attract and retain customers. Customers may cancel their subscription to our service for many reasons, including a perception that they do not use the service sufficiently, the need to cut household expenses, competitive services providing a better value or experience, or customer service issues not being satisfactorily resolved. If too many of our customers cancel our service, or if we are unable to attract new customers in numbers sufficient to grow our business, our operating results will be adversely affected. If too many customers cancel our service, we may be required to incur

significantly higher marketing and advertising expenditures than we currently anticipate to replace these customers. We expect to derive an increasing portion of our revenues in the future from subscriptions to our cloud-based offerings. This subscription model prices and delivers our products in a way that differs from the historical pricing and delivery methods of our language learning solutions. These changes reflect a shift from perpetual license sales and distribution of our software in favor of providing our customers the right to access certain of our software in a hosted environment or use downloaded software for a specified subscription period. This cloud strategy requires continued investment in product development and cloud operations, and may give rise to a number of risks, including a lag in sales,

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dissatisfaction from perpetual license customers, difficulty setting optimal pricing that could negatively affect sales and/or earnings, revenues that decline over the short or long term, confusion among our customers, resellers and investors and higher than forecasted costs.

If we move our consumer business substantially online and sell our solutions pursuant to a monthly, quarterly or other subscription fee, rather than an upfront fee, our revenue, results of operations and cash flow will be negatively impacted in the short term.

Historically, we have predominantly sold our packaged software programs for a single upfront fee and recorded 65-90% of the revenue at the time of sale. During the year-ended December 31, 2013 consumer revenue from paid online learners increased to \$24.6 million or 12% of consumer revenue compared to \$15.0 million or 7% of consumer revenue for the year-ended December 31, 2012. We are delivering more of our solutions online pursuant to different duration subscription fees. Selling in this manner will result in substantially less cash and revenue from the initial sale to the customer and could have a substantially negative impact on our revenue, results of operations and cash flow in the short term.

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 enterprise and education customers on a purchase order basis and we receive orders when these customers need products and services. As a result, their orders are typically not evenly distributed throughout the year. Our quarterly results of operations also may fluctuate significantly as a result of a variety of other factors, including the timing of holidays and advertising initiatives, changes in our products, services and advertising initiatives and changes in those of our competitors. Budgetary constraints of our enterprise and education customers may also cause our quarterly results to fluctuate.

As a result of these seasonal and quarterly fluctuations, we believe that comparisons of our results of operations between different quarters are not necessarily meaningful and that these comparisons are not reliable as indicators of our future performance. In addition, these fluctuations could result in volatility and adversely affect our cash flows. 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.

Our introduction of Rosetta Stone Version 4 TOTALe increased our costs as a percentage of revenue, and these and future product introductions may not succeed and may harm our business, financial results and reputation.

Rosetta Stone Version 4 TOTALe integrates our existing language-learning software solutions with web-based services, which provide opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. We 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. The services associated with Rosetta Stone Version 4 TOTALe have decreased our margins. Rosetta Stone Version 4 TOTALe sells at a higher price per unit than our Version 3 software solutions and customers may choose to not engage with conversation coaches or be willing to pay higher prices to do so. Rosetta Stone Version 4 TOTALe has also presented new management and marketing challenges that differ from the challenges we faced in our previous business. In addition, we are now required to defer recognition of a portion of each sale of Version 4 TOTALe in connection with the subscription terms of our online socialization services. We cannot assure you that Rosetta Stone Version 4 TOTALe will be successful or profitable, or if it is profitable, that it will provide an adequate return on capital expended. If Rosetta Stone Version 4 TOTALe is not successful, our business, financial results and reputation may be harmed. We anticipate having to make investments in new products in the future and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including

innovativeness, developer support, and effective distribution and marketing. Customers may not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all.

During 2013, we discontinued sales of new ReFLEX subscriptions; however we will continue to incur costs to fulfill existing subscriptions.

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.

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

As part of our ongoing corporate transformation, we have undertaken several restructuring actions as well as changes to our product team which may not deliver the expected results and these actions may adversely affect our business. In the second quarter of 2013 we shuttered our kiosk sales channel in the U.S. Revenue from other sales channels may not replace the lost revenue from our discontinued U.S. kiosk sales channel. In addition, the recognition of our brand name and our ability to successfully reach potential new customers may suffer as we are no longer able to expose potential customers to our products and services via our U.S. kiosks. In the first quarter of 2014 we announced our plan to streamline our Asian operations including closing our office in Japan and streamlining our operations in South Korea. Our future business plan for these markets includes indirectly distributing our products and services through resellers. Given the challenges we have experienced in successfully expanding into these markets, our new indirect distribution plan may not be successful.

