

ROSETTA STONE INC
Form 10-Q
November 07, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended September 30, 2016
Commission file number: 1-34283
Rosetta Stone Inc.

(Exact name of registrant as specified in its charter)
Delaware 043837082
(State of incorporation) (I.R.S. Employer
Identification No.)
1621 North Kent Street, Suite 1200
Arlington, Virginia 22209
(Zip Code)
(Address of principal executive offices)

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

1919 North Lynn St., 7th Fl. Arlington, Virginia
(Former name or former address, if changed since last report)

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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer 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 Exchange Act). Yes No

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

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As of November 1, 2016, there were 22,064,243 shares of the registrant's Common Stock, \$.00005 par value, outstanding.

ROSETTA STONE INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ROSETTA STONE INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 32,221	\$ 47,782
Restricted cash	398	80
Accounts receivable (net of allowance for doubtful accounts of \$1,149 and \$1,196, at September 30, 2016 and December 31, 2015, respectively)	38,096	47,327
Inventory	8,046	7,333
Deferred sales commissions	14,016	13,526
Prepaid expenses and other current assets	4,426	3,612
Total current assets	97,203	119,660
Deferred sales commissions	4,598	5,614
Property and equipment, net	25,020	22,532
Goodwill	48,991	50,280
Intangible assets, net	23,878	28,244
Other assets	1,698	2,213
Total assets	\$ 201,388	\$ 228,543
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 9,862	\$ 10,778
Accrued compensation	11,628	8,201
Income tax payable	156	121
Obligations under capital lease	551	521
Other current liabilities	22,750	35,318
Deferred revenue	115,699	106,868
Total current liabilities	160,646	161,807
Deferred revenue	29,294	35,880
Deferred income taxes	5,868	4,998
Obligations under capital lease	2,255	2,622
Other long-term liabilities	870	826
Total liabilities	198,933	206,133
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	—	—
Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 23,445 and 23,150 shares issued and 22,445 and 22,150 shares outstanding at September 30, 2016 and December 31, 2015, respectively	2	2
Additional paid-in capital	189,367	185,863
Accumulated loss	(171,731) (149,794)

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Accumulated other comprehensive loss	(3,748)	(2,226)
Treasury stock, at cost, 1,000 and 1,000 shares at September 30, 2016 and December 31, 2015, respectively	(11,435)	(11,435)
Total stockholders' equity	2,455		22,410	
Total liabilities and stockholders' equity	\$ 201,388		\$ 228,543	

See accompanying notes to consolidated financial statements

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

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Revenue:				
Product	\$9,666	\$13,905	\$27,656	\$48,088
Subscription and service	39,027	35,897	114,755	111,567
Total revenue	48,693	49,802	142,411	159,655
Cost of revenue:				
Cost of product revenue	2,461	3,372	7,495	12,728
Cost of subscription and service revenue	5,910	5,294	16,888	16,260
Total cost of revenue	8,371	8,666	24,383	28,988
Gross profit	40,322	41,136	118,028	130,667
Operating expenses:				
Sales and marketing	27,161	30,234	86,694	100,939
Research and development	6,347	7,056	19,666	22,981
General and administrative	9,969	12,053	30,864	39,727
Impairment	1,028	358	3,930	809
Lease abandonment and termination	—	—	30	—
Total operating expenses	44,505	49,701	141,184	164,456
Loss from operations	(4,183)	(8,565)	(23,156)	(33,789)
Other income and (expense):				
Interest income	11	1	34	12
Interest expense	(120)	(90)	(353)	(271)
Other income and (expense)	633	819	2,788	(1,265)
Total other income and (expense)	524	730	2,469	(1,524)
Loss before income taxes	(3,659)	(7,835)	(20,687)	(35,313)
Income tax expense (benefit)	1,793	(534)	1,250	47
Net loss	\$(5,452)	\$(7,301)	\$(21,937)	\$(35,360)
Loss per share:				
Basic	\$(0.25)	\$(0.34)	\$(1.00)	\$(1.65)
Diluted	\$(0.25)	\$(0.34)	\$(1.00)	\$(1.65)
Common shares and equivalents outstanding:				
Basic weighted average shares	21,993	21,771	21,936	21,493
Diluted weighted average shares	21,993	21,771	21,936	21,493

See accompanying notes to consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss	\$(5,452)	\$(7,301)	\$(21,937)	\$(35,360)
Other comprehensive loss, net of tax:				
Foreign currency translation loss	(313)	(814)	(1,522)	(1,207)
Other comprehensive loss	(313)	(814)	(1,522)	(1,207)
Comprehensive loss	\$(5,765)	\$(8,115)	\$(23,459)	\$(36,567)
See accompanying notes to consolidated financial statements				

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

	Nine Months Ended September 30,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(21,937)	\$(35,360)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense	3,457	5,369
(Gain) loss on foreign currency transactions	(2,831)	1,345
Bad debt expense	471	1,603
Depreciation and amortization	9,812	10,175
Deferred income tax expense	857	572
Loss on disposal of equipment	132	56
Amortization of deferred financing fees	203	104
Loss on impairment	3,930	809
Loss (gain) from equity method investments	46	(9)
Gain on divestiture of subsidiary	—	(660)
Net change in:		
Restricted cash	(354)	3
Accounts receivable	8,912	26,340
Inventory	(723)	(1,631)
Deferred sales commissions	552	(4,301)
Prepaid expenses and other current assets	(705)	(60)
Income tax receivable or payable	48	(937)
Other assets	365	(205)
Accounts payable	(923)	(8,930)
Accrued compensation	3,423	(4,974)
Other current liabilities	(13,077)	(21,381)
Other long-term liabilities	43	(418)
Deferred revenue	2,353	13,117
Net cash used in operating activities	(5,946)	(19,373)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(9,628)	(7,205)
Proceeds from sale of fixed assets	38	—
Acquisitions, net of cash acquired	—	(1,688)
Net cash outflow from divestiture of subsidiary	—	(186)
Other investing activities	—	(286)
Net cash used in investing activities	(9,590)	(9,365)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	47	114
Payment of deferred financing costs	(182)	(125)
Payments under capital lease obligations	(440)	(468)
Net cash used in financing activities	(575)	(479)
Decrease in cash and cash equivalents	(16,111)	(29,217)
Effect of exchange rate changes in cash and cash equivalents	550	(1,073)
Net decrease in cash and cash equivalents	(15,561)	(30,290)

