



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 \$191 million as of June 30, 2011 (based on the last sale price of such stock as quoted on the New York Stock Exchange).

As of February 27, 2012, there were 20,940,891 shares of common stock outstanding.

**Documents incorporated by reference:** Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2012 Annual Meeting of Stockholders to be held on May 23, 2012 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.*

### PART I

#### Item 1. *Business*

##### Overview

We are a leading provider of technology-based language-learning solutions. We develop, market, and sell language-learning solutions consisting of software, online services, 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. Our customers include individuals, educational institutions, armed forces, government agencies and corporations.

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language-learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages, which have enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 86% of our revenue for the year ended December 31, 2011 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Barnes & Noble, Best Buy, Books-a-Million, Staples and Costco.

We were incorporated in Delaware in 2005.

##### Our Industry

The language-learning market is highly fragmented 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 tapes and software that rely primarily on grammar and translation; and free online offerings that provide basic content and opportunities to practice writing and speaking.

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*Key Drivers of Demand in the Language-Learning Market.* We believe that language learning is important and valued by individuals and institutions in the United States and throughout the world. The demand for language learning is driven in part by:

- individuals seeking the enjoyment and enrichment brought by learning a language;
- professionals conducting business in a global economy;
- schools seeking to educate their students in local and foreign languages;
- companies training their employees;
- leisure travelers seeking language proficiency for independent international travel;
- armed forces training soldiers to communicate in foreign languages;
- immigrants and expatriates seeking to successfully function in their new environments;
- individuals connecting with their ethnic and family roots; and
- parents supplementing their children's education.

*Limitations of Traditional Methods for Language Learning.* The human brain has a natural capacity to learn languages. Children learn their native language without using rote memorization or adult analytical abilities for grammatical understanding. They learn at their own pace through their immersion in the language spoken around them and using trial and error. They do not rely on translation. By contrast, foreign languages have traditionally been taught by focusing on memorization, grammar translation and word translation, typically in an academic classroom setting. This traditional method involves learning complex grammar rules, conjugating verbs and memorizing vocabulary lists. Students have little practice speaking or listening in the classroom, and practice outside the classroom typically involves listening to audio recordings and pronunciation exercises, with little or no feedback on pronunciation accuracy. Many students who were taught languages using the traditional method regard it as ineffective and boring.

*Emergence of Immersion Language Learning.* To address some of the shortcomings of traditional language-learning methods, language-learning specialists have developed an alternative method for teaching language known as immersion learning, in which only the target language is spoken. We believe that immersion learning is more effective than the traditional translation and grammar method in helping learners move towards conversational fluency. Immersion learning provides a more natural, direct learning environment, where the learner deduces meaning and develops an intuition of language structure. This is similar to the manner in which children learn their native language, without an awareness of formal grammar rules or the necessity to translate. Most immersion learning programs, however, require either one-on-one teaching, a small group course or travel to a foreign country. These programs can cost several thousand dollars and are less convenient than self-study alternatives.

*Use of Interactive Technologies.* There has been a rapid adoption of interactive technologies and software tools to help learning in both consumer and institutional markets, supported by the rapid increase in computing technologies and internet use. Given busy lifestyles, adult language learners seek solutions that work flexibly and do not require physical classroom attendance. Educators are interested in deploying learning tools that are relevant to their students, who have had extensive exposure to computer software and interactive games. Corporations are recognizing the value and effectiveness of using their technology investment to help increase the skills of their workforce.

*The Need for a High-Quality, Trusted Solution.* Consumers and institutions face a confusing array of alternatives when choosing a language course due to the fragmented nature of the language-learning market. Most providers of language-learning offer little information to potential customers about their teaching methods and do not have well known brands. The few major internationally known language

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learning providers generally offer only classroom instruction, which is not convenient for all prospective language learners. In addition, there are numerous self-study courses in the market available at a variety of price points, most of which are offered as audio and books and do not provide an interactive, immersion learning experience. There are also many community websites that provide free opportunities to practice.

We believe that language learners seek a trusted and recognized name-brand solution that is more convenient and affordable than classroom alternatives, and more effective, interactive and engaging than other self-study options. We believe the combination of these elements is not offered by traditional providers of language instruction and that we have a market solution that provides this combination.

### **Rosetta Stone Solutions**

Our mission is to change the way people learn languages. We believe our solutions provide an effective way to learn languages in a convenient and engaging manner. Our approach, called *Dynamic Immersion*, eliminates translation and grammar explanation and is designed to leverage the innate, natural language-learning ability that children use to learn their native language. We consider traditional translation and grammar methods as obstacles that delay and impede the successful acquisition of language proficiency, and our solutions avoid those elements. Our technology based self-study courses allow our customers to learn using the immersion method on their own schedule and for a price that is significantly lower than most classroom-based or one-on-one alternatives.

Although other audio and software publishers claim to teach with immersion methods, we believe that we are the only self-study solution that teaches strictly without any translation or explicit grammar explanations. Our proprietary solutions have been developed over the past 19 years by professionals with extensive expertise in linguistic, education and instructional technology. We estimate that our content library consists of more than 25,000 individual photographic images and more than 400,000 professionally recorded sound files. We design the sequencing of our content to optimize learning. The result is a rigorous and complete language-learning curriculum that is also designed to be flexible, fun and convenient.

Our language-learning solutions are built upon a flexible software platform that supports multiple languages and is deployable on personal computers, on local networks, online, tablets and smart phones. The platform incorporates a number of proprietary technologies that are central to enabling language learning, including:

- speech recognition that is focused on the unique challenges of language learners;
- *Adaptive Recall* algorithms that repeat content at scheduled intervals to promote long-term retention;
- reporting features and curriculum options designed to enhance the effectiveness and administration of classroom, enterprise and home school learning; and
- an intuitive user interface that assists the learner's transition from listening comprehension to speaking.

Rosetta Stone offers a broad product suite, with courses currently available in over 30 languages. Our courses are available in up to five levels of proficiency per language, with each level providing approximately 40 hours of instruction and containing multiple units, lessons and activities.

In July 2009, we introduced Rosetta Stone *TOTALe*, an online language-learning solution that integrates our online courses with online services, including coach-led practice sessions, language games, interaction with native speakers and live support from customer service agents. Rosetta Stone Version 4 *TOTALe*, which was released in September 2010, combines packaged course software and

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online services. The content of *TOTALe* and Version 4 *TOTALe* are functionally the same. We offer our customers access and payment alternatives without differentiating the learning experience. We launched Rosetta Stone Version 4 *TOTALe* in Japan in February 2011, in the United Kingdom in May of 2011 and in South Korea in July of 2011.

In July 2011, we introduced in South Korea, *ReFLEX*, an online subscription language-learning solution designed specifically for English learners who seek to improve their listening and speaking skills with an online course and coach-led practice sessions. We intend to launch this solution in Japan in 2012.

We also provide an online peer-to-peer practice environment called SharedTalk, at [www.sharedtalk.com](http://www.sharedtalk.com), where registered language learners meet for language exchange to practice their foreign language skills. During 2011, we had more than 154,000 active SharedTalk users.

In addition, we have developed Rosetta Stone products for the exclusive use of Native communities to help promote revitalization of their endangered languages, including Mohawk, Chitimacha, Inuttitut, Iñupiaq and Navajo. In 2011, we stopped accepting applications to develop new endangered languages while we evaluate the program.

Our innovative solutions have received numerous awards and recognitions, including a finalist for the 2011 SXSW Interactive Awards in the Education Resource category for Rosetta Stone Version 4 *TOTALe*, a 2010 Consumer Electronics Show (CES) Innovation Design and Engineering award in the online retail category for Rosetta Stone *TOTALe*, an honorable mention for the Adobe MAX 2010 Awards for Rosetta Stone *TOTALe*, a 2010 United States Distance Learning Association (USDLA) silver award in the Best Practices in Distance Learning Programming category for Rosetta Stone Classroom Version 3, a 2010 Best Educational Software Award (BESSIE) in the Best Multi-Level Foreign Language Website category for Rosetta Stone Classroom Version 3, a 2010 Chief Learning Officer Learning in Practice Award (bronze for excellence in e-learning) for Rosetta Stone Enterprise Version 3, the 2010 Top Training and Simulation Companies list for companies that have made a significant impact on the military training industry by *Military Training Technology*, the 2009 National Parenting Publications Awards (NAPPA) Honors Award for Rosetta Stone Version 3 Personal Edition, four classroom specific awards in 2009 for Classroom Version 3, two enterprise specific awards in 2009, the 2009 BESSIE in the Best Multi-Level Foreign Language Website category for Rosetta Stone Classroom Version 3, iParenting Media Excellent Product of 2009 award in the software category for Rosetta Stone Personal Edition Version 3, the 2009 Children's Technology Review Editor's Choice Award for Rosetta Stone Personal Edition Version 3, the 2009 Parent Tested Parent Approved (PTPA) Media Awards for Rosetta Stone Personal Edition Version 3, and the 2009 Creative Child Media of the Year Award in the educational media category for Rosetta Stone Personal Edition Version 3.

## **Our Strategy**

Our goal is to strengthen our position as a leading provider of language-learning solutions and address the challenges facing our company. Our challenges include a changing U.S. consumer market, an extremely competitive marketplace, a tightened media environment and evolving product delivery platforms. These factors have contributed to a decline in our U.S. consumer bookings from 2009 to 2011. We intend to strengthen our position and address our challenges through the following strategies:

*Reposition U.S. Consumer Business and Increase U.S. Market Share.* We are evaluating changes in our marketing, pricing, packaging and delivery methods to strengthen our brand and improve the relevance of our offering. In addition, we are evaluating developing more targeted language-learning solutions for learners with different needs. We are also considering diversifying our product portfolio and marketing to address new segments in the language-learning market. In addition, we are exploring ways to provide greater lifetime values to customers, such as the introduction of Version 4 *TOTALe*, mobile applications and other software solutions to generate greater revenue per customer over time.