In late 2012 and the first half of 2013 we restructured our product team including hiring a new Chief Product Officer, eliminating approximately seventy positions in our Harrisonburg, Virginia location and hiring personnel in Austin, Texas and San Francisco, California as well as on-boarding product personnel from Livemocha in Seattle, Washington and Lexia in Concord, Massachusetts. Our Chief Product Officer resigned in December 2013. Although we filled this position in February 2014, we may not successfully integrate the new product team into our organization due to a variety of factors including the change in leadership and the challenges associated with managing personnel spread across multiple locations. We have substantially increased our research and development expense as a result of expanding our team into more expensive labor markets and our development of new products, including mobile applications. If we are unsuccessful in introducing new products and services to the marketplace, we may not be able to recover our investment in research and development.

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

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

The acquisitions of Livemocha, Lexia, Vivity and Tell Me More are significant to our anticipated future results. The anticipated benefits of the acquisitions could be impacted by a number of risks specific to our business, as well as by risks related to the integration process.

The significant risks and challenges that may limit our ability to achieve the anticipated benefits of acquisitions include:

- lack of employee retention stemming from the acquisitions;
- sales of the acquired products and services may not perform as we anticipated;
- the risk of increased attrition of the acquired entities' customers;
- the risk that cross-selling Rosetta Stone products and services to customers of the acquired entities (and vice versa) may not be successful;
- the pipeline of the acquired entities' future products under development may take longer than predicted to launch or may fail to launch at all; and
- the difficulty of integrating the acquired entities' technology into our current and future products and services.

If we are unsuccessful in addressing these risks and challenges it may adversely harm our business and prospects. Our existing business may suffer if we are unable to successfully integrate acquired companies into our business or otherwise manage the growth associated with multiple acquisitions.

We have acquired businesses, personnel and technologies in the past and we intend to continue to evaluate and pursue acquisitions and strategic investments. The process of integrating the acquired entities' operations into our operations could result in unforeseen operating difficulties, absorb significant management attention, and require significant resources that would otherwise be available for the ongoing execution and development of our existing operations.

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Challenges and risks from such investments and acquisitions include:

- negative effects on products and product pipeline from the changes and potential disruption that may follow the acquisition;
 - diversion of our management’s attention away from our business;
 - declining employee morale and retention issues resulting from changes in compensation, or changes in management, reporting relationships, or future prospects;
 - the need to integrate the operations, systems, technologies, products and personnel of each acquired company, the inefficiencies and lack of control that may result if such integration is delayed or not implemented, and unforeseen difficulties and expenditures that may arise in connection with integration;
 - the difficulty in determining the appropriate purchase price of acquired companies may lead to the overpayment from certain acquisitions and the potential impairment of intangible assets and goodwill acquired in the acquisitions;
 - the difficulty in successfully evaluating and utilizing the acquired products, technology, or personnel;
 - the potential incurrence of debt, contingent liabilities, amortization expenses or restructuring charges in connection with any acquisition;
 - the need to implement controls, procedures and policies appropriate for a larger public company at companies that prior to acquisition had lacked such controls, procedures and policies;
 - the difficulty in accurately forecasting and accounting for the financial impact of an acquisition transaction, including accounting charges and integrating and reporting results for acquired companies that do not historically follow U.S. GAAP;
 - risks associated with our expansion into new international markets and doing business internationally, including those described under the risk factor caption “Our expansion into international markets may not succeed and imposes special risks” elsewhere in this Annual Report on Form 10-K; and
 - in the case of foreign acquisitions, the need to integrate operations across different cultures and languages and to address the particular economic, currency, political and regulatory risks associated with specific countries.
- The loss of key personnel or the failure to attract and retain highly qualified personnel, including personnel obtained through acquisitions, 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, including key personnel of entities we have acquired or may acquire in the future. 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 non-executive 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.
- 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.
- 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 learning solutions. Any damage, interruption or failure of our systems, networks and databases could prevent us from processing customer orders and result in degradation or interruptions in delivery of our products and services. Notwithstanding our efforts to protect against interruptions in the availability of our e-commerce websites and internet-based products and services, we do occasionally experience unplanned outages or technical difficulties. In addition, we do not have complete redundancy for all of our systems. 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. If we move additional product features to online systems or more of our business online, all of these considerations will become more significant.