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Cash and cash equivalents—beginning of period	47,782	64,657
Cash and cash equivalents—end of period	\$32,221	\$34,367
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	\$150	\$167
Income taxes, net of refunds	\$363	\$1,222
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	\$565	\$99
Equipment acquired under capital lease	\$27	\$—
See accompanying notes to consolidated financial statements		

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

1. NATURE OF OPERATIONS

Rosetta Stone Inc. and its subsidiaries ("Rosetta Stone," or the "Company") develop, market and support a suite of language-learning, literacy and brain fitness solutions consisting of perpetual software products, web-based software subscriptions, online and professional services, audio practice tools and mobile applications. The Company's offerings are sold on a direct basis and through select third party retailers and distributors. The Company provides its solutions to customers through the sale of packaged software and web-based software subscriptions, domestically and in certain international markets.

On March 14, 2016, the Company announced the withdrawal of direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings (the "2016 Restructuring Plan"). Where appropriate, the Company will seek to operate through partners in the geographies being exited. The Company has also initiated processes to close the software development operations in France and China. These actions are additive to the plan announced on March 11, 2015 (the "2015 Restructuring Plan") to accelerate and prioritize focus on satisfying the needs of the passionate learners in the United States and select non-U.S. geographies in the Consumer language business. See Note 2 "Summary of Significant Accounting Policies," Note 13 "Restructuring," Note 16 "Segment Information" and Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" within Part 1 for additional information about these strategic undertakings and the associated impact to the Company's financial statements and financial results.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

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

The carrying value of any equity method investment is reported in "Other assets" on the consolidated balance sheets.

Basis of Presentation

The accompanying consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and applicable rules and regulations of the Securities and Exchange Commission ("SEC") regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's most recent Annual Report on Form 10-K filed with the SEC on March 14, 2016. The September 30, 2016 consolidated balance sheet included herein includes account balances as of December 31, 2015 that were derived from the audited financial statements as of that date. The Consolidated Financial Statements and the Notes to the Consolidated Financial Statements do not include all disclosures required for annual financial statements and notes.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the Company's statement of financial position at September 30, 2016 and December 31, 2015, the Company's results of operations for the three and nine months ended September 30, 2016 and 2015 and its cash flows for the nine months ended September 30, 2016 and 2015 have been made. The

results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2016. All references to September 30, 2016 or to the three and nine months ended September 30, 2016 and 2015 in the notes to the consolidated financial statements are unaudited.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make certain estimates and assumptions. The amounts reported in the consolidated financial statements include significant estimates and assumptions that have been made, including, but not limited to, those related to revenue recognition, allowance for doubtful accounts, estimated sales returns and reserves, stock-based compensation, restructuring costs, fair value of intangibles and goodwill, disclosure of contingent assets and liabilities, disclosure of contingent litigation, and allowance for valuation of deferred tax assets. The Company bases its estimates and assumptions on historical experience and on various other judgments that are believed to be reasonable under the circumstances. The Company continuously evaluates its estimates and assumptions. Actual results may differ from these estimates and assumptions.

Revenue Recognition

The Company's primary sources of revenue are web-based software subscriptions, online services, perpetual product software, and bundles of perpetual product software and online services. The Company also generates revenue from the sale of audio practice products, mobile applications, and professional services. Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenue is recorded net of discounts.

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

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

For non-software multiple element arrangements the Company allocates revenue to all deliverables based on their relative selling prices. The Company's non-software multiple element arrangements primarily occur as sales to its Enterprise & Education Language and Literacy customers. These arrangements can include web-based subscription services, audio practice materials and professional services or any combination thereof. The Company does not have a sufficient concentration of stand-alone sales of the various deliverables noted above to its Enterprise & Education Language and Literacy customers, and therefore cannot establish VSOE for each deliverable. Third party evidence of fair value does not exist for the web-based subscription, audio practice and professional services due to the lack of interchangeable language-learning products and services within the market. Accordingly, the Company determines the relative selling price of the web-based subscription, audio practice tools and professional services deliverables

included in its non-software multiple-element arrangements using the best estimated selling price. The Company determines the best estimated selling price based on its internally published price list which includes suggested sales prices for each deliverable based on the type of client and volume purchased. This price list is derived from past experience and from the expectation of obtaining a reasonable margin based on what each deliverable costs the Company.

In the U.S. and Canada, the Company offers consumers who purchase packaged software and audio practice products directly from the Company a 30-day, unconditional, full money-back refund. The Company also permits some of our retailers and distributors to return unsold packaged products, subject to certain limitations. In accordance with ASC subtopic 985-605, Software: Revenue Recognition ("ASC 985-605"), the Company estimates and establishes revenue reserves for packaged

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

product returns at the time of sale based on historical return rates, estimated channel inventory levels, the timing of new product introductions and other factors.

The Company distributes its products and services both directly to the end customer and indirectly through resellers. Resellers earn commissions generally calculated as a fixed percentage of the gross sale to the end customer. The Company evaluates each of its reseller relationships in accordance with ASC subtopic 605-45, Revenue Recognition - Principal Agent Considerations (“ASC 605-45”) to determine whether the revenue recognized from indirect sales should be the gross amount of the contract with the end customer or reduced for the reseller commission. In making this determination the Company evaluates a variety of factors including whether it is the primary obligor to the end customer. Revenue is recorded net of taxes.

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

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

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

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

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

Restructuring Costs

As part of the 2016 Restructuring Plan and the 2015 Restructuring Plan, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. In connection with these plans, the Company incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included in our operating expense line items on the Statement of Operations.

