

ROSETTA STONE INC
Form 10-Q
August 11, 2009

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2009

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)

**1919 North Lynn St., 7th Fl,
Arlington, Virginia**
(Address of Principal Executive Offices)

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

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 July 23, 2009, 20,342,252 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)**

	June 30, 2009	December 31, 2008
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 66,173	\$ 30,626
Restricted cash	62	34
Accounts receivable (net of allowance for doubtful accounts of \$1,137 and \$1,103, respectively)	25,172	26,497
Inventory, net	6,581	4,912
Prepaid expenses and other current assets	7,117	6,598
Income tax receivable	7,133	
Deferred income taxes	2,282	2,282
Total current assets	114,520	70,949
Property and equipment, net	17,962	15,727
Goodwill	34,199	34,199
Intangible assets, net	10,611	10,645
Deferred income taxes	6,828	6,828
Other assets	753	470
Total assets	\$ 184,873	\$ 138,818
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 3,229	\$ 3,207
Accrued compensation	6,352	8,570
Other current liabilities	19,888	21,353
Deferred revenue	16,379	14,382
Current maturities of long-term debt related party (Note 8)		4,250
Total current liabilities	45,848	51,762
Long-term debt related parties (Note 8)		5,660
Deferred revenue	1,841	1,362
Other long-term liabilities	818	963
Total liabilities	48,507	59,747
Commitments and contingencies (Note 12)		
Stockholders' equity:		
Class A, Series A-1 Convertible Preferred Stock, \$0.001 par value; zero and 269 shares authorized; zero and 269 shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively		26,876
Class A, Series A-2 Convertible Preferred Stock, \$0.001 par value; zero and 178 shares authorized; zero and 178 shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively		17,820
Class B Convertible Preferred Stock, \$0.001 par value; zero and 115 shares authorized; zero and 111 issued and outstanding at June 30, 2009 and December 31, 2008, respectively		11,341

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Preferred Stock, \$0.001 par value; 10,000 and zero shares authorized; zero and zero shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively

Class A Convertible Common Stock, \$0.00005 par value; zero and 900 shares authorized; zero and zero shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively

Class B Convertible Common Stock, \$0.00005 par value; zero and 20,000 shares authorized; zero and zero shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively

Non-designated common stock, \$0.00005 par value, 190,000 and 39,100 shares authorized; 20,342 and 1,936 shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively

	2	1
Additional paid-in capital	128,264	10,814
Accumulated income	8,326	12,422
Accumulated other comprehensive loss	(226)	(203)

Total stockholders' equity	136,366	79,071
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Total liabilities and stockholders' equity	\$ 184,873	\$ 138,818
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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 June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(unaudited)		(unaudited)	
Revenue:				
Product	\$ 48,672	\$41,630	\$ 91,512	\$71,848
Subscription and service	7,788	6,112	15,233	11,479
Total revenue	56,460	47,742	106,745	83,327
Cost of revenue:				
Cost of product revenue	7,193	5,968	13,136	9,998
Cost of subscription and service revenue	509	577	994	1,083
Total cost of revenue	7,702	6,545	14,130	11,081
Gross profit	48,758	41,197	92,615	72,246
Operating expenses				
Sales and marketing	27,147	21,737	50,759	39,782
Research and development	10,101	3,758	14,944	8,290
General and administrative	23,167	8,856	33,054	17,384
Total operating expenses	60,415	34,351	98,757	65,456
Income (loss) from operations	(11,657)	6,846	(6,142)	6,790
Other income and (expense):				
Interest income	23	98	54	314
Interest expense	(24)	(225)	(339)	(521)
Other income (expense)	(61)	(175)	35	112
Total other expense	(62)	(302)	(250)	(95)
Income (loss) before income taxes	(11,719)	6,544	(6,392)	6,695
Income tax (benefit) provision	(4,427)	3,183	(2,295)	3,766
Net income (loss)	\$ (7,292)	\$ 3,361	\$ (4,097)	\$ 2,929
Earnings (loss) per share:				
Basic	\$ (0.42)	\$ 1.77	\$ (0.42)	\$ 1.56
Diluted	\$ (0.42)	\$ 0.20	\$ (0.42)	\$ 0.17
Common shares and equivalents outstanding:				
Basic weighted average shares	17,370	1,899	9,698	1,881
Diluted weighted average shares	17,370	16,827	9,698	16,815

See accompanying notes to condensed consolidated financial statements.

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ROSETTA STONE INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30,	
	2009	2008
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ (4,097)	\$ 2,929
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:		
Stock-based compensation expense	20,114	742
Bad debt expense	141	346
Depreciation and amortization	2,494	3,376
Write down of deferred financing costs	209	52
Loss on disposal of equipment	21	12
Net change in:		
Restricted cash	(28)	332
Accounts receivable	1,316	(8,358)
Inventory	(1,641)	(2,585)
Prepaid expenses and other current assets	(7,707)	(781)
Other assets	(414)	(12)
Accounts payable and accrued expenses	22	(626)
Accrued compensation	(2,275)	(436)
Other current liabilities	(1,329)	1,418
Other long-term liabilities	(159)	
Deferred revenue	2,340	505
Net cash provided by (used in) operating activities	9,007	(3,086)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(4,905)	(3,034)
Net cash used in investing activities	(4,905)	(3,034)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from common stock issuance, net of issuance costs	49,192	
Proceeds from the exercise of stock options	85	214
Payment of payroll taxes on stock option exercises	(89)	
Payment of payroll taxes on net common stock issuance	(7,887)	
Proceeds from long-term debt	9,929	
Payments under capital lease obligations	(2)	(5)
Principal payments under long-term debt	(19,839)	(1,700)
Net cash provided by (used in) financing activities	31,389	(1,491)
Increase (decrease) in cash and cash equivalents	35,491	(7,611)
Effect of exchange rate changes in cash and cash equivalents	56	(122)
Net increase (decrease) in cash and cash equivalents	35,547	(7,733)
Cash and cash equivalents beginning of year	30,626	21,691
Cash and cash equivalents end of year	\$ 66,173	\$ 13,958
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	\$ 87	\$ 591

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Income taxes, net	\$ 6,169	\$ 2,865
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	\$ 840	\$ 583
Accrued liability of capital lease obligation on equipment	\$ 18	\$

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 subsidiaries ("Rosetta Stone," the "Company" or the "Successor") develop, market and support a suite of language learning solutions consisting of software, online services and audio practice tools primarily under the *Rosetta Stone* brand name. The Company's 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. Rosetta Stone Inc. has five wholly owned subsidiaries.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying 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 Prospectus filed pursuant to Rule 424(b) under the Securities and Exchange Act, as amended (the "Securities Act") with the SEC on April 16, 2009 (the "Prospectus"). The December 31, 2008 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 include all adjustments necessary for the fair presentation of the Company's statement of financial position at June 30, 2009 and December 31, 2008, the Company's results of operations, and its cash flows for the three and six months ended June 30, 2009 and 2008. The results for the three and six months ended June 30, 2009 are not necessarily indicative of the results to be expected for the year ending December 31, 2009. All references to June 30, 2009 or to the three and six months ended June 30, 2009 and 2008 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

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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. Revenue is recognized for software products and related services in accordance with the Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, and the Securities and Exchange Commission Staff Accounting Bulletin ("SAB") No. 101, *Revenue Recognition in Financial Statements*, as amended by SAB No. 104, *Revenue Recognition, Corrected Copy*.

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

Revenue is recognized from the sale of packaged software and audio practice products when the product has been delivered, assuming the remaining revenue recognition criteria have been met. Software products include sales to end user customers and resellers. In most cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products are recognized as the products are shipped and title passes. A limited amount of packaged software products are sold to resellers on a consignment basis. Revenue is recognized for these consignment transactions once the end-user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with Emerging Issue Task Force ("EITF") No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a reseller of the Vendor's Products)*, 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. Customers are permitted to make payments for packaged software purchases in installments over a period of time, which typically ranges between three and five months. Given that these installment payment plans are for periods less than twelve months and a successful collection history has been established, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met. Packaged software is provided to customers who purchase directly from us with a six-month right of return. We also allow our retailers to return unsold products, subject to some limitations. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 48, *Revenue Recognition When Right of Return Exists*, 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 EITF No. 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*. Revenue for online software subscriptions is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and twelve months. Some online licensing arrangements include a specified number of

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

licenses that can be activated over a period of time, which typically ranges between twelve and twenty-four months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and twelve months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement and the subscription services are made available to the customer. Amounts received in advance of revenue recognition are classified as deferred revenue.

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 from the sale of packaged software products with specific upgrade rights is recognized in accordance with SOP 97-2, *Software Revenue Recognition*. Revenue recognition for these sales is deferred until the earlier of the point at which sufficient vendor-specific objective evidence ("VSOE") exist for the specific upgrade right or all elements of the arrangement have been delivered.