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

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

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

We may be subject to legal liability for cloud-based online services and for data security breaches which could compromise our information technology network security, trade secrets and customer data.

Our services enable 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 United States 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 cloud based offerings. 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.

Hackers develop and deploy viruses, worms, and other malicious software programs that attack our commerce website, products and services and gain access to our networks and data centers. Groups of hackers may also act in a coordinated manner to launch distributed denial of service attacks, or other coordinated attacks. Sophisticated organizations or individuals may launch targeted attacks using novel methods to gain access to computers running our software. These threats may result in breaches of our network or data security, disruptions of our internal systems and business applications, impairment of our ability to complete sale transactions on our website or provide services to our customers, product development delays, harm to our competitive position from the compromise of confidential business information, or other negative impacts on 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 Global Enterprise & Education business store proprietary and confidential customer, employee and other sensitive data, such as names, addresses, other personal information and credit card numbers. Our call centers also process confidential customer data, which is provided to employees in the call centers. 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.

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

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

We are exposed to risks associated with credit card and payment fraud, and with credit card processing and alternative payment methods, 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.

From time to time, credit card processing fees may increase as a result of rate changes by the payment processing companies or changes in our business practices which increase the fees on a cost-per-transaction basis. Such increases may adversely affect our results of operations.

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

We accept payment methods other than payment cards, particularly in some areas of the world. As our service continues to evolve and expand internationally, we will likely continue to explore accepting various forms of payment, which may have higher fees and costs than our currently accepted payment methods. If more consumers use higher cost payment methods, our payment costs could increase and our financial results could suffer.

Any significant interruptions in the operations of our website, 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 our website, an in-house call center and third-party call centers to sell our solutions, respond to customer service and technical support requests and process orders. 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 and offer more products, we will need to update our website and also may need more capacity from 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 website and call centers to purchase our solutions. If we experience technical difficulties with our websites or if our call center operators do not convert inquiries into sales at expected rates, our ability to generate revenue could be impaired. Training and retaining qualified call center operators is challenging due to the expansion of our product and service offerings and the seasonality of our business. If we do not adequately train our call center operators, they will not convert inquiries into sales at an acceptable rate.

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, due to 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.

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If any of our products or services contain defects or errors or if new product releases or services are delayed, our reputation could be harmed, resulting in significant costs to us and impairing our ability to sell our solutions. If our products or services contain defects, errors or security vulnerabilities, our reputation could be harmed, which could result in significant costs to us and impair our ability to sell our products in the future. In the past, we have encountered product development delays due to errors or defects. We would expect that, despite our testing, errors 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 enterprise and education 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 subject us to special risks that could adversely affect our business.

Government sales entail a variety of risks as evidenced by the non-renewal of our contracts with the U.S. Army and the U.S. Marine Corps in 2011. These risks include the following:

• government contracts are subject to the approval of appropriations by the U.S. 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;

• 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.

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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 enterprise and education 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.

Our Fit Brains products are based on research in the field of neuroscience. The goal of Fit Brains is to help improve concentration, enhance memory and strengthen overall cognitive functions. If the validity of the associated neuroscience or the conclusions that we draw from it is challenged, our reputation could be harmed and our business prospects and financial results could be materially and adversely affected.

We rely heavily on neuroscience to demonstrate that our products help to improve concentration, memory and overall cognitive functions, which involve certain risks. In particular, our products are designed to develop key cognitive areas and help build stronger connections within the brain, also known as cognitive reserve, may be unfamiliar to customers. Therefore, it may be difficult to convince customers about the effectiveness of our products. Our sales and marketing efforts, as well as our reputation, could be adversely impacted if related areas of neuroscience are proven to be false.

If we are unable to successfully cross-sell Fit Brains' products to Rosetta Stone customers, our growth prospects could be adversely impacted.

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

During 2013, we continued to transition our distribution to more online in the consumer 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. If we move more of our consumer business online we will also collect less cash from our initial transactions with consumers which could substantially decrease our revenues in the short term. Conditions that can cause delays in revenue recognition include software arrangements that have undelivered elements for which we have not yet established vendor specific objective evidence of fair value, requirements that we deliver services for significant enhancements or modifications to customize our software for a particular customer or material customer acceptance criteria.

