

ROSETTA STONE INC  
Form 10-Q  
May 10, 2011

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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 March 31, 2011

Commission File Number: 1-34283

**ROSETTA STONE INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**043837082**

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

**1919 North Lynn St., 7<sup>th</sup> Fl,  
Arlington, Virginia**

(Address of Principal Executive Offices)

**22209**

(Zip Code)

**800-788-0822**

(Registrant's telephone number, including zip code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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

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

As of May 3, 2011, 21,013,474 shares of the registrant's Common Stock, \$.00005 par value, were outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****ROSETTA STONE INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

|   | March 31,<br>2011 | December 31,<br>2010 |
|---|-------------------|----------------------|
|   | (unaudited)       |                      |
| <b>Assets</b>   |                   |                      |
| Current assets:   |                   |                      |
| Cash and cash equivalents   | \$ 112,539        | \$ 115,756           |
| Restricted cash   | 56                | 85                   |
| Short term investments  | 8,217             | 6,410                |
| Accounts receivable (net of allowance<br>for doubtful accounts of \$1,759 and<br>\$1,761, respectively) | 29,687            | 48,056               |
| Inventory, net  | 10,366            | 9,928                |
| Prepaid expenses and other current<br>assets  | 7,713             | 7,763                |
| Income tax receivable   | 4,098             | 2,210                |
| Deferred income taxes   | 13,484            | 11,159               |
| <b>Total current assets</b>   | <b>186,160</b>    | <b>201,367</b>       |
| Property and equipment, net   | 21,940            | 21,073               |
| Goodwill  | 34,876            | 34,856               |
| Intangible assets, net  | 10,926            | 10,948               |
| Deferred income taxes   | 7,168             | 6,498                |
| Other assets  | 1,779             | 1,732                |
| <b>Total assets</b>   | <b>\$ 262,849</b> | <b>\$ 276,474</b>    |

**Liabilities and stockholders' equity**

|                                  |               |               |
|----------------------------------|---------------|---------------|
| Current liabilities:             |               |               |
| Accounts payable                 | \$ 6,725      | \$ 7,631      |
| Accrued compensation             | 7,684         | 10,514        |
| Other current liabilities        | 31,735        | 32,625        |
| Deferred revenue                 | 40,545        | 41,965        |
| <b>Total current liabilities</b> | <b>86,689</b> | <b>92,735</b> |
| Deferred revenue                 | 5,214         | 5,193         |
| Other long-term liabilities      | 240           | 230           |
| <b>Total liabilities</b>         | <b>92,143</b> | <b>98,158</b> |

Commitments and contingencies  
(Note 12)**Stockholders' equity:**Preferred stock, \$0.001 par value;  
10,000 and 10,000 shares authorized,  
zero and zero shares issued and  
outstanding at March 31, 2011 and

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December 31, 2010, respectively

|   |                |                |
|---|----------------|----------------|
| Non-designated common stock,<br>\$0.00005 par value, 190,000 and<br>190,000 shares authorized, 21,012 and<br>20,975 shares issued and outstanding<br>at March 31, 2011 and December 31,<br>2010, respectively | 2              | 2              |
| Additional paid-in capital  | 140,430        | 139,022        |
| Accumulated income  | 29,789         | 39,069         |
| Accumulated other comprehensive<br>income   | 485            | 223            |
| <b>Total stockholders' equity</b>   | <b>170,706</b> | <b>178,316</b> |

|   |                   |                   |
|---|-------------------|-------------------|
| <b>Total liabilities and stockholders'<br/>equity</b> | <b>\$ 262,849</b> | <b>\$ 276,474</b> |
|---|-------------------|-------------------|

See accompanying notes to condensed consolidated financial statements

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## ROSETTA STONE INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

|  | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2011                            | 2010      |
|  | (unaudited)                     |           |
| Revenue:                                   |                                 |           |
| Product                                    | \$ 42,303                       | \$ 53,734 |
| Subscription and service                   | 14,675                          | 9,280     |
| Total revenue                              | 56,978                          | 63,014    |
| Cost of revenue:                           |                                 |           |
| Cost of product revenue                    | 8,795                           | 7,780     |
| Cost of subscription and service revenue   | 2,667                           | 862       |
| Total cost of revenue                      | 11,462                          | 8,642     |
| Gross profit                               | 45,516                          | 54,372    |
| Operating expenses                         |                                 |           |
| Sales and marketing                        | 37,820                          | 28,361    |
| Research and development                   | 6,484                           | 5,470     |
| General and administrative                 | 14,808                          | 13,643    |
| Total operating expenses                   | 59,112                          | 47,474    |
| Income (loss) from operations              | (13,596)                        | 6,898     |
| Other income and (expense):                |                                 |           |
| Interest income                            | 80                              | 77        |
| Interest expense                           | (3)                             | (8)       |
| Other income (expense)                     | 2                               | (8)       |
| Total other income (expense)               | 79                              | 61        |
| Income (loss) before income taxes          | (13,517)                        | 6,959     |
| Income tax provision (benefit)             | (4,236)                         | 1,954     |
| Net income (loss)                          | \$ (9,281)                      | \$ 5,005  |
| Earnings (loss) per share:                 |                                 |           |
| Basic                                      | \$ (0.45)                       | \$ 0.25   |
| Diluted                                    | \$ (0.45)                       | \$ 0.24   |
| Common shares and equivalents outstanding: |                                 |           |
| Basic weighted average shares              | 20,675                          | 20,258    |
| Diluted weighted average shares            | 20,675                          | 21,060    |

See accompanying notes to condensed consolidated financial statements



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## ROSETTA STONE INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

Three Months Ended  
March 31,

2011          2010

(unaudited)

**CASH FLOWS FROM OPERATING  
ACTIVITIES:**

|   |            |          |
|---|------------|----------|
| Net income  | \$ (9,281) | \$ 5,005 |
| Adjustments to reconcile net income to cash provided by operating activities: |            |          |
| Stock-based compensation expense  | 1,437      | 874      |
| Bad debt expense  | 216        | 54       |
| Depreciation and amortization   | 2,114      | 1,454    |
| Deferred income tax benefit   | (2,977)    | 211      |
| Loss on sales of equipment  | 15         |          |
| Net change in:  |            |          |
| Restricted cash   | 28         | (3)      |
| Accounts receivable   | 18,319     | 9,578    |
| Inventory   | (412)      | (1,729)  |
| Prepaid expenses and other current assets                                     | 66         | (110)    |
| Other assets  | (63)       | (72)     |
| Accounts payable  | (1,013)    | 1,011    |
| Accrued compensation  | (2,867)    | (4,022)  |
| Other current liabilities   | (1,119)    | (1,687)  |
| Income tax payable  | (2,004)    | (3,658)  |
| Excess tax benefit from stock options exercised                               | (18)       | (75)     |
| Other long term liabilities   | (6)        | (113)    |
| Deferred revenue  | (1,503)    | (2,151)  |
| Net cash provided by operating activities                                     | 932        | 4,567    |

**CASH FLOWS FROM INVESTING ACTIVITIES:**

|  |         |         |
|--|---------|---------|
| Purchases of property and equipment        | (2,651) | (1,144) |
| Purchases of available-for-sale securities | (1,807) |         |
| Acquisition, net of cash acquired          | (75)    |         |
| Net cash used in investing activities      | (4,533) | (1,144) |

**CASH FLOWS FROM FINANCING ACTIVITIES:**

|  |         |        |
|--|---------|--------|
| Proceeds from the exercise of stock options                  | 40      | 163    |
| Tax benefit of stock options exercised                       | 18      | 75     |
| Payments under capital lease obligations                     | (3)     | (1)    |
| Net cash provided by financing activities                    | 55      | 237    |
| Increase (decrease) in cash and cash equivalents             | (3,546) | 3,660  |
| Effect of exchange rate changes in cash and cash equivalents | 329     | (128)  |
| Net increase (decrease) in cash and cash equivalents         | (3,217) | 3,532  |
| Cash and cash equivalents beginning of year                  | 115,756 | 95,188 |



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|                                       |            |           |
|---------------------------------------|------------|-----------|
| Cash and cash equivalents end of year | \$ 112,539 | \$ 98,720 |
|---------------------------------------|------------|-----------|

**SUPPLEMENTAL CASH FLOW DISCLOSURE:**

Cash paid during the periods for:

|          |      |      |
|----------|------|------|
| Interest | \$ 3 | \$ 8 |
|----------|------|------|

|                   |        |          |
|-------------------|--------|----------|
| Income taxes, net | \$ 523 | \$ 5,137 |
|-------------------|--------|----------|

Noncash financing and investing activities:

|  |          |        |
|--|----------|--------|
| Accrued liability for purchase of property and equipment | \$ 1,769 | \$ 386 |
|--|----------|--------|

|  |       |       |
|--|-------|-------|
| Equipment acquired under capital lease | \$ 16 | \$ 14 |
|--|-------|-------|

See accompanying notes to condensed consolidated financial statements

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. NATURE OF OPERATIONS**

Rosetta Stone Inc. and its subsidiaries ("Rosetta Stone," the "Company" or the "Successor") develops, markets and supports a suite of language learning solutions consisting of software products, online services and audio practice tools under the *Rosetta Stone* brand name. The Company's software products are sold on a direct basis and through select retailers. The Company provides its software applications to customers through the sale of packaged software and online subscriptions. Rosetta Stone Inc. was incorporated on December 23, 2005 in the state of Delaware and acquired Rosetta Stone Holdings Inc., a Delaware corporation, on January 4, 2006. Rosetta Stone Holdings Inc. acquired Rosetta Stone Ltd. (formerly Fairfield & Sons, Ltd.) and Rosetta Stone (UK) Limited (formerly Fairfield & Sons UK Limited), on January 4, 2006. Rosetta Stone Inc. has eight wholly owned operating subsidiaries: Rosetta Stone Holdings Inc., a Delaware corporation, Rosetta Stone Ltd., a Virginia corporation, Rosetta Stone International Inc., a Delaware corporation, Rosetta Stone Brazil Holding LLC, a Delaware Corporation, Rosetta Stone (UK) Limited, a corporation incorporated under the laws of England and Wales, Rosetta Stone Japan Inc., a company incorporated under the laws of Japan, Rosetta Stone GmbH, a company incorporated under the laws of Germany, and Rosetta Stone Ensino de Linguas Ltda., a company incorporated under the laws of Brazil.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Principles of Consolidation***

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

***Basis of Presentation***

The accompanying condensed consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("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 Annual Report on Form 10-K filed with the SEC on March 14, 2011. The December 31, 2010 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures, including notes, required by GAAP.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and in the opinion of management include all adjustments necessary for the fair presentation of the Company's statement of financial position at March 31, 2011 and December 31, 2010, the Company's results of operations for the three months ended March 31, 2011 and 2010 and its cash flows for the three months ended March 31, 2011 and 2010. The results for the three months ended March 31, 2011 are not necessarily indicative of the results to be expected for the year ending December 31, 2011. All references to March 31, 2011 or to the three months ended

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

March 31, 2011 and 2010 in the notes to the condensed consolidated financial statements are unaudited.