Employee severance and related benefit costs primarily include cash payments, outplacement services, continuing health insurance coverage, and other benefits. Where no substantive involuntary termination plan previously exists, these severance

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

Other related costs generally include external consulting and legal costs associated with the strategic shift in business focus of the Company’s Consumer business. Such costs are recognized at fair value in the period in which the costs are incurred.

Income Taxes

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

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of September 30, 2016. When measuring the need for a valuation allowance on a jurisdiction by jurisdiction basis, the Company assesses both positive and negative evidence regarding whether these deferred tax assets are realizable. In determining deferred tax assets and valuation allowances, the Company is required to make judgments and estimates related to projections of profitability, the timing and extent of the utilization of temporary differences, net operating loss carryforwards, tax credits, applicable tax rates, transfer pricing methodologies and tax planning strategies. The valuation allowance is reviewed quarterly and is maintained until sufficient positive evidence exists to support a reversal. Because evidence such as the Company’s operating results during the most recent three-year period is afforded more weight than forecasted results for future periods, the Company’s cumulative loss in certain jurisdictions represents significant negative evidence in the determination of whether deferred tax assets are more likely than not to be utilized in certain jurisdictions. This determination resulted in the need for a valuation allowance on the deferred tax assets of certain jurisdictions. The Company will release this valuation allowance when it is determined that it is more likely than not that its deferred tax assets will be realized. Any future release of valuation allowance may be recorded as a tax benefit increasing net income.

Fair Value of Financial Instruments

The Company values its assets and liabilities using the methods of fair value as described in ASC topic 820, Fair Value Measurements and Disclosures, (“ASC 820”). ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The three levels of fair value hierarchy are described below:

Level 1: Quoted prices for identical instruments in active markets.

Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3: Significant inputs to the valuation model are unobservable.

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, restricted cash, accounts receivable, accounts payable and other accrued expenses approximate fair value due to relatively short periods to maturity.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Divestitures

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

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance ASC topic 718, Compensation—Stock Compensation ("ASC 718"). Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date. For options granted with service and/or performance conditions, the fair value of each grant is estimated on the date of grant using the Black-Scholes option pricing model. For options granted with market-based conditions, the fair value of each grant is estimated on the date of grant using the Monte-Carlo simulation.

The Company estimates the expected term of options using a combination of historical information and the simplified method for estimating the expected term. The Company uses its own historical stock price data to estimate its forfeiture rate and expected volatility over the most recent period commensurate with the estimated expected term of the awards. For the risk-free interest rate, the Company uses a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.

The Company's restricted stock and restricted stock unit grants are accounted for as equity awards. Stock compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. For equity awards granted with market-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.

Foreign Currency Translation and Transactions

The functional currency of the Company's foreign subsidiaries is their local currency. Accordingly, assets and liabilities of the foreign subsidiaries are translated into U.S. dollars at exchange rates in effect on the balance sheet date. Income and expense items are translated at average rates for the period. Translation adjustments are recorded as a component of other comprehensive loss in stockholders' equity.

Cash flows of consolidated foreign subsidiaries, whose functional currency is their local currency, are translated to U.S. dollars using average exchange rates for the period. The Company reports the effect of exchange rate changes on cash balances held in foreign currencies as a separate item in the reconciliation of the changes in cash and cash equivalents during the period.

The following table presents the effect of exchange rate changes on total comprehensive loss (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss	\$(5,452)	\$(7,301)	\$(21,937)	\$(35,360)
Foreign currency translation loss	(313)	(814)	(1,522)	(1,207)
Comprehensive loss	\$(5,765)	\$(8,115)	\$(23,459)	\$(36,567)

Comprehensive Loss

Comprehensive loss consists of net loss and other comprehensive loss. Other comprehensive loss refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' equity.

For the three and nine months ended September 30, 2016 and 2015, the Company's comprehensive loss consisted of

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three and nine months ended September 30, 2016 was \$8.7 million and \$27.2 million, respectively, and for the three and nine months ended September 30, 2015 was \$10.1 million and \$32.3 million, respectively.

Recently Issued Accounting Standards Updates ("ASU") Not Yet Adopted

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 changes the methodology for measuring credit losses on financial instruments and the timing of when such losses are recorded. ASU 2016-13 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those years, beginning after December 15, 2018. The Company is in the process of evaluating the adoption date and impact of the new guidance on the Company's consolidated financial statements and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). Under ASU 2016-09, accounting for share-based payment award transactions was simplified related to the accounting for (a) income tax effects; (b) minimum statutory tax withholding requirements; (c) and forfeitures. ASU 2016-09 is effective for public entities in annual periods beginning after December 15, 2016, including interim periods within those annual periods. Early adoption is permitted. The Company is in the process of evaluating the adoption date and impact of the new guidance on the Company's consolidated financial statements and disclosures.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02"). Under ASU 2016-02, entities will be required to recognize a lease liability and a right-of-use asset for all leases. Lessor accounting is largely unchanged. ASU 2016-02 is effective for public entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is in the process of evaluating the impact of the new guidance on the Company's consolidated financial statements and disclosures.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 changes how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option that are attributable to their own credit. Under the new guidance, entities will be required to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. The accounting for other financial instruments, such as loans and investments in debt securities is largely unchanged. ASU 2016-01 is effective for public entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not believe that the adoption of this guidance will have a material impact on the Company's consolidated financial statements and disclosures.

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

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which replaces the current revenue accounting guidance. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date which defers the effective date of the updated

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply a five step model to 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract and 5) recognize revenue when (or as) the entity satisfies a performance obligation. The New Revenue Standard is effective for annual periods beginning after December 31, 2017. Entities may choose from two adoption methods, with certain practical expedients. The Company expects that it will adopt the New Revenue Standard beginning in the first quarter of 2018 and is currently evaluating the appropriate transition method and any impact of the New Revenue Standard on the Company's consolidated financial statements and disclosures.