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

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

regulations imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the cost of hedging our foreign exchange exposure could increase.

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

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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.

Changes in applicable accounting principles could negatively affect our financial performance.

Our financial statements are prepared in accordance with accounting principles generally accepted in the U.S. ("GAAP") and are subject to interpretation by the SEC and the Financial Accounting Standards Board ("FASB"). A change in GAAP or interpretations of GAAP may have a negative effect on our reported financial results and even retroactively affect previously reported results. The FASB is currently working together with the International Accounting Standards Board ("IASB") on several projects to align accounting principles internationally. These efforts by the FASB and IASB could change the accounting principles applicable to us and result in materially worse financial results for us in areas including, but not limited to, principles for recognizing revenue.

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

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

Changes in, or interpretations of, tax rules and regulations may adversely affect our effective tax rates.

We are subject to tax in multiple U.S. and foreign tax jurisdictions. If certain foreign earnings previously treated as permanently reinvested are repatriated, the related U.S. tax liability may be reduced by any foreign income taxes paid on these earnings. Unanticipated changes in our tax rates could affect our future results of operations. Our future effective tax rates could be unfavorably affected by changes in the tax rates in jurisdictions where our income is earned or by changes in the valuation of our deferred tax assets and liabilities.

Our investment portfolio may become impaired by deterioration of the capital markets.

We follow an established investment policy and set of guidelines to monitor and help mitigate our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes. As of December 31, 2013, our cash consisted of highly liquid investments with original maturities of three months or less and demand deposits with financial institutions. If financial market conditions worsen in the future, investments in some financial instruments may suffer from market liquidity and credit problems. We cannot predict future market conditions or market liquidity, or credit availability, and can provide no assurance that our investment portfolio will remain materially unimpaired.

Catastrophic events may disrupt our business and may not be manageable under our Crisis Management Policy.

We rely on our network infrastructure and enterprise applications, internal technology systems and our website for our development, marketing, operational, support, hosted services and sales activities. A disruption, infiltration or failure of these systems or third-party hosted services that we rely on for some of our business systems could, in the event of a major earthquake, fire, flood, power loss, telecommunications failure, software or hardware malfunctions, cyber-attack, war, terrorist attack or other catastrophic event, cause system interruptions, reputational harm, loss of intellectual property, delays in our product development, lengthy interruptions in our services, breaches of data security and loss of critical data and could prevent us from fulfilling our customers' orders. We have developed certain disaster recovery plans and backup systems to reduce the potentially adverse effect of such events, but a catastrophic event that results in the destruction or disruption of any of our data centers or our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our future operating results could be adversely affected.

If government regulations relating to the Internet or other areas of our business change, we may need to alter the manner in which we conduct our business, or incur greater operating expenses.

The adoption or modification of laws or regulations relating to the Internet or other areas of our business could limit or otherwise adversely affect the manner in which we currently conduct our business. In addition, the growth and development of

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the market for online commerce may lead to more stringent consumer protection laws, which may impose additional burdens on us. If we are required to comply with new regulations or legislation or new interpretations of existing regulations or legislation, this compliance could cause us to incur additional expenses or alter our business model. Changes in how network operators handle and charge for access to data that travel across their networks could adversely impact our business.

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

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, patents, pending patent applications, trade dress and designs are valuable and integral to our success and competitive position. To protect our proprietary rights, we rely on a combination of patents, copyrights, trademarks, trade secret laws, confidentiality procedures, contractual provisions and technical measures.

We have six issued patents in the U.S. and eight foreign patents. This includes patents held by Tell Me More (Auralog) acquired in January 2014. We have several patent applications on file in the U.S. and other countries. However, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims. Even if patents are issued from our patent applications, which are not certain, they may be 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 guarantee that our confidentiality agreements with our employees, consultants and other third parties will not be breached, that we will be able to effectively enforce these agreements, that we will have adequate remedies for any breach, or that our trade secrets and other proprietary information will not be disclosed or will otherwise be protected.

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

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against software piracy, we lose significant revenue due to illegal use of our software and from counterfeit copies 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, including counterfeiters, 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 and unauthorized websites, which could harm our reputation and cause us to lose sales.