In accordance with EITF No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Product*, 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 multi-element contracts will be recognized ratably once the PCS and online hosting periods begin, over the longer of the PCS or online hosting period. When the current estimates of total contract revenue and contract cost indicate a loss for a fixed fee arrangement, a provision for the entire loss on the contract is recorded.

Stock Split

On March 23, 2009, in connection with the Company's initial public offering of common stock, the Board of Directors approved a 1.3-to-1 split of common stock to stockholders of record as of such date. All references to the number of common shares and per share amounts have been restated as appropriate to reflect the effect of the split for all periods presented.

Intellectual Property Indemnities

The Company indemnifies certain institutional customers against third party claims of intellectual property rights infringement related to the Company's products. The Company has not incurred any

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

costs or accrued any liabilities as a result of such obligations. Given that the amount of any potential liabilities related to such indemnities cannot be determined until an infringement claim has been made, the Company is unable to determine the maximum amount of losses that it could incur related to such indemnifications. Historically, any amounts payable pursuant to such intellectual property indemnifications have not had a material effect on the Company's business, financial condition or results of operations.

Income Taxes

Income taxes are accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes* ("SFAS No. 109"), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax basis of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The impact of tax rate changes on deferred tax assets and liabilities is recognized in the year that the change is enacted.

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payments* ("SFAS No. 123(R)"), which was adopted by the Company effective January 1, 2006. Under SFAS No. 123(R), 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.

During the six months ended June 30, 2009, 458,579 stock options were granted at a weighted average exercise price of \$18.16 per share. The aggregate grant date fair value of options issued during the period was \$4.7 million, which will be recognized over the requisite service period of the options, which is also the vesting period. During the six months ended June 30, 2009 and 2008, 18,797 and 67,149 stock options were exercised, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2009 and 2008 was approximately \$277,000 and \$497,000, respectively.

During the six months ended June 30, 2009, 169,225 shares of restricted stock were granted. The aggregate grant date fair value of the awards was \$3.1 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. The Company did not grant any restricted stock prior to April 2009.

During the six months ended June 30, 2009, 8,772 restricted stock units were granted. The aggregate grant date fair value of the awards was \$158,000, which was recognized as expense on the grant date, as the awards were immediately vested. The Company's restricted stock unit awards are accounted for as equity awards. The grant date fair value is based on the market price of the

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Company's common stock at the date of grant. The Company did not grant any restricted stock units prior to April 2009.

During the six months ended June 30, 2009, our Board of Directors awarded 10 of our key employees a total of 591,491 shares of common stock. This grant is net of the number of shares required to be withheld to satisfy the federal, state and local tax withholding obligations, which were paid by the Company to the respective taxing authorities in cash. Thus, we refer to the grant as a "net issuance." The aggregate grant date fair value of the awards was \$18.5 million, which was recognized as expense on the grant date, as the grants were immediately vested.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. For the six months ended June 30, 2009 and 2008, the fair value of options granted was calculated using the following assumptions:

	Six Months Ended June 30,	
	2009	2008
Expected stock price volatility	61.1% - 61.2%	60.4% - 62.10%
Expected term of options	6 years	6 years
Expected dividend yield		
Risk-free interest rate	1.71% - 2.46%	2.69% - 3.36%

Since the Company's stock has historically not been publicly quoted 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.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Cost of revenue	\$ 9	\$	\$ 11	\$ 1
Sales and marketing	581	36	635	69
Research and development	5,228	137	5,375	217
General and administrative	13,820	236	14,093	455
Total	\$19,638	\$409	\$20,114	\$742

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 reconciliation of the changes in cash and cash equivalents during the period.

Comprehensive income (loss) consisted of the following (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net income (loss)	\$(7,292)	\$3,361	\$(4,097)	\$2,929
Foreign currency translation loss	43	141	(23)	(106)
Total comprehensive income (loss)	\$(7,249)	\$3,502	\$(4,120)	\$2,823

Recently Issued Accounting Standards

In February 2008, the FASB issued FASB Staff Position FAS 157-1, *Application of FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 1* ("FSP 157-1") and FASB Staff Position FAS 157-2, *Effective Date of FASB Statement No. 157* ("FSP 157-2"). The provisions of SFAS No. 157, *Fair Value Measurements* ("SFAS 157"), which provide guidance for, among other things, the definition of fair value and the methods used to measure fair value, were adopted January 1, 2008 for financial instruments. The provisions adopted in 2008 did not have an impact on the Company's financial statements. FSP 157-1 and FSP 157-2 collectively delay the effective date of SFAS No. 157 for all nonrecurring fair value measurements of nonfinancial assets and liabilities (except for those that are recognized or disclosed at fair value in the financial statements on a recurring basis) until fiscal years beginning after November 15, 2008, and changed the scope of SFAS 157. On January 1, 2009 the Company adopted the provisions in SFAS 157 for nonrecurring fair value measurements of nonfinancial assets and liabilities. The provisions adopted in the first quarter of 2009 did not have an impact on the Company's financial statements as the Company did not have any fair value measurements of nonfinancial assets and liabilities as of June 30, 2009.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* ("SFAS No. 141(R)"), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

nature and financial effects of the business combination. SFAS No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. The Company will assess the impact of SFAS No. 141(R) if and when a future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* ("SFAS No. 160"). SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS No. 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of SFAS No. 160 did not have a material impact on the Company's financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133* ("SFAS No. 161"). SFAS No. 161 requires enhanced disclosures about an entity's derivative and hedging activities. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. The adoption of SFAS No. 161 did not have a significant impact on the Company's financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ("SFAS No. 162"). SFAS No. 162 identifies the sources of accounting principles and provides the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS No. 162 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 162 did not have significant impact on the Company's financial position, results of operation, or cash flows.

On October 10, 2008, the FASB issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active*. The FSP was effective upon issuance, including periods for which financial statements have not been issued. The FSP clarified the application of SFAS No. 157 in an inactive market and provided an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. The adoption of this FSP did

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

not have a material impact on the Company's consolidated financial position and the results of operations.

In April 2009, the FASB issued FASB Staff Position FAS 157-4, *Determining Fair Value When Volume or Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ("FSP 157-4"). FSP 157-4 provides guidance on how to determine the fair value of assets and liabilities when the volume and level of activity for the asset or liability has significantly decreased. FSP 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly. In addition, FSP 157-4 requires disclosure in interim and annual periods of the inputs and valuation methods used in determining fair value and a discussion of any changes in those valuation methods. FSP 157-4 is effective for annual and interim periods ending on or after June 15, 2009. The adoption of this FSP did not have a material impact on the Company's consolidated financial position and the results of operations.

On May 28, 2009, the FASB issued Statement No. 165, *Subsequent Events* ("SFAS No. 165"). Although SFAS No. 165 does not significantly change current practice surrounding the disclosure of subsequent events, it provides guidance on management's assessment of subsequent events and the requirement to disclose the date through which subsequent events have been evaluated. SFAS No. 165 became effective for the quarter ended June 30, 2009. The Company has evaluated subsequent events through August 10, 2009 for this quarterly report on Form 10-Q for the quarter ended June 30, 2009. The adoption of SFAS No. 165 did not have any impact on the Company's consolidated financial position or results of operations.

On June 12, 2009, the FASB issued Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* ("SFAS No. 167"). SFAS No. 167 modifies the existing quantitative guidance used in determining the primary beneficiary of a variable interest entity ("VIE") by requiring entities to qualitatively assess whether an enterprise is a primary beneficiary, based on whether the entity has (i) power over the significant activities of the VIE, and (ii) an obligation to absorb losses or the right to receive benefits that could be potentially significant to the VIE. SFAS No. 167 becomes effective for all new and existing VIEs on January 1, 2010. The adoption of SFAS No. 167 will not have a material effect on our consolidated financial statements.

On June 29, 2009, the FASB issued Statement No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - A Replacement of FASB Statement No. 162* ("SFAS No. 168"). SFAS No. 168 establishes the FASB Accounting Standards Codification (the "Codification") as the primary source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC are also sources of authoritative GAAP for SEC registrants. SFAS No. 168 and the Codification become effective on September 30, 2009. When effective, the Codification will supersede all existing non-SEC accounting and reporting standards and the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead, the FASB will issue Accounting Standards Updates, which will serve only to: (a) update the Codification; (b) provide background information about the guidance; and (c) provide the basis for conclusions on the change(s) in the Codification. The adoption of SFAS No. 168 and the Codification on September 30, 2009 will not have a material effect on our consolidated financial statements.

