

ROSETTA STONE INC  
Form 10-K  
March 07, 2013

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

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

For the fiscal year ended December 31, 2012

Commission file number: 1-34283

**Rosetta Stone Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State of incorporation)

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

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

**22209**  
(Zip Code)

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

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

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

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

**None**

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

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

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$169.0 million as of June 30, 2012 (based on the last sale price of such stock as quoted on the New York Stock Exchange).

As of February 22, 2013, there were 21,345,526 shares of common stock outstanding.

**Documents incorporated by reference:** Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2013 Annual Meeting of Stockholders to be held on May 23, 2013 are incorporated by reference into Part III.

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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

*This Annual Report on Form 10-K contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements include, but are not limited to, statements regarding: our business strategies; information regarding our future financial performance; our projected plans and objectives; our development of new products including an English remediation solution; international expansion and our development of a business model to drive growth; the sufficiency of our cash flows from operations and available sources of funds; the impact of inflation on our financial position and results of operations; the effect of state tax law examination on our results of operations and financial position; our technology and product development initiatives; and our intellectual property strategy. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included throughout this filing and particularly in Item 1A: "Risk Factors" section set forth in this Annual Report on Form 10-K. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to revise or publicly release any revision to any such forward-looking statement, except as may otherwise be required by law.*

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**PART I**

**Item 1. Business**

**Overview**

Rosetta Stone Inc. ("Rosetta Stone", "the Company", "we", or "us") is a leading provider of technology-based, language-learning solutions. We develop, market, and sell language-learning solutions consisting of software, online services, mobile applications 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 over 30 languages.

Rosetta Stone Inc. was incorporated in Delaware in 2005 and completed our initial public offering in April 2009. Our operations are headquartered in Arlington, VA, and we have several operating locations in the U.S. as well as various international office locations in Asia and Europe.

The strategic plan of the management team through 2015 includes three primary areas of focus:

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

In pursuing these priorities, we plan to balance margin with growth.

**Business Segments**

During 2012, we had a change in our chief operating decision maker ("CODM"), which led to a fourth quarter change in what our CODM uses to measure profitability and allocate resources. Accordingly, beginning with the fourth quarter of 2012, we have three operating segments, North America Consumer, Rest of World ("ROW") Consumer and Institutional. From the first quarter of 2011 through the third quarter of 2012 we had two operating segments, Consumer and Institutional. Prior to 2011 we operated as a single segment.

The North America Consumer and ROW Consumer segments derive revenues from individuals and sales to retail partners. The North America Consumer segment includes sales made within the United States and Canada; the ROW Consumer segment includes sales made in countries other than the U.S. and Canada. The Institutional segment derives revenues from sales to educational institutions, government agencies and corporations worldwide.

For additional information regarding our segments, see Note 15 of Item 8, *Financial Statements and Supplementary Data*. Prior periods are presented consistent with our current operating segments and definition of segment contribution.

**Products and Services**

*Core Product Offering*

Our primary products include Rosetta Stone Version 4 *TOTALe* and Rosetta Stone *TOTALe* online. Version 4 *TOTALe* includes each of the components described below and is available as either tangible packaged software or as an online download of perpetual software. Rosetta Stone *TOTALe* online combines dedicated conversational coaching and an online software subscription and is available



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in a selection of time-based offers (e.g. three, six and 12 months durations). *ReFLEX*, a solution designed specifically for English learners who want to improve their listening and speaking skills, is sold as an online subscription in South Korea and Japan. The core Rosetta Stone language-learning solution offered in *TOTALe* online and Version 4 *TOTALe* is offered in over 30 languages under the *Rosetta Stone* brand. Each language currently has up to five levels and there are four different editions of our product: personal, enterprise, classroom and home school.

Our solutions are available both in a perpetual format (CD-ROM or download) and by subscription online through our language-learning portal. For the year ended December 31, 2012, approximately 66% of our revenue was from CD-ROM or download sales while approximately 34% was from online subscriptions to both consumers and institutions.

Our solutions include stand-alone sales and bundles of certain of the following components:

*Rosetta Course* is the self-study interactive language-learning curriculum that is the core component of the Rosetta Stone offering. The course consists of sequences of listening, speaking, reading, and writing interactions designed to teach, reinforce and test learners through our software program.

*Rosetta Studio* is a series of coach-led practice sessions that align with the curriculum in *Rosetta Course*. Studio sessions provide learners with the opportunity to practice what they have learned in *Rosetta Course*, by talking with a native-speaking coach and other learners.