3. DIVESTITURES

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

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

4. NET LOSS PER SHARE

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

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Numerator:				
Net loss	\$ (5,452)	\$ (7,301)	\$ (21,937)	\$ (35,360)
Denominator:				
Weighted average number of common shares:				
Basic	21,993	21,771	21,936	21,493
Diluted	21,993	21,771	21,936	21,493
Loss per common share:				
Basic	\$ (0.25)	\$ (0.34)	\$ (1.00)	\$ (1.65)

Diluted

\$(0.25) \$(0.34) \$(1.00) \$(1.65)

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. NET LOSS PER SHARE (Continued)

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

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Stock options	96	31	18	38
Restricted stock units	183	182	171	96
Restricted stocks	132	27	116	78
Total common stock equivalent shares	411	240	305	212

5. INVENTORY

Inventory consisted of the following (in thousands):

	September 30, 2016	December 31, 2015
Raw materials	\$ 4,231	\$ 3,375
Finished goods	3,815	3,958
Total inventory	\$ 8,046	\$ 7,333

6. GOODWILL

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisition of Livemocha, Inc. ("Livemocha") in April 2013, the acquisition of Lexia Learning Systems, Inc. ("Lexia") in August 2013, and the acquisitions of Vivity Labs, Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") in January 2014.

The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC topic 350, Intangibles - Goodwill and other ("ASC 350"), or more frequently, if impairment indicators arise.

The following table shows the balance and changes in goodwill for the Company's operating segments for the nine months ended September 30, 2016 (in thousands):

	Enterprise & Education Language Segment	Literacy Segment	Consumer Consumer LaFit Reporting Unit	Total
Balance as of December 31, 2015	\$ 38,700	\$ 9,962	\$ 1,618	\$ 50,280
Impairment of Consumer Fit Brains	—	—	—(1,740)	(1,740)
Effect of change in foreign currency rate	329	—	—122	451
Balance as of September 30, 2016	\$ 39,029	\$ 9,962	\$ —	\$ 48,991

Annual Impairment Testing of Goodwill

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

charges were recorded in connection with the annual analysis for these reporting units.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. GOODWILL (Continued)

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

Interim Impairment Review of Goodwill

The Company also routinely reviews goodwill at the reporting unit level for potential impairment as part of the Company's internal control framework. The Company's reporting units with goodwill balances were evaluated to determine if a triggering event has occurred. As of September 30, 2016, the Company concluded that there were no indicators of impairment that would cause us to believe that it is more likely than not that the fair value of our reporting units with goodwill is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no goodwill impairment charges were recorded in the third quarter connection with the interim impairment review.

7. INTANGIBLE ASSETS

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

	September 30, 2016			December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Tradename/trademark *	\$12,465	\$(1,493)	\$10,972	\$12,442	\$(1,271)	\$11,171
Core technology	15,353	(10,552)	4,801	15,149	(7,817)	7,332
Customer relationships	26,383	(18,348)	8,035	26,245	(16,603)	9,642
Website	12	(12)	—	12	(12)	—
Patents	300	(230)	70	300	(201)	99
Total	\$54,513	\$(30,635)	\$23,878	\$54,148	\$(25,904)	\$28,244

* Included in the tradename/trademark line above is the Rosetta Stone tradename, which is the Company's only indefinite-lived intangible asset. As of September 30, 2016, the carrying value of the tradename asset was \$10.6 million.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INTANGIBLE ASSETS (Continued)

Amortization Expense for the Long-lived Intangible Assets

The following table presents amortization of intangible assets included in the related financial statement line items during the respective periods (in thousands):

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Included in cost of revenue:				
Cost of product revenue	\$42	\$59	\$134	\$200
Cost of subscription and service revenue	104	88	305	239
Total included in cost of revenue	146	147	439	439
Included in operating expenses:				
Sales and marketing	463	693	1,720	2,115
Research and development	350	448	1,244	1,358
General and administrative	—	—	—	—
Total included in operating expenses	813	1,141	2,964	3,473
Total	\$959	\$1,288	\$3,403	\$3,912

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining three months of 2016 and years thereafter (in thousands):

	As of September 30, 2016
2016 - remaining	\$ 960
2017	3,831
2018	3,238
2019	1,532
2020	1,282
2021	940
Thereafter	1,488
Total	\$ 13,271

Impairment Reviews of Intangible Assets

The Company also routinely reviews indefinite-lived intangible assets and long-lived assets for potential impairment as part of the Company's internal control framework.

During the second quarter of 2016, the Company revised the business outlook and financial projections for the Consumer Fit Brains reporting unit, which prompted a long-lived intangible asset impairment analysis of the Consumer Fit Brains tradename, developed technology, and customer relationships. The carrying values of the intangible assets exceeded the estimated fair values. As a result, the Company recorded an impairment loss of \$1.2 million associated with the impairment of the remaining carrying value of the Consumer Fit Brains long-lived intangible assets as of June 30, 2016. The impairment charge was recorded in the "Impairment" line on the statement of operations.

As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of September 30, 2016 to determine if indicators of impairment exist. The Company concluded that there were no potential indicators of impairment related to this indefinite-lived intangible asset. Additionally all other long-lived intangible assets were evaluated to determine if indicators of impairment exist and the Company concluded that there are no potential

indicators of impairment.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. OTHER CURRENT LIABILITIES

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

	September 30, 2016	December 31, 2015
Accrued marketing expenses	\$ 9,555	\$ 20,022
Accrued professional and consulting fees	1,618	1,746
Sales return reserve	2,637	3,728
Sales, withholding and property taxes payable	3,682	3,879
Other	5,258	5,943
Total other current liabilities	\$ 22,750	\$ 35,318

9. FINANCING ARRANGEMENTS

Revolving Line of Credit

On October 28, 2014, Rosetta Stone Ltd. ("RSL"), a wholly owned subsidiary of parent company Rosetta Stone Inc., executed a Loan and Security Agreement with Silicon Valley Bank ("Bank") to obtain a \$25.0 million revolving credit facility (the "credit facility"). The Company executed the First Amendment to the credit facility with the Bank effective March 31, 2015, the Second Amendment effective May 1, 2015, the Third Amendment effective June 29, 2015, and the Fourth Amendment effective December 29, 2015. The Company is subject to certain covenants under the Loan and Security Agreement, including financial covenants and limitations on indebtedness, encumbrances, investments and distributions and dispositions of assets, certain of which covenants were amended in the First, Second, Third, and Fourth Amendments, which were primarily amended to reflect updates to the Company's financial outlook. The Third Amendment also changed the definition of "change of control" to eliminate a clause referring to a change in a portion of the Board of Directors within a twelve-month period.