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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 SFAS No. 128, *Earnings Per Share* ("SFAS No. 128"). Basic income (loss) per share is computed using net income (loss) and the weighted average number of common shares outstanding. Diluted earnings per share reflect the weighted average number of common shares 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 preferred shares. Common equivalent shares are excluded from the diluted computation if their effect is anti-dilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(dollars in thousands, except per share amounts)			
<i>Numerator:</i>				
Net income (loss)	\$ (7,292)	\$ 3,361	\$ (4,097)	\$ 2,929
<i>Denominator:</i>				
Weighted average number of common shares:				
Basic	17,370	1,899	9,698	1,881
Diluted	17,370	16,827	9,698	16,815
Income (loss) per common share:				
Basic	\$ (0.42)	\$ 1.77	\$ (0.42)	\$ 1.56
Diluted	\$ (0.42)	\$ 0.20	\$ (0.42)	\$ 0.17

For the three and six months ended June 30, 2009 and 2008, the following common equivalent shares were included in the calculation of the Company's diluted net income per share (in thousands), respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
<i>Equity instruments:</i>				
Convertible preferred stock		14,508		14,508
Restricted common stock units				
Restricted common stock				
Stock options		420		426
Total common stock equivalent shares		14,928		14,934

For the three and six months ended June 30, 2009, convertible preferred stock, outstanding stock options, restricted stock units and restricted stock of 14.5 million, 2.1 million, 9,000, and 168,000, 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)

4. INVENTORY

Inventory consisted of the following (dollars in thousands):

	June 30, 2009	December 31, 2008
Raw materials	\$ 4,669	\$ 3,023
Finished goods	2,938	2,359
	7,607	5,382
Reserve for obsolete inventory	(1,026)	(470)
Inventory, net	\$ 6,581	\$ 4,912

5. GOODWILL

The Company acquired Rosetta Stone Ltd. (formerly Fairfield & Sons, Ltd.) and its subsidiary, Rosetta Stone (UK) Limited (formerly Fairfield & Sons UK Limited), on January 4, 2006. As a result of the acquisition, the Company recorded goodwill in the amount of \$34.2 million. The Company had no acquisition activity during 2007, 2008 or the six months ended June 30, 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 SFAS No. 142, *Goodwill and Other Intangibles*. 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 during the years ended December 31, 2007, 2008 or the six months ended June 30, 2009. For tax purposes, the goodwill balance of \$34.2 million will be amortized over a period of 15 years.

6. INTANGIBLE ASSETS

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

	June 30, 2009			December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trade name / trademark	\$ 10,607	\$	\$ 10,607	\$ 10,607	\$	\$ 10,607
Core technology	2,453	(2,453)		2,453	(2,453)	
Customer relationships	10,739	(10,739)		10,739	(10,706)	33
Website	12	(8)	4	12	(7)	5
Total	\$23,811	\$ (13,200)	\$ 10,611	\$23,811	\$ (13,166)	\$ 10,645

Amortization of intangible assets for the six months ended June 30, 2009 and 2008 totaled \$33,000 and \$1.5 million, respectively. For the six months ended June 30, 2009 and 2008, zero and \$13,000 of amortization expense was included in cost of revenue, and \$33,000 and \$1.5 million was included in sales and marketing, respectively.

Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****6. INTANGIBLE ASSETS (Continued)**

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining six months of 2009 and years thereafter (dollars in thousands):

2009 remaining	\$ 1
2010	3
Total	\$ 4

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, ("SFAS No. 144"), 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 six months ended June 30, 2009 or June 30, 2008.

7. OTHER CURRENT LIABILITIES

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

	June 30, 2009	December 31, 2008
Marketing expenses	\$ 7,423	\$ 4,803
Professional and consulting fees	1,014	2,249
Sales return reserve	2,674	3,229
Taxes payable	1,200	2,859
Other	7,577	8,213
	\$ 19,888	\$ 21,353

8. BORROWING AGREEMENT

On January 4, 2006, the Company entered into a Credit Agreement with Madison Capital that provides the Company a \$4.0 million revolving credit facility ("Revolver") and a \$17.0 million term loan ("Term Loan"). The Credit Agreement was amended on August 2, 2007 and April 23, 2008 to amend certain covenants, terms, and definitions. Under the credit agreement, all amounts outstanding under the Revolver and the Term Loan accrue interest at the Base Rate plus the Applicable Margin or the LIBOR Rate plus the Applicable Margin, as specified by the Company. As of December 31, 2008, the interest rate on the term loan was 4.65%.

On January 16, 2009, the Company entered into a new credit agreement with Wells Fargo Bank, N.A. ("Wells Fargo") that provides the Company with a \$12.5 million revolving line of credit. This revolving credit facility has a two-year term and the applicable interest rate is 2.5% above one month LIBOR, or approximately 2.81% as of June 30, 2009. 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

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

8. BORROWING AGREEMENT (Continued)

result, the Company has no borrowings owed to Madison Capital under either their term loan or revolving credit facility, and the Company has 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 is available to the Company for borrowing.

Long-term borrowings consisted of the following (dollars in thousands):

	June 30, 2009	December 31, 2008
Term Loan, Madison Capital		\$ 9,910
Revolver, Wells Fargo Bank, N.A.		
		9,910
Less current portion		(4,250)
Total		\$ 5,660

Certain of the Company's assets are pledged as collateral to secure any borrowings by the Company under the credit agreement with Wells Fargo. The line of credit contains financial covenants tested on a quarterly basis and are applicable for the term of the loan. The primary covenants under the line of credit are limitations on liens and encumbrances, restrictions on investments, limitations on the sale of certain assets, and a minimum liquidity threshold. In addition, the Company is required to provide a quarterly report to the lender within 45 days following the end of a quarter, and an audited annual report 120 days following the close of the fiscal year. Non-compliance with debt covenants are considered events of default and could result in the line of credit becoming immediately due and/or being terminated.

Interest expense for the six months ended June 30, 2009 and 2008 was \$0.3 million and \$0.5 million, respectively.

9. INCOME TAXES

In accordance with SFAS No. 109 and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, the income tax provision for the six month period ended June 30, 2009 is based on the estimated annual effective tax rate for fiscal year 2009. 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.

The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* ("FIN No. 48") on January 1, 2007. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN No. 48 prescribes a recognition threshold and measurement

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(UNAUDITED)

9. INCOME TAXES (Continued)

attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

At the adoption date and as of June 30, 2009, the Company had no material unrecognized tax benefits and no adjustments to liabilities or operations were required under FIN No. 48. The Company's practice is to recognize interest and penalty expense related to uncertain tax positions in income tax expense, which were zero at the adoption date and for the six months ended June 30, 2009.

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 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 of 2,137,200 as of December 31, 2008. The stock options granted under the Stock 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 June 30, 2009 there were 1,899,947 shares available for future grant under the 2009 Plan.

In accordance with SFAS No. 123(R), the fair value of stock-based awards to employees is calculated as of the date of grant. Compensation expense is then recognized on a straight-line basis over the requisite service period of the award. 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.

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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 stock option activity from January 1, 2009 to June 30, 2009:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2009	1,657,799	\$ 6.48	8.05	\$ 18,268,386
Options granted	458,579	18.16		
Options exercised	(18,797)	4.50		
Options cancelled	(33,321)	10.33		
Options Outstanding, June 30, 2009	2,064,260	9.03	8.05	38,011,699
Vested and expected to vest at June 30, 2009	1,919,712	8.48	7.95	36,399,700
Exercisable at June 30, 2009	891,492	4.98	7.25	20,025,743

As of June 30, 2009, there was approximately \$8.5 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 2.57 years. During the six months ended June 30, 2009, 169,225 shares of restricted stock were granted. The aggregate grant date fair value of the awards was \$3.1 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 six months ended June 30, 2009, there were 1,128 shares of restricted stock that were forfeited. As of June 30, 2009, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the statement of operations was \$2.9 million and is expected to be recognized over a period of 3.41 years.

The following table summarized the Company's restricted stock award activity from January 1, 2009 to June 30, 2009:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards January 1, 2009			
Awards granted	169,225	\$ 18.40	
Awards vested			
Awards cancelled	(1,128)	18.00	
Nonvested Awards, June 30, 2009	168,097	18.40	\$ 1,519,597

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 FASB Staff Position No. 123(R)-3 as Amended, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*, ("FSP 123(R)-3").

Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****11. STOCKHOLDERS' EQUITY**

At June 30, 2009, 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.

On February 28, 2008, the Company changed the par value of its Common Stock from \$0.001 to \$0.00005 per share. At June 30, 2009, 20,342,252 shares of Common Stock were issued and outstanding.

On March 23, 2009, in connection with the Company's initial public offering of common stock, the Board of Directors approved a 1.3-to-1 split of common stock to stockholders of record as of such date. All references to the number of common shares and per share amounts have been restated as appropriate to reflect the effect of the split for all periods presented.

On April 21, 2009, in conjunction with our qualified underwritten initial public offering of common stock, our total outstanding preferred shares in the amount of 557,989 automatically converted at a ratio of 26:1 into 14,507,714 shares of Common Stock. At June 30, 2009, the Company had no preferred shares outstanding.

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. Rent expense was \$5.3 million and \$3.7 million for the six months ended June 30, 2009 and 2008, respectively.

