ROSETTA STONE INC
Form 10-Q
November 07, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2013

Commission File Number: 1-34283

ROSETTA STONE INC.

(Exact name of Registrant as specified in its charter)

Delaware	**043837082**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1919 North Lynn St., 7th Fl.	
Arlington, Virginia	**22209**
(Address of Principal Executive Offices)	(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 x No o

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 x No o

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

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

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

As of October 31, 2013, 21,889,614 shares of the registrant s Common Stock, $.00005 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ROSETTA STONE INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(Unaudited)

	September 30, 2013	December 31, 2012 (As Adjusted)*
Assets		
Current assets:		
Cash and cash equivalents	$ 113,104	$ 148,190
Restricted cash	82	73
Accounts receivable (net of allowance for doubtful accounts of $1,182 and $1,297, respectively)	46,339	49,946
Inventory	7,038	6,581
Prepaid expenses and other current assets	10,391	8,651
Income tax receivable	648	1,104
Deferred income taxes	79	30
Total current assets	177,681	214,575
Property and equipment, net	18,029	17,213
Goodwill	49,972	34,896
Intangible assets, net	29,801	10,825
Deferred income taxes	218	257
Other assets	3,225	1,680
Total assets	$ 278,926	$ 279,446
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 7,588	$ 6,064
Accrued compensation	13,094	16,830
Other current liabilities	30,482	36,387
Deferred revenue	62,168	59,195
Total current liabilities	113,332	118,476
Deferred revenue	10,463	4,221
Deferred income taxes	9,251	8,400
Other long-term liabilities	2,627	155
Total liabilities	135,673	131,252
Commitments and contingencies (Note 12)		

Stockholders equity:				
Preferred stock, $0.001 par value; 10,000 and 10,000 authorized; zero and zero shares issued and outstanding September 30, 2013 and December 31, 2012, respectively				
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 22,650 and 21,951 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively		2		2
Additional paid-in capital		168,026		160,693
Accumulated loss		(25,444)		(13,158)
Accumulated other comprehensive income		669		657
Total stockholders equity		143,253		148,194
Total liabilities and stockholders equity	$	278,926	$	279,446

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012 (As Adjusted) *	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012 (As Adjusted) *
Revenue:				
Product	$ 34,038	$ 42,462	$ 107,087	$ 127,534
Subscription and service	26,834	21,817	79,847	67,006
Total revenue	60,872	64,279	186,934	194,540
Cost of revenue:				
Cost of product revenue	7,325	7,858	21,263	24,087
Cost of subscription and service revenue	3,419	3,327	9,969	11,892
Total cost of revenue	10,744	11,185	31,232	35,979
Gross profit	50,128	53,094	155,702	158,561
Operating expenses				
Sales and marketing	34,844	36,830	104,904	110,518
Research and development	8,797	5,177	25,248	17,944
General and administrative	13,987	14,474	40,209	41,050
Lease abandonment	7		835	
Total operating expenses	57,635	56,481	171,196	169,512
Loss from operations	(7,507)	(3,387)	(15,494)	(10,951)
Other income and (expense):				
Interest income	21	42	105	141
Interest expense	(9)		(54)	
Other (expense) income	(305)	(27)	105	(71)
Total other income (expense)	(293)	15	156	70
Loss before income taxes	(7,800)	(3,372)	(15,338)	(10,881)
Income tax (benefit) provision	(3,631)	28,691	(3,052)	27,739
Net loss	$ (4,169)	$ (32,063)	$ (12,286)	$ (38,620)
Net loss per share:				
Basic	$ (0.19)	$ (1.52)	$ (0.57)	$ (1.84)
Diluted	$ (0.19)	$ (1.52)	$ (0.57)	$ (1.84)
Common shares and equivalents outstanding:				
Basic weighted average shares	21,827	21,073	21,587	21,004
Diluted weighted average shares	21,827	21,073	21,587	21,004

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

(Unaudited)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012 (As Adjusted)*	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012 (As Adjusted)*
Net loss	$ (4,169)	$ (32,063)	$ (12,286)	$ (38,620)
Other comprehensive income (loss), net of tax:				
Foreign currency translation gain (loss)	373	230	12	205
Unrealized gain on available-for-sale securities		5		23
Other comprehensive income (loss)	373	235	12	228
Comprehensive loss	$ (3,796)	$ (31,828)	$ (12,274)	$ (38,392)

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012 (As Adjusted)*
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (12,286)	$ (38,620)
Adjustments to reconcile net loss to cash (used in) provided by operating activities:		
Stock-based compensation expense	6,229	6,208
Bad debt expense	682	1,335
Depreciation and amortization	7,005	6,230
Deferred income tax (benefit) expense	(4,527)	25,846
Loss on disposal of equipment	246	752
Net change in:		
Restricted cash	(9)	15
Accounts receivable	5,672	11,149
Inventory	(506)	1
Prepaid expenses and other current assets	(1,593)	662
Income tax receivable	391	(2,080)
Other assets	(1,662)	(78)
Accounts payable	961	(377)
Accrued compensation	(4,180)	1,476
Other current liabilities	(8,092)	(6,690)
Other long term liabilities	329	(44)
Deferred revenue	7,606	5,707
Net cash (used in) provided by operating activities	(3,734)	11,492
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(6,415)	(2,939)
Proceeds from available-for-sale securities		9,711
Acquisitions, net of cash acquired	(25,675)	
Net cash (used in) provided by investing activities	(32,090)	6,772
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	2,379	830
Repurchase of shares from exercised stock options	(1,040)	
Tax benefit of stock options exercised		
Proceeds from equity offering, net of issuance costs	(228)	
Payments under capital lease obligations	(213)	(5)
Net cash provided by financing activities	898	825
(Decrease) increase in cash and cash equivalents	(34,926)	19,089
Effect of exchange rate changes in cash and cash equivalents	(160)	441
Net (decrease) increase in cash and cash equivalents	(35,086)	19,530
Cash and cash equivalents beginning of year	148,190	106,516
Cash and cash equivalents end of period	$ 113,104	$ 126,046
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	$ 10	$
Income taxes	$ 2,745	$ 3,487

Noncash financing and investing activities:				
Accrued liability for purchase of property and equipment	$	1,147	$	316
Equipment acquired under capital lease	$	586	$	
Accrued merger consideration	$	3,375		

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. NATURE OF OPERATIONS

Rosetta Stone Inc. and its subsidiaries (Rosetta Stone, or the Company) develop, market and support a suite of language and reading learning solutions consisting of software products, online services and audio practice tools under the Rosetta Stone, Lexia and Livemocha brand names. The Company s software products are sold on a direct basis and through select retailers. The Company provides its software applications to customers through the sale of packaged software and online subscriptions, domestically and in certain international markets.