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

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

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

The credit facility contains customary affirmative and negative covenants, including covenants that limit or restrict our ability to, among other things, incur additional indebtedness, dispose of assets, execute a material change in business, acquire or dispose of an entity, grant liens, make share repurchases, and make distributions, including payment of dividends. The Company is required to maintain compliance with a minimum liquidity amount and minimum financial performance requirements, as defined in the credit facility. As of September 30, 2016, the Company was in compliance with all covenants.

The credit facility contains customary events of default, including among others, non-payment defaults, covenant defaults, bankruptcy and insolvency defaults, and a change of control default, in each case, subject to customary exceptions. The

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. FINANCING ARRANGEMENTS (Continued)

occurrence of a default event could result in the Bank's acceleration of repayment obligations of any loan amounts then outstanding.

As of September 30, 2016, there were no borrowings outstanding and the Company was eligible to borrow \$24.5 million of available credit, less \$4.0 million in letters of credit that have been issued by the Bank on the Company's behalf, resulting in a net borrowing availability of \$20.5 million. A quarterly commitment fee accrues on any unused portion of the credit facility at a nominal annual rate.

Capital Leases

The Company enters into capital leases under non-committed arrangements for equipment and software. In addition, the Company holds a capital lease for a building near Versailles, France.

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

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

	As of September 30, 2016
2016-remaining	\$ 128
2017	665
2018	513
2019	510
2020	505
2021	503
Thereafter	376
Total minimum lease payments	\$ 3,200
Less amount representing interest	394
Present value of net minimum lease payments	\$ 2,806
Less current portion	551
Obligations under capital lease, long-term	\$ 2,255

10. INCOME TAXES

In accordance with ASC topic 740, Income Taxes ("ASC 740"), and ASC subtopic 740-270, Income Taxes: Interim Reporting, the income tax provision for the nine months ended September 30, 2016 is based on the estimated annual effective tax rate for fiscal year 2016. The estimated effective tax rate may be subject to adjustment in subsequent quarterly periods as the estimates of pretax income for the year, along with other items that may affect the rate, may change and may create a different relationship between domestic and foreign income and loss.

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

Valuation Allowance Recorded for Deferred Tax Assets

The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of September 30, 2016, the analysis of the need for a valuation allowance on U.S. deferred tax assets considered that the U.S. entity has incurred a three-year cumulative loss. As previously disclosed, if the Company does not have sufficient objective positive evidence to overcome a three-year cumulative loss, a valuation allowance may be necessary. In evaluating whether to record a valuation allowance, the guidance in ASC

740 deems that the existence of cumulative losses in recent years

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. INCOME TAXES (Continued)

is a significant piece of objectively verifiable negative evidence that is difficult to overcome. An enterprise that has cumulative losses is generally prohibited from using an estimate of future earnings to support a conclusion that realization of an existing deferred tax asset is more likely than not.

Consideration has been given to the following positive and negative evidence:

- Three-year cumulative evaluation period ended September 30, 2016 results in a cumulative U.S. pre-tax loss; from 2006, when the U.S. entity began filing as a C-corporation for income tax purposes, through 2010, the U.S. entity generated taxable income each year;

• the Company has a history of utilizing all operating tax loss carryforwards and has not had any tax loss carryforwards or credits expire unused;

• lengthy loss carryforward periods of 20 years for U.S. federal and most state jurisdictions apply; and

• the Company incurred a U.S. federal jurisdiction net operating loss for the most recently completed calendar year and has additional net operating loss carryforwards subject to limitation pursuant to IRC Section 382.

As of September 30, 2016, a valuation allowance was provided for the U.S., Japan, China, Hong Kong, Mexico, Spain, France, Brazil, and Canada where the Company has determined the deferred tax assets will not more likely than not be realized.

Evaluation of the remaining jurisdictions as of September 30, 2016 resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation will be adjusted accordingly, which could materially affect the Company's financial position and results of operations.

As of September 30, 2016, and December 31, 2015, the Company's U.S. deferred tax liability was \$5.8 million and \$4.8 million, respectively, related to its goodwill and indefinite lived intangibles. As of September 30, 2016 the Company had foreign net deferred tax liabilities of \$0.1 million compared to foreign net deferred tax liabilities of \$0.2 million at December 31, 2015. As of September 30, 2016, and December 31, 2015, the Company had no unrecognized tax benefits.

For the nine months ended September 30, 2016 the Company recorded an income tax expense of \$1.3 million. The tax expense was related to current year profits of operations in Germany and the U.K. partially offset by a current year loss in Canada. The loss in Canada includes a \$1.7 million goodwill impairment charge that was non-deductible for tax. Additionally, the tax expense relates to the tax impact of the amortization of indefinite-lived intangible assets and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities.

11. STOCK-BASED COMPENSATION

2006 Stock Incentive Plan

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

2009 Omnibus Incentive Plan

On February 27, 2009, the Company's Board of Directors approved the 2009 Omnibus Incentive Plan (the "2009 Plan") that provides for the ability of the Company to grant up to 2,437,744 of new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. The stock incentive awards and options granted under the 2009 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants.

On May 26, 2011 the Board of Directors authorized and the Company's shareholders' approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan. On May 23, 2012, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,122,930 additional shares of common stock to the 2009 Plan. On May 23, 2013, the Board of Directors authorized and the Company's shareholders approved the allocation of 2,317,000 additional shares of common stock to the 2009 Plan. On May 20, 2014, the Board of Directors authorized and the Company's shareholders approved the allocation of 500,000 additional shares of common stock to the 2009 Plan. On June 12, 2015, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,200,000 additional shares of common stock to the 2009 Plan. At September 30, 2016 there were 1,264,747 shares available for future grant under the 2009 Plan.