*Use of Estimates*

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires that management make certain estimates and assumptions. Significant estimates and assumptions have been made regarding the allowance for doubtful accounts, estimated sales returns, stock-based compensation, fair value of assets and liabilities acquired, lease abandonment accrual, fair value of intangibles and goodwill, fair value of stock issued, inventory reserve, disclosure of contingent assets and liabilities and disclosure of contingent litigation. Actual results may differ from these estimates.

*Revenue Recognition*

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe*. Rosetta Stone *TOTALe* online, which was released in July 2009, combines dedicated conversational coaching and an online software subscription. Rosetta Stone V4 *TOTALe*, which was released in September 2010, combines packaged software and dedicated conversational coaching. The Company recognizes revenue for software products and related services in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition* ("ASC 985-605").

Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed and determinable; and collectability is probable. Revenues from packaged software and audio practice products and online software subscriptions are recorded net of discounts.

Revenue is recognized from the sale of packaged software and audio practice products when the product has been delivered, assuming the remaining revenue recognition criteria have been met. Software products include sales to end-user customers and resellers. In most cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products are recognized as the products are shipped and title passes and risks of loss have been transferred. For most of the Company's 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. A limited amount of packaged software products are sold to resellers on a consignment basis. Revenue is recognized for these consignment transactions once the end-user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with Accounting Standards Codification subtopic 985-605-50, *Software: Revenue Recognition: Customer Payments and Incentives* ("ASC 985-605-50"), price protection for changes in the manufacturer suggested retail value granted to resellers for the inventory that they have on hand at the date the price protection is offered is recorded as a reduction to revenue. 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

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

months. Given that these installment payment plans are for periods less than 12 months and a successful collection history has been established, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met. Packaged software is provided to customers who purchase directly from us with a six-month right of return. The company also allows its retailers to return unsold products, subject to some limitations. In accordance with Accounting Standards Codification subtopic 985-605-15, *Software: Revenue Recognition: Products* ("ASC 985-605-15"), product revenue is reduced for estimated returns, which are based on historical return rates.

Revenue for software license agreements sold via online software subscriptions as hosting agreements are recognized in accordance with Accounting Standards Codification subtopic 985-605-05, *Software: Revenue Recognition: Background* ("ASC 985-605-05"). Revenue for online software subscriptions is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between 3 and 12 months. Some online licensing arrangements include a specified number of licenses that can be activated over a period of time, which typically ranges between 12 and 24 months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement and the subscription services are made available to the customer. In connection with packaged software product sales and online software subscriptions, technical support is provided to customers, including customers of resellers, at no additional charge. As the fee for technical support is included in the initial licensing fee, the technical support and services are generally provided within one year, the estimated cost of providing such support is deemed insignificant and no unspecified upgrades/enhancements are offered, technical support revenues are recognized together with the software product and license revenue. Costs associated with the technical support are accrued at the time of sale.

Revenue for online service subscriptions for dedicated conversational coaching are recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically is 3 months. Rosetta Stone V4 *TOTALe* bundles, which include dedicated conversational coaching online services and packaged software, allow customers to begin their online services at any point during a registration window, which typically ranges between 6 and 12 months from the date of purchase from the Company or an authorized reseller. Dedicated conversational coaching online service subscriptions that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Accounts receivable and deferred revenue are recorded at the time a customer purchases the online services.

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

The Company has been engaged to develop language learning software for certain endangered languages under fixed-fee arrangements. These arrangements also include contractual periods of post-contract support ("PCS") and online hosting services ranging from one to ten years. Revenue for

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

multi-element contracts are recognized ratably once the PCS and online hosting periods begin, over the longer of the PCS or online hosting period. When the current estimates of total contract revenue and contract cost indicate a loss for a fixed fee arrangement, a provision for the entire loss on the contract is recorded.

*Revenue Recognition for Arrangements with Multiple Deliverables*

As of January 1, 2010, the Company began to recognize revenue prospectively for new arrangements with multiple deliverables in accordance with ASU No. 2009-13, "Revenue Recognition (Topic 605) Multiple Deliverable Revenue Arrangements ("ASU No. 2009-13"). For multi-element arrangements that include online services and auxiliary items, such as headsets and audio practice products which provide stand-alone value to the customer, the Company allocates revenue to all deliverables based on their relative selling prices in accordance with ASU No. 2009-13. The new accounting principles establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows: (i) vendor-specific objective evidence of fair value ("VSOE"), (ii) third-party evidence of selling price ("TPE"), and (iii) best estimate of the selling price ("ESP"). VSOE generally exists only when the Company sells the deliverable separately and is the price actually charged by the Company for that deliverable. ESPs reflect its best estimates of what the selling prices of elements would be if they were sold regularly on a stand-alone basis.

The Company has identified two deliverables generally contained in arrangements involving the sale of online services bundled with auxiliary items. The first deliverable is the auxiliary items, which are delivered at the time of sale, and the second deliverable is the online services. The Company allocates revenue between these two deliverables using the relative selling price method. Amounts allocated to the auxiliary items are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services. The auxiliary item cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

The Company has identified two deliverables generally contained in Rosetta Stone V4 *TOTALe* software arrangements. The first deliverable is the packaged software, which is delivered at the time of sale, and the second deliverable is the dedicated conversational coaching online services. The Company allocates revenue between these two deliverables using the relative selling price method. Amounts allocated to the software are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services or upon expiry of the online services. The language learning software cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

The Company accounts for multiple element arrangements that consist only of software or software related products, in accordance with industry specific accounting guidance for software and software related transactions. For such transactions, revenue on arrangements that include multiple elements is allocated to each element based on the relative fair value of each element, and fair value is generally determined by VSOE. If the Company cannot objectively determine the fair value of any undelivered element included in such multiple element arrangements, the Company defers revenue

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements.

***Income Taxes***

The Company accounts for income taxes in accordance with Accounting Standards Codification topic 740, *Income Taxes* ("ASC 740"), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax bases of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred 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.

***Fair Value of Financial Instruments***

In 2008 and 2009, the Company adopted the provisions of ASC No. 820, "Fair Value Measurements." The valuation techniques required by ASC No. 820 are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. These two types of inputs create the following fair value hierarchy:

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.

See table below for summary of the Company's financial instruments accounted for at fair value on a recurring basis, which consist only of our short-term investments that are marked to fair value at each

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

balance sheet date, as well as the fair value of the accrual for the contingent purchase price of our acquisition of SGLC International Co. Ltd. ("SGLC") in 2009:

|  | Fair Value as of March 31, 2011 using: |   |   |  |
|--|--|---|---|--|
|  | March 31,<br>2011                      | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <i>Assets:</i>                         |  |   |   |  |
| Short-term investments                 | \$ 8,217                               | \$ 8,217  | \$  | \$   |
| Total                                  | \$ 8,217                               | \$ 8,217  | \$  | \$   |
| <i>Liabilities:</i>                    |  |   |   |  |
| Contingent purchase price accrual      | \$ 573                                 | \$  | \$  | \$ 573   |
| Total                                  | \$ 573                                 | \$  | \$  | \$ 573   |
| <b><i>Stock-Based Compensation</i></b> |  |   |   |  |

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

*Stock Options*

During the three months ended March 31, 2011, 89,935 stock options were granted at a weighted average exercise price of \$19.80 per share. The aggregate grant date fair value of options issued during the period was \$1.0 million, which will be recognized as expense over the requisite service period of the options, which is also the vesting period. During the three months ended March 31, 2010, 334,645 stock options were granted at a weighted average exercise price of \$25.95 per share. During the three months ended March 31, 2011 and 2010, 5,062 and 24,237 stock options were exercised, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2011 and 2010 was approximately \$66,000 and \$0.4 million, respectively.

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. For the three months ended March 31, 2011 and 2010, the fair value of options granted was calculated using the following assumptions:

|                                 | Three Months Ended<br>March 31, |               |
|---------------------------------|---------------------------------|---------------|
|                                 | 2011                            | 2010          |
| Expected stock price volatility | 57.1% - 57.3%                   | 61.2%         |
| Expected term of options        | 6 years                         | 6 years       |
| Expected dividend yield         |                                 |               |
| Risk-free interest rate         | 1.96% - 2.35%                   | 1.84% - 1.91% |

Since the Company's stock has been publicly quoted since April 2009 and the Company has a limited history of stock option activity, the Company reviewed a group of comparable industry-related companies to estimate its expected volatility over the most recent period commensurate with the estimated expected term of the awards. In addition to analyzing data from the peer group, the Company also considered the contractual option term and vesting period when determining the expected option life and forfeiture rate. 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.

*Restricted Stock*

During the three months ended March 31, 2011, 38,708 shares of restricted stock were granted. There were no restricted stock units granted. The aggregate grant date fair value of the awards was \$0.8 million, which will be recognized as expense on a straight-line basis over the requisite service period of the awards, which is also the vesting period. The Company's restricted stock grants are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant. During the three months ended March 31, 2010, 78,748 shares of restricted stock were granted. The aggregate grant date fair value of the awards was \$2.0 million.

*Long Term Incentive Program*

On January 4, 2011, the Company's Board of Directors approved the Rosetta Stone Inc. Long Term Incentive Program ("LTIP"), a new Long-Term Incentive plan for certain of the Company's executives. The LTIP will be administered under the Rosetta Stone Inc. 2009 Omnibus Incentive Plan (the "Plan"), and the 1,000,000 shares allocated to the LTIP will be taken from the shares reserved under the Plan. Executives designated by the Board of Directors will be eligible to receive shares of restricted common stock for each milestone level of total market capitalization achieved, as specified in individual award agreements. The shares received will be restricted in that after issuance of the shares, they are subject to vesting over a two year period. For each milestone level of market capitalization reached above the base market capitalization as of October 1, 2010, the compensation committee of the Board of Directors will allocate a share incentive pool amongst the participating executives as specified in individual award agreements.



Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In accordance with the agreements communicated to the executives after the approval of the plan by the Board of Directors, the LTIP participants were granted minimum participation percentages of each tranche of shares issued at each milestone level reached. For these minimum shares to be received, the Company determined that a grant date was achieved. The grant date fair value of the minimum awards was \$6.1 million which was derived using a Monte Carlo valuation model. This value will be amortized as stock-based compensation expense over the derived service period of 5 years. Stock-based compensation expense for unallocated LTIP shares will be recognized when the milestones are met, the Board determines the allocation to each individual, and the shares are granted. The grant date fair value determined at that time will be amortized over the vesting period.

During the three months ended March 31, 2011, the Company recorded \$0.3 million to stock-based compensation expense related to the LTIP, and as of March 31, 2011, there was \$5.8 million of unrecognized stock-based compensation expense related to minimum awards that is expected to be recognized over a period of 5 years.

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

|                            | <b>Three Months<br/>Ended<br/>March 31,</b> |               |
|----------------------------|---|---------------|
|                            | <b>2011</b>                                 | <b>2010</b>   |
| Cost of revenue            | \$ 11                                       | \$ 13         |
| Sales and marketing        | 246   | 164           |
| Research & development     | 328   | 253           |
| General and administrative | 852   | 444           |
| <b>Total</b>               | <b>\$ 1,437</b>                             | <b>\$ 874</b> |

***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 income (loss) in stockholders' equity.

Cash flows of consolidated foreign subsidiaries, whose functional currency is the 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

Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 income (dollars in thousands):

|   | <b>Three Months<br/>Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2011</b>                                 | <b>2010</b> |
| Net income (loss)                                       | \$ (9,281)                                  | \$ 5005     |
| Foreign currency translation gain (loss)                | 275   | (88)        |
| Unrealized gain (loss) on available-for-sale securities | (13)  |             |
| Total comprehensive income (loss)                       | \$ (9,019)                                  | \$ 4,917    |

***Recently Issued Accounting Standards***

In August 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft on lease accounting that would require entities to recognize assets and liabilities arising from lease contracts on the balance sheet. The proposed exposure draft states that lessees and lessors should apply a "right-of-use model" in accounting for all leases. Under the proposed model, lessees would recognize an asset for the right to use the leased asset, and a liability for the obligation to make rental payments over the lease term. The lease term is defined as the longest possible term that is "more likely than not" to occur. The accounting by a lessor would reflect its retained exposure to the risks or benefits of the underlying leased asset. A lessor would recognize an asset representing its right to receive lease payments based on the expected term of the lease. The final standard is expected to be issued in calendar 2011. The proposed standard, as currently drafted, will have a material impact on the Company's reported results of operations and financial position. This exposure draft is non-cash in nature and will not impact the Company's cash position.

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

## 3. NET INCOME (LOSS) PER SHARE

Net income (loss) per share is computed under the provisions of Accounting Standards Codification topic 260, *Earnings Per Share*. Basic income per share is computed using net income (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.

|   | <b>Three Months Ended<br/>March 31,</b>                         |             |
|---|---|-------------|
|   | <b>2011</b>   | <b>2010</b> |
|   | <b>(dollars in thousands,<br/>except per share<br/>amounts)</b> |             |
| <i>Numerator:</i>                         |   |             |
| Net Income (loss)                         | \$ (9,281)  | \$ 5,005    |
| <i>Denominator:</i>                       |   |             |
| Weighted average number of common shares: |   |             |
| Basic                                     | 20,675  | 20,258      |
| Diluted                                   | 20,675  | 21,060      |
| Income (loss) per common share:           |   |             |
| Basic                                     | \$ (0.45)   | \$ 0.25     |
| Diluted                                   | \$ (0.45)   | \$ 0.24     |

For the three months ended March 31, 2011 and 2010, the following common stock equivalent shares were included in the calculation of the Company's diluted net income per share (in thousands):

|                                      | <b>Three Months<br/>Ended<br/>March 31,</b> |             |
|--------------------------------------|---|-------------|
|                                      | <b>2011</b>                                 | <b>2010</b> |
| <i>Equity Instruments:</i>           |   |             |
| Restricted common stock units        | 10  |             |
| Restricted common stock              | 95  |             |
| Stock options                        | 697   |             |
| Total common stock equivalent shares | 802   |             |

For the three months ended March 31, 2011, outstanding stock options, restricted stock units and restricted stock of \$2.1 million, 22,000 and 322,000, respectively, were not included in the diluted net loss per share calculation, as they were anti-dilutive.

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (UNAUDITED)

**3. NET INCOME (LOSS) PER SHARE (Continued)**

Share based awards to purchase 333,145 shares of common stock that had an exercise price in excess of the average market price of the common stock during the three months ended March 31, 2010, were not included in the calculation of diluted earnings per share because they were anti-dilutive.

**4. INVENTORY**

Inventory consisted of the following (dollars in thousands):

|                                | March 31,<br>2011 | December 31,<br>2010 |
|--------------------------------|-------------------|----------------------|
| Raw materials                  | \$ 6,391          | \$ 4,423             |
| Finished goods                 | 6,839             | 7,892                |
|                                | 13,230            | 12,315               |
| Reserve for obsolete inventory | (2,864)           | (2,387)              |
| Inventory, net                 | \$ 10,366         | \$ 9,928             |

**5. GOODWILL**

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006 and the acquisition of certain assets of SGLC in November 2009. 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 Accounting Standards Codification topic 350, *Intangibles Goodwill and Other* ("ASC 350"). If an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value, goodwill will be evaluated for impairment between annual tests. The Company's annual testing resulted in no impairments of goodwill since the dates of acquisition. For income tax purposes, the goodwill balance is amortized over a period of 15 years. Beginning in 2011, the Company began reporting its results in two reporting units Consumer and Institutional. In June, the Company will test goodwill for impairment under the new reporting structure. As of March 31, 2011, there has been no indication of impairment of goodwill.

The following table represents the balance and changes in goodwill for the three months ended March 31, 2011 (in thousands):

|   |           |
|---|-----------|
| Balance as of December 31, 2010           | \$ 34,856 |
| Effect of change in foreign currency rate | 20        |
| Balance as of March 31, 2011              | \$ 34,876 |

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

## 6. INTANGIBLE ASSETS

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

|                           | March 31, 2011        |                          |                     | December 31, 2010     |                          |                     |
|---------------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                           | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Trade name/<br>trademark  | \$ 10,607             | \$                       | \$ 10,607           | \$ 10,607             | \$                       | \$ 10,607           |
| Core technology           | 2,453                 | (2,453)                  |                     | 2,453                 | (2,453)                  |                     |
| Customer<br>relationships | 10,847                | (10,815)                 | 32                  | 10,844                | (10,800)                 | 44                  |
| Website                   | 12                    | (12)                     |                     | 12                    | (12)                     |                     |
| Patents                   | 300                   | (13)                     | 287                 | 300                   | (3)                      | 297                 |
| Total                     | \$ 24,219             | \$ (13,293)              | \$ 10,926           | \$ 24,216             | \$ (13,268)              | \$ 10,948           |

Amortization of intangible assets for the three months ended March 31, 2011 and 2010 totaled \$23,000 and \$14,000, respectively. For the three months ended March 31, 2011 and 2010, \$10,000 and zero was included in research and development expense and \$13,000 and \$14,000 was included in sales and marketing expense, respectively.

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining nine months of 2011 and years thereafter (dollars in thousands):

|                |        |
|----------------|--------|
| 2011 remaining | \$ 62  |
| 2012           | 40     |
| Thereafter     | 217    |
| Total          | \$ 319 |

In accordance with Accounting Standards Codification topic 360, *Property, Plant, and Equipment*, the Company reviews its long-lived assets, including property and equipment and intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be fully recoverable. If the total of the expected undiscounted future net cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between the fair value and carrying amount of the asset. There were no impairment charges for the three months ended March 31, 2011 or March 31, 2010.

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

**7. OTHER CURRENT LIABILITIES**

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

|                                  | March 31,<br>2011 | December 31,<br>2010 |
|----------------------------------|-------------------|----------------------|
| Marketing expenses               | \$ 13,699         | \$ 11,075            |
| Professional and consulting fees | 3,983             | 2,820                |
| Sales return reserve             | 4,905             | 8,391                |
| Taxes payable                    | 2,579             | 2,722                |
| Other                            | 6,569             | 7,617                |
|                                  | \$ 31,735         | \$ 32,625            |

**8. BORROWING AGREEMENT**

On January 16, 2009, the Company entered into a credit agreement with Wells Fargo Bank, N.A. ("Wells Fargo"), which provided the Company with a \$12.5 million revolving line of credit. This revolving credit facility had a two-year term and the applicable interest rate was 2.5% above one month LIBOR, or approximately 2.76% as of December 31, 2010. On January 16, 2009, the Company borrowed approximately \$9.9 million under this revolving credit facility and used these funds to repay the entire outstanding principal and interest of the Term Loan the Company had with Madison Capital. As a result, the Company had no borrowings owed to Madison Capital under either their Term Loan or Revolver, and the Company had terminated these credit agreements. As a result of the early repayment of the Madison Capital Loan, the Company wrote-off the remaining unamortized capitalized financing costs associated with this loan. The amount of the write-off was approximately \$0.2 million. Upon completion of the Company's initial public offering, the Company repaid the \$9.9 million balance of its revolving credit facility with Wells Fargo during the three months ended June 30, 2009, and a total of \$12.5 million under revolving credit facility was available to the Company for borrowing thereunder.

Interest expense for the three months ended March 31, 2011 and 2010 was \$3,000 and \$8,000, respectively.

On January 17, 2011, the Company allowed its \$12.5 million revolving line of credit with Wells Fargo to expire.

**9. INCOME TAXES**

In accordance with Accounting Standards Codification topic 740, *Income Taxes*, and Accounting Standards Codification subtopic 740-270, *Income Taxes: Interim Reporting*, the income tax provision for the three month period ended March 31, 2011 is based on the estimated annual effective tax rate for fiscal year 2011. 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, change and create a different relationship between domestic and foreign income and loss.

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**9. INCOME TAXES (Continued)**

The Company adopted Accounting Standards Codification topic 740-10-25, *Income Taxes: Overall: Background* ("ASC 740-10-25") on January 1, 2007, which clarified the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. 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.

At the adoption date and as of March 31, 2011, the Company had no material unrecognized tax benefits and no adjustments to liabilities or operations were required under ASC 740-10-25. The Company's practice is to recognize interest and penalty expense related to uncertain tax positions in income tax expense, which were zero at both the adoption date and for the three months ended March 31, 2011.

**10. STOCK PLANS**

*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 a new Stock Incentive and Award Plan (the "2009 Plan") that provides for the ability of the Company to grant up to 2,437,744 new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. The stock incentive awards and options granted under the 2009 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date.

Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants. At March 31, 2011 there were 26,391 shares available for future grant under the 2009 Plan.