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In addition, we plan on increasing the percent of business that is delivered online through a selection of time-based offers (e.g. 3, 6 and 12 month language products). We also plan to augment select retail relationships while reducing our financial exposure to underperforming store-based retail partners. In addition, we plan to realign our cost structure to help fund investment in areas of growth.

*Reposition Global Kiosks.* During 2012, based on our evaluation of historical and forecasted kiosk sales performance, we plan to significantly reduce the size of our worldwide kiosk program, in addition to continually reviewing the performance of remaining kiosk locations.

*Increase Our Focus on the Global Institutional Market.* We plan to intensify our efforts to engage new large institutional customers for which language learning is critical. We expect to expand our direct sales force along with our institutional marketing activities.

*Increase Our Focus on Sizeable Non-U.S. Markets.* We generated approximately 21% of our revenue in 2011 from sales outside the United States. We believe that there is a significant opportunity for us to expand our business internationally utilizing many of the successful marketing and distribution strategies we have used in the United States. We have established subsidiaries in the United Kingdom, Japan, Germany, South Korea and Brazil to develop our international business. In addition, we are exploring opportunities to expand our presence further in Asia, Europe and Latin America. Because our solutions do not rely upon translation from the target language into the learner's native language, they require only modest localization to be used by learners from other native language backgrounds, and thus we believe that we can efficiently scale our business internationally. We launched Version 4 *TOTALe* in Japan in February 2011, in the United Kingdom in May 2011, and in South Korea in July 2011. In addition, we launched *ReFLEX* in South Korea in July 2011.

*Extend Our Technological and Product Leadership.* We intend to apply new technologies to maintain our product leadership. We currently are working on a variety of product development initiatives. For example, Rosetta Stone Version 4 *TOTALe*, which was released in September 2010, combines packaged software with opportunities to practice with dedicated conversational coaches and other language learners to increase language socialization as well as online language-learning games. In July 2011, we launched our English remediation solution, *ReFLEX*, targeting intermediate learners in Asia. This solution targets intermediate English learners in Asia who can read and write, but have low conversational fluency. It provides learners with foundational phonetic skills while building confidence through spoken conversation and activating learners' strong English grammar and vocabulary knowledge in conversational practice sessions designed to carefully advance learners to converse fluidly and confidently with native speakers. In addition, we will continue to support delivering our language-learning content on existing platforms such as iPhones, iPads and similar devices. We intend to continue improving the efficacy of our solutions by continuing to develop products with higher frequency of socialization and optimizing the content of our solutions.

## **Products and Services**

### Core Product Offering

The core Rosetta Stone language-learning solution is offered in two versions for over 30 languages under the *Rosetta Stone* brand. Each language currently has up to five levels, with each consecutive level representing a higher level of proficiency. We sell each level as a standalone unit, although we offer a price incentive to customers to purchase all available levels of a language as a bundle, where that option is available.



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As of December 31, 2011, we offer the following languages:

**Version 4 (24 Languages)**

*5 Levels (9 Languages)*

- Chinese (Mandarin)
- English (American)
- English (British)
- French
- German
- Italian
- Russian
- Spanish (Latin American)
- Spanish (Spain)

*3 Levels (15 Languages)*

- Arabic
- Dutch
- Farsi (Persian)
- Greek
- Hebrew
- Hindi
- Irish (Gaelic)
- Japanese
- Korean
- Polish
- Portuguese
- Swedish
- Tagalog
- Turkish
- Vietnamese

**Version 3 (7 Languages)**

*3 Levels (1 Language)*

- Latin

*1 Level (6 Languages)*

- Arabic (Iraqi)
- Dari
- Indonesian
- Pashto
- Swahili
- Urdu

In addition to the Version 3 languages listed above, Rosetta Stone continues to sell Version 4 languages using our Version 3 software in select markets and to institutional customers.

In June 2011, we released (i) levels 4 & 5 for Chinese (Mandarin) and Russian and (ii) *TOTALe* Companion HD on the Apple iPad. We also introduced Dari, Indonesian, Pashto, Swahili and Urdu in the consumer market. These languages were previously available only to our institutional customers.

In November 2011, we developed a downloadable version of *TOTALe* Version 4 that is available through the Amazon software download store. We also introduced our *TOTALe* Companion product on the Android platform.

As of December 31, 2011, the following components are included with each software version:

Version	Rosetta Course	Rosetta Studio	Rosetta World	Audio Companion	<i>TOTALe</i> Companion HD (iOS)	<i>TOTALe</i> Companion (iOS and Android)
Version 4 <i>TOTALe</i>	X	X	X	X	X	X
Version 3	X			X		

- *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*, improving confidence.



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- *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 MP3 players. The *Audio Companion* provides a convenient opportunity for practicing material that was previously learned through the software program. Unlike other common audio products, Rosetta Stone does not rely solely on an audio environment to teach, so we can create an immersive audio environment, using only the target language, which reinforces material learned from our software program.
- *TOTALe Companion HD* is a learning tool that provides access to Rosetta Course with the exception of the review and writing path steps. *TOTALe Companion HD* includes our speech recognition technology.

*TOTALe Companion* is an additional practice tool that is available on Apple iPhone, Apple iPod Touch and select Android enabled smartphones. *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.

We have four different editions of our product: personal, enterprise, classroom and home school.

<u>Version</u>	<u>Personal Edition</u>	<u>Home School Edition</u>	<u>Enterprise Edition</u>	<u>Classroom Edition</u>
Version 4	X		X	X
Version 3	X	X	X	X

Each edition utilizes the same core software product, but includes different ancillary features as follows:

- *Personal Edition*—This edition is targeted to individual consumers and contains the core software product we use for all editions.
- *Enterprise Edition*—This edition is targeted to businesses, armed forces, government organizations and not-for-profit entities and can accommodate organizations of any size, from individual learners to entire global organizations. This edition includes management tools that provide easy-to-use administrative and reporting functionality. These tools deliver easy-to-read reports and graphs that track learner activity, progress and scores, thereby providing organizations with key information they need to measure return on their language-learning investment.
- *Classroom Edition*—This edition is targeted to language programs in primary, secondary and higher education settings and is scalable to accommodate a variety of implementations, from individual schools to district-wide programs and universities. The classroom edition is designed to be incorporated into a teacher's overall language-learning curriculum, complementing in-class teaching and enabling individualized self-paced learning outside the classroom. The classroom edition includes a learner management tool, the *Rosetta Stone Manager*, which provides easy-to-use administrative and reporting functionality. This tool enables teachers to plan lessons and generate reports and graphs that track student and classroom activity, progress and scores.
- *Home School Edition*—This edition is targeted to families with home school students and is designed to provide parents the tools and resources they need to manage student progress without extensive planning or supervision. The home school edition includes administrative tools

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that permit parents to follow student progress and access specific information about student performance, such as completed exercises, test scores, and time spent learning, and to generate printable progress reports. In addition, parents have the ability to enroll their students in predefined curriculum paths designed to assist in lesson planning and in achieving learning objectives.

Our solutions are available both pre-packaged and by subscription online through our language-learning portal. For the year ended December 31, 2011, approximately 73% of our revenue was from CD-ROM sales while approximately 27% was from online subscriptions to both consumers and institutions.

We also provide an online peer-to-peer practice environment called *SharedTalk*, at [www.sharedtalk.com](http://www.sharedtalk.com), where registered language learners meet for language exchange and to practice their foreign language skills. During 2011, we had more than 154,000 active *SharedTalk* users. In addition, we have developed Rosetta Stone products for the exclusive use of Native American communities to help to save their endangered languages, including Mohawk, Chitimacha, Inuktitut, Iñupiaq and Navajo.

### ReFLEX Product Offering

In July 2011, Rosetta Stone introduced *ReFLEX*, a solution designed specifically for English learners who want to improve their listening and speaking skills. *ReFLEX* is sold as an online subscription in South Korea to the English language-learning market. We intend to launch *ReFLEX* in Japan in 2012. *ReFLEX* improves learners' ability to converse in English. Learners are guided by an adaptive artificial intelligence system to practice in daily 30 minute sessions focusing on the challenging phonetic and prosodic differences between English and other languages, speaking without translation, and conversing with live native speakers in Rosetta Studio sessions.

### **Technology**

We develop most of our own technology, including our proprietary unified language-learning software platform. Our newest application, Version 4, currently supports up to five levels of proficiency and is available in 24 languages. Version 3 currently supports up to five levels of proficiency and is available in 31 languages. The technology underlying Version 3 and Version 4 is designed to handle the complexities of a wide variety of languages, including languages written from right-to-left such as Arabic and Hebrew and languages with characters such as Chinese and Japanese.

Our Version 3 and Version 4 platform is flexible and capable of meeting a wide range of market requirements, including:

- enabling reporting features and additional curriculum options for our home school edition;
- providing our solutions in a local networked environment to enable a class management tool in the classroom edition;
- offering our solutions online through a commercial learning management system for our enterprise customers; and
- providing localized interfaces and help files in the user's native language, which are currently available in nine languages.

In each of these cases, the learner receives the same engaging language-learning experience and content.

We have developed a speech recognition technology focused on the unique challenges of language learners, stressing non-native speech understanding and pronunciation feedback. This technology, which

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is included in Version 3 and Version 4, is available for all of our languages on those versions and runs on all widely available operating systems and on local and online applications. Our speech recognition models include languages traditionally not supported by general-purpose speech recognition software, such as Irish.