Valuation Assumptions

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

• Service-Based Restricted Stock Awards, Restricted Stock Units, and Performance-Based Restricted Stock Awards:

Fair value is determined based on the quoted market price of our common stock on the date of grant.

Service-Based Stock Options and Performance-Based Stock Options: Fair value is determined using the Black-Scholes pricing model, which requires the use of estimates, including the risk-free interest rate, expected volatility, expected dividends, and expected term.

Market-Based Restricted Stock Awards and Market-Based Stock Options: The fair value of the market-based awards is determined using a Monte-Carlo simulation model. The Monte Carlo valuation also estimates the number of market-based awards that would be awarded which is reflected in the fair value on the grant date.

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

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

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

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

Stock-Based Compensation Expense

Stock compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. For equity awards granted with market-based conditions, stock compensation is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Included in cost of revenue:				
Cost of product revenue	\$7	\$9	\$14	\$47
Cost of subscription and service revenue	15	26	13	23
Total included in cost of revenue	22	35	27	70
Included in operating expenses:				
Sales and marketing	348	364	667	952
Research and development	391	342	561	653
General and administrative	878	1,233	2,202	3,694
Total included in operating expenses	1,617	1,939	3,430	5,299
Total	\$1,639	\$1,974	\$3,457	\$5,369

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

Service-Based Stock Options

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

	Service-based Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Service-based Options Outstanding, January 1, 2016	1,837,165	\$ 10.58	7.70	\$ 130,262
Service-based options granted	464,194	7.50		
Service-based options exercised	(10,826)	4.33		
Service-based options canceled	(285,587)	11.00		
Service-based Options Outstanding, September 30, 2016	2,004,946	9.85	7.74	765,258
Vested and expected to vest September 30, 2016	1,861,112	9.98	7.64	656,452
Exercisable at September 30, 2016	1,210,830	\$ 10.42	7.07	\$ 310,664

As of September 30, 2016, future compensation cost related to the non-vested portion of the service-based stock option awards not yet recognized in the consolidated statement of operations was \$3.7 million and is expected to be recognized over a weighted average period of 2.54 years.

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

Service-Based Restricted Stock Awards

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

	Nonvested Service-Based Awards Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Service-based Awards, January 1, 2016	341,579	\$ 10.61	\$ 3,624,153
Service-based awards granted	261,208	7.43	
Service-based awards vested	(127,302)	10.78	
Service-based awards canceled	(35,475)	10.26	
Nonvested Service-Based Awards, September 30, 2016	440,010	\$ 8.71	\$ 3,833,719

As of September 30, 2016, future compensation cost related to the nonvested portion of the service-based restricted stock awards not yet recognized in the consolidated statement of operations was \$3.0 million and is expected to be recognized over a weighted average period of 2.00 years.

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

Restricted Stock Units

The following table summarizes the Company's restricted stock unit activity from January 1, 2016 to September 30, 2016:

	Units Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Units Outstanding, January 1, 2016	187,942	\$ 11.16	\$ 1,257,332
Units granted	67,663	7.70	521,005
Units released	(58,719)	11.51	
Units cancelled	(8,829)	8.50	
Units Outstanding, September 30, 2016	188,057	9.93	1,594,723
Vested and expected to vest at September 30, 2016	130,512	7.70	410,047
Vested and deferred at September 30, 2016	82,157	\$ 12.44	\$ 696,691

For the nine months ended September 30, 2016, 67,663 restricted stock units were granted to members of the Board of Directors as part of their compensation packages. Restricted stock units convert to common stock following the separation of service with the Company. Beginning June 2015, all restricted stock unit awards vest quarterly over a one year period from the date of grant, with expense recognized straight-line over the vesting period. Prior to June 2015, all restricted stock unit awards were immediately vested with expense recognized in full on the grant date. The Company's restricted stock units are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant. The Company did not grant any restricted stock units prior to April 2009.

Performance and Market Conditioned Restricted Stock Awards and Stock Options

On April 4, 2016, the Company named Mr. John Hass as President, CEO and Chairman of the Board. In conjunction with his appointment, the Compensation Committee approved a stock-based compensation package for Mr. Hass aimed to provide significant reward potential for achieving outstanding Company operating performance results and building shareholder value. The package was comprised of performance-based restricted stock awards (PRSAs), performance-based stock options (PSOs), market-based restricted stock awards (MRSAs), and market-based stock options (MSOs). Awards also vest if a majority change in control of the Company occurs during the performance or vesting period.

Performance Conditioned:

In addition to the performance condition, the PRSAs and PSOs also have a service condition. Vesting of PRSAs and PSOs are dependent upon whether the Company achieves certain operating performance targets which are based on the Company's defined measures of revenue, bookings, adjusted free cash flow, and adjusted EBITDA, measured against the full-year 2016 operating results. Following the end of the performance measurement period on December 31, 2016, PRSAs and PSOs issued based on the operating performance metrics will vest 50%, 25%, and 25% on April 4, 2017, 2018 and 2019, respectively.

The Company records compensation expense ratably for each vesting tranche of the PRSAs and PSOs based on the probability that operating performance conditions will be met and to what extent. Changes in the probability estimates will be accounted for in the period of change using a cumulative catch-up adjustment to retroactively apply the new probability estimates. In any period in which the Company determines that achievement of the performance metrics is not probable, the Company ceases recording compensation expense and all previously recognized compensation expense for the award is reversed.