The following table summarizes future minimum operating lease payments for the remaining six months of 2009 and the years thereafter (dollars in thousands):

Periods Ending December 31,	
2009 remaining	\$ 3,334
2010	3,798
2011	3,078
2012	1,907
2013	1,724
2014 and thereafter	199
	\$14,040

The Company accounts for its leases under the provisions of SFAS No. 13, *Accounting for Leases*, 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 \$0.5 million at June 30, 2009. The deferred rent asset was \$23,000 at

Table of Contents**ROSETTA STONE INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(UNAUDITED)****12. COMMITMENTS AND CONTINGENCIES (Continued)**

June 30, 2009. The deferred rent asset is classified in prepaid and other current assets as all associated leases have less than one year remaining on their term.

On October 6, 2008, the Company entered into an operating sublease agreement (the "Lease") for additional office space in Arlington, Virginia. The Lease is for a five year period terminating on December 31, 2013 with total rental payments of \$7.5 million. Rents range from \$117,000 per month for the first year of the Lease term to \$132,000 per month in the final year of the Lease term. The Company provided the landlord a security deposit of \$352,000 in the form of a letter of credit. The Company has the option to renew this Lease for an additional three-year period.

The Company exited its facility at 1101 Wilson Boulevard, Arlington, Virginia in December 2008 as a result of a relocation of its headquarters to 1919 North Lynn Street, Arlington, Virginia. The Company estimated its liability under operating lease agreements and accrued exit costs in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, as the leases associated with this facility do not terminate until December 31, 2009 and August 31, 2013, respectively. Accrued exit costs associated with the headquarters relocation were charged to lease abandonment expense in December 2008.

The following table summarizes the accrued exit costs for the 1101 Wilson Boulevard facility at June 30, 2009 (dollars in thousands):

Accrued exit costs, beginning of period	\$ 1,676
Costs incurred and charged to expense	15
Principal reductions	(333)
Accrued exit costs, end of period	\$ 1,358
Accrued exit cost liability:	
Short-term	\$ 553
Long-term	805
Total	\$ 1,358

Litigation

The Company is involved in various litigation matters arising out of the normal course of business. In the opinion of management, the amount of liability, if any, resulting from the final resolution of these matters will not have a material adverse impact on the Company's results of operations, financial position and cash flows.

13. SEGMENT INFORMATION

The Company operates as one reportable segment as the principal business activity relates to selling language learning software. The chief operating decision maker, the Chief Executive Officer, evaluates the performance of the Company based upon consolidated software revenues.

Products and services are sold primarily in the United States, but also include sales through direct and indirect sales channels in other countries, primarily in Japan and Europe. Less than 6% of the Company's revenues were generated from sales outside of the United States for the six months ended June 30, 2009. As of June 30, 2009 the Company had \$0.8 million of long-lived assets held outside of the United States.

No single customer accounted for more than 10% of the Company's revenue for the six months ended June 30, 2009.

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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 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 Quarterly Report on Form 10-Q 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," "plan," "project," "seek," "should," "target," "will," "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." 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.

Overview

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

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages, which have enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 86% of our revenue for the six months ended June 30, 2009 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Apple, Barnes & Noble and Borders.

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

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

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

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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.

Product revenue consists of revenue from sales of our packaged software and audio products. Subscription and service revenue consists primarily of revenue from our online software subscriptions. The content of our packaged software and subscription offerings are the same. We simply offer our customers the ability to choose which format they prefer without differentiating the learning experience.

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

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Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2008 accounted for 32% of our annual revenue in 2008. Our institutional revenue is seasonally stronger in the second and third quarters of the calendar year due to education, home school and government purchasing cycles. We expect these trends to continue.

Cost of Revenue

Cost of product revenue consists of the direct and indirect materials and labor costs to produce and distribute our products. Such costs include packaging materials, computer headsets, freight, inventory receiving, personnel costs associated with product assembly, third-party royalty fees and inventory storage, obsolescence and shrinkage. Cost of subscription and service revenue primarily represents costs associated with supporting our online language learning service, which includes hosting costs and depreciation. We also include the cost of credit card processing and customer technical support in both cost of product revenue and cost of subscription and service revenue. We expect our cost of revenue to increase in absolute dollars in future periods as our unit sales continue to grow. Cost of revenue may also increase as a percentage of revenue in future periods as we are planning to release service offerings that will have higher direct costs to deliver to customers.

Operating Expenses

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

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

Sales and Marketing. Our sales and marketing expenses consist primarily of direct advertising expenses related to television, print, radio, online and other direct marketing activities, personnel costs for our sales and marketing staff, rental payments for our kiosks and commissions paid to our sales personnel. Sales and marketing expenses also include amortization expense of intangible assets related to customer relationships associated with the 2006 acquisition of Fairfield & Sons, Ltd. These intangible assets were fully amortized by January 2009. In 2007, we began to make significant investments to expand our sales and marketing operations in Europe and Japan. We established local sales offices and call centers, added employees and launched marketing and public relations campaigns within each 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, higher insurance premiums and

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compliance costs in connection with Section 404 of the Sarbanes-Oxley Act of 2002. We also intend to increase administrative expenses as a result of our planned international expansion.

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

Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Interest expense is related to our long-term debt, the outstanding balance of which was zero as of June 30, 2009. We expect interest expense to decrease in future periods as we paid off the entire balance of our outstanding long-term debt with proceeds from our initial public offering in April 2009. Interest income represents interest received on our cash and cash equivalents.

Income Tax Expense

Income tax expense consists of federal and state income taxes in the United States. For the six months ended June 30, 2009, our effective tax rate in the United States was approximately 38%, although operating results of our international subsidiaries, in combination with our loss in the United States, lowered our worldwide effective tax rate to 36%. We expect our worldwide rate to be approximately 40% in 2009 and beyond assuming no general increase in U.S. federal or state income tax rates applicable to companies such as ours. However, we expect our income tax expense to increase in absolute dollars as our income continues to grow.

Critical Accounting Policies and Estimates

In presenting our financial statements in conformity with accounting principles generally accepted in the United States, 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.

There have been no material changes to our critical accounting policies. For further information on our critical and other significant accounting policies, see our Prospectus filed pursuant to Rule 424(b) under the Securities Act with the SEC on April 16, 2009.

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

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

	Three months ended June 30,		2009 versus 2008 %		Six months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change	2009	2008	Change	Change
(dollars in thousands)								
Revenue								
Product	\$ 48,672	\$41,630	\$ 7,042	16.9%	\$ 91,512	\$71,848	\$ 19,664	27.4%
Subscription and service	7,788	6,112	1,676	27.4	15,233	11,479	3,754	32.7
Total revenue	56,460	47,742	8,718	18.3	106,745	83,327	23,418	28.1
Cost of revenue								
Cost of product revenue	7,193	5,968	1,225	20.5	13,136	9,998	3,138	31.4
Cost of subscription and service revenue	509	577	(68)	-11.8	994	1,083	(89)	-8.2
Total cost of revenue	7,702	6,545	1,157	17.7	14,130	11,081	3,049	27.5
Gross profit	48,758	41,197	7,561	18.4	92,615	72,246	20,369	28.2
Operating Expenses:								
Sales and marketing	27,147	21,737	5,410	24.9	50,759	39,782	10,977	27.6
Research and development	10,101	3,758	6,343	168.8	14,944	8,290	6,654	80.3
General and administrative	23,167	8,856	14,311	161.6	33,054	17,384	15,670	90.1
Total operating expenses	60,415	34,351	26,064	75.9	98,757	65,456	33,301	50.9
Income (loss) from operations	(11,657)	6,846	(18,503)	270.3	(6,142)	6,790	(12,932)	190.5
Other income and expense:								
Interest income	23	98	(75)	-76.5	54	314	(260)	-82.8
Interest expense	(24)	(225)	201	-89.3	(339)	(521)	182	-34.9
Other (expense) income	(61)	(175)	114	-65.1	35	112	(77)	-68.8
Total interest and other income (expense), net	(62)	(302)	240	-79.5	(250)	(95)	(155)	163.2
Income (loss) before income taxes	(11,719)	6,544	(18,263)	-279.1	(6,392)	6,695	(13,087)	-195.5
Income tax expense (benefit)	(4,427)	3,183	(7,610)	-239.1	(2,295)	3,766	(6,061)	-160.9
Net income (loss)	\$ (7,292)	\$ 3,361	\$ (10,653)	-317.0	\$ (4,097)	\$ 2,929	\$ (7,026)	-239.9

Table of Contents**Comparison of the three months ended June 30, 2009 and the three months ended June 30, 2008****Revenue**

	Three months ended June 30,				2009 versus 2008	
	2009		2008		Change	% Change
	(dollars in thousands)					
Product revenue	\$48,672	86.2%	\$41,630	87.2%	\$ 7,042	16.9%
Subscription and service revenue	7,788	13.8	6,112	12.8	1,676	27.4
Total revenue	\$56,460	100.0	\$47,742	100.0	\$ 8,718	18.3
<i>Revenue by sales channel:</i>						
Direct-to-consumer	\$25,944	46.0	\$20,691	43.3	\$ 5,253	25.4
Kiosk	9,279	16.4	8,017	16.8	1,262	15.7
Global retail	7,679	13.6	8,747	18.3	(1,068)	-12.2
Total consumer	42,902	76.0	37,455	78.5	5,447	14.5
Institutional	13,558	24.0	10,287	21.5	3,271	31.8
Total revenue	\$56,460	100.0	\$47,742	100.0	\$ 8,718	18.3

Our total revenue for the three months ended June 30, 2009 was \$56.4 million, an increase of \$8.7 million, or 18.3%, from the three months ended June 30, 2008.