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

We own several U.S. trademark registrations, including registrations of the Rosetta Stone, Tell Me More, Livemocha, Lexia Learning and Lexia trademarks, hold common law trademark rights and have trademark applications pending in the U.S. and abroad for additional trademarks. Even if federal registrations and registrations in other countries are granted to us, our trademark rights may be challenged. It is also possible that our competitors will adopt trademarks similar to ours, thus impeding our ability to build brand identity and possibly leading to customer confusion. In fact, various third parties have registered trademarks that are similar to ours in the U.S. and overseas. 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 U.S. 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 related to our business. 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. Third parties also may acquire country specific domain names in the form of Country Code Top Level Domains which include our trademarks and which prevent us from operating country specific websites from which customers can view our products and engage in transactions with us. Moreover, the regulation of domain names in the United States and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars or modify the requirements for holding domain names. Recently, ICANN (the Internet Corporation for Assigned Names and Numbers), the international authority over top-level domain names, expanded the number of generic Top Level

Domains ("TLDs") which allow companies and organizations to create additional Web addresses that appear to the right of the "dot," such as the long-standing TLDs, ".com," ".gov" and ".org." ICANN may also add additional TLDs in the future. 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. Moreover, attempts may be made to register our trademarks as new TLDs or as domain names within the selected new TLDs and we will have to make efforts to enforce our rights against such registration attempts.

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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 we have and they 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 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

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.

Our stock price is volatile, and changes in net revenue, margin or earnings shortfalls or the volatility of the market generally could cause the market price of our stock to decline.

The market price for our common stock has experienced significant fluctuations and may continue to fluctuate significantly. Our quarterly financial results have fluctuated in the past and are likely to vary significantly in the future due to a number of factors, many of which are outside of our control and which could adversely affect our operations and operating results. A number of factors may affect the market price for our common stock, including: shortfalls in revenue, margins,

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earnings or key performance metrics, confusion on the part of industry analysts and investors about the impact of our subscription offerings, shortfalls in the number of subscribers, changes in analyst estimates or recommendations, new product announcements by competitors, seasonal variations in demand, loss of a large customer, variations in competitors' financial performance and regulatory or macro-economic effects.

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

Provisions in our second amended and restated certificate of incorporation and second amended and restated bylaws, and in the Delaware General Corporation Law, may make it difficult and expensive for a third party to pursue a takeover attempt we oppose even if a change in control of our company would be beneficial to the interests of our stockholders. Any provision of our second amended and restated certificate of incorporation or second amended and restated bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our board of directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our corporate headquarters are located in Arlington, Virginia, where we sublease space on two floors of a large office building. The term of this sublease was amended in the fourth quarter of 2012 and runs through December 31, 2018. In the first quarter of 2014, we vacated one of the floors of our Arlington, Virginia headquarters and are currently in the process of trying to sublease a portion of the excess space.

We currently own two facilities in Harrisonburg, Virginia, that serve as our operations offices. In addition, we lease a facility in Harrisonburg, Virginia for use as a packing and distribution center for all of our U.S. and some of our international fulfillment, in addition to sales operations.

We also lease space for small offices used primarily for research and development activities in various locations in the United States and for regional sales offices in London, United Kingdom, San Paulo, Brazil, Seoul, South Korea, and Tokyo, Japan.

With the acquisitions of Vivity and Tell Me More in January 2014, we gained office space in various additional international locations, including near Versailles, France, and Beijing, China.

Item 3. Legal Proceedings

In April 2010, a purported class action lawsuit was filed against us in the Superior Court of the State of California, County of Alameda for damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and other persons similarly situated who are or were employed as salaried managers by us in our retail locations in California are due unpaid wages and other relief for our violations of state wage and hour laws. Plaintiffs moved to amend their complaint to

include a nationwide class in January 2011. In March 2011, the case was removed to the United States District Court for the Northern District of California. In November 2011, the parties agreed to a mediator's proposed settlement terms, and as a result, as of September 30, 2011, we reserved \$0.6 million for the proposed settlement amount. We dispute the plaintiffs' claims and have not admitted any wrongdoing with respect to the case. In September 2013, the court entered a final order directing payment of the \$0.6 million settlement amount and in October 2013, the Company

paid this amount in final settlement of the lawsuit.