We have developed proprietary algorithms we call *Adaptive Recall*, which are designed to enhance the learner's experience by reintroducing content at longer and longer intervals in order to improve long-term retention. *Adaptive Recall*, available in Version 3 and Version 4, is designed to be efficient with a learner's time, bringing material back in the program less and less frequently as the learner remembers over extended periods of time.

We have developed a proprietary student management system, which is designed to allow teachers and administrators to configure their own lesson plans using our content and exercises and to review reports for evaluation of student progress.

We have developed an intuitive user interface that assists in the learner's transition from listening comprehension to speaking, making language skill development an integrated experience.

We have also created proprietary content development tools that allow our curriculum specialists to write, edit, manage and publish our course materials. These tools allow authors, translators, voicers, photographers and editors to work efficiently and cooperatively across multiple locations.

## Content and Curriculum

The foundation of *Dynamic Immersion* is our proprietary content, consisting of a total of more than 25,000 individual photographic images and more than 400,000 professionally recorded sound files. Each Version 3 and Version 4 language contains approximately 10,000 individual photographic images and 15,000 professionally recorded sound files. We believe these photographic images and recorded sound files are a competitive strength, as we have created many of the pictures and all of the sound files ourselves. We believe that our images and their juxtaposition convey a universal meaning, which makes it possible for us to broadly deploy the same images across multiple languages. In addition, we have developed a sophisticated method for sequencing the images, which is designed to build a rich curriculum that incrementally teaches the user the most important and relevant language skills necessary to achieve fluency. We believe that our sequence of images is as effective for someone learning Arabic or Mandarin Chinese as it is for someone learning Spanish or English. To supplement our core content, we incorporate specific nuances for each language, such as dual forms for parts of speech in Arabic. Our ability to tailor our content also enables us to develop customized versions of our language-learning solutions to address the specific needs of various industries. In the future, we may develop customized versions for other industries, such as healthcare, business, real estate and retail.

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In addition to visual learning experiences, our Version 3 and Version 4 solutions incorporate an integrated speech program utilizing our voice recognition application, which works in languages that are traditionally not supported by general-purpose speech recognition software. As an integral component of the program, this voice recognition feature works with our learners to promote the appropriate pronunciation of the words and concepts included in the lesson.

Throughout the curriculum sequence, our program combines the introduction of new concepts, practice of recent material and production of key phrases. As learners progress along our curriculum, they transition from seeing and recognizing to speaking as our program prompts them to pronounce the words they are being taught. Our solution covers all aspects necessary for fluency within a completely immersive environment without requiring translation or explanation, including alphabet, vocabulary, intuitive grammar, reading, writing, listening, pronunciation and conversation. While rigorous and complete, the curriculum is designed to remain flexible, allowing learners to alter their individual pace and focus of instruction to meet their particular goals and abilities. The language content for our respective courses is organized into up to five levels of proficiency, with each level providing approximately 40 hours of instruction and containing multiple units, lessons and activities.

**Customers**

Our customers include individuals, home school parents, educational institutions, armed forces, government agencies, corporations and not-for-profit institutions. We sell to our customers through a direct-to-consumer, indirect retail consumer, home shopping networks in Korea and institutional marketing and distribution strategy.

Channel	Customer Type	Representative Customers
Consumer	Individual	Based on our internal studies, 57% annually earn more than \$75,000 and 40% earn more than \$100,000
	Retailers*	Amazon.com, Barnes & Noble, Best Buy, Books-a-Million, Staples and Costco
	Home Shopping Network	GS Home Shopping, Inc. (Korea)
Institutional	Educational Institutions	Primary and Secondary Schools: New York City Department of Education (NY), DeKalb County Schools (GA), Clark County School District (NV), School District of Hillsborough County (FL), Region 7 Education Service Center (TX), Lodi Unified School District (CA), School Board of Orange County (FL), Santa Fe Public Schools (NM) Universities: Liberty University, Rutgers—The State University of New Jersey, Northwood University
	Government, Armed Forces and Not-for-Profit Organizations	Foreign Service Institute, TSA—Virginia, Centers for Disease Control, Servicio Nacional de Aprendizaje (Columbia), Caribbean Examinations Council, Administrative Office of the U.S. Courts, U.S. Air Force, American Cancer Society, New York Public Library
	Corporations	Andarko Petroleum Corp., Burberry Group, Deere & Company, Emerson Electric Co., Interstate Operating Company, Marriott International, Inc., Molex Inc., National Oilwell Varco, Inc., Northern Trust, Pitney Bowes Inc.

\* We use third party distributors to sell to Best Buy, Staples and some smaller retailers.

## Marketing and Distribution Channels

Our multi-channel marketing and distribution model consists of print, online, television and radio direct-response advertising, kiosks, our institutional sales force and retail resellers. We believe that this marketing and distribution model, through which each channel complements and supports the others, provides:

- greater brand awareness across channels;
- cost-effective consumer acquisition and education;
- premium brand building; and
- improved convenience for consumers.

### *Consumer*

Consumer sales accounted for approximately 77% of our revenue for the year ended December 31, 2011. Our 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, Staples and Costco, home shopping networks such as GS Home Shopping, Inc. in Korea and consignment distributors such as Navarre. We believe these channels complement each other, as consumers that 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.* Our direct-to-consumer channel, which we define as sales generated through either our websites or call centers, accounted for approximately 66% of our consumer revenue for the year ended December 31, 2011. We utilize several forms of advertising to drive our direct-to-consumer sales, including print, online, television and radio. Our marketing to this channel also supports the kiosk and retail channels.

*Rosetta Stone Kiosks.* As of December 31, 2011, we operated 174 retail kiosks, including 103 full service retail outlets, in airports, malls and other strategic high-traffic locations in 28 states and the District of Columbia. As of December 31, 2011, we operated 8 kiosks in the United Kingdom, 11 in Japan, 47 in South Korea and 5 in Germany. Many of our international kiosks are inside the stores of other retailers. These company operated kiosks accounted for approximately 14% of our consumer revenue for the year ended December 31, 2011. During 2012, based on our evaluation of historical and forecasted kiosk sales performance, we plan to significantly reduce the size of our worldwide kiosk program, in addition to continually reviewing the performance of remaining kiosk locations.

*Retailers.* Sales to retailers accounted for approximately 18% of our consumer revenue for the year ended December 31, 2011. 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, Staples and Costco. Sales in the retail channel are highly correlated with our media expenditures in the direct-to-consumer channel. We plan to expand select retail relationships while reducing our financial exposure to underperforming store-based retail partners.

*Home Schools.* We promote interest in this market through advertising in publications focused on home schooling, attending local trade shows, seminars and direct mailings. For the years ended December 31, 2011 and 2010, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current

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year presentation. Home school sales accounted for approximately 2% of our consumer revenue for the year ended December 31, 2011.

### ***Institutional***

Institutional sales accounted for approximately 23% of our revenue for the year ended December 31, 2011. Our institutional distribution model is focused on targeted sales activity primarily through a direct sales force in four markets: schools, colleges and universities; the U.S. armed forces and 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 and represented approximately 56% of our institutional revenue for the year ended December 31, 2011. In our experience, colleges, universities and schools frequently rely on references from peer institutions and an official request-for-proposal, or RFP, process when selecting a vendor. We generate sales leads from sources such as visiting potential customer sites to provide briefings on our solutions and the industry, interacting with attendees at trade shows and conferences, responding to inbound calls based on recommendations from existing customers, and monitoring and responding to RFPs.

*Federal Government Agencies and Armed Forces, Not-for-Profit.* These customers include governmental agencies, armed forces and organizations developing workforces to serve non-native speaking populations, offering literacy programs and preparing members for overseas missions and accounted for approximately 20% of our institutional revenue for the year ended December 31, 2011. Many customers in this market license our products through online subscriptions.

*Corporations.* We promote interest in this market with onsite visits, trade show and seminar attendance, speaking engagements and direct mailings. Many of our customers in the market prefer online subscription delivery of our products. Corporations represented 24% of our institutional revenue for the year ended December 31, 2011.

### ***International***

International sales accounted for approximately 21% of our revenue for the year ended December 31, 2011. In the near term, our international activity is primarily focused on successfully growing our business in the United Kingdom, Germany, South Korea, Japan and Brazil, where we are utilizing many of the same strategies that we developed in the U.S. market. We opened our United Kingdom office in 2005, our Japan office in 2007, our South Korea office in 2009, our Germany office in 2010, and our Brazil office in 2011. Over time, we believe that we will be able to develop a similar business model in other markets in Europe, Asia and Latin America.

### **Product Development**

Our product portfolio is a result of significant investment in product development over 19 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 \$24.2 million, \$23.4 million and \$26.2 million for the years ended December 31, 2011, 2010 and 2009, respectively.



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### **Sourcing and Fulfillment**

Our strategy is to maintain a flexible, diversified and low-cost manufacturing base. 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.

### **Competition**

The language-learning industry is highly fragmented and subject to rapidly changing consumer preferences and industry trends. We expect competition in the markets that we serve to persist and intensify. We face varying degrees of competition from a wide variety of companies providing language learning solutions including:

- language learning center operators;
- audio CD and MP3 download providers;
- pre-packaged software producers;
- textbook publishers;
- online tutoring service providers; and
- online community practice providers.

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

We believe that the principal competitive factors in our industry include:

- product differentiation, including:
  - teaching method,
  - effectiveness,
  - accessibility and convenience,
  - availability and quality of speech recognition, and
  - fun and likelihood of continued engagement,
- brand recognition and reputation;
- price; and
- effective advertising.