In accordance with Accounting Standards Codification topic 718, *Compensation - Stock Compensation* ("ASC 718"), the fair value of stock-based awards to employees is calculated as of the

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (UNAUDITED)

## 10. STOCK PLANS (Continued)

date of grant. Compensation expense is then recognized on a straight-line basis over the requisite service period of the award. The Company uses the Black-Scholes pricing model to value its stock options, which requires the use of estimates, including future stock price volatility, expected term and forfeitures. Stock-based compensation expense recognized is based on the estimated portion of the awards that are expected to vest. Estimated forfeiture rates were applied in the expense calculation.

*Stock Options*

The following table summarized the Company's stock option activity from January 1, 2011 to March 31, 2011:

|  | Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Contractual<br>Life (years) | Aggregate<br>Intrinsic<br>Value |
|--|------------------------|--|--|---------------------------------|
| Options Outstanding,<br>January 1, 2011          | 2,020,927              | \$ 13.25                                 | 7.36   | \$ 17,733,080                   |
| Options granted                                  | 89,935                 | 19.80                                    |  |                                 |
| Options exercised                                | (5,062)                | 6.90                                     |  |                                 |
| Options cancelled                                | (9,530)                | 19.81                                    |  |                                 |
| Options Outstanding,<br>March 31, 2011           | 2,096,270              | 13.51                                    | 7.18   | 7,810,198                       |
| Vested and expected to<br>vest at March 31, 2011 | 1,975,715              | 13.00                                    | 7.07   | 7,808,584                       |
| Exercisable at March 31,<br>2011                 | 1,203,278              | 8.27                                     | 6.1  | 7,676,468                       |

As of March 31, 2011, there was approximately \$8.2 million of unrecognized stock-based compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 2.68 years.

Stock options are granted at the discretion of the Board of Directors or the Compensation Committee (or its authorized member(s)) and expire 10 years from the date of the grant. Options generally vest over a four-year period based upon required service conditions. No options have performance or market conditions. The Company calculates the pool of additional paid-in capital associated with excess tax benefits using the "simplified method" in accordance with ASC 718.

*Restricted Stock Awards*

During the three months ended March 31, 2011, 38,708 shares of restricted stock were granted. The aggregate grant date fair value of the awards was \$0.8 million, which will be recognized on a straight-line basis as expense over the requisite service period of the awards, which is also the vesting period. During the three months ended March 31, 2011, 6,715 shares of restricted stock were forfeited. As of March 31, 2011, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the statement of operations was \$5.0 million and is expected to be recognized over a period of 2.73 years.





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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

## 10. STOCK PLANS (Continued)

The following table summarized the Company's restricted stock award activity from January 1, 2010 to March 31, 2011:

|                                      | Nonvested<br>Outstanding | Weighted<br>Average<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic<br>Value |
|--------------------------------------|--------------------------|---|---------------------------------|
| Nonvested Awards,<br>January 1, 2011 | 307,524                  | \$ 21.69  |                                 |
| Awards granted                       | 38,708                   | 19.79   |                                 |
| Awards vested                        | (17,552)                 | 25.19   |                                 |
| Awards cancelled                     | (6,715)                  | 20.31   |                                 |
| Nonvested Awards,<br>March 31, 2011  | 321,965                  | 21.31   | \$ 6,861,074                    |

*Long Term Incentive Program*

On January 4, 2011, the Company's Board of Directors approved the Rosetta Stone Inc. Long Term Incentive Program ("LTIP"), a new Long-Term Incentive plan for certain of the Company's executives. The LTIP will be administered under the Rosetta Stone Inc. 2009 Omnibus Incentive Plan (the "Plan"), and the 1,000,000 shares allocated to the LTIP will be taken from the shares reserved under the Plan. The purpose of the LTIP is to: advance the best interests of the Company; motivate senior management to achieve key financial and strategic business objectives of the Company; offer eligible executives a competitive total compensation package; reward executives in the success of the Company; provide ownership in the Company; and retain key talent. Executives designated by the Board of Directors will be eligible to receive shares of restricted common stock for each milestone level of total market capitalization achieved, as specified in individual award agreements. The shares received will be restricted in that after issuance of the shares; they are subject to vesting over a two year period. For each milestone level of market capitalization reached above the base market capitalization as of October 1, 2010, the compensation committee of the Board of Directors will allocate a share incentive pool amongst the participating executives as specified in individual award agreements. Although minimum participation percentages have been communicated to certain plan participants, all share grants under the LTIP are contingent upon achievement of the market capitalization thresholds.

In accordance with the agreements communicated to the executives after the approval of the plan by the Board of Directors, the LTIP participants were granted minimum participation percentages of each tranche of shares issued at each milestone level reached. As of March 31, 2011, the target market capitalization required to trigger the first issuance of shares was below the minimum threshold, and no shares were issued. The minimum participation percentages given to plan participants were considered grants in accordance with the provisions of ASC 718. The grant date fair value of the minimum awards was \$6.1 million which was derived using a Monte Carlo valuation model. This value will be amortized as stock-based compensation expense over the derived service period of 5 years. Stock-based compensation expense for unallocated LTIP shares will be recognized when the milestones are met, the Board determines the allocation to each individual, and the shares are granted. The grant date fair value determined at that time will be amortized over the vesting period.

Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****10. STOCK PLANS (Continued)**

During the three months ended March 31, 2011, the Company recorded \$0.3 million to stock-based compensation expense related to the LTIP, and as of March 31, 2011, there was \$5.8 million of unrecognized stock-based compensation expense related to minimum awards that is expected to be recognized over a period of 5 years.

**11. STOCKHOLDERS' EQUITY**

At March 31, 2011, 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 March 31, 2011, the Company had shares of Common Stock issued and outstanding of 21,012,434.

**12. COMMITMENTS AND CONTINGENCIES***Operating Leases*

The Company leases many kiosks, copiers, parking spaces, buildings, a warehouse and office space under operating lease and site license arrangements, some of which contain renewal options. The rental payments under some kiosk site licenses are based on a minimum rental plus a percentage of the kiosk's sales in excess of stipulated amounts. Kiosk site licenses range from a period of one month to five years. Building, warehouse and office space leases range from three months to 85 months. Certain leases also include lease renewal options.

The following table summarizes future minimum operating lease payments for the remaining nine months of 2011 and the years thereafter (in thousands):

|                             |           |
|-----------------------------|-----------|
| Periods Ending December 31, |           |
| 2011 remaining              | \$ 5,048  |
| 2012                        | 3,088     |
| 2013                        | 2,230     |
| 2014                        | 360       |
| 2015 and thereafter         | 207       |
|                             | \$ 10,933 |

Rent expense was \$3.7 million and \$3.2 million for the three months ended March 31, 2011 and 2010, respectively.

The Company accounts for its leases under the provisions of Accounting Standards Codification topic 840, *Accounting for Leases* ("ASC 840"), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense. The deferred rent liability was \$0.7 million at March 31,

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**ROSETTA STONE INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(UNAUDITED)**

**12. COMMITMENTS AND CONTINGENCIES (Continued)**

2011. The deferred rent asset was \$0.2 million at March 31, 2011. The deferred rent asset is classified in prepaid and other assets as all associated leases have less than one year remaining on their term.

*Litigation*

In July 2009, the Company filed a lawsuit in the United States District Court for the Eastern District of Virginia against Google Inc., seeking, among other things, to prevent Google from infringing upon its trademarks. In August 2010, the U.S. District Court for the Eastern District of Virginia issued its final order dismissing our trademark infringement lawsuit against Google. The Company has appealed the District Court's decision to the U.S. Court of Appeals for the Fourth Circuit. The Company has incurred, and may continue to incur material legal fees and other costs and expenses in pursuit of our claims against Google.

On or about April 28, 2010, a purported class action lawsuit was filed against the Company in the Superior Court of the State of California, County of Alameda for damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and other persons similarly situated who are or were employed as salaried managers by the Company in its retail locations in California are due unpaid wages and other relief for the Company's violations of state wage and hour laws. Plaintiffs moved to amend their complaint to include a nationwide class on January 21, 2011. On March 16, 2011, the case was removed to the United States District Court for the Northern District of California, Oakland Division. We intend to vigorously defend this matter. However, we cannot predict the timing and the ultimate outcome of this matter. Even if the plaintiffs are unsuccessful in their claims against us, we will incur legal fees and other costs in the defense of these claims.

On or about March 24, 2011, a purported securities class action lawsuit was filed on behalf of persons who purchased the Company's publicly traded securities between February 25, 2010 and February 28, 2011 against the Company and certain of its present and former officers in the United States District Court for the Eastern District of Virginia alleging violations of federal securities law in connection with various public statements and alleged material omissions made by the Company. The complaint names as defendants Rosetta Stone Inc., Tom P.H. Adams, President and Chief Executive Officer, Brian D. Helman, former Chief Financial Officer, and Matthew C. Sysak, Vice President and Controller. We intend to vigorously defend this matter. However, we cannot predict the timing and ultimate outcome of this case. Even if the plaintiffs are unsuccessful in their claims against us, we will incur legal fees and other costs in the defense of these claims.

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 adverse impact on its business, financial condition or results of operations.

**13. SEGMENT INFORMATION**

Beginning in 2011, we conducted our business in two operating segments Consumer and Institutional. These segments also represent our reportable segments.

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## ROSETTA STONE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

## 13. SEGMENT INFORMATION (Continued)

We measure the performance of our operating segments based upon operating segment revenue and operating segment contribution margin. Operating segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, research and development and selling, marketing, and administrative expenses. We do not allocate certain expenses, which include the majority of general and administrative expenses, facilities and communication expenses, purchasing expenses, manufacturing support and logistic expenses, depreciation and amortization, amortization of capitalized software development costs, stock-based compensation. These expenses are included in the unallocated expenses section of the table presented below. Revenue from transactions between our operating segments is not material.

With the exception of goodwill, we do not identify or allocate our assets by operating segment. Consequently, we do not present assets or liabilities by operating segment.