*Rosetta World* is an interactive community of language learners. *Rosetta World* gives learners the opportunity to play games with other learners in a structured manner that reinforces what they have learned in *Rosetta Course* and *Rosetta Studio*.

*Audio Companion* is a series of digital audio files that contain lessons directly aligned to the Rosetta Stone curriculum, allowing users to practice and carry on their immersive experience when they are away from a computer. The lessons on the *Audio Companion* can be transferred to various audio platforms.

*TOTALe Companion HD* is a learning tool that provides access to *Rosetta Course* with the exception of the review and writing path steps, for use on tablet devices. *TOTALe Companion HD* includes our speech recognition technology.

*TOTALe Companion* includes a series of practice lessons which use images, audio and our speech recognition technology to help users refine their speaking skills while they are away from their computer.

*Product Developments*

Our product portfolio is a result of significant investment in product development over 20 years. Our product development focuses on both software and content development. Our development efforts include both creating new solutions and adding new languages to existing solutions. Our development team has specific expertise in speech recognition, interface design, immersion learning and instructional design.

Our research and development expenses were \$23.5 million, \$24.2 million, and \$23.4 million for the years ended December 31, 2012, 2011 and 2010, respectively.

We are evaluating changes to our products to strengthen our brand and improve the relevance of our offerings. We are developing our first set of products for children. In addition, we are enhancing our offering for educational organizations to expand our Institutional business. We intend to make our products more modular, flexible and mobile.

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**Distribution Channels**

Our global consumer distribution model comprises a mix of our call centers, websites, network of kiosks, select retail resellers, such as Amazon.com, Barnes & Noble, Best Buy, Books-a-Million, Costco, Groupon and Staples, home shopping networks such as GS Home Shopping in Korea and consignment distributors such as Navarre. We believe these channels complement each other, as consumers who have seen our direct-to-consumer advertising may purchase at our kiosks or retailers, and those who have seen our solutions demonstrated at our kiosks may purchase solutions through our retailers, websites or call centers.

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

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

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

*Rosetta Stone Kiosks.* As of December 31, 2012, we operated 87 retail kiosks, including 57 full service retail outlets, in airports, malls and other strategic high-traffic locations in 19 states. As of December 31, 2012, we operated one kiosk in the United Kingdom, three in Japan, and 26 in South Korea.

Our institutional distribution model is focused on targeted sales activity primarily through a direct sales force in four markets: schools, colleges and universities; federal government agencies; corporations; and not-for-profit organizations. Regional sales managers are responsible for sales of our solutions in their territories and supervise account managers who are responsible for maintaining our customer base.

*Educational Institutions.* These customers include primary and secondary schools.

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

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

**Sourcing and Fulfillment**

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

We package and distribute our products primarily from our fulfillment facility in Harrisonburg, Virginia. We also contract with third-party fulfillment vendors in Munich, Germany, and Tokyo, Japan.



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**Competition**

The Rosetta Stone brand is recognized as a leading technology-based, language-learning solution. The language-learning market is highly fragmented globally and consists of the following primary models: classroom instruction utilizing the traditional approach of memorization, grammar and translation; immersion-based classroom instruction; self-study books, audio recordings and software that relies primarily on grammar and translation; and free online and mobile offerings that provide content and opportunities to practice writing and speaking.

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

**Seasonality**

Our business is affected by variations in seasonal trends. These variations are primarily related to increased sales of our products and services to consumers in the fourth quarter during the holiday selling season as well as higher sales to governmental and educational institutions in the second and third quarters. We sell to a significant number of our retailers, distributors and institutional customers on a purchase order basis and we receive orders when these customers need products and services. As a result, their orders are typically not evenly distributed throughout the year.

**Intellectual Property**

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

We have five U.S. patents, two foreign patents and several U.S. and foreign patents pending. Many of these pending patents relate to our language teaching methods.

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

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

We are registering or have registered in the United States all editions of our Version 3 *TOTALe* languages and *ReFLEX*. We have a registered copyright for the refreshed Rosetta Stone blue stone logo design in the United States. We intend to continue to strategically register copyrights in our various products.

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

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on our trade dress, which is the overall image and appearance of our solutions, and we believe that our trade dress helps to distinguish our solutions in the marketplace.

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

**Employees**

As of December 31, 2012, we had 1,550 total employees, consisting of 879 full-time and 671 part-time employees. None of our employees are represented by a collective bargaining agreement. We believe our employee relations are good.