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 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 of America (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 omitted pursuant to such rules and regulations. Accordingly, these interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K filed with the SEC on March 7, 2013. The December 31, 2012 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, except for the Company s voluntary change for sales commissions as described below.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and in the opinion of management include all normal recurring adjustments necessary for the fair presentation of the Company s consolidated statement of financial position at September 30, 2013 and December 31, 2012, the Company s results of operations for the three and nine months ended September 30, 2013 and 2012 and its cash flows for the nine months ended September 30, 2013 and 2012. The results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results to be expected for the year ending December 31, 2013. All references to September 30, 2013 or to the three and nine months ended September 30, 2013 and 2012 in the notes to the consolidated financial statements are unaudited.

Use of Estimates

The preparation of financial statements in accordance with GAAP 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 intangibles and goodwill, inventory reserve, disclosure of contingent assets and liabilities, disclosure of contingent litigation, and allowance for valuation of deferred tax assets. Actual results may differ from these estimates.

Changes in Accounting Principle

In the third quarter of 2013, the Company voluntarily changed its accounting policy for sales commissions related to non-cancellable Software-as-a-Service (SaaS) contracts, from recording an expense when incurred, to deferral of the sales commission in proportion to the consideration allocated to each of the elements in the arrangement and in, or over, the same period the revenue is recognized for each of the elements in the arrangement (i.e. over the non-cancellable term of the contract for the SaaS deliverable). The Company is anticipating a significant increase in contracts with multi-year subscriptions and a corresponding increase in sales commissions due, among other reasons, to its acquisition of Lexia Learning Systems, Inc. (Lexia) in August 2013. Lexia provides services using a SaaS model and has historically had long-term arrangements with material sales commissions paid to its network of resellers and has applied a sales commission deferral and amortization policy.

The Company believes the deferral method described above is preferable primarily because (i) the sales commission charges are so closely related to obtaining the revenue from the non-cancellable contracts that they should be deferred and charged to expense over the same period that the related revenue is recognized; and (ii) it provides a single accounting policy, consistent with that used by Lexia, that makes it easier for financial statement users to understand. Deferred commission amounts are recoverable through the future revenue streams under the non-cancellable arrangements.

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Short-term deferred commissions are included in prepaid expenses and other current assets, while long-term deferred commissions are included in other assets in the accompanying consolidated balance sheets. The amortization of deferred commissions is included in sales and marketing expense in the accompanying consolidated statements of operations.

The accompanying consolidated financial statements and related notes have been adjusted to reflect the impact of this change and the associated deferred tax impact retrospectively to all prior periods. Under the as previously reported basis, there was no book / tax basis difference related to commission expense. Under the as adjusted basis, the deferred commission asset creates a deferred tax liability related to commissions expense which has been deducted for tax purposes.

The following tables present the effects of the retrospective application of the voluntary change in accounting principle for sales commissions related to non-cancellable SaaS contracts for all periods presented, effective as of January 1, 2012 (in thousands):

Consolidated Balance Sheet (in thousands)

	September 30, 2013			December 31, 2012		
	Computed under Prior Method	Impact of Commission Adjustment	As Reported	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Prepaid expenses and other current assets	$ 6,457	$ 3,934	$ 10,391	$ 5,204	$ 3,447	$ 8,651
Deferred income taxes (current)	$ 141	$ (62)	$ 79	$ 79	$ (49)	$ 30
Total current assets	$ 173,809	$ 3,872	$ 177,681	$ 211,177	$ 3,398	$ 214,575
Other assets	$ 3,060	$ 165	$ 3,225	$ 1,484	$ 196	$ 1,680
Deferred income taxes (non-current)	$ 221	$ (3)	$ 218	$ 260	$ (3)	$ 257
Total assets	$ 274,892	$ 4,034	$ 278,926	$ 275,855	$ 3,591	$ 279,446
Accumulated loss	$ (29,478)	$ 4,034	$ (25,444)	$ (16,749)	$ 3,591	$ (13,158)
Total stockholders equity	$ 139,219	$ 4,034	$ 143,253	$ 144,603	$ 3,591	$ 148,194
Total liabilities and stockholders equity	$ 274,892	$ 4,034	$ 278,926	$ 275,855	$ 3,591	$ 279,446

Consolidated Statement of Operations (in thousands, except per share data)

	Three Months Ended March 31, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 38,404	$ 166	$ 38,570
Loss from operations	$ (2,359)	$ (166)	$ (2,525)
Income tax provision (benefit)	$ (742)	$ (66)	$ (808)
Net loss	$ (1,903)	$ (100)	$ (2,003)
Basic net loss per share	$ (0.09)	$ (0.01)	$ (0.10)
Diluted net loss per share	$ (0.09)	$ (0.01)	$ (0.10)

Shares used in computing basic net loss per share	20,942	20,942
Shares used in computing diluted net loss per share	20,942	20,942

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	As Previously Reported	**Impact of Commission Adjustment**	**As Adjusted**	**As Previously Reported**	**Impact of Commission Adjustment**	**As Adjusted**
Sales and marketing	$ 35,125	$ (6)	$ 35,119	$ 73,529	$ 160	$ 73,689
Loss from operations	$ (5,045)	$ 6	$ (5,039)	$ (7,404)	$ (160)	$ (7,564)
Income tax provision (benefit)	$ (160)	$ 16	$ (144)	$ (902)	$ (50)	$ (952)
Net loss	$ (4,544)	$ (10)	$ (4,554)	$ (6,447)	$ (110)	$ (6,557)
Basic net loss per share	$ (0.22)	$ 0.00	$ (0.22)	$ (0.31)	$	$ (0.31)
Diluted net loss per share	$ (0.22)	$ 0.00	$ (0.22)	$ (0.31)	$	$ (0.31)
Shares used in computing basic net loss per share	20,995		20,995	20,969		20,969
Shares used in computing diluted net loss per share	20,995		20,995	20,969		20,969

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Consolidated Statement of Operations (in thousands, except per share data), continued

	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 37,113	$ (283)	$ 36,830	$ 110,641	$ (123)	$ 110,518
Loss from operations	$ (3,670)	$ 283	$ (3,387)	$ (11,074)	$ 123	$ (10,951)
Income tax provision (benefit) (1)	$ 29,735	$ (1,044)	$ 28,691	$ 28,833	$ (1,094)	$ 27,739
Net loss	$ (33,390)	$ 1,327	$ (32,063)	$ (39,837)	$ 1,217	$ (38,620)
Basic net loss per share	$ (1.58)	$ 0.06	$ (1.52)	$ (1.90)	$ 0.06	$ (1.84)
Diluted net loss per share	$ (1.58)	$ 0.06	$ (1.52)	$ (1.90)	$ 0.06	$ (1.84)
Shares used in computing basic net loss per share	21,073		21,073	21,004		21,004
Shares used in computing diluted net loss per share	21,073		21,073	21,004		21,004

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(1) During the third quarter of 2012 the Company established a full valuation allowance to reduce the deferred tax assets of its operations in Brazil, Japan and the U.S. The amount of the valuation allowance recorded in the third quarter of 2012 would have been reduced by the amount of the deferred tax liability arising from the deferred commission asset had commissions expense been accounted for under the as adjusted policy which resulted in the $1.0 million and $1.1 million income tax benefit shown as the adjustment for the three and nine month periods ended September 30, 2012, respectively.