Operating results by segment for the three months ended March 31, 2011 and 2010 were as follows (in thousands):

|   | Three Months Ended<br>March 31, |              |
|---|---------------------------------|--------------|
|   | 2011                            | 2010         |
| <b>Revenue:</b>                                     |                                 |              |
| Consumer  | \$ 42,662                       | \$ 51,221    |
| Institutional                                       | 14,316                          | 11,793       |
| <br>Total revenue                                   | <br>56,978                      | <br>63,014   |
| <b>Segment contribution:</b>                        |                                 |              |
| Consumer  | 9,863                           | 24,524       |
| Institutional                                       | 9,270                           | 8,373        |
| <br>Total segment contribution                      | <br>19,133                      | <br>32,897   |
| <b>Unallocated expenses, net:</b>                   |                                 |              |
| Amortization of acquired intangibles                | 10                              |              |
| Stock-based compensation                            | 1,299                           | 808          |
| Unallocated cost of sales                           | 5,220                           | 2,522        |
| Unallocated sales and marketing                     | 6,313                           | 4,306        |
| Unallocated research and development                | 6,146                           | 5,218        |
| Unallocated general and administrative              | 13,741                          | 13,145       |
| <br>Total unallocated expenses, net                 | <br>32,729                      | <br>25,999   |
| <b>Operating income (loss)</b>                      | <b>(13,596)</b>                 | <b>6,898</b> |
| Other income, net                                   | 79                              | 61           |
| <br>Income (loss) before provision for income taxes | <br>\$ (13,517)                 | <br>\$ 6,959 |

Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****13. SEGMENT INFORMATION (Continued)*****Geographic Information***

Revenue by major geographic region is based primarily upon the geographic location of the customers who purchase our products. The geographic locations of distributors and resellers who purchase and resell our products may be different from the geographic locations of end customers. The information below summarizes revenue from customers by geographic area for the three months ended March 31, 2011 and 2010 (in thousands):

|                      | <b>Three Months Ended<br/>March 31,</b> |                  |
|----------------------|---|------------------|
|                      | <b>2011</b>                             | <b>2010</b>      |
| United States        | \$ 41,271                               | \$ 52,476        |
| International        | 15,707                                  | 10,538           |
| <b>Total revenue</b> | <b>\$ 56,978</b>                        | <b>\$ 63,014</b> |

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Quarterly Report on Form 10-Q (this "Report") contains "forward-looking statements" that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "will," "plan," "project," "seek," "should," "target," "would," and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2011. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. Unless the context otherwise requires, references in this Report to "we", "us" or "our" shall mean the Company.

**Overview**

We are a leading provider of technology-based language learning solutions. We develop, market and sell language learning solutions consisting of software, online services and audio practice tools primarily under our *Rosetta Stone* brand. Our teaching method, which we call *Dynamic Immersion*, is designed to leverage the innate, natural language learning ability that children use to learn their native language. Our courses are based on our proprietary interactive technologies and pedagogical content and utilize a sophisticated sequencing of images, text and sounds to teach a new language without translation or grammar explanation. We believe our award-winning solutions provide an effective, convenient and fun way to learn languages. We currently offer our self-study language learning solutions in 34 languages. Our customers include individuals, educational institutions, armed forces, government agencies and corporations.

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages, which have enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 82% of our revenue for the year ended December 31, 2010 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Apple, Barnes & Noble, Borders, Best Buy, Staples, Costco and Office Depot.

We generate revenue primarily from sales of packaged software and audio practice products and online software subscriptions. Our continued growth depends, in part, on our ability to maintain strong brand recognition in order to generate sales from new customers. We continuously balance our need to achieve short-term financial goals with the equally critical need to invest in our products, our brand

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and our infrastructure to ensure our future success. In making decisions about spending levels in our various functional organizations, we consider many factors, including:

our ability to expand our presence and penetration of existing markets;

the extent to which we can sell new products and services to existing customers;

our success in expanding our brand;

the evolution of our product and service offerings; and

our ability to expand our presence and reach geographically.

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

customer acceptance of our product and service offerings;

continued product and service innovation;

average revenue per customer;

direct marketing variables, including:

print, television and radio media discounts and rates;

the relevance of our advertising;

online pay-per-click and other online advertising rates;

internal and external call center conversion rates; and

website traffic and conversion rates;

customer brand loyalty;

the number and quality of our kiosk locations;



our presence in international markets; and

cross-channel management of consumer and institutional markets.

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

### **Components of Our Statement of Operations**

#### ***Revenue***

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

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Our professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe*. Rosetta Stone *TOTALe* online, which was released in July 2009, combines dedicated conversational coaching and an online software subscription. Rosetta Stone Version 4 *TOTALe*, which was released in September 2010, combines packaged software and dedicated conversational coaching. The content of our packaged software and subscription offerings are the same. We simply offer our customers the

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ability to choose which format they prefer without differentiating the learning experience. We began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions in the U.S. consumer market as part of our Rosetta Stone Version 4 *TOTALe* launch. As a result, we defer approximately 15%-20% of each of these bundled sales over the term of the subscription license.

We sell our solutions directly to individuals, educational institutions, armed forces, government agencies and corporations. We distribute our consumer products predominantly through our direct sales channels, primarily our websites and call centers, which we refer to as our direct-to-consumer channel. We also distribute our consumer products through our kiosks, which we own, as well as through select retailers. The majority of our consumer customers purchase our packaged software and audio practice products, online software subscriptions and professional services. We sell to institutions primarily through our direct institutional sales force. Many institutions elect to license our products on a subscription basis. For purposes of explaining variances in our revenue, we separately discuss changes in our consumer and institutional sales channels because the customers and revenue drivers of these channels are different. We anticipate that revenue growth in 2011 will slow and revenue associated with the U.S. Consumer business may decline.

For the three months ended March 31, 2011, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current year presentation. This presentation is also consistent with how we manage the home school channel.

Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2010 accounted for 29% of our annual revenue in 2010. Our institutional revenue is seasonally stronger in the second and third quarters of the calendar year due to education and government purchasing cycles. We expect these trends to continue.

***Cost of Product and Subscription and Service Revenue***

Cost of product revenue consists of the direct and indirect materials and labor costs to produce and distribute our products. Such costs include packaging materials, computer headsets, freight, inventory receiving, personnel costs associated with product assembly, third-party royalty fees and inventory storage, obsolescence and shrinkage. Cost of subscription and service revenue primarily represents costs associated with supporting our online language learning service, which includes hosting costs and depreciation. We also include the cost of credit card processing and customer technical support in both cost of product revenue and cost of subscription and service revenue. Cost of revenue will also increase as a percentage of revenue in future periods as a result of our launch of Rosetta Stone Version 4 *TOTALe*, which includes services that have higher direct costs to deliver to customers than our existing software solutions.

***Operating Expenses***

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

Our operating expenses primarily consist of personnel costs, direct advertising and marketing expenses and professional fees associated with contract product development, legal, accounting and consulting. Personnel costs for each category of operating expenses include salaries, bonuses, stock-based compensation and employee benefit costs.

*Sales and Marketing.* Our sales and marketing expenses consist primarily of direct advertising expenses related to television, print, radio, online and other direct marketing activities, personnel costs

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for our sales and marketing staff, rental payments for our kiosks and commissions paid to our sales personnel. Sales and marketing expenses also include amortization expense of intangible assets related to customer relationships associated with the 2006 acquisition of Fairfield & Sons, Ltd. These intangible assets were fully amortized by January 2009. In 2007, we began to make significant investments to expand our sales and marketing operations in Europe and Japan. In 2009, we began to make significant investments to expand our sales and marketing operations in South Korea, and in 2010 we established an office in Germany. In each case we established local sales offices and call centers, added employees and launched marketing and public relations campaigns within the region. We intend to continue to expand our sales activities within these regions as well as to expand our presence into new countries, in addition to expanding our media and advertising campaigns in the United States. As a result, we expect sales and marketing expenses to increase in future periods.

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

*General and Administrative.* General and administrative expenses consist primarily of personnel costs of our executive, finance, legal, human resources and other administrative personnel, as well as accounting and legal professional services fees and other corporate expenses. We expect general and administrative expenses to increase in future periods as we expect to continue to invest in corporate infrastructure and incur additional expenses associated with being a public company, including increased legal and accounting costs, investor relations costs, independent director compensation, exchange listing fees and stockholder related fees, higher insurance premiums and compliance costs in connection with Section 404 of the Sarbanes-Oxley Act of 2002. In 2011, we expect there will be increases to certain general and administrative expenses to support our expansion into new international markets. However, we also are taking steps to reduce certain general and administrative expenses as we realign our resources with our business priorities.

***Other Income (Expense)***

Other income (expense) primarily consists of interest income and interest expense. Interest expense is primarily related to our long-term debt, the outstanding balance of which was zero as of March 31, 2011 and December 31, 2010. Interest income represents interest received on our cash and cash equivalents.

***Income Tax Expense (Benefit)***

For the three months ended March 31, 2011, our worldwide effective tax rate was approximately 31%. For the year ended December 31, 2010, our effective tax rate was approximately (3%) primarily as a result of the release of the valuation allowance on deferred tax assets in the United Kingdom and Japan subsidiaries. The effective rate includes federal, state and international components. Our worldwide rate may vary on a quarterly and annual basis based upon the contribution of international operations to taxable income and any changes in applicable federal, state or international income tax rates. We expect our worldwide rate to be approximately 28%-35% in 2011 and beyond assuming no general change in federal, state or foreign income tax rates applicable to companies such as ours. We expect our income tax expense to increase in absolute dollars as our income continues to grow.

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**Critical Accounting Policies and Estimates**

In presenting our financial statements in conformity with accounting principles generally accepted in the United States, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures.

Some of the estimates and assumptions we are required to make relate to matters that are inherently uncertain as they pertain to future events. We base these estimates and assumptions on historical experience or on various other factors that we believe to be reasonable and appropriate under the circumstances. On an ongoing basis, we reconsider and evaluate our estimates and assumptions. Our future estimates may change if the underlying assumptions change. Actual results may differ significantly from these estimates.

*Revenue Recognition for Arrangements with Multiple Deliverables*

As of January 1, 2010, we began to recognize revenue prospectively for new arrangements with multiple deliverables in accordance with ASU No. 2009-13, "Revenue Recognition (Topic 605) Multiple Deliverable Revenue Arrangements" ("ASU No. 2009-13"). For multi-element arrangements that include online services and auxiliary items, such as headsets and audio practice products which provide stand-alone value to the customer, we allocate revenue to all deliverables based on their relative selling prices in accordance with ASU No. 2009-13. The new accounting principles establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows: (i) vendor-specific objective evidence of fair value ("VSOE"), (ii) third-party evidence of selling price ("TPE"), and (iii) best estimate of the selling price ("ESP"). VSOE generally exists only when we sell the deliverable separately and is the price that we actually charge for that deliverable. ESPs reflect our best estimates of what the selling prices of elements would be if they were sold regularly on a stand-alone basis.