**Financial Information by Segment and Geographic Area**

For a discussion of financial information by segment and geographic area, see Note 15 to the consolidated financial statements contained in this Annual Report on Form 10-K.

**Available Information**

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

**Item 1A. Risk Factors**

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

*Our actual operating results may differ significantly from our guidance.*

From time to time, we may release guidance in our quarterly earnings releases, quarterly earnings conference call, or otherwise, regarding our future performance that represents our management's estimates as of the date of release. This guidance, which includes forward-looking statements, is based on projections prepared by our management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party compiles or examines the projections and, accordingly, no such person expresses any opinion or any other form of assurance with respect thereto.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We generally state possible outcomes as high and low ranges, which are intended to provide a sensitivity analysis as

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variables are changed but are not intended to represent that actual results could not fall outside of the suggested ranges. The principal reason that we release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such persons.

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

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

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

At December 31, 2012, we had net deferred tax assets of \$30.1 million which was offset by a valuation allowance of \$29.8 million for certain jurisdictions. We recorded the valuation allowance to reflect uncertainties about whether we will be able to realize some of our deferred tax assets before they expire. The valuation allowance is based on our estimates of taxable income for the jurisdictions in which we operate and the period over which our deferred tax assets will be realizable. We could in the future be required to increase the valuation allowance to take into account additional deferred tax assets that we may be unable to realize. An increase in the valuation allowance would have an adverse impact, which could be material, on our income tax provision and net income in the period in which we record the increase.

**Risks Related to Our Business**

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

We released Rosetta Stone Version 4 TOTALe and ReFLEX in various markets over the past few years. Rosetta Stone Version 4 TOTALe integrates our existing language-learning software solutions with web-based services, which provide opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. ReFLEX integrates online language-learning software solutions to improve the listening and speaking skills of English learners with web-based services, which provide opportunities for practice with dedicated language conversation coaches and other language learners. These language coach services have a much higher cost as a percentage of revenue than our software solutions and remain a risk factor due to the growth of these offerings as a percentage of our sales. We offer Rosetta Stone Version 4 TOTALe primarily by bundling the web-based services of TOTALe with our software and audio offerings. At the same time, we expect to provide augmented, free peer-to-peer language practice. The services associated with Rosetta Stone Version 4 TOTALe and ReFLEX have decreased our margins. Rosetta Stone Version 4 TOTALe sells at a higher price per unit than our Version 3 software solutions and customers may not choose to engage with conversation coaches or be willing to pay higher prices to do so. Rosetta Stone Version 4 TOTALe and ReFLEX have also presented new management and marketing challenges that differ from the challenges we faced in our previous business. In addition, we are now required to defer recognition of a portion of each sale of Version 4 TOTALe and ReFLEX in connection with the subscription terms of our online socialization services. We cannot assure you that Rosetta Stone Version 4 TOTALe and

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*ReFLEX* will be successful or profitable, or if it is profitable, that it will provide an adequate return on capital expended. If Rosetta Stone Version 4 *TOTALe* and/or *ReFLEX* are not successful, our business, financial results and reputation may be harmed. We anticipate having to make investments in new products in the future, such as a children's product, and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Customers may not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all.

***Our introduction of an English remediation solution targeting intermediate learners in Asia may not succeed and may harm our business, financial results and reputation.***

We introduced our English remediation solution, *ReFLEX*, in South Korea and Japan over the past two years. This solution targets more advanced English learners in Asia, and provides learners with foundational phonetic skills needed to properly hear and produce distinctions that are present in English, but absent in Asian languages. This online solution carries some lower price points than our full Rosetta Stone Version 4 *TOTALe* language-learning solution and may cannibalize sales of our Version 4 solution in Asia. We have devoted significant capital, personnel and management attention to develop and launch the English remediation offering, including related research and development expenses, and incurring marketing expenses relating to the launch. This product has presented new management and marketing challenges. Consumer demand for *ReFLEX* in South Korea and Japan has not been as high as we projected. We cannot assure you that the English remediation solution will be successful or profitable, or if it is profitable, that it will provide an adequate return on capital expended.

***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; and

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

***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;

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

provide appealing solutions that engage our customers;

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

effectively position and market our products and services;

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

identify cost-effective sales distribution channels, 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.