	Three Months Ended March 31, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 37,060	$ 213	$ 37,273
Loss from operations	$ (4,138)	$ (213)	$ (4,351)
Income tax provision (benefit)	$ 977	$ (9)	$ 968
Net loss	$ (4,700)	$ (204)	$ (4,904)
Basic net loss per share	$ (0.22)	$ (0.01)	$ (0.23)
Diluted net loss per share	$ (0.22)	$ (0.01)	$ (0.23)
Shares used in computing basic net loss per share	21,360		21,360
Shares used in computing diluted net loss per share	21,360		21,360

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 33,144	$ (357)	$ 32,787	$ 70,203	$ (144)	$ 70,059
Loss from operations	$ (3,991)	$ 357	$ (3,634)	$ (8,130)	$ 144	$ (7,986)
Income tax provision (benefit)	$ (400)	$ 13	$ (387)	$ 576	$ 4	$ 580
Net loss	$ (3,557)	$ 344	$ (3,213)	$ (8,257)	$ 140	$ (8,117)
Basic net loss per share	$ (0.16)	$ 0.01	$ (0.15)	$ (0.38)	$	$ (0.38)
Diluted net loss per share	$ (0.16)	$ 0.01	$ (0.15)	$ (0.38)	$	$ (0.38)
Shares used in computing basic net loss per share	21,569		21,569	21,465		21,465

Shares used in computing diluted net loss per share	21,569	21,569	21,465	21,465

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Consolidated Statement of Operations (in thousands, except per share data), continued

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 35,156	$ (312)	$ 34,844	$ 105,360	$ (456)	$ 104,904
Loss from operations	$ (7,819)	$ 312	$ (7,507)	$ (15,950)	$ 456	$ (15,494)
Income tax provision (benefit)	$ (3,640)	$ 9	$ (3,631)	$ (3,065)	$ 13	$ (3,052)
Net loss	$ (4,472)	$ 303	$ (4,169)	$ (12,729)	$ 443	$ (12,286)
Basic net loss per share	$ (0.20)	$ 0.01	$ (0.19)	$ (0.59)	$ 0.02	$ (0.57)
Diluted net loss per share	$ (0.20)	$ 0.01	$ (0.19)	$ (0.59)	$ 0.02	$ (0.57)
Shares used in computing basic net loss per share	21,827		21,827	21,587		21,587
Shares used in computing diluted net loss per share	21,827		21,827	21,587		21,587

Consolidated Statement of Comprehensive Loss (in thousands)

	Three Months Ended March 31, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (1,903)	$ (100)	$ (2,003)
Other comprehensive income (loss)	$ (1,601)	$ (100)	$ (1,701)

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,544)	$ (10)	$ (4,554)	$ (6,447)	$ (110)	$ (6,557)
Other comprehensive income (loss)	$ (4,853)	$ (10)	$ (4,863)	$ (6,454)	$ (110)	$ (6,564)

	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (33,390)	$ 1,327	$ (32,063)	$ (39,837)	$ 1,217	$ (38,620)
Other comprehensive income (loss)	$ (33,155)	$ 1,327	$ (31,828)	$ (39,609)	$ 1,217	$ (38,392)

	Three Months Ended March 31, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,700)	$ (204)	$ (4,904)
Other comprehensive income (loss)	$ (5,181)	$ (204)	$ (5,385)

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (3,557)	$ 344	$ (3,213)	$ (8,257)	$ 140	$ (8,117)
Other comprehensive income (loss)	$ (3,437)	$ 344	$ (3,093)	$ (8,618)	$ 140	$ (8,478)

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,472)	$ 303	$ (4,169)	$ (12,729)	$ 443	$ (12,286)
Other comprehensive income (loss)	$ (4,099)	$ 303	$ (3,796)	$ (12,717)	$ 443	$ (12,274)

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Consolidated Statement of Cash Flows (in thousands)

	Three Months Ended March 31, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (1,903)	$ (100)	$ (2,003)
Deferred income tax provision (benefit)	$ (1,314)	$ (66)	$ (1,380)
Prepaid expenses and other current assets	$ 503	$ 118	$ 621
Other assets	$ (1,209)	$ 48	$ (1,161)
Net cash provided by (used in) operating activities	$ 2,656	$	$ 2,656

	Six Months Ended June 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (6,447)	$ (110)	$ (6,557)
Deferred income tax provision (benefit)	$ (1,156)	$ (50)	$ (1,206)
Prepaid expenses and other current assets	$ 649	$ 140	$ 789
Other assets	$ (1,065)	$ 20	$ (1,045)
Net cash provided by (used in) operating activities	$ 6,068	$	$ 6,068

	Nine Months Ended September 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (39,837)	$ 1,217	$ (38,620)
Deferred income tax provision (benefit)	$ 26,940	$ (1,094)	$ 25,846
Prepaid expenses and other current assets	$ 785	$ (123)	$ 662
Other assets	$ (78)	$	$ (78)
Net cash provided by (used in) operating activities	$ 11,492	$	$ 11,492

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Consolidated Statement of Cash Flows (in thousands)

	Three Months Ended March 31, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,700)	$ (204)	$ (4,904)
Deferred income tax provision (benefit)	$ 298	$ (9)	$ 289
Prepaid expenses and other current assets	$ (2,559)	$ 113	$ (2,446)
Other assets	$ 5	$ 100	$ 105
Net cash provided by (used in) operating activities	$ (5,635)	$	$ (5,635)

	Six Months Ended June 30, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (8,257)	$ 140	$ (8,117)
Deferred income tax provision (benefit)	$ (627)	$ 4	$ (623)
Prepaid expenses and other current assets	$ (2,568)	$ (176)	$ (2,744)
Other assets	$ 10	$ 32	$ 42
Net cash provided by (used in) operating activities	$ (3,147)	$	$ (3,147)

	Nine Months Ended September 30, 2013		
	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted
Net loss	$ (12,729)	$ 443	$ (12,286)
Deferred income tax provision (benefit)	$ (4,539)	$ 12	$ (4,527)
Prepaid expenses and other current assets	$ (1,106)	$ (487)	$ (1,593)
Other assets	$ (1,694)	$ 32	$ (1,662)
Net cash provided by (used in) operating activities	$ (3,734)	$	$ (3,734)

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The change in accounting principle resulted in an increase to accumulated income of $2,878 thousand as of January 1, 2012 to $21,960 thousand from $19,082 thousand, as previously reported.