We have identified two deliverables generally contained in arrangements involving the sale of online services bundled with auxiliary items. The first deliverable is the auxiliary items, which are delivered at the time of sale, and the second deliverable is the online services. We allocate revenue between these two deliverables using the relative selling price method. Amounts allocated to the auxiliary items are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services. The auxiliary item cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

We have identified two deliverables generally contained in Rosetta Stone V4 *TOTALe* software arrangements. The first deliverable is the packaged software, which is delivered at the time of sale, and the second deliverable is the dedicated conversational coaching online services. We allocate revenue between these two deliverables using the relative selling price method. Amounts allocated to the software are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services or upon expiry of the online services. The language learning software cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

We account for multiple element arrangements that consist only of software or software related products, in accordance with industry specific accounting guidance for software and software related transactions. For such transactions, revenue on arrangements that include multiple elements is allocated to each element based on the relative fair value of each element, and fair value is generally determined by VSOE. If we cannot objectively determine the fair value of any undelivered element included in such multiple element arrangements, we defer revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements.

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*Goodwill*

In accordance with ASC 350, goodwill is not amortized and is tested for impairment annually on June 30th and whenever events and circumstances occur indicating goodwill might be impaired. Beginning in 2011, we began reporting our results in two reporting units Consumer and Institutional. The first step is a screen for potential impairment by comparing the fair value of our reporting units with their carrying amount. The second step measures the amount of impairment loss, if any. As of June 30, 2010 and 2009, we reviewed the goodwill for impairment and determined that no impairment of goodwill was identified during any of the periods presented, nor are the reporting units at risk of failing step one of the goodwill impairment test.

For further information on our critical and other significant accounting policies, see our Annual Report on Form 10-K filed with the SEC on March 14, 2011.

We believe that the following critical accounting policies involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements:

Revenue Recognition

Stock-based Compensation

Income Taxes

Allowance for Doubtful Accounts Receivable

Sales Return Reserve

Table of Contents**Results of Operations**

The following table sets forth our consolidated statements of operations for the periods specified, including dollar and percentage of change from the prior periods indicated:

|  | Three months ended<br>March 31, |           | 2011 versus 2010 |          |
|--|---------------------------------|-----------|------------------|----------|
|  | 2011                            | 2010      | Change           | % Change |
| (dollars in thousands)                         |                                 |           |                  |          |
| <b>Revenue</b>                                 |                                 |           |                  |          |
| Product  | \$ 42,303                       | \$ 53,734 | \$ (11,431)      | -21.3%   |
| Subscription and service                       | 14,675                          | 9,280     | 5,395            | 58.1%    |
| Total revenue                                  | 56,978                          | 63,014    | (6,036)          | -9.6%    |
| <b>Cost of revenue</b>                         |                                 |           |                  |          |
| Cost of product revenue                        | 8,795                           | 7,780     | 1,015            | 13.0%    |
| Cost of subscription and service revenue       | 2,667                           | 862       | 1,805            | 209.4%   |
| Total cost of revenue                          | 11,462                          | 8,642     | 2,820            | 32.6%    |
| <b>Gross margin</b>                            | 45,516                          | 54,372    | (8,856)          | -16.3%   |
| Operating Expenses:                            |                                 |           |                  |          |
| Sales and marketing                            | 37,820                          | 28,361    | 9,459            | 33.4%    |
| Research and development                       | 6,484                           | 5,470     | 1,014            | 18.5%    |
| General and administrative                     | 14,808                          | 13,643    | 1,165            | 8.5%     |
| Total operating expenses                       | 59,112                          | 47,474    | 11,638           | 24.5%    |
| <b>Income (loss) from operations</b>           | (13,596)                        | 6,898     | (20,494)         | -297.1%  |
| Other income and expense:                      |                                 |           |                  |          |
| Interest income                                | 80                              | 77        | 3                | 3.9%     |
| Interest expense                               | (3)                             | (8)       | 5                | -62.5%   |
| Other (expense) income                         | 2                               | (8)       | 10               | -125.0%  |
| Total interest and other income (expense), net | 79                              | 61        | 18               | 29.5%    |
| <b>Income (loss) before income taxes</b>       | (13,517)                        | 6,959     | (20,476)         | -294.2%  |
| Income tax expense (benefit)                   | (4,236)                         | 1,954     | (6,190)          | -316.8%  |
| <b>Net income (loss)</b>                       | \$ (9,281)                      | \$ 5,005  | \$ (14,286)      | -285.4%  |

**Comparison of the three months ended March 31, 2011 and the three months ended March 31, 2010**

Our revenue decreased to \$57.0 million for the three months ended March 31, 2011 from \$63.0 million for the three months ended March 31, 2010. The decrease was due to decreases in our Consumer Segment, primarily U.S.-based kiosk and retail verticals, partially offset by an increase in our Institutional Segment. Revenue per kiosk decreased due to lower foot traffic in kiosk locations. In 2011, we will continue to evaluate the need to scale back the US kiosk footprint while balancing the costs of operating the kiosks with the positive branding effect they provide. Retail revenue decreased due to lower than anticipated sales in our retail channel during the fourth quarter of 2010, which resulted in higher than normal inventory levels at the end of 2010 and lower restocking orders during the three months ended March 31, 2011.

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We reported an operating loss of \$(13.6) million during the three months ended March 31, 2011 compared to operating income of \$6.9 million in the three months ended March 31, 2010. The operating loss was due to a decrease in gross profit of \$8.9 million to \$45.5 million from \$54.4 million, and an increase in operating expenses of \$11.6 million. The decrease in gross profit was primarily due to the combination of a decrease in revenue and gross margin as a result of higher direct costs associated with our web-based services offering Version 4 *TOTALe* that include higher direct costs to deliver to customers than our previous software solutions. The increase in operating expenses was primarily due to \$4.1 million in personnel-related costs and \$5.6 million in increased media and marketing activities.

As of March 31, 2011, we employed approximately 1,900 personnel, including full time, part-time and temporary employees, compared to approximately 1,700 as of March 31, 2010.

**Revenue by Operating Segment**

The following table sets forth revenue for each of our two operating segments for the three months ended March 31, 2011 and 2010:

|                        | Three months ended March 31, |        | 2011 versus 2010 |          |            |        |
|------------------------|------------------------------|--------|------------------|----------|------------|--------|
|                        | 2011                         | 2010   | Change           | % Change |            |        |
| (dollars in thousands) |                              |        |                  |          |            |        |
| <i>Consumer:</i>       |                              |        |                  |          |            |        |
| Direct-to-Consumer     | \$ 31,856                    | 55.9%  | \$ 31,026        | 49.2%    | \$ 830     | 2.7%   |
| Kiosk                  | 7,312                        | 12.8%  | 9,391            | 14.9%    | (2,079)    | -22.1% |
| Retail                 | 2,585                        | 4.5%   | 9,608            | 15.2%    | (7,023)    | -73.1% |
| Homeschool             | 909                          | 1.6%   | 1,197            | 1.9%     | (288)      | -24.1% |
| Total consumer revenue | 42,662                       | 74.9%  | 51,222           | 81.3%    | (8,560)    | -16.7% |
| Institutional          | 14,316                       | 25.1%  | 11,792           | 18.7%    | 2,524      | 21.4%  |
| Total Revenue          | \$ 56,978                    | 100.0% | \$ 63,014        | 100.0%   | \$ (6,036) | -9.6%  |

**Consumer Segment**

Consumer revenue was \$42.7 million for the three months ended March 31, 2011, a decrease of \$8.6 million, or 17%, from the three months ended March 31, 2010. The number of units sold decreased 14% during the three months ended March 31, 2011 compared to the prior year period, resulting in a \$7.0 million decrease in revenue, offset by a slight increase in average selling price per unit from \$391 to \$392, which resulted in a \$0.1 million increase in revenue. The overall decrease in consumer revenue was primarily driven by continued weakness in the U.S. kiosk and U.S. retail sales verticals, offset by growth in our international consumer verticals. Additionally, there was a \$1.7 million increase in consumer deferred revenue during the three months ended March 31, 2011 compared to the prior year period, which was primarily related to our Version 4 *TOTALe* online services described below.

We are in the process of testing changes to the pricing of our products across all sales verticals in the U.S. market. While final results are not yet known, initial indications are that a reduction in the price of our products results in increased unit volume and revenue.

Product revenue represented 91% of total consumer revenue for the three months ended March 31, 2011, with the balance attributable to subscription and service revenue. We began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions in the U.S. consumer market during the third quarter of 2010 with the launch of Rosetta Stone Version 4 *TOTALe*. As a result, we defer

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approximately 15% - 20% of each of these bundled sales. We will recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition*.

*Direct-to-Consumer*

Direct-to-consumer revenue was \$31.9 million for the three months ended March 31, 2011, an increase of \$0.8 million or 3%, from the three months ended March 31, 2010. The increase in direct-to-consumer revenue was primarily driven by \$3.7 million in growth in our international direct-to-consumer markets, offset by a \$2.4 million revenue deferral associated with Version 4 *TOTALe* and a \$0.5 million decline in our U.S. direct-to-consumer business. The decline in our U.S. direct-to-consumer business was driven by lower web conversion and call center traffic, in addition to a decline on our invested media. The worldwide average selling price per unit increased 16% during the three months ended March 31, 2011 compared to the prior year period, resulting in a \$4.7 million increase in revenue, partially offset by a 5% decrease in units sold during the three months ended March 31, 2011 compared to the prior year period, resulting in a \$1.5 million decrease in revenue.

The downward trends in the U.S. could continue through the remainder of 2011. We are considering significant changes in our marketing, pricing, product and packaging to change the negative trends in the U.S. market.

*Kiosk*

Kiosk revenue was \$7.3 million for the three months ended March 31, 2011, a decrease of \$2.1 million, or 22%, from the three months ended March 31, 2010. The number of worldwide kiosks decreased slightly from 240 as of March 31, 2010 to 237 as of March 31, 2011. The number of units sold decreased 17% during the three months ended March 31, 2011 compared to the prior year period, resulting in a \$1.5 million decrease in revenue, primarily due to lower foot traffic and cannibalization as a result of the expansion of our distribution channels. We plan to continually review kiosk performance in 2011 and we may close our underperforming kiosk locations.

*Retail*

Retail revenue was \$2.6 million for the three months ended March 31, 2011, a decrease of \$7.0 million or 73% from the three months ended March 31, 2010. The number of units sold in the U.S. decreased 54% during the three months ended March 31, 2011, compared to the prior year period, resulting in a \$4.6 million decrease in revenue. The decline was due to lower than anticipated sales in our retail channel during the fourth quarter of 2010, which resulted in higher than normal inventory levels at the end of 2010 and lower restocking orders during the three months ended March 31, 2011. We are in the process of testing changes to the pricing of our products across all sales verticals in the U.S. market. While final results are not yet known, initial indications are that a reduction in the price of our products results in increased unit volume and revenue. Based on the test results to date, we have recorded a \$3.1 million reserve related to partial price protection that may be granted in the second quarter when the pricing strategy is implemented. The decrease in U.S. retail revenue was partially offset by a \$0.9 million increase in international retail revenue.