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

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

The success of our business depends to a significant extent upon discretionary consumer spending, which is subject to a number of factors, including general economic conditions, consumer confidence, employment levels, business conditions, interest rates, availability of credit, inflation and taxation. Adverse trends in any of these economic indicators may cause consumer spending to decline further, which could hurt our sales and profitability. For our retail business, we depend on the continued popularity of physical stores and malls to generate customer traffic for retailers such as Barnes & Noble, Best Buy, Books-A-Million, Costco, and Staples which sell our products and our retail mall-based kiosks. We also depend on continued airline travel to generate traffic for our retail kiosks located in airports. Decreases in physical store, mall or airport retail traffic adversely affect our consumer sales and our profitability and financial condition. In addition, an increase in the taxation of online sales could result in reduced online purchases or reduced margins on such sales. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors.

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

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers and distributors are highly concentrated on a small group, including Amazon.com, Barnes & Noble, Best Buy, Books-A-Million, Costco, Groupon, Navarre, and Staples. Sales to or through our retailers and distributors accounted for approximately 17% of our revenue for the year ended December 31, 2012, compared to 14% for the year ended December 31, 2011.

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We have no control over the amount of products that these retailers and distributors purchase from us or sell on our behalf, we do not have long-term contracts with any of them, and they have no obligation to offer or sell our products or to give us any particular shelf space or product placement within their stores. Thus, there is no guarantee that this source of revenue will continue at the same level as it has in the past or that these retailers and distributors will not promote competitors' products over our products or enter into exclusive relationships with competitors. Any material adverse change in the principal commercial terms, material decrease in the volume of sales generated by our larger retailers or distributors or major disruption or termination of a relationship with these retailers and distributors could result in a potentially significant decline in our revenue and profitability. Furthermore, product display locations and promotional activities that retailers undertake can affect the sales of our products. The fact that we also sell our products directly could cause retailers or distributors to reduce their efforts to promote our products or stop selling our products altogether. As evidenced by the bankruptcy and liquidation of Borders, book stores and other traditional physical retailers are experiencing diminished foot traffic and sales. Reduced customer foot traffic in these stores is likely to reduce their sales of our products. In addition, if one or more of these bookstores or other retailers or distributors are unable to meet their obligations with respect to accounts payable to us, we could be forced to write off such accounts. Any bankruptcy, liquidation, insolvency or other failure of any of these retailers or distributors could result in significant financial loss and cause us to lose revenue in future periods.

***Product returns and pricing concessions could exceed our estimates, which would diminish our reported revenue.***

In the United States, we offer consumers who purchase our packaged software and audio practice products directly from us six-month unconditional full money-back. We also permit some of our retailers and distributors to return packaged products, subject to certain limitations. We establish revenue reserves for packaged product returns based on historical experience, estimated channel inventory levels, the timing of new product introductions and other factors. If packaged product returns exceed our reserve estimates, the excess would offset reported revenue, which could hurt our reported financial results.

We continue to test changes to the pricing and delivery methods of our products. If we reduce our prices or our method of delivery as a result of successful tests in an effort to increase sales volume and overall market penetration, we may provide our retailers and distributors with price protection on existing inventories, which would allow these retailers and distributors a credit against amounts owed with respect to unsold packaged product under certain conditions. These price protection reserves could be material in future periods. It is uncertain whether these strategies will prove successful or whether we will be able to develop the necessary infrastructure and business models.

The intense competition we face in the sales of our language learning solutions and general economic and business conditions can put pressure on us to change our prices. If our competitors offer deep discounts on certain products or services or develop products that the marketplace considers more valuable, we may need to lower prices or offer other favorable terms in order to compete successfully. Any such changes may reduce margins and could adversely affect operating results. Any broad-based change to our prices and pricing policies could cause our revenues to decline or be delayed as our sales force implements and our customers adjust to the new pricing policies. If we do not adapt our pricing models to reflect changes in customer use of our products or changes in customer demand, our revenues could decrease.

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***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. 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 or in select local markets. The resources of these competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements, reduce prices to win new customers and offer free language-learning software or online services. We may not be able to compete successfully against current or future competitors.

As the market for foreign language solutions continues to develop, a number of other companies with greater resources than ours could attempt to enter the market or increase their presence by acquiring or forming strategic alliances with our competitors or our distributors or by introducing their own competing products. These companies and their products may be superior to any of our current competition. We have also seen increased competition from imitation products which are lower priced, lower quality products that attempt to capitalize on the popularity of our products by utilizing similar packaging and marketing materials. In addition, we see increased competition from community practice providers which provide low priced entry points for consumers interested in learning languages. We may not have the financial resources, technical expertise, marketing, distribution or support capabilities to compete effectively with any of these new entrants to the market.