Revenue Recognition

The Company s primary products include Rosetta Stone *TOTALe* online and Rosetta Stone Version 4 *TOTALe*. Rosetta Stone *TOTALe* online combines an online software subscription with conversational coaching and is available in a selection of time-based offers (e.g. three, six and 12 month durations). Version 4 *TOTALe* includes a *TOTALe* online subscription bundled with perpetual software available as a CD-ROM or download. Revenue is also derived from the sale of audio practice products and professional services, which include training and implementation services.

Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenues are recorded net of discounts. The Company recognizes revenue for software products and related services in accordance with Accounting Standards Codification (ASC) subtopic 985-605, *Software: Revenue Recognition* (ASC 985-605).

For multiple element arrangements that include *TOTALe* online software subscriptions bundled with auxiliary items, such as headsets and audio practice products which provide stand-alone value to the customer, the Company allocates revenue to all deliverables based on their relative selling prices in accordance with ASC subtopic 605-25 *Revenue Recognition Multiple-Element Arrangements* (ASC 605-25). The Company has identified two deliverables generally contained in sales of Rosetta Stone *TOTALe* online software subscriptions. The first deliverable is the auxiliary items, which are delivered at the time of sale, and the second deliverable is the online services.

For Rosetta Stone Version 4 *TOTALe*, which is a multiple-element arrangement that includes perpetual software bundled with the subscription and conversational coaching components of the *TOTALe* online service, the Company allocates revenue to all deliverables based on vendor-specific objective evidence of fair value (VSOE), in accordance with ASC subtopic 985-605-25 *Software: Revenue Recognition Multiple-Element Arrangements* (ASC 985-605-25). The Company has identified two

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deliverables generally contained in Rosetta Stone V4 *TOTALe* software arrangements. The first deliverable is the perpetual software, which is delivered at the time of sale, and the second deliverable is subscription service. Revenue is allocated between these two deliverables using the residual method based on the existence of VSOE of the subscription service.

Revenue for online service subscriptions including conversational coaching is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Rosetta Stone Version 4 *TOTALe* bundles, which include packaged software and an online service subscription including conversational coaching, allow customers to begin their online services at any point during a registration window, which is up to six months from the date of purchase from the Company or an authorized reseller. Online service subscriptions that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Some online licensing arrangements include a specified number of licenses that can be activated over a period of time, which typically ranges between six and 24 months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement.

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 and audio practice products is recognized as the products are shipped and title passes and risks of loss have been transferred. For most product sales, these criteria are met at the time the product is shipped. For some sales to resellers and certain other sales, the Company defers revenue until the customer receives the product because Rosetta Stone legally retains a portion of the risk of loss on these sales during transit. A limited amount of packaged software products are sold to resellers on a consignment basis. Revenue is recognized for these consignment transactions once the end user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with ASC subtopic 985-605-50, *Software: Revenue Recognition: Customer Payments and Incentives* (ASC 985-605-50), price protection for changes in the manufacturer suggested retail value granted to resellers for the inventory that they have on hand at the date the price protection is offered is recorded as a reduction to revenue. In accordance with ASC 985-605-50, cash sales incentives to resellers are accounted for as a reduction of revenue, unless a specific identified benefit is identified and the fair value is reasonably determinable.

The Company offers customers the ability to make payments for packaged software purchases in installments over a period of time, which typically ranges between three and five months. Given that these installment payment plans are for periods less than 12 months 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 the Company with a limited right of return. The Company also allows its retailers to return unsold products, subject to some limitations. In accordance with ASC subtopic 985-605-15, *Software: Revenue Recognition: Products* (ASC 985-605-15), product revenue is reduced for estimated returns, which are based on historical return rates.

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

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

On April 1, 2013, the Company completed its acquisition of Livemocha, Inc. (Livemocha). Online subscription revenue from Livemocha is recognized ratably over the term of the subscription and is included in the Company s results from operations after the acquisition date.

On August 1, 2013, the Company completed its acquisition of Lexia. The Lexia product offering includes term licenses with software hosting arrangements and subscriptions. License and hosting revenues are recognized over the term of the arrangement. Subscription fees are recognized on a straight line basis over the term of the subscription. As part of the Lexia acquisition, the Company acquired $1.2 million of deferred revenue. The deferred revenue will be recognized as revenue, on a contract by contract basis over the remaining term of the arrangements, which expire at various dates through 2022. The Company is the primary obligor to its end-user customers and therefore acts as principal in customer sales transactions, with its resellers acting as agents. Revenue is recognized on a gross basis accordingly, with related reseller commissions charged to sales and marketing expense.

Income Taxes

The Company accounts for income taxes in accordance with ASC topic 740, *Income Taxes* (ASC 740), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of

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the differences between the financial statement carrying amounts of assets and liabilities versus the respective tax bases of such assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The impact of tax rate changes on deferred tax assets and liabilities is recognized in the year that the change is enacted.

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of September 30, 2013. When measuring the need for a valuation allowance on a jurisdiction by jurisdiction basis, the Company assesses both positive and negative evidence regarding whether these deferred tax assets are realizable. In determining deferred tax assets and valuation allowances, the Company is required to make judgments and estimates related to projections of profitability, the timing and extent of the utilization of temporary differences, net operating loss carryforwards, tax credits, applicable tax rates, transfer pricing methodologies and tax planning strategies. The valuation allowance is reviewed quarterly and is maintained until sufficient positive evidence exists to support a reversal. Because evidence such as the Company s operating results during the most recent three-year period is afforded more weight than forecasted results for future periods, the Company s cumulative loss in certain jurisdictions represents significant negative evidence in the determination of whether deferred tax assets are more likely than not to be utilized in certain jurisdictions. This determination resulted in the need for a valuation allowance on the deferred tax assets of certain jurisdictions. The Company will release this valuation allowance when it is determined that it is more likely than not that its deferred tax assets will be realized. Any future release of valuation allowance may be recorded as a tax benefit increasing net income.

Fair Value of Financial Instruments

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

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

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

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

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

On November 1, 2009, the Company acquired certain assets from SGLC International Co. Ltd. (SGLC), a software reseller headquartered in Seoul, South Korea. As the assets acquired constituted a business, this transaction was accounted for under ASC topic 805, *Business Combinations* (ASC 805). The purchase price consisted of an initial cash payment of $100,000, followed by three annual cash installment payments if the acquired company s revenues exceed certain targeted levels each of these years. The amount was calculated as the lesser of a percentage of the revenue generated or a fixed amount for each year, based on the terms of the agreement.