## **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.

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We have four U.S. patents and several international and U.S. 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*, *Rosettastone.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 utilize today and those we develop in the future.

We are registering or have registered in the United States all editions of our Version 3 languages. We have a registered copyright in the refreshed Rosetta Stone blue stone logo and 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 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, 2011, we had 1,888 total employees, consisting of 1,013 full-time and 875 part-time employees. Our personnel consisted of 334 employees in sales and marketing, 210 employees in research and development, 209 in general and administrative, 544 in coaching, customer and product support, 40 in operations and logistics and 551 kiosk sales employees. None of our employees is 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 16 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

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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 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.***

We currently believe that we are likely to have sufficient taxable income in the future to realize the benefit of all of our deferred tax assets, consisting primarily of reserves and accruals that are not currently deductible for tax purposes. However, some or all of these deferred tax assets could expire unused if we are unable to generate sufficient taxable income in the future to utilize them. If it becomes more likely than not that our deferred tax assets will expire unused, we would record a valuation allowance, which may materially increase our income tax expense, and therefore adversely affect our results of operations and tangible net worth in the period in which it is recorded.

***Risks Related to Our Business***

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

We released Rosetta Stone Version 4 TOTALe in the United States in the third quarter of 2010 and in Japan, the United Kingdom and South Korea in 2011. We introduced ReFLEX in South Korea in July 2011. 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 web-based services have a much higher cost as a percentage of revenue than our software solutions. 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 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 face in our existing 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. Consumer demand for Rosetta Stone Version 4 TOTALe has not been as high as we projected and overall, our unit sales contracted in 2011 compared to 2010. We cannot assure you that Rosetta Stone Version 4 TOTALe and 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.

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

In July 2011, we introduced our English remediation solution, ReFLEX, in South Korea. We intend to introduce ReFLEX in Japan during 2012. This solution targets advanced English learners in Asia, and will provide 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 will carry 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 new product presents new management and marketing challenges that differ from the challenges we face in our existing business. Consumer demand for ReFLEX in South Korea 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. If we are not successful in our launch of the English remediation solution, our business, financial results and reputation may be harmed.

***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

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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. Our December 2010 study found that the consumer spending on language learning in the U.S. contracted from approximately \$5.2 billion in 2007 to approximately \$4 billion in 2010. Our study also indicates that U.S. consumer spending on language learning has declined by 24% since 2007, even as the total number of buyers has expanded by 28%. Some of the potential developments that could negatively affect interest in and demand for language-learning software products include:

- a decline in international travel;
- changes in U.S. laws or policies making it more difficult for foreign persons to visit or take up residence in the United States; and
- a reduction in the roles of the U.S. armed forces or other governmental agencies in foreign countries.

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

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

- identify, anticipate, understand and respond to these trends in a timely manner;
- introduce appealing new products and performance features on a timely basis;
- 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.

Although unit sales of our products increased compared to 2010, revenues from Version 4 *TOTALe* have been less than expected. In addition, the sales of *ReFLEX* in South Korea have been less than we anticipated. We have also been experiencing changes in consumer demand with respect to our kiosk sales channel. We closed 23 kiosk locations in the fourth quarter of 2011 and plan to significantly reduce the size of our worldwide kiosk program based on our evaluation of historical and forecasted kiosk sales performance.

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

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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 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. We depend on the continued popularity of malls as shopping destinations and the ability of mall anchor tenants and other attractions to generate customer traffic for our retail mall-based kiosks. We also depend on continued airline travel to generate traffic for our retail kiosks located in airports. In addition, we depend on the continued popularity of traditional store-based retailers such as Barnes & Noble, Best Buy, Costco, Books-A-Million and Staples to sell our products. Decreases in mall, airport or traditional store-based 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, Staples, Costco, Navarre and our home shopping network partner in Korea, GS Home Shopping, Inc. Sales to or through our retailer and distributors accounted for approximately 14% of our revenue for the year ended December 31, 2011, which was down approximately 4% from our revenue generated from these channels for the year ended December 31, 2010. On February 16, 2011, Borders filed for Chapter 11 bankruptcy reorganization and we recorded a charge of \$0.9 million during the three months ended December 31, 2010 associated with the potential loss of our accounts receivable from Borders. In July 2011, Borders announced plans to close down all of the Company's retail stores and liquidate inventory. The liquidation of inventory by Borders reduced foot traffic and sales of our products by our other retailers.

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 Borders Chapter 11 liquidation, book stores and other traditional store-based retailers are experiencing diminished foot traffic and sales. Reduced customer foot traffic in these stores is likely

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to reduce their sales of our products. In addition, if one or more 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.***

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 are in the process of testing 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.

### ***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. 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 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.



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

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

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

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

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

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

- create greater awareness of our brands and our language-learning solutions;
- select the right market, media and specific media vehicle in which to advertise;
- identify the most effective and efficient level of spending in each market, media and specific media vehicle;
- determine the appropriate creative message and media mix for advertising, marketing and promotional expenditures;
- effectively manage marketing costs, including creative and media expenses, in order to maintain acceptable customer acquisition costs;
- drive traffic to our websites, call centers, kiosks and distribution channels; and
- convert customer inquiries into actual orders.

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

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

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we have obtained in the past. If any of these events occur, we may be forced to purchase time slots and publication dates at higher prices, which will increase our costs.

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

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

***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 continued expansion into international markets. We are currently expanding our direct sales channels in Europe, Asia and Latin America. In addition, we are expanding our indirect sales channels in Europe, Asia and Latin America through retailer and distributor arrangements with third parties. If we are unable to expand our international operations successfully and in a timely manner, our ability to pursue our growth strategy will be impaired. Such expansion may be more difficult or take longer than we 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;

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- 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;
- difficulties with providing appropriate and appealing products to suit consumer preferences and capabilities in these markets, such as the potential need to customize English language software solutions for local markets;
- difficulties with establishing successful kiosk sales channels;
- inability to successfully develop relationships with significant retailers and distributors;
- potential political and economic instability in some regions;
- potential unpredictable changes in foreign government regulations;
- legal and cultural differences in the conduct of business;
- import and export license requirements, tariffs, taxes and other trade barriers;
- inflation and fluctuations in currency exchange rates;
- potentially adverse tax consequences;
- difficulties in enforcing contracts and collecting accounts receivable, and longer payment cycles, especially in emerging markets;
- the burden and difficulties 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.



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

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

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

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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 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.

***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 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 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 75-90% of the revenue at the time of sale. We are exploring delivering more of our solutions online pursuant to monthly 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.

***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 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

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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 33% from 259 as of December 31, 2010 to 174 as of December 31, 2011. In 2012, based on our evaluation of historical and forecasted kiosk sales performance, we plan to significantly reduce 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-learning solutions, including our online language courses and *Rosetta Stone TOTALE*, and our *SharedTalk* online peer-to-peer collaborative and interactive community. Any damage, interruption or failure of our systems, networks and databases could prevent us from processing customer orders and result in degradation or interruptions in delivery of our products and services. Notwithstanding our efforts to protect against interruptions in the availability of our e-commerce websites and internet-based products and services, we do occasionally experience unplanned outages or technical difficulties. In addition, we do not have complete redundancy for all of our systems. We do not maintain real-time back-up of all of our data, and in the event of system disruptions, we could experience loss of data which could cause us to lose customers and could harm our reputation and cause us to face unexpected liabilities and expenses. If we continue to expand our business, we will put additional strains on these systems. If we move additional product features to online systems or more of our business online, all of these considerations will become more significant. We may also need to grow, reconfigure or relocate our data centers in response to changing business needs, which may be costly and lead to unplanned disruptions of service.



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***We are subject to U.S. and foreign government regulation of online services which could subject us to claims, judgments, and remedies, including monetary liabilities and limitations on our business practices.***

We are subject to regulations and laws directly applicable to providers of online services. The application of existing domestic and international laws and regulations to us relating to issues such as user privacy and data protection, data security, defamation, promotions, billing, consumer protection, accessibility, content regulation, quality of services, and intellectual property ownership and infringement in many instances is unclear or unsettled. In addition, we will also be subject to any new laws and regulations directly applicable to our domestic and international activities. Internationally, we may also be subject to laws regulating our activities in foreign countries and to foreign laws and regulations that are inconsistent from country to country. We may incur substantial liabilities for expenses necessary to defend litigation in connection with such regulations and laws or to comply with these laws and regulations, as well as potential substantial penalties for any failure to comply.

***We may be subject to legal liability for new web-based online services.***

*Rosetta Stone TOTALE* enables individuals to exchange information and engage in various online activities on a domestic and an international basis. The law relating to the liability of providers of online services for activities of their users is currently unsettled both within the U.S. and internationally. Claims may be brought against us for defamation, negligence, copyright or trademark infringement, unlawful activity, tort, including personal injury, fraud, or other theories based on the nature and content of information that may be posted online or generated by our users. Defense of any such actions could be costly and involve significant time and attention of our management and other resources and may require us to change our business in an adverse manner.

In addition, the amount of data we store for our users on our servers (including personal information) will increase as we increase our web based services. Any systems failure or compromise of our security that results in the release of our users' data could seriously limit the adoption of our products and services as well as harm our reputation and brand and, therefore, our business. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand the number of web based products and services we offer as well as increase the number of countries where we operate.

Further, failure or perceived failure by us to comply with our policies, applicable requirements, or industry self-regulatory principles related to the collection, use, sharing or security of personal information, or other privacy, data-retention or data-protection matters could result in a loss of user confidence in us, damage to our brands, and ultimately in a loss of users, advertising partners, or affiliates, which could adversely affect our business.