The PRSAs were granted at "target" (at 100% of target). Based upon actual attainment of the operating performance results through December 31, 2016 relative to target, actual issuance of RSAs can fall anywhere between a maximum of 200% and 0% of the target number of PRSAs originally granted. As of September 30, 2016, future compensation cost related to the nonvested portion of the PRSAs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 1.81 years.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's PRSA activity from January 1, 2016 to September 30, 2016:

	Nonvested PRSAs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested PRSAs, January 1, 2016	—	\$ —	\$—
PRSAs granted	70,423	7.10	500,003
PRSAs vested	—	—	
PRSAs canceled	—	—	
Performance adjustments	(25,209)		
Nonvested PRSAs, September 30, 2016	45,214	\$ 7.10	\$ 321,019

The PSOs were granted at "maximum" (at 200% of target). Based on actual attainment of the operating performance results through December 31, 2016 relative to maximum, actual issuance of stock options can fall anywhere between 100% and 0% of the maximum number of PSOs originally granted. As of September 30, 2016, future compensation cost related to the nonvested portion of the PSOs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 1.81 years.

The following table summarizes the Company's PSO activity from January 1, 2016 to September 30, 2016:

	PSOs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
PSOs Outstanding, January 1, 2016	—	\$	—\$ —
PSOs granted	314,465	3.24	1,000,242
PSOs released	—	—	
PSOs cancelled	—	—	
Performance adjustments	(213,515)	3.24	
PSOs Outstanding, September 30, 2016	100,950	3.24	321,099
Vested and expected to vest at September 30, 2016	—	—	—
Exercisable at September 30, 2016	—	\$	—\$ —

Market Conditioned:

In addition to the market condition, the MRSAs and MSOs also have a service condition. Vesting of these MRSAs and MSOs are dependent upon whether the Company achieves predetermined growth rates of total shareholder return for the two-year measurement period beginning on January 4, 2016 and ending on December 29, 2017. Following the end of the market performance measurement period on December 29, 2017, MRSAs issued based on total shareholder return will vest annually on a pro-rata basis over three years beginning April 4, 2018. The Company records compensation expense ratably for each vesting tranche of the MRSAs and MSOs based on the Monte Carlo fair value estimated on the grant date, regardless of meeting or not meeting the market conditions.

The MRSAs were granted at "target" (at 100% of target). Based upon actual attainment of total shareholder return growth rate results through December 29, 2017 relative to target, actual issuance of RSAs can fall anywhere between a maximum of 200% and 0% of the target number of MRSAs originally granted. As of September 30, 2016, future compensation cost related to the nonvested portion of the MRSAs not yet recognized in the consolidated statement of operations was \$0.4 million and is expected to be recognized over a weighted average period of 2.78 years.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's MRSA activity from January 1, 2016 to September 30, 2016:

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

The MSOs were granted at "maximum" (at 200% of target). Based on actual attainment of total shareholder return growth rate results through December 29, 2017 relative to maximum, actual issuance of stock options can fall anywhere between 100% and 0% of the maximum number of MSOs originally granted. As of September 30, 2016, future compensation cost related to the nonvested portion of the MSOs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 2.78 years.

The following table summarizes the Company's MSO activity from January 1, 2016 to September 30, 2016:

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

12. STOCKHOLDERS' EQUITY

At September 30, 2016, the Company's Board of Directors had the authority to issue 200,000,000 shares of stock, of which 190,000,000 were designated as Common Stock, with a par value of \$0.00005 per share, and 10,000,000 were designated as Preferred Stock, with a par value of \$0.001 per share. At September 30, 2016, the Company had shares of common stock issued of 23,444,912 and shares of common stock outstanding of 22,444,912.

On August 22, 2013, the Company's Board of Directors approved a share repurchase program under which the Company is authorized to repurchase up to \$25 million of its outstanding common stock from time to time in the open market or in privately negotiated transactions depending on market conditions, other corporate considerations, debt facility covenants and other contractual limitations, and applicable legal requirements. For the year ended December 31, 2013, the Company paid \$11.4 million to repurchase 1,000,000 shares at a weighted average price of \$11.44 per share as part of this program. No shares were repurchased during 2014, 2015, or the nine months ended September 30, 2016. Shares repurchased under the program were recorded as treasury stock on the Company's consolidated balance sheet. The shares repurchased under this program during the year ended December 31, 2013 were not the result of an accelerated share repurchase agreement. Management has not made a decision on whether

shares purchased under this program will be retired or reissued.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. RESTRUCTURING

2016 Restructuring Plan

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

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

• Employee severance and related benefits costs incurred in connection with headcount reductions involving employees primarily in France, China, Brazil, Canada, Spain, Mexico, U.S. and the U.K.;

• Contract termination costs associated with operating lease terminations from office closures; and

• Other related costs.

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

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at September 30, 2016
Severance costs	\$	—\$ 4,407	\$ (2,716)	\$ —	\$ 1,691
Contract termination costs	—	163	(41)	(69)	53
Other costs	—	542	(320)	(121)	101
Total	\$	—\$ 5,112	\$ (3,077)	\$ (190)	\$ 1,845

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

2015 Restructuring Plan

In the first quarter of 2015, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. The Company committed to the 2015 Restructuring Plan and has completed a large portion of the 2015 Restructuring Plan as of September 30, 2016. The Company does not expect to incur any additional restructuring costs in connection with the 2015 Restructuring Plan. In the third quarter of 2016, the final payments were made against the 2015 Restructuring Plan accruals.

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

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

• Contract termination costs; and

• Other related costs.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. RESTRUCTURING (Continued)

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. RESTRUCTURING (Continued)

The following table summarizes activity with respect to the restructuring charges for the 2015 Restructuring Plan during the nine months ended September 30, 2016 (in thousands):

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at September 30, 2016
Severance costs	\$ 252	\$ 71	\$ (323)	\$	—\$ —
Contract termination costs	—	—	—	—	—
Other costs	—	—	—	—	—
Total	\$ 252	\$ 71	\$ (323)	\$	—\$ —

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

Restructuring Cost

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015		Incurred through September 30, 2016
Severance costs	\$(8)	\$98	\$4,478	\$7,257	\$ 11,718
Contract termination costs	69	—	163	1,135	1,297
Other costs	101	7	542	417	959
Total	\$162	\$105	\$5,183	\$8,809	\$ 13,974

As of September 30, 2016, the entire restructuring liability of \$1.8 million was classified as a current liability within accrued compensation and other current liabilities on the consolidated balance sheets.