Based on these terms, the minimum additional cash payment would have been zero if none of the minimum revenue targets were met, and the maximum additional payment would have been $1.1 million, which amount was recorded as contingent consideration at its fair value of $850,000, resulting in a total purchase price of $950,000 including the initial cash payment of $100,000 above. Together with the initial cash payment and the first two contingent payments made, additional payments of zero and $300,000 were made in accordance with the terms of the purchase in 2013 and 2012, respectively.

See table below for a summary of the opening balances to the closing balances of the contingent purchase consideration (in thousands):

	As of September 30,	
	2013	**2012**
Contingent purchase price accrual, beginning of period	$	$ 300
Minimum revenue target met, increase in contingent liability charged to expense in the period		
Payment of contingent purchase liability		
Contingent purchase price accrual, end of period	$	$ 300

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See table below for a summary of the Company s financial instruments accounted for at fair value on a recurring basis, which consist only of short-term investments that are marked to fair value at each balance sheet date, as well as the fair value of the accrual for the contingent purchase price of the acquisition of SGLC in 2009 (in thousands):

	Fair Value as of September 30, 2013 using:				Fair Value as of September 30, 2012 using:			
	September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:								
Short-term investments	$	$	$	$	$	$	$	$
Total	$	$	$	$	$	$	$	$
Liabilities:								
Contingent purchase price accrual	$	$	$	$	$ 300	$	$	$ 300
Total	$	$	$	$	$ 300	$	$	$ 300

There were no changes in the valuation techniques or inputs used as the basis to calculate the contingent purchase price accrual.

Business Combinations

The Company recognizes all of the assets acquired, liabilities assumed and contractual contingencies from the acquired company as well as contingent consideration at fair value on the acquisition date. The excess of the total purchase price over the fair value of the assets and liabilities acquired is recognized as goodwill. Acquisition-related costs are recognized separately from the acquisition and expensed as incurred. Generally, restructuring costs incurred in periods subsequent to the acquisition date are expensed when incurred. Subsequent changes to the purchase price (i.e., working capital adjustments) or other fair value adjustments determined during the measurement period are recorded as adjustments to goodwill.

Stock-Based Compensation

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

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. For the nine months ended September 30, 2013 and 2012, the fair value of options granted was calculated using the following assumptions:

	Nine Months Ended September 30,	
	2013	**2012**
Expected stock price volatility	64.4% - 68.0%	65.0% - 66.1%
Expected term of options	6 years	6 years
Expected dividend yield		
Risk-free interest rate	0.75% - 1.65%	0.60% - 0.88%

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

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award.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Cost of revenue	$ 86	$ 64	$ 108	$ 225
Sales and marketing	669	320	1,067	753
Research & development	348	338	971	1,243
General and administrative	1,422	1,755	4,083	3,987
Total	$ 2,525	$ 2,477	$ 6,229	$ 6,208

Foreign Currency Translation and Transactions

The functional currency of each 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 accumulated other comprehensive income in stockholders equity.

Cash flows of consolidated foreign subsidiaries are translated to U.S. dollars using average exchange rates for the period. The Company reports the effect of exchange rate changes on cash balances held in foreign currencies as a separate item in the reconciliation of the changes in cash and cash equivalents during the period. The following table presents the effect of exchange rate changes and the net unrealized gains and losses from the available-for-sale securities on total comprehensive income (loss) (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012 (As Adjusted)*	2013	2012 (As Adjusted)*
Net Loss	$ (4,169)	$ (32,063)	$ (12,286)	$ (38,620)
Foreign currency translation gain (loss)	373	230	12	205
Unrealized gain on available-for-sale securities		5		23
Total comprehensive loss	$ (3,796)	$ (31,828)	$ (12,274)	$ (38,392)

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three and nine months ended September 30, 2013 was $15.9 million and $43.4 million, respectively, and for the three and nine months ended September 30, 2012 was $16.9 million and $47.6 million, respectively.

Recently Issued Accounting Standards

In July 2012, the Financial Accounting Standards Board (FASB) issued new guidance on the impairment testing of indefinite-lived intangible assets (Accounting Standards Update (ASU) 2012-02, *Intangibles Goodwill and Other* (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment), effective for calendar years beginning after September 15, 2012. Early adoption is permitted. The objective of this standard update is to simplify how an entity tests indefinite-lived intangible assets for impairment. The amendments in this standard will allow an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment test. Only if an entity determines, based on qualitative assessment, that it is more likely than not that the

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indefinite-lived intangible asset is impaired will it be required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test. The Company adopted this guidance beginning in fiscal year 2013, and the adoption of such guidance did not have a material impact on the Company s reported results of operations or financial position.

In February 2013, the FASB issued ASU No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* (ASU 2013-02), which requires disclosure of significant amounts reclassified out of accumulated other comprehensive income by component and their corresponding effect on the respective line items of net income. The Company adopted this guidance beginning in fiscal year 2013, and the adoption of such guidance did not have a material impact on the Company s reported results of operations or financial position.

In July 2013, the FASB issued ASU No. 2013-11*, Income Taxes (Topic 740): Presentation of Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (ASU 2013-11), which requires that an unrecognized tax benefit be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except for a situation in which some or all of such net operating loss carryforward, a similar loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable tax jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU 2013-11 is effective for the Company beginning January 1, 2014. The Company believes the adoption of ASU 2013-11 will not have a material impact on the Company s reported results of operations or financial position.

3. BUSINESS COMBINATIONS

Livemocha, Inc.

On April 1, 2013, the Company completed its acquisition of Livemocha (the Livemocha Merger). Livemocha is one of the world s largest online language-learning communities with over 16 million registered members. The acquisition of Livemocha s technology platform will accelerate the Company s transition to cloud-based learning solutions and reinforces its leadership position in the competitive language-learning industry. The aggregate amount of consideration paid by the Company was $8.4 million in cash.

The acquisition of Livemocha resulted in goodwill of approximately $4.9 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Livemocha Merger were expensed and are included in operating expenses. Transaction costs incurred in connection with the Merger were $0.4 million during the nine months ended September 30, 2013. The results of operations for Livemocha have been included in the consolidated results of operations for the period April 1, 2013 through September 30, 2013.

The Company has preliminarily allocated the purchase price based on current estimates of the fair values of assets acquired and liabilities assumed in connection with the Livemocha acquisition. The table below summarizes the preliminary estimates of fair value of the Livemocha assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date. Any changes to the initial estimates of the fair value of the assets and liabilities will be recorded as adjustments to those assets and liabilities and residual amounts will be allocated to goodwill. The Company expects to finalize the purchase accounting for the acquisition of Livemocha, including determining the final valuations for assets and liabilities, by the time it files its Annual Report on Form 10-K for the year ending December 31, 2013.