***Our possession and use of personal information presents risks and expenses that could harm our business. Unauthorized disclosure or manipulation of such data, whether through breach of our network security or otherwise, could expose us to costly litigation and damage our reputation.***

Maintaining our network security is of critical importance because our online e-commerce systems and our online administration tools for our institutional business store proprietary and confidential customer, employee and other sensitive data, such as names, addresses, other personal information and credit card numbers. Our call centers also process confidential customer data, which is provided to employees in the call centers. We and our vendors use commercially available encryption technology to transmit personal information when taking orders. We use security and business controls to limit access and use of personal information. However, third parties may be able to circumvent these security and business measures by developing and deploying viruses, worms and other malicious software programs that are designed to attack or attempt to infiltrate our systems and networks. In addition, employee error, malfeasance or other errors in the storage, use or transmission of personal information could

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result in a breach of customer or employee privacy. We employ contractors and temporary and part-time employees who may have access to the personal information of customers and employees. It is possible such individuals could circumvent our controls, which could result in a breach of customer or employee privacy.

Possession and use of personal information in conducting our business subjects us to legislative and regulatory burdens that could require notification of data breaches, restrict our use of personal information and hinder our ability to acquire new customers or market to existing customers. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.

If third parties improperly obtain and use the personal information of our customers or employees, we may be required to expend significant resources to resolve these problems. A major breach of our network security and systems could have serious negative consequences for our businesses, including possible fines, penalties and damages, reduced customer demand for our products and services, harm to our reputation and brand and loss of our ability to accept and process customer credit card orders.

***We are exposed to risks associated with credit card and payment fraud and with credit card processing, which could cause us to lose revenue.***

Many of our customers use credit cards or automated payment systems to pay for our products and services. We have suffered losses, and may continue to suffer losses, as a result of orders placed with fraudulent credit cards or other fraudulent payment data. For example, under current credit card practices, we may be liable for fraudulent credit card transactions if we do not obtain a cardholder's signature, a frequent practice in internet sales. We employ technology solutions to help us detect fraudulent transactions. However, the failure to detect or control payment fraud could cause us to lose sales and revenue.

***Any significant interruptions in the operations of our call center or third-party call centers could cause us to lose sales and disrupt our ability to process orders and deliver our solutions in a timely manner.***

We rely on both an in-house call center and third-party call centers to sell our solutions, respond to customer service and technical support requests and process orders. Any significant interruption in the operation of these facilities, including an interruption caused by our failure to successfully expand or upgrade our systems or to manage these expansions or upgrades, could reduce our ability to receive and process orders and provide products and services, which could result in lost and cancelled sales and damage to our brand and reputation.

As we grow, we will need more capacity from those existing call centers or we will need to identify and contract with new call centers. We may not be able to continue to locate and contract for call center capacity on favorable terms, or at all. Additionally, the rates those call centers charge us may increase or those call centers may not continue to provide service at the current levels.

We structure our marketing and advertising to drive potential customers to our call centers and websites to purchase our solutions. If our call center operators do not convert inquiries into sales at expected rates, our ability to generate revenue could be impaired. Training and retaining qualified call center operators is challenging due to the expansion of our product and service offerings and the seasonality of our business. If we do not adequately train our call center operators, they will not convert inquiries into sales at an acceptable rate.

Our call center employs a large number of personnel and historically has been subject to a high turnover rate among employees. We may have to terminate employees from time to time as our business changes and labor demands shift among our facilities. Any significant increase in labor costs, deterioration of employee relations, slowdowns or work stoppages at any of our locations, due to

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employee turnover or otherwise, could harm our business and profitability. In addition, high employee turnover could increase our exposure to employee-related litigation. Likewise, the third-party call centers we utilize face similar issues.

***If any of our products contain defects or errors or if new product releases or services are delayed, our reputation could be harmed, resulting in significant costs to us and impairing our ability to sell our solutions.***

If our products contain defects, errors or security vulnerabilities, our reputation could be harmed, which could result in significant costs to us and impair our ability to sell our products in the future. In the past, we have encountered product development delays due to errors or defects. We would expect that, despite our testing, errors will be found in new products and product enhancements in the future. Significant errors in our products or services could lead to, among other things:

- delays in or loss of market acceptance of our products and services;
- diversion of our resources;
- a lower rate of license renewals or upgrades for consumer and institutional customers;
- injury to our reputation; or
- increased service expenses or payment of damages.

In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products and services. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms, or at all, we could face significant financial losses.

***Our sales to U.S. government agencies and armed forces subject us to special risks that could adversely affect our business.***

Government sales entail a variety of risks as evidenced by the non-renewal of our contracts with the U.S. Army and the U.S. Marine Corps in 2011. These risks include the following:

- government contracts are subject to the approval of appropriations by the United States Congress to fund the expenditures by the agencies under these contracts. Congress often appropriates funds for government agencies on a yearly basis, even though their contracts may call for performance over a number of years;
- our products and services are included on a General Services Administration, or GSA, schedule. The loss of the GSA schedule covering our software products and related services could cause us to lose our ability to sell our products and services to U.S. government customers;
- we must comply with complex federal procurement laws and regulations in connection with government contracts, which may impose added costs on our business; and
- federal government contracts contain provisions and are subject to laws and regulations that provide government customers with rights and remedies not typically found in commercial contracts. These rights and remedies allow government clients, among other things, to terminate existing contracts, with short notice, for convenience, without cause, reduce or modify contracts or subcontracts, and claim rights in products, systems, and technology produced by us.

***If we fail to effectively upgrade our information technology systems, we may not be able to accurately report our financial results or prevent fraud.***

As part of our efforts to continue improving our internal control over financial reporting, we plan to continue to upgrade our existing financial information technology systems in order to automate several controls that are currently performed manually. We may experience difficulties in transitioning to these upgraded systems, including loss of data and decreases in productivity, as personnel become familiar with these new systems. In addition, our management information systems will require modification and refinement as we grow and as our business needs change, which could prolong difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems or respond to changes in our business needs, we may not be able to effectively manage our business and we may fail to meet our reporting obligations. In addition, as a result of the automation of these manual processes, the data produced may cause us to question the accuracy of previously reported financial results.

***Our software products must interoperate with computer operating systems of our customers. If we are unable to ensure that our products interoperate properly with customer systems, our business could be harmed.***

Our products must interoperate with our customers' computer systems, including student learning management systems of our institutional customers. As a result, we must continually ensure that our products interoperate properly with these systems. Changes in operating systems, the technologies we incorporate into our products or the computer systems our customers use may damage our business.

***As our product and service offerings become more complex, our reported revenue may become less predictable.***

Our planned expansion of products and services will generate more varied sources of revenue than our existing business. In the fourth quarter of 2011, we made announcements regarding our business, including evolving from a CD-ROM based desktop software model to digital services, combining self-study with live online conversational coaching in a multi-device platform. In 2012, we intend to work further on our plans to transition our distribution to more online in the consumer business. The accounting policies that apply to these sources of revenue may be more complex than those that apply to our traditional products and services. In addition, we may change the manner in which we sell our software licenses, and such change could cause delays in revenue recognition in accordance with accounting standards. Under these accounting standards, even if we deliver products and services to, and collect cash from, a customer in a given fiscal period, we may be required to defer recognizing revenue from the sale of such product or service until a future period when all the conditions necessary for revenue recognition have been satisfied. If we move more of our consumer business online we will also collect less cash from our initial transactions with consumers which could substantially decrease our revenues in the short term. Conditions that can cause delays in revenue recognition include software arrangements that have undelivered elements for which we have not yet established vendor specific objective evidence of fair value, requirements that we deliver services for significant enhancements or modifications to customize our software for a particular customer or material customer acceptance criteria.

***Many of our expenses are fixed and many are based, in significant part, on our expectations of our future revenue and are incurred prior to the sale of our products and services. Therefore, any significant decline in revenue for any period could have an immediate negative impact on our margins, net income and financial results for the period.***

Our expense levels are based, in significant part, on our estimates of future revenue and many of these expenses are fixed in the short term. As a result, we may be unable to adjust our spending in a

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timely manner if our revenue falls short of our expectations. Accordingly, any significant shortfall of revenue in relation to our estimates could have an immediate negative effect on our profitability. In addition, as our business evolves, we anticipate increasing our operating expenses to expand our product development, technical support, sales and marketing and administrative organizations. Any such expansion could cause material losses to the extent we do not generate additional revenue sufficient to cover the additional expenses.

***We may need to raise additional funds to pursue our growth strategy or continue our operations, and we may be unable to raise capital when needed.***

From time to time, we may seek additional equity or debt financing to provide for the capital expenditures required to finance working capital requirements, continue our expansion, develop new products and services or make acquisitions or other investments. In addition, if our business plans change, general economic, financial or political conditions in our markets change, or other circumstances arise that have a material effect on our cash flow, the anticipated cash needs of our business as well as our conclusions as to the adequacy of our available sources of capital could change significantly. Any of these events or circumstances could result in significant additional funding needs, requiring us to raise additional capital. We cannot predict the timing or amount of any such capital requirements at this time. If financing is not available on satisfactory terms, or at all, we may be unable to expand our business or to develop new business at the rate desired and our results of operations may suffer.

***Acquisitions, joint ventures and strategic alliances may have an adverse effect on our business.***

We may make acquisitions or enter into joint ventures and strategic alliances as part of our long-term business strategy. Such transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we do not realize a satisfactory return on our investment, that we experience difficulty integrating new employees, business systems, and technology, diversion of management's attention from our other businesses or that we acquire undiscovered liabilities such as patent infringement claims or violations of the U.S. Foreign Corrupt Practices Act and similar worldwide anti-bribery laws. It may take longer than expected to realize the full benefits, such as increased revenue, enhanced efficiencies, or market share, or those benefits may ultimately be smaller than anticipated, or may not be realized. These events could harm our operating results or financial condition.