In June 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG (“Langenscheidt”) in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone GmbH’s use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. In January 2012, the District Court of Cologne ordered an injunction of Rosetta Stone GmbH’s use of the color yellow in packaging, on its website and in television commercials and declared Rosetta Stone liable for damages, attorneys’ fees and costs to Langenscheidt. No dollar amounts have been specified yet for the award of damages by the District Court of Cologne. In its decision, the District Court of Cologne also ordered the destruction of Rosetta Stone GmbH’s product and packaging which utilized the color yellow and which was deemed to have infringed Langenscheidt’s trademark. The Court of Appeals in Cologne affirmed the District Court’s decision. Langenscheidt has not posted the necessary bond to immediately enforce that decision. We commenced a separate proceeding for the cancellation of Langenscheidt’s German trademark registration of yellow as an abstract color mark. In June 2012, the German Patent and Trademark Office rendered a decision in the cancellation proceeding denying our request to cancel Langenscheidt’s German trademark registration. We have filed appeals of the decisions in both cases to the German Federal Supreme Court on the grounds of law. We cannot predict the timing and ultimate outcome of this matter, however, we believe the range of possible loss is immaterial to our financial statements. Even if the plaintiff is unsuccessful in its claims against us, we will incur legal fees and other costs in the defense of these claims and appeals.

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 impact on our business, financial condition or results of operations.

Item 4. Mine Safety Disclosures

Not applicable.

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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, or NYSE, 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, 2013		
Fourth Quarter	\$16.53	\$11.34
Third Quarter	17.30	14.70
Second Quarter	18.30	14.46
First Quarter	15.44	11.55
Year ended December 31, 2012		
Fourth Quarter	\$13.27	\$10.52
Third Quarter	14.28	9.26
Second Quarter	14.69	9.50
First Quarter	10.50	6.95

On February 21, 2014, the last reported sales price of our common stock on the NYSE was \$12.35 per share. As of that date, there were approximately 213 holders of record of our common stock.

Repurchases of Equity Securities

The following is a summary of common shares repurchased by the Company under its stock repurchase program during the three months ended December 31, 2013:

Date	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly announced Plans or Programs (1)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
November 26, 2013 (2)	500,000	\$11.45	500,000	\$19,275,000
December 6, 2013 (2)	500,000	\$11.42	500,000	\$13,565,000
Total	1,000,000	\$11.44	1,000,000	\$13,565,000

(1) On August 22, 2013, our Board of Directors approved a share repurchase program under which we are authorized to repurchase up to \$25 million of our outstanding common stock from time to time from August 22, 2013 to August 22, 2015.

(2) Purchase was a privately negotiated transaction.

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.

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, 2013, with the

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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.

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, 2013, 2012, 2011, 2010 and 2009, and the consolidated balance sheet data as of December 31, 2013, 2012, 2011, 2010 and 2009 have been derived from Rosetta Stone Inc. audited consolidated financial statements. The selected consolidated financial data should be read in conjunction with the information under “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations,” our consolidated financial statements, the related notes and the accompanying independent registered public accounting firm’s report which refers to a change in accounting for costs associated with sales commissions, which are included in “Item 15. Exhibits and Financial Statement Schedules.” The selected consolidated financial data below has been adjusted to reflect the impact of this change retrospectively to all prior periods. Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

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	Year Ended December 31,				
	2013(1)	2012(2)	2011(3)	2010	2009(4)
	(in thousands, except per share data)				
Statements of Operations Data:					
Revenue	\$264,645	\$273,241	\$268,449	258,868	\$252,271
Cost of revenue	45,714	48,910	49,116	38,999	33,427
Gross profit	218,931	224,331	219,333	219,869	218,844
Operating expenses:					
Sales and marketing	146,104	150,882	160,942	130,335	115,108
Research and development	33,995	23,453	24,218	23,437	26,239
General and administrative	56,432	55,262	62,031	53,239	57,182
Lease abandonment	842	—	—	(583)	(8)
Total operating expenses	237,373	229,597	247,191	206,428	198,521
Income (loss) from operations	(18,442)	(5,266)	(27,858)	13,441	20,323
Other income and expense:					
Interest income	117	187	302	262	159
Interest expense	(61)	—	(5)	(66)	(356)
Other (expense) income	368	3	142	(220)	112
Interest and other income (expense), net	424	190	439	(24)	(85)
Income (loss) before income taxes	(18,018)	(5,076)	(27,419)	13,417	20,238
Income tax expense (benefit)	(1,884)	28,909	(7,769)	(178)	7,010
Income (loss) attributable to common stockholders	(16,134)	(33,985)	(19,650)	13,595	\$13,228
Income (loss) per share attributable to common stockholders:					
Basic	\$(0.75))			