The preliminary purchase price is allocated as follows (in thousands):

Cash	$	191
Accounts receivable		267
Other current assets		92
Fixed assets		35
Accounts payable and accrued expenses		(901)
Deferred revenue		(794)
Net deferred tax liability		(1,161)
Net tangible assets acquired		(2,271)
Goodwill		5,142
Amortizable intangible assets		5,500
Preliminary purchase price	$	8,371

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The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

	Preliminary Estimated Useful Lives		Preliminary Estimated Value April 1, 2013
Online community	3 years	$	1,800
Enterprise relationships	5 years		100
Technology platform	5 years		3,400
Tradename	2 years		200
Total assets		$	5,500

In connection with the Livemocha Merger, the Company recorded deferred tax liabilities related to definite-lived intangible assets that were acquired. As a result of this deferred tax liability balance, the Company reduced its deferred tax asset valuation allowance by $1.2 million. Such reduction was recognized as an income tax benefit in the consolidated statements of operations for the nine months ended September 30, 2013.

Lexia Learning Systems, Inc.

On August 1, 2013, the Company completed its acquisition of Lexia (the Lexia Merger). Lexia is one of the most trusted and established companies in the reading technology market. The transaction marks the Company s first extension beyond language learning and takes the Company deeper into the EdTech industry. The aggregate amount of consideration paid by the Company was $21.1 million in cash, net of working capital and deferred revenue adjustments, including a holdback of $3.4 million with 50% of such holdback to be paid within 30 days of the Company filing its Form 10-K for the year ended December 31, 2013 and 50% of such holdback to be paid on the 18 month anniversary of the acquisition.

The acquisition of Lexia resulted in goodwill of approximately $9.9 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Lexia Merger were expensed and are included in operating expenses. Transaction costs incurred in connection with the Lexia Merger were $0.1 million during the three and nine months ended September 30, 2013. The results of operations for Lexia have been included in the consolidated results of operations for the period August 1, 2013 through September 30, 2013.

The Company has preliminarily allocated the purchase price based on current estimates of the fair values of assets acquired and liabilities assumed in connection with the Lexia acquisition. The table below summarizes the preliminary estimates of fair value of the Lexia assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date. Any changes to the initial estimates of the fair value of the assets and liabilities will be recorded as adjustments to those assets and liabilities and residual amounts will be allocated to goodwill. The Company expects to finalize the purchase accounting for the acquisition of Lexia, including determining the final valuations for assets and liabilities, within one year of the acquisition date.

The preliminary purchase price is allocated as follows (in thousands):

Cash	$	263
Accounts receivable		2,404
Other current assets		105
Fixed assets		255
Accounts payable and accrued expenses		(899)
Deferred revenue		(1,223)
Net deferred tax liability		(4,210)
Net tangible assets acquired		(3,305)
Goodwill		9,938
Amortizable intangible assets		14,500
Preliminary purchase price	$	21,133

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The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

	Preliminary Estimated Useful Lives		Preliminary Estimated Value August 1, 2013
Enterprise relationships	10 years		9,400
Technology platform	7 years		4,100
Tradename	5 years		1,000
Total assets		$	14,500

In connection with the Lexia Merger, the Company recorded deferred tax liabilities related to definite-lived intangible assets that were acquired. As a result of this deferred tax liability balance, the Company reduced its deferred tax asset valuation allowance by $4.2 million. Such reduction was recognized as an income tax benefit in the consolidated statements of operations for the three and nine months ended September 30, 2013.

Pro Forma Adjusted Summary

The results of Livemocha and Lexia s operations have been included in the consolidated financial statements subsequent to the acquisition date.

The following schedule presents unaudited consolidated pro forma results of operations data as if the Livemocha and Lexia Mergers (the Mergers) had occurred on January 1, 2012. This information does not purport to be indicative of the actual results that would have occurred if the Mergers had actually been completed on the date indicated, nor is it necessarily indicative of the future operating results or the financial position of the combined company (in thousands, except per share amounts):

	Three Months Ended September 30,				Nine Months Ended September 30,			
		2013		2012		2013		2012
Revenue	$	61,193	$	65,261	$	189,146	$	197,269
Net income (loss)	$	(4,756)	$	(36,853)	$	(21,505)	$	(52,317)
Basic loss per share	$	(0.22)	$	(1.75)	$	(1.00)	$	(2.49)
Diluted loss per share	$	(0.22)	$	(1.75)	$	(1.00)	$	(2.49)

The operations of Livemocha have been integrated into the overall operations of the Company. The results of Livemocha are reported within the results of the Company s operating segments and are not recorded on a stand-alone basis. Therefore it is impracticable to report revenue and earnings from Livemocha for the period ended September 30, 2013. The Company recorded revenue of $0.3 million and a net loss of $1.8 million from Lexia for the three and nine months ended September 30, 2013.

4. NET LOSS PER SHARE

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

The following table sets forth the computation of basic and diluted net loss per common share:

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	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
	(dollars in thousands, except per share amounts)	(As Adjusted)*	(dollars in thousands, except per share amounts)	(As Adjusted)*
Numerator:				
Net Loss	$ (4,169)	$ (32,063)	$ (12,286)	$ (38,620)
Denominator:				
Weighted average number of common shares:				
Basic	21,827	21,073	21,587	21,004
Diluted	21,827	21,073	21,587	21,004
Loss per common share:				
Basic	$ (0.19)	$ (1.52)	$ (0.57)	$ (1.84)
Diluted	$ (0.19)	$ (1.52)	$ (0.57)	$ (1.84)

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commission (See Note 2).

For the three and nine months ended September 30, 2013 and 2012, no common stock equivalent shares were included in the calculation of the Company s diluted net income per share.

For the three months ended September 30, 2013, outstanding stock options, restricted stock units and restricted stock of 227,000, 91,000 and 246,000 respectively, were not included in the diluted net loss per share calculation, as they were anti-dilutive. For the three months ended September 30, 2012, outstanding stock options, restricted stock units and restricted stock of 357,000, 79,000 and 206,000, respectively, were not included in the diluted net loss per share calculation, as they were anti-dilutive. For the nine months ended September 30, 2013, outstanding stock options, restricted stock units and restricted stock of 317,000, 91,000 and 245,000, respectively, were not included in the diluted net loss per share calculation, as they were anti-dilutive. For the nine months ended September 30, 2012, outstanding stock options, restricted stock units and restricted stock of 338,000, 60,000 and 167,000, respectively, were not included in the diluted net loss per share calculation, as they were anti-dilutive.