### **Risks Related to Intellectual Property Rights**

***Protection of our intellectual property is limited, and any misuse of our intellectual property by others, including software piracy, could harm our business, reputation and competitive position.***

Our intellectual property is important to our success. We believe our trademarks, copyrights, trade secrets, pending patents, trade dress and designs are valuable and integral to our success and competitive position. To protect our proprietary rights, we rely on a combination of patents, copyrights, trademarks, trade secret laws, confidentiality procedures, contractual provisions and technical measures.

We have four issued patents in the United States. We have several patent applications on file in the United States and other countries. However, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims. Even if patents are issued from our patent applications, which is not certain, they may be contested, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies now or in the future. In addition, we have not emphasized patents as a source of significant competitive advantage

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and have instead sought to primarily protect our proprietary rights under laws affording protection for trade secrets, copyright and trademark protection of our products, brands, trademarks and other intellectual property where available and appropriate. However, all of these measures afford only limited protection and may be challenged, invalidated or circumvented by third parties. In addition, these protections may not be adequate to prevent our competitors or customers from copying or reverse-engineering our products. Third parties could copy all or portions of our products or otherwise obtain, use, distribute and sell our proprietary information without authorization. Third parties may also develop similar or superior technology independently by designing around our intellectual property, which would decrease demand for our products. In addition, our patents may not provide us with any competitive advantages and the patents of others may seriously impede our ability to conduct our business.

We protect our products, trade secrets and proprietary information, in part, by requiring all of our employees to enter into agreements providing for the maintenance of confidentiality and the assignment of rights to inventions made by them while employed by us. We also enter into non-disclosure agreements with our technical consultants, customers, vendors and resellers to protect our confidential and proprietary information. We cannot assure you that our confidentiality agreements with our employees, consultants and other third parties will not be breached, that we will be able to effectively enforce these agreements, that we will have adequate remedies for any breach, or that our trade secrets and other proprietary information will not be disclosed or will otherwise be protected.

We rely on contractual and license agreements with third parties in connection with their use of our products and technology. There is no guarantee that such parties will abide by the terms of such agreements or that we will be able to adequately enforce our rights, in part because we rely, in many instances, on "click-wrap" and "shrink-wrap" licenses, which are not negotiated or signed by individual licensees. Accordingly, some provisions of our licenses, including provisions protecting against unauthorized use, copying, transfer, resale and disclosure of the licensed software program, may be unenforceable under the laws of several jurisdictions.

Protection of trade secret and other intellectual property rights in the markets in which we operate and compete is highly uncertain and may involve complex legal questions. The laws of countries in which we operate may afford little or no protection to our trade secrets and other intellectual property rights. Although we defend our intellectual property rights and combat unlicensed copying and use of software and intellectual property rights through a variety of techniques, preventing unauthorized use or infringement of our intellectual property rights is inherently difficult. Despite our enforcement efforts against software piracy, we lose significant revenue due to illegal use of our software and from counterfeit copies of our software. If piracy activities increase, it may further harm our business.

We also expect that the more successful we are, the more likely that competitors will try to illegally use our proprietary information and develop products that are similar to ours, which may infringe on our proprietary rights. In addition, we could potentially lose future trade secret protection for our source code if any unauthorized disclosure of such code occurs. The loss of future trade secret protection could make it easier for third parties to compete with our products by copying functionality. In addition, any changes in, or unexpected interpretations of, the trade secret and other intellectual property laws in any country in which we operate may compromise our ability to enforce our trade secret and intellectual property rights. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our confidential information and trade secret protection. If we are unable to protect our proprietary rights or if third parties independently develop or gain access to our or similar technologies, our business, revenue, reputation and competitive position could be harmed.

***Third-party use of our trademarks as keywords in internet search engine advertising programs may direct potential customers to competitors' websites, which could harm our reputation and cause us to lose sales.***

Competitors and other third parties, including counterfeiters, purchase our trademarks and confusingly similar terms as keywords in internet search engine advertising programs and in the header and text of the resulting sponsored link advertisements in order to divert potential customers to their websites. Preventing such unauthorized use is inherently difficult. If we are unable to protect our trademarks and confusingly similar terms from such unauthorized use, competitors and other third parties may continue to drive potential online customers away from our websites to competing and unauthorized websites, which could harm our reputation and cause us to lose sales.

***Our trademarks are limited in scope and geographic coverage and may not significantly distinguish us from our competition.***

We own several federal trademark registrations, including registrations of the *Rosetta Stone* mark, hold common law trademark rights and have trademark applications pending in the United States and abroad for additional trademarks. Even if federal registrations and registrations in other countries are granted to us, our trademark rights may be challenged. It is also possible that our competitors will adopt trademarks similar to ours, thus impeding our ability to build brand identity and possibly leading to customer confusion. In fact, various third parties have registered trademarks that are similar to ours in the United States and overseas. We could incur substantial costs in prosecuting or defending trademark infringement suits. If we fail to effectively enforce our trademark rights, our competitive position and brand recognition may be diminished.

***We have not registered copyrights for all our products, which may limit our ability to enforce them.***

We have not registered our copyrights in all of our software, written materials, website information, designs or other copyrightable works. The United States Copyright Act automatically protects all of our copyrightable works, but without a registration we cannot enforce those copyrights against infringers or seek certain statutory remedies for any such infringement. Preventing others from copying our products, written materials and other copyrightable works is important to our overall success in the marketplace. In the event we decide to enforce any of our copyrights against infringers, we will first be required to register the relevant copyrights, and we cannot be sure that all of the material for which we seek copyright registration would be registrable in whole or in part, or that once registered, we would be successful in bringing a copyright claim against any such infringers.

***We must monitor and protect our internet domain names to preserve their value. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe on or otherwise decrease the value of our trademarks.***

We own several domain names that include the terms Rosetta Stone and Rosetta World. Third parties may acquire substantially similar domain names that decrease the value of our domain names and trademarks and other proprietary rights which may hurt our business. Third parties also may acquire country specific domain names in the form of Country Code Top Level Domains which include our trademarks and which prevent us from operating country specific websites from which customers can view our products and engage in transactions with us. Moreover, the regulation of domain names in the United States and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars or modify the requirements for holding domain names. In June 2011, ICANN (the Internet Corporation for Assigned Names and Numbers), the international authority over top-level domain names, gave final approval of the expansion of generic Top Level Domains ("TLDs") which will allow companies and organizations to create additional Web addresses that appear to the right of the "dot," such as already created TLDs, ".com," ".gov" and ".org." Applications for new TLDs currently are being accepted until April 12, 2012. As a result, we may not maintain exclusive

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rights to all potentially relevant domain names in the United States or in other countries in which we conduct business, which could harm our business or reputation. Moreover, attempts may be made to register our trademarks as new TLDs and we will have to make efforts to enforce our rights against such registration attempts.

### ***Claims that we misuse the intellectual property of others could subject us to significant liability and disrupt our business.***

We may become subject to material claims of infringement by competitors and other third parties with respect to current or future products, e-commerce and other web-related technologies, online business methods, trademarks or other proprietary rights. Our competitors, some of which may have substantially greater resources than we have and they have made significant investments in competing products and technologies, may have, or seek to apply for and obtain, patents, copyrights or trademarks that will prevent, limit or interfere with our ability to make, use and sell our current and future products and technologies, and we may not be successful in defending allegations of infringement of these patents, copyrights or trademarks. Further, we may not be aware of all of the patents and other intellectual property rights owned by third parties that may be potentially adverse to our interests. We may need to resort to litigation to enforce our proprietary rights or to determine the scope and validity of a third-party's patents or other proprietary rights, including whether any of our products, technologies or processes infringe the patents or other proprietary rights of third parties. We may incur substantial expenses in defending against third-party infringement claims regardless of the merit of such claims. The outcome of any such proceedings is uncertain and, if unfavorable, could force us to discontinue sales of the affected products or impose significant penalties or restrictions on our business. We do not conduct comprehensive patent searches to determine whether the technologies used in our products infringe upon patents held by others. In addition, product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies.

### ***We do not own all of the software, other technologies and content used in our products and services.***

Some of our products and services include intellectual property owned by third parties, including software that is integrated with internally developed software and a portion of our voice recognition software, which we license from the University of Colorado. From time to time we may be required to renegotiate with these third parties or negotiate with new third parties to include their technology or content in our existing products, in new versions of our existing products or in wholly new products. We may not be able to negotiate or renegotiate licenses on commercially reasonable terms, or at all, and the third-party software may not be appropriately supported, maintained or enhanced by the licensors. If we are unable to obtain the rights necessary to use or continue to use third-party technology or content in our products and services, the inability to support, maintain and enhance any software could result in increased costs, or in delays or reductions in product shipments until equivalent software could be developed, identified, licensed and integrated.

### ***Our use of open source software could impose limitations on our ability to commercialize our products.***

We incorporate open source software into our products and may use more open source software in the future. The use of open source software is governed by license agreements. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that these licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, make generally available, in source code form, proprietary code that links to certain open source modules, re-engineer our products, discontinue the sale of our products if re-engineering could not be accomplished on a cost-effective and timely basis, or



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become subject to other consequences. In addition, open source licenses generally do not provide warranties or other contractual protections regarding infringement claims or the quality of the code. Thus, we may have little or no recourse if we become subject to infringement claims relating to the open source software or if the open source software is defective in any manner.