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Cost of revenue	\$(5)	\$28	\$567	\$125
Sales and marketing	68	(45)	2,287	4,369
Research and development	(16)	56	912	757
General and administrative	115	66	1,417	3,558
Total	\$162	\$105	\$5,183	\$8,809

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

At each reporting date, the Company will evaluate its accrued restructuring costs to ensure the liabilities reported are still appropriate. Any changes to the estimated costs of executing approved restructuring plans will be reflected in the Company's consolidated statements of operations.

14. LEASE ABANDONMENT AND TERMINATION

As part of the Company's effort to reduce general and administrative expenses through a planned space consolidation at its Arlington, Virginia headquarters location, the Company incurred lease abandonment charges of \$3.2 million in the first quarter of 2014. Prior to January 31, 2014, the Company occupied the 6th and 7th floors at its Arlington, Virginia headquarters.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. LEASE ABANDONMENT AND TERMINATION (Continued)

The Company estimated the liability under operating lease agreements and accrued lease abandonment costs in accordance with ASC 420, Exit or Disposal Cost Obligation ("ASC 420"), as the Company has no future economic benefit from the abandoned space and the lease does not terminate until December 31, 2018. All leased space related to the 6th floor was abandoned and ceased to be used by the Company on January 31, 2014.

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

	As of September	
	30,	2015
	2016	2015
Accrued lease abandonment costs, beginning of period	\$1,281	\$1,679
Costs incurred and charged to expense	30	—
Principal reductions	(328)	(358)
Accrued lease abandonment costs, end of period	\$983	\$1,321
Accrued lease abandonment costs liability:		
Short-term	\$422	\$426
Long-term	561	895
Total	\$983	\$1,321

15. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases copiers, parking spaces, buildings, a warehouse and office space under operating lease and site license arrangements, some of which contain renewal options. Building, warehouse and office space leases range from 12 months to 74 months. Certain leases also include lease renewal options.

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

	As of
	September
	30, 2016
Periods Ending December 31,	
2016-remaining	\$ 975
2017	4,741
2018	4,370
2019	1,740
2020	1,003
2021	589
Thereafter	—
Total	\$ 13,418

Total expenses under operating leases are \$1.2 million and \$1.3 million for the three months ended September 30, 2016 and 2015, respectively. Total expenses under operating leases are \$3.3 million and \$4.0 million for the nine months ended September 30, 2016 and 2015, respectively.

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. COMMITMENTS AND CONTINGENCIES (Continued)

Litigation

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

16. SEGMENT INFORMATION

In March 2016, the Company announced its strategy to position the organization for success. The Company has prioritized the growth of literacy sales and is taking actions to align resources to drive this growth. As a result of this shift, the Company reevaluated its segment structure. Prior to the strategy shift, the Company was managed in two operating segments - "Enterprise & Education" and "Consumer". Following the shift, the Company is managed in three operating segments - "Enterprise & Education Language", "Literacy", and "Consumer". The current Literacy segment was previously a component of the "Enterprise & Education" segment and is comprised solely of the Lexia business. The Literacy segment focuses on delivering subscription-based English literacy-learning and assessment solutions to grades K through 12. The Company's current operating segments also represent the Company's reportable segments. The Company will continue to evaluate its management reporting and will update its operating and reportable segments as appropriate.

The Company assesses profitability of each segment in terms of segment contribution. Segment contribution is the measure of profitability used by our Chief Operating Decision Maker ("CODM"). The CODM assesses profitability and performance of the Company on its current operating segments. Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. Segment contribution excludes depreciation, amortization, stock compensation, research and development, restructuring related and other non-recurring expenses. The Company does not allocate expenses beneficial to all segments, which includes certain general and administrative expenses such as legal fees, payroll processing fees, and accounting related expenses. These expenses are included in the unallocated expenses section of the table presented below. Revenue from transactions between the Company's operating segments is not material. Prior periods have been reclassified to reflect our current segment presentation and definition of segment contribution.

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. SEGMENT INFORMATION (Continued)

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

	Three Months Ended		Nine Months Ended		
	September 30, 2016	2015	September 30, 2016	2015	
Revenue:					
Enterprise & Education Language	\$18,336	\$19,548	\$54,157	\$57,104	
Literacy	8,786	5,784	24,313	14,687	
Consumer	21,571	24,470	63,941	87,864	
Total revenue	\$48,693	\$49,802	\$142,411	\$159,655	
Segment contribution:					
Enterprise & Education Language	\$7,931	\$5,875	\$20,783	\$14,671	
Literacy	850	176	3,124	(141)	
Consumer	6,163	5,791	14,974	22,566	
Total segment contribution	\$14,944	\$11,842	\$38,881	\$37,096	
Unallocated expenses, net:					
Unallocated cost of sales	\$1,334	\$775	\$3,870	\$2,093	
Unallocated sales and marketing	1,124	1,193	5,496	7,983	
Unallocated research and development	6,347	7,056	19,666	22,981	
Unallocated general and administrative	9,294	11,025	29,045	37,019	
Unallocated non-operating expense/(income)	(524)	(730)	(2,469)	1,524	
Unallocated impairment	1,028	358	3,930	809	
Unallocated lease abandonment expense	—	—	30	—	
Total unallocated expenses, net	\$18,603	\$19,677	\$59,568	\$72,409	
Loss before income taxes	\$(3,659)	\$(7,835)	\$(20,687)	\$(35,313)	
Segment contribution margin:					
Enterprise & Education Language	43.3	% 30.1	% 38.4	% 25.7	%
Literacy	9.7	% 3.0	% 12.8	% (1.0)	%
Consumer	28.6	% 23.7	% 23.4	% 25.7	%

Geographic Information

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

The information below summarizes revenue from customers by geographic area for the three and nine months ended September 30, 2016 and 2015 (in thousands):