Consumer

Consumer revenue was \$42.9 million for the three months ended June 30, 2009, an increase of \$5.4 million, or 14.5%, from the three months ended June 30, 2008. The increase in consumer revenue was attributable to a 26% increase in the average selling price of each unit, which accounted for an \$8.9 million increase in revenue, partially offset by a 9% decrease in unit sales, which resulted in a \$3.5 million decrease in revenue. The reduction in unit volume was due primarily to discontinuation of our entry level three-month online subscription offering in October 2008. Online three-month subscriptions decreased from approximately 10% of total unit sales to less than 1% of total unit sales for the three months ended June 30, 2008 and 2009, respectively. In addition, we also received a \$2.6 million initial stocking order from Barnes & Noble in June 2008 to support their expansion of our product line to over 650 of their stores nationally. Excluding this significant inventory stocking order and three-month subscriptions sales in the 2008 period, unit sales increased by 15%. Our sales growth was driven by a 21% increase in our direct advertising expenditures as well as growth in our retail distribution network as the number of kiosks increased from 141 at June 30, 2008 to 183 at June 30, 2009. The decline in global retail revenues was due to the significant inventory stocking order in June 2008, combined with a \$0.7 million reserve related to price protection rights granted to resellers.

The growth in our average selling price per unit was primarily due to the expansion of our product offering combined with a change in our sales mix. In June 2008, we released our compact disc audio practice tool, the Audio Companion, for 14 languages and added it for another 7 languages in September 2008. In October 2008, we bundled our Audio Companion together with our core software application, which resulted in an increase of our average list prices of approximately 13%. We also released 11 additional Version 3 languages during the second half of 2008. In May 2009, we released levels 4 and 5 in English (US) and Spanish (Latin America) as well as Levels 1, 2, and 3 of Rosetta Stone Version 3 and the Audio Companion in Filipino (Tagalog), Latin, Turkish and Vietnamese.

All Version 3 solutions include three course levels, except English (US) and Spanish (Latin America), which include five course levels. Our Version 2 solutions only include one or two levels. Upon the release of a language in Version 3, we discontinue selling that language in Version 2 and, as

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a result, sales of Version 3 products replace sales of Version 2 products for that language. Our solutions are often purchased in sets including all available course levels for a language. The additional levels included in Version 3 results in a greater number of available products at our highest price point for a complete set. In addition, our three-month online subscription was our lowest priced product and was eliminated in October 2008. As a result of a shift in our sales mix towards more comprehensive set solutions, combined with the elimination of our three-month online subscription, our average selling price per unit increased during the three months ended June 30, 2009 compared to the 2008 period.

Product revenue represented 95% of total consumer revenue for the three months ended June 30, 2009, with the balance attributable to subscription and service revenue.

Institutional

Institutional revenue was \$13.6 million for the three months ended June 30, 2009, an increase of \$3.3 million, or 31.8%, compared to the three months ended June 30, 2008. The increase in institutional revenue was primarily due to expansion of our direct sales force. As a result, we had a \$1.7 million increase in education and home school revenue, a \$1.1 million increase in government and military revenue and a \$0.4 million increase in corporate revenue over the comparable prior year period.

Product revenue represented 59% of total institutional revenue for the three months ended June 30, 2009, and subscription and service revenue represented 41% for the same period.

Cost of Revenue and Gross Profit

	Three months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Revenue				
Product	\$48,672	\$41,630	\$7,042	16.9%
Subscription and service	7,788	6,112	1,676	27.4
Total revenue	56,460	47,742	8,718	18.3
Cost of revenue				
Cost of product revenue	7,193	5,968	1,225	20.5
Cost of subscription and service revenue	509	577	(68)	-11.8
Total cost of revenue	7,702	6,545	1,157	17.7
Gross profit	\$48,758	\$41,197	\$7,561	18.4
Gross margin percentages	86.4%	86.3%	0.1%	

Cost of revenue for the three months ended June 30, 2009 was \$7.7 million, an increase of \$1.2 million, or 18%, from the three months ended June 30, 2008. As a percentage of total revenue, cost of revenue remained consistent at 14% for the three months ended June 30, 2009 and 2008, respectively. The increase in cost of revenue was primarily attributable to expansion of our product offering combined with a change in our sales mix, offset in part by the absence in the 2009 period of intangible amortization related to core technology associated with the acquisition of Fairfield & Sons, Ltd., which was fully amortized in 2008. We expect our cost of revenue to increase in absolute dollars in future periods if unit sales continue to grow, if we continue to expand our product offering or if we see continued shift in our sales mix. Cost of revenue will likely increase as a percentage of revenue in future periods as we are planning to release subscription and service offerings that will have higher direct costs to deliver to customers.

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	Three months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Sales and marketing	\$27,147	\$21,737	\$ 5,410	24.9%
Research and development	10,101	3,758	6,343	168.8
General and administrative	23,167	8,856	14,311	161.6
Total operating expenses	\$60,415	\$34,351	\$26,064	75.9

Sales and Marketing Expenses

Sales and marketing expenses for the three months ended June 30, 2009 were \$27.1 million, an increase of \$5.4 million or 25%, from the three months ended June 30, 2008. As a percentage of total revenue, sales and marketing expenses increased to 48% for the three months ended June 30, 2009, compared to 46% for the three months ended June 30, 2008. The dollar and percentage increase in sales and marketing expenses was primarily attributable to the continued expansion of our direct marketing activities. Advertising and marketing expenses grew by \$1.4 million and were primarily related to internet marketing. We also expanded the number of our kiosks from 141 at June 30, 2008 to 183 at June 30, 2009, which resulted in \$1.2 million of additional kiosk operating expenses, including sales compensation related expenses. Personnel costs related to growth in our institutional sales channel and marketing and sales support activities also increased by \$1.7 million. In addition, the stock compensation charge related to common stock awarded to key employees resulted in a \$0.4 million increase in sales and marketing expense. Completion in January 2009 of the amortization of the intangible assets associated with the acquisition of Fairfield & Sons, Ltd. resulted in a \$0.8 million in reduction in amortization expense in the 2009 period compared to the 2008 period.

Research and Development Expenses

Research and development expenses were \$10.1 million for the three months ended June 30, 2009, an increase of \$6.3 million, or 169%, from the three months ended June 30, 2008. As a percentage of total revenue, research and development expenses increased to 18% for the three months ended June 30, 2009 compared to 8% for the three months ended June 30, 2008. The dollar and percentage increase was primarily attributable to the stock compensation charge related to common stock awarded to key employees resulting in a \$5.0 million increase in research and development expense. In addition, research and development expenses increased by \$1.4 million due to the addition of new product development personnel associated with the development of new products and services that are complementary to our existing solutions.

General and Administrative Expenses

General and administrative expenses for the three months ended June 30, 2009 were \$23.2 million, an increase of \$14.3 million, or 162%, from the three months ended June 30, 2008. As a percentage of revenue, general and administrative expenses increased to 41% for the three months ended June 30, 2009 compared to 19% for the three months ended June 30, 2008. The dollar and percentage increase was primarily attributable to the stock compensation charge related to common stock awarded to key employees resulting in a \$13.4 million increase in general and administrative expense. In addition, general and administrative expenses increased by \$0.9 million due to greater personnel related costs as we expanded our finance, information technology and other administrative functions to support the overall growth in our business.

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Stock-Based Compensation Charge

Included in each of the respective operating expense lines for the three months ended June 30, 2009 is a portion of the \$18.8 million charge related to common stock awarded in April 2009 to 10 of our key employees, including our named executive officers, equal to a total of 591,491 shares. The following table presents the stock-based compensation charge by operating expense line item (in thousands):

	Three Months Ended June 30, 2009
Cost of sales	\$
Sales and marketing	377
Research and development	5,033
General and administrative	13,393
Total	\$ 18,803

Interest and Other Income (Expense)

	Three months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Interest income	\$ 23	\$ 98	\$ (75)	-76.5%
Interest expense	(24)	(225)	201	-89.3
Other income (expense)	(61)	(175)	114	-65.1
Total	\$(62)	\$(302)	\$ 240	-79.5

Interest income represents interest earned on our cash and cash equivalents. Interest income for the three months ended June 30, 2009 was \$23,000, a decrease of \$75,000, or 77%, from the three months ended June 30, 2008.

Interest expense is related to our long-term debt, the outstanding balance of which was zero as of June 30, 2009. Interest expense for the three months ended June 30, 2009 was \$24,000, a decrease of \$0.2 million, or 89%, from the three months ended June 30, 2008. The decrease was primarily due to the retirement of our previous Madison Capital term loan. We expect interest expense will decrease in future periods as we used proceeds from the initial public offering to repay the outstanding balance of our long-term debt with Wells Fargo in April 2009.