### **Risks Related to Owning Our Common Stock**

*Some of our stockholders could together exert significant influence over our company.*

As of December 31, 2011, funds affiliated with ABS Capital Partners beneficially owned in the aggregate shares representing approximately 25% of our outstanding voting power. Two managing members of the general partner of ABS Capital Partners currently serve on our board of directors. Additionally, as of December 31, 2011, Norwest Equity Partners VIII, LP, or Norwest, beneficially owned in the aggregate shares representing approximately 16% of our outstanding voting power. One managing member of the general partner of Norwest currently serves on our board of directors. As a result, these stockholders could together potentially have significant influence over all matters presented to our stockholders for approval, including election and removal of our directors and change of control transactions. The interests of these stockholders may not always coincide with the interests of the other holders of our common stock.

*If securities analysts do not publish research or reports about our business or if they publish negative evaluations of our stock, the price of our stock could decline.*

The trading market for our common stock depends in part on the research and reports that industry or financial analysts publish about us or our business. If one or more of the analysts covering our business downgrade their evaluations of or recommendations regarding our stock, or if one or more of the analysts cease providing research coverage on our stock, the price of our stock could decline. If one or more of these analysts cease providing research coverage on our stock, we could lose visibility in the market for our stock, which in turn could cause our stock price to decline.

*Provisions in our organizational documents and in the Delaware General Corporation Law may prevent takeover attempts that could be beneficial to our stockholders.*

Provisions in our second amended and restated certificate of incorporation and second amended and restated bylaws, and in the Delaware General Corporation Law, may make it difficult and expensive for a third party to pursue a takeover attempt we oppose even if a change in control of our company would be beneficial to the interests of our stockholders. Any provision of our second amended and restated certificate of incorporation or second amended and restated bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our board of directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner. However, because funds affiliated with ABS Capital Partners and Norwest acquired their shares prior to our initial public offering, Section 203 is currently inapplicable to any business combination or transaction with them or their affiliates. In addition, our second amended and restated certificate of incorporation includes a classified board of directors and requires that any action to be

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taken by stockholders must be taken at a duly called meeting of stockholders and may not be taken by written consent. Our second amended and restated bylaws require that any stockholder proposals or nominations for election to our board of directors must meet specific advance notice requirements and procedures, which make it more difficult for our stockholders to make proposals or director nominations.

**Item 1B. *Unresolved Staff Comments***

None.

**Item 2. *Properties***

Our corporate headquarters are located in Arlington, Virginia, where we sublease approximately 31,281 square feet of space. The term of this sublease runs through December 31, 2013.

We continue to lease approximately 8,038 square feet of space in Arlington, Virginia, which was the site of our corporate headquarters until late 2008, with lease terms ending August 31, 2013. We intend to occupy this space until the end of the lease term.

We currently own two facilities with approximately 62,000 and 14,500 square feet of usable space in Harrisonburg, Virginia, that serve as our operations offices. In addition, we lease two facilities with approximately 56,000 and 6,000 square feet in Harrisonburg, Virginia for use as a packing and distribution center for all of our U.S. and some of our international fulfillment, in addition to sales operations.

We also lease space for our three full service retail outlets in California, New Jersey, and Virginia, and small offices in Boulder, Colorado, Tokyo, Japan, Seoul, South Korea, Munich, Germany, London, United Kingdom, Shanghai, China and Sao Paulo, Brazil. Our Boulder office serves as a research and development location while our Tokyo, Seoul, Sao Paulo and London offices serve as regional sales offices. Our Shanghai, China office is representative.

As of December 31, 2011, we also had site licenses for 174 kiosks. Most of our kiosk site licenses have terms of one to 89 months and provide for a minimum rent plus a percentage rent based upon sales after certain minimum thresholds have been achieved. These site licenses generally require that we pay insurance, utilities, real estate taxes and repair and maintenance expenses. Some of the site licenses also contain early termination options, which can be exercised by us or the licensor under certain conditions. Based on our evaluation of historical and forecasted kiosk sales performance, during 2012, we plan to significantly reduce the size of our worldwide kiosk program, in addition to continually reviewing the performance of remaining kiosk locations.

**Item 3. *Legal Proceedings***

In July 2009, we filed a lawsuit in the United States District Court for the Eastern District of Virginia against Google Inc., seeking, among other things, to prevent Google from infringing upon our trademarks. In August 2010, the U.S. District Court for the Eastern District of Virginia issued its final order dismissing our trademark infringement lawsuit against Google. We appealed the District Court's decision to the U.S. Court of Appeals for the Fourth Circuit. The U.S. Court of Appeals heard oral argument on the Company's appeal on September 22, 2011 and the decision is pending. We have incurred, and may continue to incur material legal fees and other costs and expenses in pursuit of our claims against Google.

On or about April 28, 2010, a purported class action lawsuit was filed against us in the Superior Court of the State of California, County of Alameda for unspecified damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and

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other persons similarly situated who are or were employed by us as salaried managers in its retail locations in California are due unpaid wages and other relief for our violations of state wage and hour laws. Plaintiffs moved to amend their complaint to include a nationwide class on January 21, 2011. In November 2011, the plaintiffs' attorneys and the Company agreed to the mediator's proposed settlement terms, and as a result, as of September 30, 2011, we reserved \$0.6 million for the proposed settlement amount. Approval of the proposed settlement by the court is pending. We dispute the plaintiffs' claims and have not admitted any wrongdoing with respect to the case.

On June 23, 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG ("Langenscheidt") in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone's use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. Langenscheidt is seeking, among other things, to enjoin Rosetta Stone GmbH from using the color yellow in Germany, a declaratory judgment that Rosetta Stone GmbH is liable for damages based on our activities in Germany, and the award of costs and attorneys' fees associated with the legal proceeding. A hearing was held on October 27, 2011 and the presiding judge indicated his opinion that Rosetta Stone GmbH has infringed on Langenscheidt's German trademark. On January 19, 2012, the District Court of Cologne ordered an injunction of Rosetta Stone GmbH's use of the color yellow in packaging, on its website and in television commercials and declared Rosetta Stone liable for damages, attorneys' fees and costs to Langenscheidt. However, no dollar amounts have been specified yet for the award of damages by the District Court of Cologne. In its decision, the District Court of Cologne also ordered the destruction of Rosetta Stone GmbH's product and packaging which utilized the color yellow and which was deemed to have infringed Langenscheidt's trademark. The decision is immediately enforceable upon Langenscheidt's posting of a bond. To date, Langenscheidt has not posted a bond. It is required in this jurisdiction for a plaintiff to post a bond in order for a decision to be immediately enforced because if the decision were reversed upon appeal, the defendant would be awarded the bond amount for costs and damages incurred. Langenscheidt has not yet pled the amount of its damages and the court has not yet made any determination as to the amount of damages. We intend to vigorously defend this matter and have filed a notice of appeal with the Court of Appeals in Cologne. In addition, we have commenced a separate proceeding directed at cancellation of Langenscheidt's German trademark registration of yellow as an abstract color mark. However, the outcome of the matter is currently not known, and the range of any potential loss is not reasonably estimable at this time. Even if the plaintiff is unsuccessful in its claims against us, we will incur legal fees and other costs in the defense of these claims.

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

**Item 4. *Mine Safety Disclosures***

Not applicable.

**PART II**

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

**Market for Common Stock**

Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol "RST." The following table sets forth, for each of the periods indicated, the high and low reported sales price of our common stock on the NYSE.

	<u>High</u>	<u>Low</u>
<b>Year ended December 31, 2011</b>		
Fourth Quarter	\$ 11.00	\$ 6.55
Third Quarter	16.12	8.92
Second Quarter	16.15	12.57
First Quarter	21.94	12.57
<b>Year ended December 31, 2010</b>		
Fourth Quarter	\$ 24.50	\$ 19.00
Third Quarter	25.66	16.75
Second Quarter	27.50	21.10
First Quarter	26.37	16.30

On February 24, 2012, the last reported sales price of our common stock on the NYSE was \$8.79 per share. As of that date, there were approximately 235 holders of record of our common stock.

**Dividends**

We have not paid any cash dividends on our common stock and do not intend to do so in the foreseeable future. We currently intend to retain all available funds and any future earnings to support the operation of and to finance the growth and development of our business.

**Securities Authorized For Issuance Under Equity Compensation Plans**

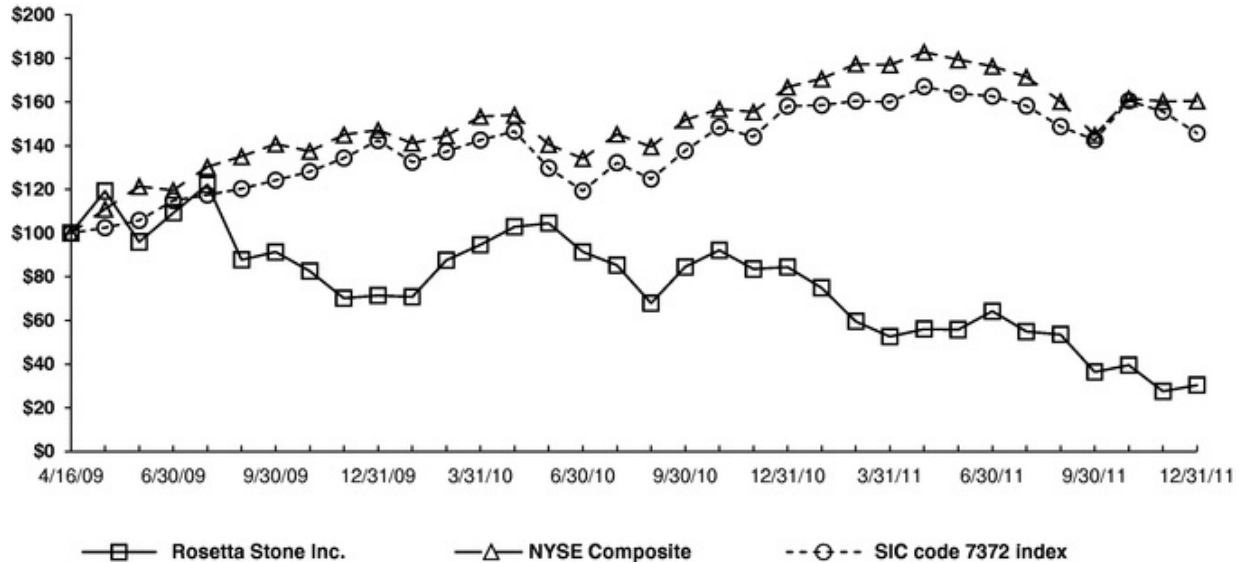
For information regarding securities authorized for issuance under equity compensation plans, see Part III "Item 12—Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters."