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

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

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

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

create greater awareness of our brands and our 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, distribution channels and kiosks; and

convert customer inquiries into actual orders.

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

Some of our radio, television and print advertising has been through the purchase of "remnant" advertising segments. These segments are random time slots and publication dates that have remained unsold and are offered at discounts to advertisers who are willing to be flexible with respect to time slots. There is a limited supply of this type of advertising and the availability of such advertising may decline or the cost of such advertising may increase. In addition, if we increase our marketing budget 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.

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

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

***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 our business, expand our products and services and extend our geographic reach, maintaining the quality and consistency of our language-learning solutions, and thus the quality of our brand, may be more difficult. In addition, software piracy and trademark infringement may harm our *Rosetta Stone* brand by undermining our reputation for quality software programs. We must continue to update our marketing communications in order to maintain and enhance our brand awareness and the value of our brand. Failure to do so may result in a decrease in brand value and related sales.





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***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.***

Our business strategy contemplates stabilizing the losses we have experienced in international markets in order to prepare for future growth and expansion into international markets. We are currently augmenting and optimizing certain of our website direct sales channels in Europe, Asia and Latin America. In addition, we are continuing to selectively expand and optimize our indirect sales channels in Europe, Asia and Latin America through retailer and distributor arrangements with third parties. If we are unable to stabilize losses in our international operations successfully and in a timely manner, our ability to subsequently pursue our growth strategy will be impaired. Such stabilization and expansion may be more difficult or take longer than we anticipate, and we may not be able to successfully market, sell, deliver and support our products and services internationally to the extent we expect.

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

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

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

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

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

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

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

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

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

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

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

protectionist laws and business practices that favor local competitors; and

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

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

***If the recognition by schools and other 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

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the education process that can result from offering courses online. If the acceptance of technology-based education does not continue to grow, our ability to continue to grow our 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, or government agencies, we could lose revenue.***

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

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governmental funding support for products such as ours would also cause us to lose revenue and could hurt our overall gross margins.

***Some of our institutional business faces a lengthy and unpredictable sales cycle for our solutions, which could delay new sales.***

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

customers' budgetary constraints and priorities;

the timing of our customers' budget cycles;

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

the length and timing of customers' approval processes.

***If we are unable to continually enhance our products and services and adapt them to technological changes and customer needs, including the emergence of new computing devices and more sophisticated online services, we may lose market share and revenue and our business could suffer.***

We need to anticipate, develop and introduce new products, services and applications on a timely and cost-effective basis that keeps pace with technological developments and changing customer needs. The process of developing new high technology products, services and applications and enhancing existing products, services and applications is complex, costly and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our market share and results of operations. For example, the number of individuals who access the internet through devices other than a personal computer, such as tablet computers, mobile devices, televisions and set-top box devices, has increased dramatically and this trend is likely to continue. Our products and services may not work or be viewable on these devices because each manufacturer or distributor may establish unique technical standards for such devices. With the exception of *TOTALe* Companion, we have no experience to date in operating versions of our products and services developed or optimized for users of alternative devices, and new devices and new platforms are continually being released. Accordingly, we may need to devote significant resources to the creation, support and maintenance of such versions. If we fail to develop or sell products and services that respond to these or other technological developments and changing customer needs, such as the demand for products designed for children, cost effectively, we may lose market share and revenue and our business could suffer.

We offer our software products and services primarily on Windows and Macintosh platforms. To the extent that there is a slowdown of customer purchases of personal computers on either the Windows or Macintosh platform or in general, to the extent that we have difficulty transitioning product or version releases to new Windows and Macintosh operating systems, or to the extent that significant demand arises for our products or competitive products on other platforms before we choose and are able to offer our products on these platforms, our business could be harmed. To the extent new releases of operating systems, including for mobile and non-PC devices, or other third-party products, platforms or devices make it more difficult for our products to perform, and our customers are persuaded to use alternative technologies, our business could be harmed.

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

We are currently involved in efforts to stabilize losses in our international business and aim to ultimately expand our operations internationally, grow our institutional business, and move our business more online, which has strained our managerial, operational, financial and other resources.

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

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

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

Historically, we have predominantly sold our packaged software programs for a single upfront fee and recorded 65-90% of the revenue at the time of sale. We are delivering more of our solutions online pursuant to different duration subscription fees. Selling in this manner will result in substantially less cash and revenue from the initial sale to the customer and could have a substantially negative impact on our revenue, results of operations and cash flow in the short term.