Other expense for the three months ended June 30, 2009 was \$61,000, a decrease of \$114,000, or 65%, from the three months ended June 30, 2008. The decrease was primarily due to a decrease in foreign exchange losses.

Income Tax Expense (Benefit)

	Three months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Income tax expense (benefit)	\$(4,427)	\$3,183	\$(7,610)	-239.1%

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Income tax expense (benefit) for the three months ended June 30, 2009 was (\$4.4) million compared to \$3.2 million for the three months ended June 30, 2008. The decrease was the result of a decrease of \$18.3 million in pre-tax income for the three months ended June 30, 2009, compared to the three months ended June 30, 2008. Our effective tax rate decreased to 38% for the three months ended June 30, 2009 compared to an effective tax rate of 49% for the three months ended June 30, 2008. The reduction in our effective tax rate was a result of changes in the geographic distribution of our income and a change in our transfer pricing agreements.

We determine the pricing among our associated entities on the basis of detailed functional and economic analysis involving benchmarking against transactions among entities that are not under common control. Based on our analysis, we made changes to the transfer pricing agreements effective January 1, 2009. The percentage of foreign losses relative to total consolidated income before tax declined for the three months ended June 30, 2009 due to the resulting change in geographic distribution of income resulting in a lower effective tax rate as compared to the three months ended June 30, 2008.

We do not currently recognize income tax benefit or expense on the results of our foreign subsidiaries. Neither our U.K. nor our Japan subsidiary has produced sustainable pretax profits as of June 30, 2009 and no valuation allowance on net operating loss carryforwards and other deferred tax assets was released. As we continue operations in accordance with the revised transfer pricing agreements, we will monitor actual results and updated projections on a quarterly basis. When and if the subsidiaries realize or realistically anticipate sustainable profitability, we will assess the appropriateness of releasing the valuation allowance in whole or in part.

Comparison of the six months ended June 30, 2009 and the six months ended June 30, 2008***Revenue***

	Six months ended June 30,				2009 versus 2008	
	2009		2008		Change	% Change
	(dollars in thousands)					
Product revenue	\$ 91,512	85.7%	\$71,848	86.2%	\$19,664	27.4%
Subscription revenue	15,233	14.3	11,479	13.8	3,754	32.7
Total Revenue	\$106,745	100.0	\$83,327	100.0	\$23,418	28.1
<i>Revenue by sales channel:</i>						
Direct-to-Consumer	\$ 50,889	47.7	\$39,616	47.5	\$11,273	28.5
Kiosk	17,500	16.4	14,152	17.0	3,348	23.7
Global Retail	14,863	13.9	12,327	14.8	2,536	20.6
Total Consumer	83,252	78.0	66,095	79.3	17,157	26.0
Institutional	23,493	22.0	17,232	20.7	6,261	36.3
Total Revenue	\$106,745	100.0	\$83,327	100.0	\$23,418	28.1

Total revenue for the six months ended June 30, 2009 was \$106.7 million, an increase of \$23.4 million, or 28.1%, from the six months ended June 30, 2008.

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Consumer

Consumer revenue was \$83.3 million for the six months ended June 30, 2009, an increase of \$17.2 million, or 26%, from the six months ended June 30, 2008. The increase in consumer revenue was attributable to a 28% increase in the average selling price of each unit, which accounted for an \$18.1 million increase in revenue, partially offset by a 1% decrease in unit sales, which resulted in a \$1.0 million decrease in revenue. The unit decrease was due to the discontinuation of our entry level 3-month online subscription offering in October 2008. Online 3-month subscriptions decreased from approximately 11% of total unit sales to 2% of total unit sales for the six months ended June 30, 2008 and 2009, respectively. In addition, we also received a \$2.6 million initial stocking order from Barnes & Noble in June 2008 to support their expansion of our product line to over 650 of their stores nationally. Excluding the inventory stock order and 3-month subscriptions sales, unit sales increased 17%. Overall sales growth was driven by a 22% increase in our direct advertising spend as well as growth in our retail distribution network as the number of kiosks increased from 141 at June 30, 2008 to 183 at June 30, 2009, and Barnes & Noble expanded our store presence from approximately 70 stores to over 650 stores in June 2008.

The growth in our average selling price per unit was primarily due to the expansion of our product offering combined with a change in our sales mix. In June 2008, we released our compact disc audio practice tool, the Audio Companion, for 14 languages and added it for another seven languages in September 2008. In October 2008, we bundled our Audio Companion together with our core software application, which resulted in an increase of our average list prices of approximately 13%. We also released 11 additional Version 3 languages during the second half of 2008. In May 2009, we released Levels 4 and 5 in English (US) and Spanish (Latin America) as well as four additional Version 3 languages. We also experienced a shift in sales mix, as Level 1-2-3 set sales increased from approximately 26% of total unit sales for the six months ended June 30, 2008 to approximately 44% of total unit sales in the six months ended June 30, 2009. In addition, our three-month online subscription was our lowest priced product and was eliminated in October 2008. As a result of a shift in our sales mix towards more comprehensive set solutions, combined with the elimination of our three-month online subscription, our average selling price per unit increased during the six months ended June 30, 2009 compared to the 2008 period.

All Version 3 solutions include three course levels, except English (US) and Spanish (Latin America), which include five course levels. Our Version 2 solutions only include one or two course levels. Upon the release of a language in Version 3, we discontinue selling that language in Version 2 and, as a result, sales of Version 3 products replace sales of Version 2 products for that language. Our solutions are often purchased in sets including all available course levels for a language. The additional levels included in Version 3 results in a greater number of available products at our highest price point for a complete set.

Product revenue represented 95% of total consumer revenue for the six months ended June 30, 2009, with the balance attributable to subscription and service revenue.

Institutional

Institutional revenue was \$23.5 million for the six months ended June 30, 2009, an increase of \$6.3 million, or 36.3%, compared to the six months ended June 30, 2008. The increase in institutional revenue was primarily due to growth of our average selling price attributed to the release of our Version 3 products in the institutional market combined with the expansion of our direct sales force. As a result, we had a \$4.1 million increase in education and home school revenue, a \$1.6 million increase in government and military revenue and a \$0.9 million increase in corporate revenue over the comparable prior year period.

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Product revenue represented 54% of total institutional revenue for the six months ended June 30, 2009, and subscription and service revenue represented 46% for the same period.

Cost of Revenue and Gross Profit

	Six months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Revenue				
Product	\$ 91,512	\$ 71,848	\$ 19,664	27.4%
Subscription and service	15,233	11,479	3,754	32.7
Total revenue	106,745	83,327	23,418	28.1
Cost of revenue				
Cost of product revenue	13,136	9,998	3,138	31.4
Cost of subscription and service revenue	994	1,083	(89)	-8.2
Total cost of revenue	14,130	11,081	3,049	27.5
Gross profit				
	\$ 92,615	\$ 72,246	\$ 20,369	28.2

Gross margin percentages	86.8%	86.7%	0.1%
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Cost of revenue for the six months ended June 30, 2009 was \$14.1 million, an increase of \$3.0 million, or 28%, from the six months ended June 30, 2008. As a percentage of total revenue, cost of revenue remained consistent at 13% for the six months ended June 30, 2009 and 2008, respectively. The increase in cost of revenue was primarily attributable to expansion of our product offering combined with a change in our sales mix, offset in part by the absence in the 2009 period of intangible amortization related to core technology associated with the acquisition of Fairfield & Sons, Ltd., which was fully amortized in 2008. We expect our cost of revenue to increase in absolute dollars in future periods if our unit sales continue to grow, if we continue to expand our product offering or if we see continued shift in our sales mix. Cost of revenue will likely increase as a percentage of revenue in future periods as we are planning to release subscription and service offerings that will have higher direct costs to deliver to customers.

Operating Expenses

	Six months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Sales and marketing	\$50,759	\$39,782	\$10,977	27.6%
Research and development	14,944	8,290	6,654	80.3
General and administrative	33,054	17,384	15,670	90.1
Total operating expenses	\$98,757	\$65,456	\$33,301	50.9

Sales and Marketing Expenses

Sales and marketing expenses for the six months ended June 30, 2009 were \$50.8 million, an increase of \$11.0 million or 28%, from the six months ended June 30, 2008. As a percentage of total revenue, sales and marketing expenses remained consistent at 48% for the six months ended June 30, 2009 and 2008. The dollar increase in sales and marketing expenses was primarily attributable to the continued expansion of our direct marketing activities. Advertising and marketing expenses grew by

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\$3.1 million and were primarily related to the purchase of additional television media and internet marketing. We also expanded the number of our kiosks from 141 at June 30, 2008 to 183 at June 30, 2009, which resulted in \$3.1 million of additional kiosk operating expenses, including sales compensation related expenses. Personnel costs related to growth in our institutional sales channel and marketing and sales support activities also increased by \$3.2 million. The stock compensation charge related to common stock awarded to key employees resulted in a \$0.4 million increase in sales and marketing expense. Completion in January 2009 of the amortization of the intangible assets associated with the 2006 acquisition of Fairfield & Sons, Ltd. resulted in a \$1.5 million reduction in amortization expense in the 2009 period compared to the 2008 period.