We are actively working to reduce our business and financial exposures by working with key partners on how we could modify the way we do business together. We are considering, among other changes, changes to credit limits, payment terms, or a change from terms to consignment. Discussions are in the early stages and the ultimate outcome is unknown. Any change in credit limits or payment terms would have no immediate impact, however a change from terms to consignment could result in recording a charge in the period of the change and the issuance of a credit to the retailer for existing inventory previously purchased on terms. Alternatively, a change from terms to consignment could



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result in a delay in the recognition of revenue on future shipments until existing inventory has been exhausted and sell through materializes. Or, if the credit quality of a partner deteriorates, we may move to delay the recording of bookings until we receive cash. We estimate the amount of the credits or delayed bookings could range from \$5 million to \$7 million.

*Home School*

For the three months ended March 31, 2011, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current year presentation.

Home school revenue was \$0.9 million for the three months ended March 31, 2011, a decrease of \$0.3 million or 24% from the three months ended March 31, 2010. In 2009, we began offering home school edition products through other sales channels, including direct-to-consumer call centers and our retail channels. As the availability of home school products in other sales channels increased during 2010, consumers began utilizing these new channels to make purchases. For the three months ended March 31, 2011, home school product sales through U.S. direct-to-consumer and retail channels increased by \$0.3 million, from the three months ended March 31, 2010.

*Institutional Segment*

Institutional revenue was \$14.3 million for the three months ended March 31, 2011, an increase of \$2.5 million, or 21%, compared to the three months ended March 31, 2010. The increase in institutional revenue was primarily due to the expansion of our direct sales force and a shift from sales of perpetual licenses to sales of renewing online subscriptions. As a result, we had a \$1.5 million increase in education revenue, a \$0.3 million increase in government revenue and a \$0.7 million increase in corporate and non-profit revenue in 2011, compared to the prior year period.

Product revenue represented 23% of total institutional revenue for the three months ended March 31, 2011, and subscription and service revenue represented 77% for the same period.

*Revenue by Product Revenue and Subscription and Service Revenue*

We categorize and report our revenue in two categories product revenue and subscription and service revenue. The following table sets forth revenue for products and subscription and services for the three months ended March 31, 2011 and 2010:

|                                  | Three months ended March 31, |                  | 2011 versus 2010  |          |
|----------------------------------|------------------------------|------------------|-------------------|----------|
|                                  | 2011                         | 2010             | Change            | % Change |
|                                  | (dollars in thousands)       |                  |                   |          |
| Product revenue                  | \$ 42,303                    | 74.2% \$ 53,734  | 85.3% \$ (11,431) | -21.3%   |
| Subscription and service revenue | 14,675                       | 25.8% 9,280      | 14.7% 5,395       | 58.1%    |
| Total revenue                    | \$ 56,978                    | 100.0% \$ 63,014 | 100.0% \$ (6,036) | -9.6%    |

*Product Revenue*

Product revenue decreased \$11.4 million, to \$42.3 million during the three months ended March 31, 2011 from \$53.7 million during the three months ended March 31, 2010. The number of consumer product units sold decreased 13% during the three months ended March 31, 2011, compared to the prior year period, resulting in a \$6.6 million decrease in hard product revenue. With the launch of Rosetta Stone Version 4 *TOTALe* in the U.S. consumer market during the third quarter of 2010, we began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual

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licenses of our Rosetta Stone Version 3 language learning solutions. Approximately 15% - 20% of each of these bundled sales is allocated to online services. As a result of the allocation of revenue to the online services component of our software, the consumer average product selling price per unit decreased by 10% during the three months ended March 31, 2011, compared to the prior year period, resulting in a \$4.2 million decrease in product revenue. Institutional product revenues decreased \$0.6 million as a result of a shift from sales of perpetual licenses to sales of renewing online subscriptions.

**Service and Support Revenue**

Subscription and service revenue increased approximately 58%, or \$5.4 million, to \$14.7 million for the three months ended March 31, 2011, from \$9.3 million during the three months ended March 31, 2010. The increase in subscription and service revenues was due to a \$2.3 million increase in consumer online service revenue related to Version 4 *TOTALe* and a \$3.1 million increase in institutional subscription and service revenue related to growth in the institutional customer base with renewing online subscriptions.

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

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the three months ended March 31, 2011 and 2010:

|  | Three months ended<br>March 31, |                  | 2011 versus 2010  |               |
|--|---------------------------------|------------------|-------------------|---------------|
|  | 2011                            | 2010             | Change            | % Change      |
| (dollars in thousands)                   |                                 |                  |                   |               |
| <b>Revenue</b>                           |                                 |                  |                   |               |
| Product                                  | \$ 42,303                       | \$ 53,734        | \$ (11,431)       | -21.3%        |
| Subscription and service                 | 14,675                          | 9,280            | 5,395             | 58.1%         |
| Total revenue                            | 56,978                          | 63,014           | (6,036)           | -9.6%         |
| <b>Cost of revenue</b>                   |                                 |                  |                   |               |
| Cost of product revenue                  | 8,795                           | 7,780            | 1,015             | 13.0%         |
| Cost of subscription and service revenue | 2,667                           | 862              | 1,805             | 209.4%        |
| Total cost of revenue                    | 11,462                          | 8,642            | 2,820             | 32.6%         |
| <b>Gross profit</b>                      | <b>\$ 45,516</b>                | <b>\$ 54,372</b> | <b>\$ (8,856)</b> | <b>-16.3%</b> |
| Gross margin percentages                 | 79.9%                           | 86.3%            | -6.4%             |               |

**Cost of Product Revenue**

Cost of product revenue for the three months ended March 31, 2011 was \$8.8 million, an increase of \$1.0 million, or 13%, from the three months ended March 31, 2010. As a percentage of product revenue, cost of product revenue increased to 21% for the three months ended March 31, 2011 compared to 15% for the three months ended March 31, 2010. The increase in cost was primarily attributable to \$0.7 million increase in expense for inventory obsolescence and scrap associated with the international Version 4 *TOTALe* launches, and a \$0.5 million increase in expense associated with product support activities. We are exploring the possibility of changing our packaging in 2011, which could result in an increase in the cost of our product revenue and additional charges as we replace the packaging in our sales channels.

Table of Contents**Cost of Subscription and Service Revenue**

Cost of subscription and service revenue for the three months ended March 31, 2011 was \$2.7 million, an increase of \$1.8 million, or 209% from the three months ended March 31, 2010. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 18% for the three months ended March 31, 2011 compared to 9% for the three months ended March 31, 2010. The increase in cost was primarily attributable to our web-based service offering in our Version 4 *TOTALe* product that includes a component of dedicated online language conversation coaching and higher direct costs to deliver to customers than our previous software solutions. We expect our cost of subscription and service revenue will increase in future periods, as a percent of revenue, associated with the launch of our Version 4 *TOTALe* solution in our international markets.

**Operating Expenses**

|                            | Three months ended<br>March 31, |           | 2011 versus 2010 |          |
|----------------------------|---------------------------------|-----------|------------------|----------|
|                            | 2011                            | 2010      | Change           | % Change |
|                            | (in thousands)                  |           |                  |          |
| Sales and marketing        | \$ 37,820                       | \$ 28,361 | \$ 9,459         | 33.4%    |
| Research and development   | 6,484                           | 5,470     | 1,014            | 18.5%    |
| General and administrative | 14,808                          | 13,643    | 1,165            | 8.5%     |
| Total operating expenses   | \$ 59,112                       | \$ 47,474 | \$ 11,638        | 24.5%    |

**Sales and Marketing Expenses**

Sales and marketing expenses for the three months ended March 31, 2011 were \$37.8 million, an increase of \$9.5 million, or 33%, from the three months ended March 31, 2010. As a percentage of total revenue, sales and marketing expenses were 66% for the three months ended March 31, 2011, compared to 45% for the three months ended March 31, 2010. The dollar and percentage increase in sales and marketing expenses were primarily attributable to the continued expansion of our direct marketing activities in the U.S. and international markets. Advertising and marketing expenses grew by \$5.6 million and were primarily related to increased cost of television media over the prior year due to declining yields on our media spend as a result of tightening media markets in the U.S., the U.K. and Germany, the launch of our new advertising campaign focused on promoting language learning and our brand, and an increase in internet marketing due to increased spending in online social media networks. Personnel-related costs related to growth in our institutional sales channel, non-kiosk consumer, and marketing and sales support activities increased by \$1.8 million over the prior year period. Consulting and outside clerical services expense in support of our marketing and sales support activities increased by \$1.1 million over the prior year period. Additionally, travel and training expense increased by \$0.5 million over the prior period as a result of increased travel in our institutional sales channel and global initiatives. The number of worldwide kiosks decreased from 240 as of March 31, 2010 to 237 as of March 31, 2011. We plan to continually evaluate our U.S. kiosk performance in 2011 to continue balancing the positive branding with the profitability of the kiosk, potentially closing underperforming kiosk locations. In the U.S. market we changed our media strategy to include advertising that promotes language learning and our brand. This change could increase our marketing expenses relative to revenue in future periods.

**Research and Development Expenses**

Research and development expenses were \$6.5 million for the three months ended March 31, 2011, an increase of \$1.0 million, or 19%, from the three months ended March 31, 2010. As a percentage of revenue, research and development expenses increased to 11% for the three months ended March 31,

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2011 compared to 9% for the three months ended March 31, 2010. The dollar and percentage increases were primarily attributable to increases in development personnel and consulting-related costs associated with the development of new products and services that are complementary to our existing solutions. We expect research and development expenses to increase in future periods as we continue to develop our English remediation solution for our Asian markets, invest in new digital platforms such as the iPad, roll out our Version 4 *TOTALe* product in our international markets, and support institutional development initiatives.

**General and Administrative Expenses**

General and administrative expenses for the three months ended March 31, 2011 were \$14.8 million, an increase of \$1.2 million, or 9%, from the three months ended March 31, 2010. As a percentage of revenue, general and administrative expenses increased to 26% for the three months ended March 31, 2011 compared to 22% for the three months ended March 31, 2010. The dollar and percentage increases were primarily attributable to a \$1.8 million increase in personnel-related costs due to expansion of our finance, legal, human resources, information technology and other administrative functions which enable continued support for our overall growth and international expansion. IT and infrastructure expenses increased \$1.2 million related to hardware and software upgrades, hosting, and telephone. Additionally, consulting expenses increased \$0.8 million primarily related to investment in our IT infrastructure and cost realignment initiatives. These increases were partially offset by a \$3.0 million decrease in legal fees associated with our trademark infringement lawsuit against Google, Inc. and other intellectual property enforcement actions. In 2011, we expect there will be increases to certain general and administrative expenses to support expansion into new international markets. However, we also are taking steps to reduce certain general and administrative expenses as we realign our resources with our business priorities.