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

Our ability to attract customers to online offerings will depend in part on our ability to consistently provide our customers with a valuable and quality experience for learning languages. If consumers do not perceive our service offering to be of value, or if we introduce new or adjust existing features or change the mix of content in a manner that is not favorably received by them, we may not be able to attract and retain customers. Customers may cancel their subscription to our service for many reasons, including a perception that they do not use the service sufficiently, the need to cut household expenses, competitive services providing a better value or experience, or customer service issues not being satisfactorily resolved. If too many of our customers cancel our service, or if we are unable to attract new customers in numbers sufficient to grow our business, our operating results will be adversely affected. If too many customers cancel our service, we may be required to incur significantly higher marketing and advertising expenditures than we currently anticipate to replace these customers. We expect to derive an increasing portion of our revenues in the future from subscriptions to our cloud-based offerings. This subscription model prices and delivers our products in a way that differs from the historical pricing and delivery methods of our language learning solutions. These changes reflect a shift from perpetual license sales and distribution of our software in favor of providing our customers the right to access certain of our software in a hosted environment or use downloaded software for a specified subscription period. This cloud strategy requires continued investment in product development

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and cloud operations, and may give rise to a number of risks, including a lag in sales, dissatisfaction from perpetual license customers, difficulty setting optimal pricing that could negatively affect sales and/or earnings, revenues that decline over the short or long term, confusion among our customers, resellers and investors and higher than forecasted costs.

***Our revenue is subject to seasonal and quarterly variations, which could cause our financial results to fluctuate significantly.***

We have experienced, and we believe we will continue to experience, substantial seasonal and quarterly variations in our revenue and net income. These variations are primarily related to increased sales of our products and services to consumers in the fourth quarter during the holiday selling season as well as higher sales to governmental and educational institutions in the second and third quarters. We sell to a significant number of our retailers, distributors and institutional customers on a purchase order basis and we receive orders when these customers need products and services. As a result, their orders are typically not evenly distributed throughout the year. Our quarterly results of operations also may fluctuate significantly as a result of a variety of other factors, including the timing of holidays and advertising initiatives, changes in our products, services and advertising initiatives and changes in those of our competitors. Budgetary constraints of our institutional customers may also cause our quarterly results to fluctuate.

As a result of these seasonal and quarterly fluctuations, we believe that comparisons of our results of operations between different quarters are not necessarily meaningful and that these comparisons are not reliable as indicators of our future performance. In addition, these fluctuations could result in volatility and adversely affect our cash flows. As our business grows, these seasonal fluctuations may become more pronounced. Any seasonal or quarterly fluctuations that we report in the future may differ from the expectations of market analysts and investors. This could cause the price of our common stock to fluctuate significantly.

***Substantially all of our inventory is located in one warehouse facility. Any damage or disruption at this facility could cause significant financial loss, including loss of revenue and harm to our reputation.***

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

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

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

Our future success also depends on our continued ability to attract and retain highly qualified technical, development, sales, services and management personnel. Competition for such personnel is

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intense, and we may fail to retain our key employees or attract or retain other highly qualified personnel in the future. Many of our employees are located in Harrisonburg, Virginia, a city that does not have a large pool of qualified replacement personnel. The lack of qualified local replacement personnel may make it more difficult to quickly find replacement personnel and may increase the costs of identifying and relocating replacement personnel to Harrisonburg, Virginia or increase costs due to hiring replacements in other higher cost of living cities such as Arlington, Virginia or Boulder, Colorado.

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

***Our kiosk business generates significant revenues, and if we are unable to successfully reposition our kiosk business, or hire, train, motivate and retain sales personnel to staff our kiosks, or to identify suitable locations and negotiate site licenses on acceptable terms, we could lose revenue, our costs could increase and our profitability could decline.***

The number of worldwide kiosks decreased 50% from 174 as of December 31, 2011 to 87 as of December 31, 2012. In 2012, based on our evaluation of historical and forecasted kiosk sales performance and profitability, we significantly reduced the size of our worldwide kiosk program, in addition to continually reviewing the performance of remaining kiosk locations.

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

***Failure to maintain the availability of the systems, networks, databases and software required to operate and deliver our internet-based products and services could damage our reputation and cause us to lose revenue.***

We rely on internal systems and external systems, networks and databases maintained by us and third-party providers to process customer orders, handle customer service requests, and host and deliver our internet-based language-