5. INVENTORY

Inventory consisted of the following (dollars in thousands):

	September 30, 2013	December 31, 2012
Raw materials	$ 4,537	$ 3,570
Finished goods	2,501	3,011
Total inventory	$ 7,038	$ 6,581

6. GOODWILL

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC in November 2009, the acquisition of Livemocha in April 2013 and the acquisition of Lexia in August 2013. The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC topic 350, *Intangibles Goodwill and Other* (ASC 350) or more frequently, if impairment indicators arise. The Company s annual testing resulted in no impairment of goodwill since the dates of acquisition. Beginning in the fourth quarter of 2012, the Company began reporting its results in three reportable segments, which also consisted of three reporting units for goodwill impairment purposes North America Consumer, Rest of World (ROW) Consumer, and Global Enterprise and Education (previously referred to as Institutional).

The goodwill recorded from the Livemocha acquisition was allocated to the reportable segments that reflect the results of the legacy Livemocha operations. The goodwill recorded from the Lexia acquisition was allocated to the Global Enterprise and Education reportable segment. The following table represents the balance and changes in goodwill by reportable segment, for the nine months ended September 30, 2013 (in thousands):

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	North America Consumer		Rest of World Consumer		Global Enterprise & Education		Total	
Balance as of December 31, 2012	$	13,499	$	2,199	$	19,198	$	34,896
Acquisition of Livemocha		4,422				720		5,142
Acquisition of Lexia						9,938		9,938
Effect of change in foreign currency rate						(4)		(4)
Balance as of September 30, 2013	$	17,921	$	2,199	$	29,852	$	49,972

7. INTANGIBLE ASSETS

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

	September 30, 2013						December 31, 2012					
	Gross Carrying Amount		Accumulated Amortization		Net Carrying Amount		Gross Carrying Amount		Accumulated Amortization		Net Carrying Amount	
Trade name/ trademark	$	11,807	$	(83)	$	11,724	$	10,607	$		$	10,607
Core technology		9,953		(2,891)		7,062		2,453		(2,453)		
Customer relationships		22,151		(11,324)		10,827		10,850		(10,850)		
Website		12		(12)				12		(12)		
Patents		300		(112)		188		300		(82)		218
Total	$	44,223	$	(14,422)	$	29,801	$	24,222	$	(13,397)	$	10,825

The intangible assets recorded as a result of the Livemocha acquisition are included in the September 30, 2013 balances. The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

	Preliminary Estimated Useful Lives	Preliminary Estimated Value April 1, 2013	
Online community	3 years	$	1,800
Customer relationships	5 years		100
Technology platform	5 years		3,400
Tradename	2 years		200
Total assets		$	5,500

The intangible assets recorded as a result of the Lexia acquisition are included in the September 30, 2013 balances. The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

	Preliminary Estimated Useful Lives	Preliminary Estimated Value August 1, 2013	
Customer relationships	10 years	$	9,400

Technology platform	7 years		4,100
Tradename	5 years		1,000
Total assets		$	14,500

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Amortization of intangible assets for the three months ended September 30, 2013 and 2012 totaled $652,000 and $10,000, respectively. For the three months ended September 30, 2013 and 2012, $180,000 and $10,000 was included in research and development expense $374,000 and zero was included in sales and marketing expense and $98,000 and zero were included in cost of service. The increase in amortization expense is due to the amortization of the intangible assets recorded as a result of the Livemocha and Lexia acquisitions.

Amortization of intangible assets for the nine months ended September 30, 2013 and 2012 totaled $1,025,000 and $30,000, respectively. For the nine months ended September 30, 2013 and 2012, $370,000 and $30,000 was included in research and development expense, $557,000 and zero was included in sales and marketing expense and $98,000 and zero were included in cost of service. The increase in amortization expense is due to the amortization of the intangible assets recorded as a result of the Livemocha and Lexia acquisitions.

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining nine months of 2013 and years thereafter (in thousands):

2013 remaining	$	795
2014		3,171
2015		3,087
2016		2,605
2017		2,453
Thereafter		7,083
Total	$	19,194

In accordance with ASC 350, the Company reviews its indefinite lived intangible assets annually as of December 31. There were no impairment charges for the nine months ended September 30, 2013 or September 30, 2012.

8. OTHER CURRENT LIABILITIES

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

		September 30, 2013		**December 31, 2012**
Marketing expenses	$	11,052	$	16,922
Professional and consulting fees		3,487		3,282
Sales return reserve		4,090		5,883
Sales, withholding, and property taxes payable		3,032		3,451
Other		8,821		6,849
	$	30,482	$	36,387

9. INCOME TAXES

In accordance with ASC topic 740, *Income Taxes* (ASC 740), and ASC subtopic 740-270, *Income Taxes: Interim Reporting*, the income tax provision for the nine months ended September 30, 2013 is based on the estimated annual effective tax rate for fiscal year 2013. The estimated effective tax rate may be subject to adjustment in subsequent quarterly periods as the estimates of pretax income for the year, along with other items that may affect the rate, may change and may create a different relationship between domestic and foreign income and loss.

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

As of September 30, 2013, the Company is under audit in the United States for the 2009, 2010 and 2011 tax years. While the ultimate results cannot be predicted with certainty, the Company believes that the resulting adjustments, if any, will not have a material adverse effect on its consolidated financial condition or results of operations.

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As of September 30, 2013 and December 31, 2012, the Company had $155,000 and $143,000, respectively, of unrecognized tax benefits, which if recognized, would decrease its effective tax rate. These liabilities for unrecognized tax benefits are included in Other Long Term Liabilities. Interest and penalties related to uncertain tax positions are recorded as part of the income tax provision and are approximately $15,000 as of September 30, 2013.

Valuation Allowance Recorded for Deferred Tax Assets

The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of September 30, 2013, the analysis of the need for a valuation allowance on U.S. deferred tax assets considered that the U.S. entity has incurred a three-year cumulative loss. As previously disclosed, if the Company does not have sufficient objective positive evidence to overcome a three-year cumulative loss, a valuation allowance may be necessary. In evaluating whether to record a valuation allowance, the guidance in ASC 740 deems that the existence of cumulative losses in recent years is a significant piece of objectively verifiable negative evidence that is difficult to overcome. An enterprise that has cumulative losses is generally prohibited from using an estimate of future earnings to support a conclusion that realization of an existing deferred tax asset is more likely than not.

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

- Three-year cumulative evaluation period ending September 30, 2013 results in a cumulative U.S. pre-tax loss;

- from 2006, when the U.S. entity began filing as a C-corporation for income tax purposes, through 2010, the U.S. entity generated taxable income each year;

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

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

- through September 30, 2013, there are no U.S. federal jurisdiction net operating loss carryforwards other than acquired net operating loss carryforwards subject to limitation pursuant to IRC Section 382.