Research and Development Expenses

Research and development expenses were \$14.9 million for the six months ended June 30, 2009; an increase of \$6.7 million, or 80%, from the six months ended June 30, 2008. As a percentage of total revenue, research and development expenses increased to 14% for the six months ended June 30, 2009 compared to 10% for the six months ended June 30, 2008. The dollar and percentage increase was primarily attributable to a stock compensation charge related to common stock awarded to key employees resulting in a \$5.0 million increase in research and development expense. In addition, research and development expenses increased by \$1.7 million due to the addition of new product development personnel associated with the development of new products and services that are complementary to our existing solutions.

General and Administrative Expenses

General and administrative expenses for the six months ended June 30, 2009 were \$33.1 million, an increase of \$15.7 million, or 90%, from the six months ended June 30, 2008. As a percentage of revenue, general and administrative expenses increased to 31% for the six months ended June 30, 2009 compared to 21% for the six months ended June 30, 2008. The dollar and percentage increase was primarily attributable to a stock compensation charge related to common stock awarded to key employees resulting in a \$13.4 million increase in general and administrative expense. In addition, general and administrative expenses increased by \$2.3 million due to greater personnel related costs as we expanded our finance, information technology and other administrative functions to support the overall growth in our business.

Stock-Based Compensation Charge

Included in each of the respective operating expense lines for the six months ended June 30, 2009 is a portion of the \$18.8 million charge related to common stock awarded to 10 of our key employees in April 2009 equal to a total of 591,491 shares. The following table presents the stock-based compensation charge by operating expense line item (in thousands):

	Six Months Ended June 30, 2009
Cost of sales	\$
Sales and marketing	377
Research and development	5,033
General and administrative	13,393
Total	\$ 18,803

Table of Contents***Interest and Other Income (Expense)***

	Six months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Interest income	\$ 54	\$ 314	\$(260)	-82.8%
Interest expense	(339)	(521)	182	-34.9
Other income (expense)	35	112	(77)	-68.8
Total	\$(250)	\$ (95)	\$(155)	163.2

Interest income represents interest earned on our cash and cash equivalents. Interest income for the six months ended June 30, 2009 was \$54,000, a decrease of \$0.3 million, or 83%, from the six months ended June 30, 2008.

Interest expense is related to our long-term debt, the outstanding balance of which was zero as of June 30, 2009. Interest expense for the six months ended June 30, 2009 was \$0.3 million, a decrease of \$0.2 million, or 35%, from the six months ended June 30, 2008. The decrease was primarily due to the retirement of our previous Madison Capital term loan. We expect interest expense will decrease in future periods as we paid off the outstanding balance of our long-term debt with proceeds from our initial public offering in April 2009.

Other income for the six months ended June 30, 2009 was \$35,000, a decrease of \$77,000, or 69%, from the six months ended June 30, 2008. The decrease was primarily the result of foreign exchange losses due to the British pound weakening against the U.S. dollar.

Income Tax Expense (Benefit)

	Six months ended June 30,		2009 versus 2008 %	
	2009	2008	Change	Change
	(dollars in thousands)			
Income tax expense (benefit)	\$(2,295)	\$ 3,766	\$(6,061)	-160.9%

Income tax expense (benefit) for the six months ended June 30, 2009 was \$(2.3) million compared to \$3.8 million for the six months ended June 30, 2008. The decrease was the result of a decrease of \$13.1 million in pre-tax income for the six months ended June 30, 2009, compared to the six months ended June 30, 2008. Our effective tax rate decreased to 36% for the six months ended June 30, 2009 compared to an effective tax rate of 56% for the six months ended June 30, 2008. The reduction in our effective tax rate was a result of changes in the geographic distribution of our income and a change in our transfer pricing agreements.

We determine the pricing among our associated entities on the basis of detailed functional and economic analysis involving benchmarking against transactions among entities that are not under common control. Based on our analysis, we made changes to the transfer pricing agreements effective January 1, 2009. The percentage of foreign losses relative to total consolidated income before tax declined for the six months ended June 30, 2009 due to the resulting change in geographic distribution of income resulting in a lower effective tax rate as compared to the six months ended June 30, 2008.

We do not currently recognize income tax benefit or expense on the results of our foreign subsidiaries. Neither our U.K. nor our Japan subsidiary has produced sustainable pretax profits as of June 30, 2009 and no valuation allowance on net operating loss carryforwards and other deferred tax assets was released. As we continue operations in accordance with the revised transfer pricing

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agreements, we will monitor actual results and updated projections on a quarterly basis. When and if the subsidiaries realize or realistically anticipate sustainable profitability, we will assess the appropriateness of releasing the valuation allowance in whole or in part.

Other Factors that May Affect Comparability

Public Company Expenses

In April 2009, we completed an initial public offering of shares of our common stock and our shares of common stock trade on the New York Stock Exchange. As a result, we will now need to comply with laws, regulations and requirements that we did not need to comply with as a private company, including provisions of the Sarbanes-Oxley Act of 2002, other applicable SEC regulations and the requirements of the New York Stock Exchange. Compliance with the requirements of being a public company requires us to increase our general and administrative expenses in order to pay our employees, legal counsel and independent registered public accountants to assist us in, among other things, instituting and monitoring a more comprehensive compliance and board governance function, establishing and maintaining internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 and preparing and distributing periodic public reports in compliance with our obligations under the federal securities laws. In addition, as a public company, it is more expensive for us to obtain directors' and officers' liability insurance. We estimate that the incremental annual public company costs will be between \$1.5 million and \$2.0 million in fiscal 2009, which will primarily be reflected in general and administrative costs.

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 operations. Since our inception, we have financed our operations solely through cash flow from operations with the exception of the acquisition of Fairfield & Sons, Ltd. which was funded in part through the sale of preferred and common stock and a \$17.0 million term loan from Madison Capital Funding LLC. At June 30, 2009, our principal sources of liquidity were cash and cash equivalents totaling \$66.2 million and available borrowings under our credit facility.

On January 16, 2009, we entered into a new secured credit agreement with Wells Fargo that provides us with a \$12.5 million revolving line of credit. This revolving credit facility has a two-year term and the applicable interest rate is 2.5% above one month LIBOR, or approximately 3% as of June 30, 2009. On January 16, 2009, we borrowed approximately \$9.9 million under this revolving credit facility and used these funds to repay the outstanding principal and interest of the term loan we had with Madison Capital. As a result, we have no borrowings owed to Madison Capital under either their term loan or revolving credit facility, and we have terminated these credit agreements. In April 2009, we completed our initial public offering and received net proceeds of \$48.8 million after deducting the underwriters discount and initial public offering expenses. We used \$9.9 million to repay Wells Fargo the outstanding principal and interest of the revolving credit facility. The full \$12.5 million under the Wells Fargo revolving credit facility remains available to us for borrowing, subject to specified conditions.

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

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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 and available sources of funds, including available borrowings under our revolving credit facility, will provide sufficient liquidity to fund our business and meet our obligations in the foreseeable future.

In April 2009, we completed an initial public offering. After deducting the payment of underwriters' discounts and commissions and offering expenses, our net proceeds from the sale of shares in the offering were \$48.8 million. The net proceeds from the offering were used to repay a \$9.9 million balance on our revolving credit facility and \$7.9 million to satisfy the federal, state and local withholding tax obligations associated with the net issuance of common stock to key employees.

Cash Flow Analysis

Net Cash Provided By Operating Activities

Net cash provided by operating activities was \$9.0 million for the six months ended June 30, 2009, compared to net cash used in operating activities of \$3.1 million for the six months ended June 30, 2008. Net cash provided by operating activities was primarily generated from net income as adjusted for depreciation, amortization and stock compensation expense, offset in part by an increase in income tax receivable resulting from net operating losses. Net loss totaled \$4.1 million for the six months ended June 30, 2009 compared to net income of \$2.9 million for the six months ended June 30, 2008. For the six months ended June 30, 2009, we incurred depreciation, amortization and stock compensation expense in the amount of \$22.6 million, compared to \$4.1 million for the six months ended June 30, 2008. Decreases in amortization resulting from the full amortization of intangible assets in January 2009 were partially offset by increases in depreciation on tangible assets associated with the expansion of the business. The increase in stock-based compensation expense was the result of an \$18.5 million expense associated with the issuance of common stock, restricted stock, restricted stock units and stock options.

Net Cash Used In Investing Activities

Net cash used in investing activities was \$4.9 million for the six months ended June 30, 2009, compared to \$3.0 million for the six months ended June 30, 2008, an increase of \$1.9 million, or 63.3%. Our investing activities during these periods 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.