**Interest and Other Income (Expense)**

|                        | Three months ended     |                | 2011 versus 2010 |          |
|------------------------|------------------------|----------------|------------------|----------|
|                        | March 31, 2011         | March 31, 2010 | Change           | % Change |
|                        | (dollars in thousands) |                |                  |          |
| Interest Income        | \$ 80                  | \$ 77          | \$ 3             | 3.9%     |
| Interest Expense       | (3)                    | (8)            | 5                | -62.5%   |
| Other Income (Expense) | 2                      | (8)            | 10               | -125.0%  |
| Total                  | \$ 79                  | \$ 61          | \$ 18            | 29.5%    |

Interest income represents interest earned on our cash and cash equivalents. Interest income for the three months ended March 31, 2011 was \$80,000, an increase of \$3,000, or 4%, from the three months ended March 31, 2010.

Interest expense is primarily related to our long-term debt, the outstanding balance of which was zero as of March 31, 2011, as well as interest related to our other operating leases. Interest expense for the three months ended March 31, 2011 was \$3,000, a decrease of \$5,000 or 63%, from the three months ended March 31, 2010. We expect interest expense to be minimal in future periods as we allowed the revolving line of credit with Wells Fargo to expire on January 17, 2011.

Other income for the three months ended March 31, 2011 was \$2,000 an increase of \$10,000 or 125% from the three months ended March 31, 2010. The increase was primarily due to an increase in trademark infringement awards compared to the prior year period.

Table of Contents**Income Tax Expense (Benefit)**

|                              | Three months<br>ended<br>March 31, |          | 2011 versus 2010 |          |
|------------------------------|------------------------------------|----------|------------------|----------|
|                              | 2011                               | 2010     | Change           | % Change |
|                              | (in thousands)                     |          |                  |          |
| Income tax expense (benefit) | \$ (4,236)                         | \$ 1,954 | \$ (6,190)       | -316.8%  |

Income tax expense (benefit) for the three months ended March 31, 2011 was (\$4.2) million, a decrease of \$6.2 million, or 317%, compared to the three months ended March 31, 2010. The decrease was the result of a decrease of \$20.5 million in pre-tax income for the three months ended March 31, 2011. Our effective tax rate increased to 31% for the three months ended March 31, 2011 compared to 28% for the three months ended March 31, 2010. The increase in our effective tax rate was a result of changes in the geographic distribution of our income.

**Liquidity and Capital Resources**

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

On January 16, 2009, we entered into a new secured credit agreement with Wells Fargo Bank, N.A., or Wells Fargo, that provided us with a \$12.5 million revolving line of credit. This revolving credit facility had a two-year term and the applicable interest rate is 2.5% above one month LIBOR. On January 17, 2011, the Company allowed its \$12.5 million revolving line of credit with Wells Fargo to expire.

We expect that our future growth will continue to require additional working capital. Our future capital requirements will depend on many factors, including development of new products, market acceptance of our products, the levels of advertising and promotion required to launch additional products and improve our competitive position in the marketplace, the expansion of our sales, support and marketing organizations, the establishment of additional offices in the United States and worldwide and building the infrastructure necessary to support our growth, the response of competitors to our products and our relationships with suppliers and clients. We have experienced increases in our expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase in the future. We believe that anticipated cash flows from operations will provide sufficient liquidity to fund our business and meet our obligations in the foreseeable future.

**Cash Flow Analysis*****Net Cash Provided By Operating Activities***

Net cash provided by operating activities was \$0.9 million for the three months ended March 31, 2011, compared to \$4.6 million for the three months ended March 31, 2010, a decrease of \$3.7 million. Net cash provided by operating activities was primarily generated from net income (loss) as adjusted for depreciation, amortization and stock compensation expense and collection of accounts receivable, offset in part by decreases in net liabilities. Net loss totaled \$9.3 million for the three months ended March 31, 2011 compared to net income of \$5.0 million for the three months ended March 31, 2010. For the three months ended March 31, 2011, we incurred depreciation, amortization and stock compensation expense in the amount of \$3.6 million, compared to \$2.3 million for the three months ended March 31, 2010. Accounts receivable decreased by \$18.3 million for the three months ended March 31, 2011, the result of increased collection efforts compared to a decrease of \$9.6 million for the

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three months ended March 31, 2010. This decrease was partially offset by a decrease in accounts payable of \$1.0 million primarily the result of more efficient cash management and the timing of cash expenditures, and a decrease in accrued compensation of \$2.9 million related to annual incentive payments. In the future, our cash flow management may not be successful in extending the timing of payments to vendors, which would then cause this cash flow benefit to reverse. If our efforts to reposition the U.S. consumer business are not successful, we would anticipate our cash flow from operations to decline for the remainder of 2011.

***Net Cash Used In Investing Activities***

Net cash used in investing activities was \$4.5 million for the three months ended March 31, 2011, compared to \$1.1 million for the three months ended March 31, 2010, an increase of \$3.4 million. Our investing activities during these periods primarily related to the purchase of property and equipment associated with the expansion of our information technology systems and our facilities as a result of our growth and international expansion, and the purchase of short-term investments.

***Net Cash Used In Financing Activities***

Net cash provided by financing activities was \$55,000 for the three months ended March 31, 2011 compared to net cash provided by financing activities of \$0.2 million for the three months ended March 31, 2010. Net cash provided by financing activities during the three months ended March 31, 2011 primarily related to proceeds received from stock option exercises.

We believe our current cash and cash equivalents, short term investments and funds generated from our operations will be sufficient to meet our working capital and capital expenditure requirements through 2011. Thereafter, we may need to raise additional funds through public or private financings or increased borrowings to develop or enhance products, to fund expansion, to respond to competitive pressures or to acquire complementary products, businesses or technologies. If required, additional financing may not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced and these securities might have rights, preferences and privileges senior to those of our current stockholders. No assurance can be given that additional financing will be available or that, if available, such financing can be obtained on terms favorable to our stockholders and us.

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

***Off-Balance Sheet Arrangements***

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

***Contractual Obligations***

The following table summarizes our contractual obligations at March 31, 2011 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

|                             | Total     | Less than<br>1 Year | 1 - 3 Years    | 3 - 5 Years | More than<br>5 Years |
|-----------------------------|-----------|---------------------|----------------|-------------|----------------------|
|                             |           |                     |                |             |                      |
|                             |           |                     | (in thousands) |             |                      |
| Operating lease obligations | \$ 10,933 | \$ 6,076            | \$ 4,381       | \$ 476      | \$                   |
| Total                       | \$ 10,933 | \$ 6,076            | \$ 4,381       | \$ 476      | \$                   |

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We anticipate that we will experience an increase in our capital expenditures and lease commitments consistent with our anticipated growth in operations, infrastructure and personnel during the remainder of 2011.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

*Foreign Currency Exchange Risk*

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

*Interest Rate Sensitivity*

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

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Our management, with the participation of our Chief Executive Officer and our Principal Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2011. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2011, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

*Changes in Internal Control over Financial Reporting*

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) or 15d-15(d) of the Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

In July 2009, we filed a lawsuit in the United States District Court for the Eastern District of Virginia against Google Inc., seeking, among other things, to prevent Google from infringing upon our trademarks. In August 2010, the U.S. District Court for the Eastern District of Virginia issued its final order dismissing our trademark infringement lawsuit against Google. We appealed the District Court's decision to the U.S. Court of Appeals for the Fourth Circuit. We have incurred, and may continue to incur material legal fees and other costs and expenses in pursuit of our claims against Google.

On or about April 28, 2010, a purported class action lawsuit was filed against us in the Superior Court of the State of California, County of Alameda for damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and other persons similarly situated who are or were employed as salaried managers by us in our retail locations in California are due unpaid wages and other relief for our violations of state wage and hour laws. Plaintiffs moved to amend their complaint to include a nationwide class on January 21, 2011. On March 16, 2011, the case was removed to the United States District Court for the Northern District of California, Oakland Division. We intend to vigorously defend this matter. However, we cannot predict the timing and the ultimate outcome of this matter. Even if the plaintiffs are unsuccessful in their claims against us, we will incur legal fees and other costs in the defense of these claims.

On or about March 24, 2011, a purported securities class action lawsuit was filed on behalf of persons who purchased our publicly traded securities between February 25, 2010 and February 28, 2011 against the Company and certain of our present and former officers in the United States District Court for the Eastern District of Virginia alleging violations of federal securities law in connection with various public statements and alleged material omissions made by us. The complaint names as defendants Rosetta Stone Inc., Tom P.H. Adams, President and Chief Executive Officer, Brian D. Helman, former Chief Financial Officer, and Matthew C. Sysak, Vice President and Controller. We intend to vigorously defend this matter. However, we cannot predict the timing and ultimate outcome of this case. Even if the plaintiffs are unsuccessful in their claims against us, we will incur legal fees and other costs in the defense of these claims.

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

**Item 1A. Risk Factors**

There have been no material changes to our risk factors contained in our Annual Report on Form 10-K filed on March 14, 2011 with the U.S. Securities and Exchange Commission for the period ended December 31, 2010. For a further discussion of our Risk Factors, refer to the "Risk Factors" discussion contained in our Annual Report on Form 10-K for the period ended December 31, 2010.

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

None

**Item 3. Defaults Upon Senior Securities**

None



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**Item 5. Other Information**

None

**Item 6. Exhibits**

**Exhibits**

- 3.1(1) Second Amended and Restated Certificate of Incorporation of the Company.
  - 3.2(1) Second Amended and Restated Bylaws of the Company.
  - 4.1(1) Specimen certificate evidencing shares of Common Stock of the Company.
  - 4.3(1) Registration Rights Agreement dated January 4, 2006 among the Company and the Investor Shareholders and other Shareholders listed on Exhibit A thereto.
  - 31.1\* Certification of Chief Executive Officer Pursuant to Rule 13-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2\* Certification of Chief Financial Officer Pursuant to Rule 13-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1\*\* Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2\*\* Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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\*  
Filed herewith

\*\*  
Furnished herewith

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

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**SIGNATURES**

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

**ROSETTA STONE INC.**

/s/ STEPHEN M. SWAD

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Stephen M. Swad  
*Chief Financial Officer*  
*(Principal Financial Officer and Duly*  
*Authorized Signatory)*

Date: May 9, 2011