During the second quarter of 2012, the Company established a full valuation allowance to reduce the deferred tax assets of the Korea subsidiary resulting in a non-cash charge of $0.4 million. During the third quarter of 2012, the Company established a full valuation allowance to reduce the deferred tax assets of its operations in Brazil, Japan, and the U.S. resulting in a non-cash charge of $0.4 million, $2.1 million, and $23.1 million, respectively. Additionally, no tax benefits were provided on 2012 losses incurred in foreign jurisdictions where the Company has determined a valuation allowance is required. As of September 30, 2013, a full valuation allowance was provided for the U.S., Korea, Japan, and Brazil where the Company has determined the deferred tax assets will more likely than not be realized.

Evaluation of the remaining jurisdictions as of September 30, 2013 resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation will be adjusted accordingly, which could materially affect the Company s financial position and results of operations.

As of September 30, 2013, and December 31, 2012, the Company s U.S. deferred tax liability was $9.3 million and $8.4 million, respectively, related to its goodwill and indefinite lived intangibles. As of September 30, 2013 and December 31, 2012, the Company s foreign net deferred tax asset was $0.3 million and $0.2 million, respectively.

On April 1, 2013 and August 1, 2013, the Company acquired all of the outstanding shares of Livemocha and Lexia, respectively. For tax purposes, the acquisitions will be treated as a non-taxable stock purchase and all of the acquired assets and assumed liabilities will retain their historical carryover tax bases. Therefore, the Company recognized deferred taxes related to all book/tax basis differences in the acquired assets and liabilities.

In connection with the Livemocha purchase accounting, the Company recognized net deferred tax liabilities of $1.2 million associated with the book/tax differences on acquired intangible assets and deferred revenue, offset by deferred tax assets associated with acquired net operating loss carryforwards. The effect of this on the tax provision for the Company resulted in a release of its valuation allowance equal to the amount of the net deferred tax liability recognized at the time of the Livemocha Merger. Thus, a tax benefit of $1.2 million was recorded during the three months ended June 30, 2013.

In connection with the Lexia purchase accounting, the Company recognized net deferred tax liabilities of $4.2 million associated with the book/tax differences on acquired intangible assets and deferred revenue, offset by deferred tax assets associated

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with acquired net operating loss carryforwards. The effect of this on the tax provision for the Company resulted in a release of its valuation allowance equal to the amount of the net deferred tax liability recognized at the time of the Lexia Merger. Thus, a tax benefit of $4.2 million was recorded during the three months ended September 30, 2013.

These tax benefits were offset by foreign withholding taxes and income tax expense related to current year profits of operations in Canada, Germany and the U.K., resulting in a total tax benefit of $3.6 million for the three months ended September 30, 2013.

For the nine months ended September 30, 2013, the Company s recorded income tax benefit of $3.1 million resulting in a partial valuation allowance release of $5.4 million related to the net deferred tax liabilities acquired with the Livemocha and Lexia acquisitions, offset by income related to current year profits of operations in Canada, Germany, and the U.K., foreign withholding taxes, the tax impact related to amortization of indefinite lived intangibles, and an inability to recognize tax benefits associated with current year losses associated with operations in Brazil, Korea, Japan, and the U.S.

10. STOCK PLANS

2006 Stock Incentive Plan

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

2009 Omnibus Incentive Plan

On February 27, 2009, the Company s Board of Directors approved a new Stock Incentive and Award Plan (the 2009 Plan) that provides for the ability of the Company to grant up to 2,437,744 new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. The stock incentive awards and options granted under the 2009 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. On May 26, 2011, the Board of Directors authorized and the Company s shareholders approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan. On May 23, 2012, the Board of Directors authorized and the Company s shareholders approved the allocation of 1,122,930 additional shares of common stock to the 2009 Plan. On May 23, 2013, the Board of Directors authorized and the Company s shareholders approved the allocation of 2,317,000 additional shares of common stock to the 2009 Plan.

Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants. At September 30, 2013 there were 3,358,715 shares available for future grant under the 2009 Plan.

In accordance with ASC topic 718, *Compensation Stock Compensation* (ASC 718), 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.

Stock Options

The following table summarizes the Company s stock option activity from January 1, 2013 to September 30, 2013:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2013	2,470,347	$ 12.57	$ 6.98	$ 6,760,327
Options granted	615,165	14.85		
Options exercised	(542,916)	5.89		
Options cancelled	(576,954)	17.71		
Options Outstanding, September 30, 2013	1,965,642	13.62	7.84	7,444,527
Vested and expected to vest at September 30, 2013	1,739,438	13.63	7.72	6,913,440
Exercisable at September 30, 2013	727,186	13.73	6.23	3,220,718

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During the three-months ended June 30, 2013, the Company allowed a former executive to net exercise 213,564 vested stock options with an exercise price of $3.85. In the net exercise, the Company repurchased 123,367 shares from the former employee based on the Company s stock price on the exercise date of $15.09 for $1.0 million.

As of September 30, 2013, there was approximately $7.7 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 2.69 years.

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

Restricted Stock Awards

The following table summarizes the Company s restricted stock award activity from January 1, 2013 to September 30, 2013:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2013	758,103	$ 11.00	$ 8,339,133
Awards granted	338,801	14.86	
Awards vested	(236,526)	10.02	
Awards cancelled	(90,138)	12.79	
Nonvested Awards, September 30, 2013	770,240	12.79	$ 9,851,370

As of September 30, 2013, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the consolidated statement of operations was $6.5 million and is expected to be recognized over a period of 2.48 years.

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

Restricted Stock Units

During the nine months ended September 30, 2013, 24,779 restricted stock units were granted. The aggregate grant date fair value of the awards was $0.4 million, which was recognized as expense on the grant date, as the awards were immediately vested. The Company s restricted stock unit 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 grant date.

Long-Term Incentive Program

On February 21, 2013, the Company s board of directors approved the 2013 Rosetta Stone Inc. Long Term Incentive Program (2013 LTIP), a new long-term incentive program. The 2013 LTIP will be administered under the Rosetta Stone Inc. 2009 Omnibus Incentive Plan (the Plan) and the shares awarded under the 2013 LTIP will be taken from the shares reserved under the Plan. The purpose of the 2013 LTIP is to: motivate senior management and other executives to achieve key financial and strategic business objectives of the Company; offer eligible executives of the Company a competitive total compensation package; reward executives in the success of the Company; provide ownership in the Company; and retain key talent. The 2013 LTIP is effective from January 1, 2013 until December 31, 2014.

Executives designated by the board of directors will be eligible to receive performance stock awards and cash upon the Company s achievement of specified performance goals between January 1, 2013 and December 31, 2014. In order for the granting of any performance stock award or any cash payment to be made under the 2013 LTIP, the Company must meet the minimum threshold requirements for each performance goal for the 2014 fiscal year in addition to the cumulative performance goals for the two year period ended December 31, 2014. Each performance goal is mutually exclusive. Each performance goal has a range of payout levels depending on the achievement of the goal ranging from zero to 200% of the incentive target.

The maximum number of shares to be issued as pe