Net Cash Used In Financing Activities

Net cash provided by financing activities was \$31.4 million for the six months ended June 30, 2009, compared to net cash used in financing activities of \$1.5 million for the six months ended June 30, 2008. Net cash provided by financing activities during the six months ended June 30, 2009 primarily related to \$49.2 million in proceeds from our initial public offering, offset by the \$9.9 million payment of the balance outstanding under our revolving credit facility and the \$7.9 million payment of taxes associated with the common stock grant to some of our key employees.

We believe that our current cash and cash equivalents and funds generated from our operations will be sufficient to meet our working capital and capital expenditure requirements at least through June 30, 2010. 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

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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 June 30, 2009 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

	Total	Less than 1 Year	1 - 3 Years	3 - 5 Years	More than 5 Years
(dollars in thousands)					
Operating lease obligations	\$ 14,040	\$ 3,334	\$ 8,783	\$ 1,855	\$ 68
Total	\$ 14,040	\$ 3,334	\$ 8,783	\$ 1,855	\$ 68

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 2009.

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.

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Item 4T. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2009. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under 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 June 30, 2009, 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) and 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.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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 from risk factors previously disclosed in our quarterly report on Form 10-Q filed on May 28, 2009 with the Securities and Exchange Commission for the quarterly period ended March 31, 2009. In addition to the other information set forth in this quarterly report on Form 10-Q, you should carefully consider the risk factors discussed below and in other documents we file with the Securities and Exchange Commission, which could materially affect our business, financial condition or future results. These are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Our actual operating results may differ significantly from our guidance.

From time to time, we may release guidance in our quarterly earnings releases, quarterly earnings conference call, or otherwise, regarding our future performance that represent our management's estimates as of the date of release. This guidance, which includes forward-looking statements, is based

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on projections prepared by our management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party compiles or examines the projections and, accordingly, no such person expresses any opinion or any other form of assurance with respect thereto.

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

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions of the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results will vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon, or otherwise consider, our guidance in making an investment decision in respect of our common stock.

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

Risks Related to Our Business

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

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

a decline in international travel;

changes in U.S. laws or policies making it more difficult for foreign persons to visit or take up residence in the United States; and

a reduction in the roles of the U.S. armed forces or other governmental agencies in foreign countries.

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

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

identify, anticipate, understand and respond to these trends in a timely manner;

introduce appealing new products and performance features on a timely basis;

anticipate and meet consumer demand for additional languages and learning levels;

effectively position and market our products and services;

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

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

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

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

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

We depend on discretionary consumer spending in the consumer segment of our business. Continued adverse trends in general economic conditions, including retail shopping patterns, airport traffic or consumer confidence, may compromise our ability to generate revenue.

The success of our business depends to a significant extent upon discretionary consumer spending, which is subject to a number of factors, including general economic conditions, consumer confidence, employment levels, business conditions, interest rates, availability of credit, inflation and taxation. The United States is in an economic downturn. Continued weak economic conditions and further adverse trends in any of these economic indicators may cause consumer spending to decline further, which could hurt our sales and profitability. We depend on the continued popularity of malls as shopping destinations and the ability of mall anchor tenants and other attractions to generate customer traffic for our retail mall-based kiosks. We also depend on continued airline travel to generate traffic for our retail kiosks located in airports. Decreases in mall or airport traffic adversely affect the sales from our kiosks and our profitability and financial condition. In addition, an increase in the taxation of online sales could result in reduced online purchases or reduced margins on such sales. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors.

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

The market for foreign language learning solutions is rapidly evolving, highly fragmented and intensely competitive, and we expect both product and pricing competition to persist and intensify. Increased competition could cause reduced revenue, price reductions, reduced gross margins and loss of market share. Our competitors include Berlitz International Inc., Simon & Schuster, Inc. (Pimsleur), a subsidiary of CBS Corporation, Random House Ventures LLC (Living Language), Disney Publishing Worldwide, a subsidiary of Walt Disney Company, and McGraw-Hill Education, a subsidiary of The

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McGraw-Hill Companies. Many of our current and potential competitors have longer operating histories and substantially greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition worldwide. The resources of these competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements, reduce prices to win new customers and offer free language learning software or online services. We may not be able to compete successfully against current or future competitors.

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

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

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

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

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

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

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

create greater awareness of our brands and our language learning solutions;

select the right market, media and specific media vehicle in which to advertise;

identify the most effective and efficient level of spending in each market, media and specific media vehicle;

determine the appropriate creative message and media mix for advertising, marketing and promotional expenditures;

effectively manage marketing costs, including creative and media expenses, in order to maintain acceptable customer acquisition costs;

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

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convert customer inquiries into actual orders.

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

Much of our radio, television and print advertising has been through the purchase of "remnant" advertising segments. These segments are random time slots and publication dates that have remained unsold and are offered at discounts to advertisers who are willing to be flexible with respect to time slots. There is a limited supply of this type of advertising and the availability of such advertising may decline or the cost of such advertising may increase. In addition, if we increase our marketing budget we cannot assure you that we can increase the amount of remnant advertising at the discounted prices we have obtained in the past. If any of these events occur, we may be forced to purchase time slots and publication dates at higher prices, which will increase our costs.

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

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

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

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

If one or more of the search engines or other online sources on which we rely for website traffic were to modify its general methodology for how it displays our websites, resulting in fewer consumers clicking through to our websites, our sales could suffer. If any free search engine on which we rely begins charging fees for listing or placement, or if one or more of the search engines or other online sources on which we rely for purchased listings, modifies or terminates its relationship with us, our expenses could rise, we could lose customers and traffic to our websites could decrease.

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

International sales accounted for approximately 5% of our revenue for the years ended December 31, 2007, 2008 and the six months ended June 30, 2009, respectively. Our business strategy contemplates continued expansion into international markets. We are currently expanding our direct sales channels in Europe and Asia. In addition, we are expanding our indirect sales channels in Europe, Asia and Latin America through retailer and distributor arrangements with third parties. If we are unable to expand our international operations successfully and in a timely manner, our ability to pursue our growth strategy will be impaired. Such expansion may be more difficult or take longer than we

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anticipate, and we may not be able to successfully market, sell, deliver and support our products and services internationally.

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

difficulty in staffing and managing geographically dispersed operations and culturally diverse work forces and increased travel, infrastructure and legal compliance costs associated with multiple international locations;

competition from local foreign language software providers and preferences for local products in some regions;

expenses associated with customizing products, support services and websites for foreign countries;

inability to identify an effective and efficient level of advertising, marketing and promotional expenditures in order to maintain acceptable customer acquisition costs;

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

difficulties with establishing successful kiosk sales channels;

inability to successfully develop relationships with significant retailers and distributors;

potential political and economic instability in some regions;

potential unpredictable changes in foreign government regulations;

legal and cultural differences in the conduct of business;

import and export license requirements, tariffs, taxes and other trade barriers;

inflation and fluctuations in currency exchange rates;

potentially adverse tax consequences;

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

the burden and difficulties in complying with a wide variety of U.S. and foreign laws, regulations, trade standards, treaties and technical standards, including the Foreign Corrupt Practices Act;

difficulty in protecting our intellectual property and the high incidence of software piracy in some regions;

costs and delays in downsizing foreign work forces as a result of differing employment and other laws;

protectionist laws and business practices that favor local competitors; and

uncertainty regarding liability for information retrieved and replicated in foreign countries.

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

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Our expansion into new web-based services may not succeed and may harm our business, financial results and reputation.

We are developing new web-based services, such as *Rosetta Stone TOTALE*, that extend our existing language learning solutions with opportunities for practice including with dedicated language conversation coaches and other language learners to increase language socialization. We expect to provide these web-based services primarily as a bundle with our software and audio offerings. At the same time, we expect to provide augmented, free peer-to-peer language practice, building on our existing success with *www.sharedtalk.com*. We will devote capital, personnel and management attention to developing these new services. These services will present new management and marketing challenges that differ from the challenges we face in our existing business. We cannot assure you that these services will be successful or that they will be profitable, or if they are profitable, that they will provide an adequate return on capital expended. If we are not successful in developing these new services, our business, financial results and reputation may be harmed.

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

We offer consumers who purchase our packaged software and audio practice products directly from us an unconditional full money-back six-month guarantee. We also permit some of our retailers and distributors to return packaged products, subject to limitations. For the year ended December 31, 2008 and the six months ended June 30, 2009, sales returns were approximately 6.1% and 6.5% of total revenue, respectively. We establish revenue reserves for packaged product returns based on historical experience, estimated channel inventory levels and the timing of new product introductions and other factors. If packaged product returns exceed our reserve estimates, the excess would offset reported revenue, which could hurt our reported financial results.

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

Our success depends in part upon the continued adoption by institutions and potential customers of technology-based education initiatives. Some academics and educators oppose online education in principle and have expressed concerns regarding the perceived loss of control over the education process that can result from offering courses online. If the acceptance of technology-based education does not grow our ability to continue to grow our institutional business could be impaired.

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