**Stockholder Return Performance Presentation**

The following graph compares the change in the cumulative total stockholder return on our common stock during the period from April 16, 2009 (the first day our stock began trading on the NYSE) through December 31, 2011, with the cumulative total return on the NYSE Composite Index and the SIC Code Index that includes all U.S. public companies in the Standard Industrial Classification (SIC) Code 7372-Prepackaged Software. The comparison assumes that \$100 was invested on April 16, 2009 in our common stock and in each of the foregoing indices and assumes reinvestment of dividends, if any.

**COMPARISON OF 32 MONTH CUMULATIVE TOTAL RETURN\***

Among Rosetta Stone Inc., the NYSE Composite Index, and SIC code 7372 index



\* \$100 invested on 4/16/09 in stock or 3/31/09 in index, including reinvestment of dividends.  
Fiscal year ending December 31.

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**Item 6. Selected Consolidated Financial Data**

The following table sets forth our selected consolidated statement of operations, balance sheet and other data for the periods indicated. The selected consolidated statement of operations data for the years ended December 31, 2011, 2010, 2009, 2008 and 2007, and the consolidated balance sheet data as of December 31, 2011, 2010, 2009, 2008 and 2007 have been derived from Rosetta Stone Inc. audited consolidated financial statements. This information should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements contained elsewhere in this Annual Report on Form 10-K. Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

	Year Ended December 31,				
	2011	2010	2009	2008	2007
(in thousands, except per share data)					
<b>Statements of Operations Data:</b>					
Revenue	\$268,449	\$258,868	\$252,271	\$209,380	\$137,321
Cost of revenue	49,116	38,999	33,427	28,676	20,687
Gross profit	219,333	219,869	218,844	180,704	116,634
Operating expenses:					
Sales and marketing	161,491	130,879	114,899	93,384	65,437
Research and development	24,218	23,437	26,239	18,387	12,893
Acquired in-process research and development		—	—	—	—
General and administrative	62,031	53,239	57,182	39,577	29,786
Lease abandonment		(583)	(8)	1,831	—
Total operating expenses	247,740	206,972	198,312	153,179	108,116
Income (loss) from operations	(28,407)	12,897	20,532	27,525	8,518
Other income and expense:					
Interest income	302	262	159	454	673
Interest expense	(5)	(66)	(356)	(891)	(1,331)
Other (expense) income	142	(220)	112	239	154
Interest and other income (expense), net	439	(24)	(85)	(198)	(504)
Income (loss) before income taxes	(27,968)	12,873	20,447	27,327	8,014
Income tax expense (benefit)	(7,980)	(411)	7,084	13,435	5,435
Net income (loss)	(19,988)	13,284	13,363	13,892	2,579
Preferred stock accretion	—	—	—	—	(80)
Income (loss) attributable to common stockholders	\$ (19,988)	\$ 13,284	\$ 13,363	\$ 13,892	\$ 2,499
Income (loss) per share attributable to common stockholders:					
Basic	\$ (0.96)	\$ 0.65	\$ 0.89	\$ 7.29	\$ 1.47
Diluted	\$ (0.96)	\$ 0.63	\$ 0.67	\$ 0.82	\$ 0.15
Common shares and equivalents outstanding:					
Basic weighted average shares	20,773	20,439	14,990	1,905	1,702
Diluted weighted average shares	20,773	21,187	19,930	16,924	16,533
<b>Other Data:</b>					
<i>Stock-based compensation included in:</i>					
Cost of sales	\$ 55	\$ 39	\$ 34	\$ 2	\$ 2
Sales and marketing	1,932	774	999	153	189
Research and development	2,448	1,181	5,959	482	360
General and administrative	7,918	2,393	15,158	953	776
Total stock-based compensation expense	\$ 12,353	\$ 4,387	\$ 22,150	\$ 1,590	\$ 1,327
<i>Intangible amortization included in:</i>					

Cost of sales	\$	—	\$	—	\$	—	\$	13	\$	1,227
Sales and marketing		45		58		42		3,003		3,596
Research and development		40		—		—		—		—
Total intangible amortization expense	\$	<u>85</u>	\$	<u>58</u>	\$	<u>42</u>	\$	<u>3,016</u>	\$	<u>4,823</u>

	As of December 31,				
	2011	2010	2009	2008	2007
	(in thousands)				
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 106,516	\$ 115,756	\$ 95,188	\$ 30,626	\$ 21,691
Total assets	277,181	276,474	225,442	138,818	110,376
Deferred revenue	51,895	47,158	26,106	15,744	12,939
Notes payable and capital lease obligation	12	—	—	9,910	13,324
Redeemable convertible preferred stock	—	—	—	—	5,000
Total stockholders' equity	\$ 171,205	\$ 178,316	\$ 156,435	\$ 79,071	\$ 58,125

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

*This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our consolidated financial statements and notes thereto which appear elsewhere in this Annual Report on Form 10-K. Our actual results may differ materially from those currently anticipated and expressed in such forward-looking statements as a result of a number of factors, including those discussed under "Risk Factors" and elsewhere in this Annual Report on Form 10-K.*

### Overview

We are a leading provider of technology-based language-learning solutions. We develop, market, and sell language-learning solutions consisting of software, online services and audio practice tools primarily under our *Rosetta Stone* brand. Our teaching method, which we call *Dynamic Immersion*, is designed to leverage the innate, natural language-learning ability that children use to learn their native language. Our courses are based on our proprietary interactive technologies and pedagogical content and utilize a sophisticated sequencing of images, text and sounds to teach a new language without translation or grammar explanation. We believe our award-winning solutions provide an effective, convenient and fun way to learn languages. We currently offer our self-study language-learning solutions in over 30 languages. Our customers include individuals, educational institutions, armed forces, government agencies and corporations.

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language-learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages, which have enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 86% of our revenue for the year ended December 31, 2011 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Barnes & Noble, Best Buy, Books-a-Million, Staples and Costco.

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

- our ability to expand our presence and penetration of existing markets;
- the extent to which we can sell new products and services to existing customers;
- our success in expanding our brand;



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- the evolution of our product and service offerings; and
- our ability to expand our presence and reach geographically.

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

- customer acceptance of our product and service offerings;
- continued product and service innovation;
- average revenue per customer;
- direct marketing variables, including:
  - print, television and radio media discounts and rates;
  - the relevance of our advertising and website;
  - online pay-per-click and other online advertising rates;
  - internal and external call center conversion rates; and
  - website traffic and conversion rates;
- customer brand loyalty;
- the number and quality of our kiosk locations;
- our presence in international markets; and
- cross-channel management of consumer and institutional markets.

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

On February 22, 2012, our board of directors promoted chief financial officer Stephen M. Swad, to president and chief executive officer ("CEO"). As our CEO assumes his new role, he is conducting an assessment of the company's critical areas over the coming months. The primary areas of focus will be:

1. further stabilizing the U.S. Consumer market;
2. regaining positive momentum in Asia;
3. taking steps to improve margins across all of our businesses, both in the U.S. and internationally; and
4. examining and evaluating ways to grow our institutional business.

While it will take some time to carry out this assessment, there are some opportunities for short-term actions to improve performance that we will be looking to effect, such as eliminating marketing investments that have low expected yields and better leveraging our worldwide G&A infrastructure.

As this process evolves, it is possible that we may record one-time expenses associated with transition to our new strategy.

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

#### ***Revenue***

We derive revenue from sales of language-learning solutions consisting of packaged software and audio practice products and online software subscriptions. Revenue is presented as product revenue or

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subscription and service revenue in our consolidated financial statements. Our audio practice products are normally combined with our packaged software products and sold as a solution.

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Our professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe* and *ReFLEX*. Rosetta Stone *TOTALe* online, which was released in July 2009, combines dedicated conversational coaching and an online software subscription. Rosetta Stone Version 4 *TOTALe*, which was released in September 2010, combines packaged software and dedicated conversational coaching. The content of our packaged software and subscription offerings are the same. We simply offer our customers the ability to choose which format they prefer without differentiating the learning experience. We began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language-learning solutions in the U.S. consumer market as part of our Rosetta Stone Version 4 *TOTALe* launch. As a result, we defer approximately 10%-25% of each of these bundled sales over the term of the subscription license.

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

For the year ended December 31, 2011 and 2010, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are now more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current year presentation. This presentation is also consistent with how we manage the home school channel.

Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2011 accounted for 32% of our annual revenue in 2011. Our institutional revenue is seasonally stronger in the second and third quarters of the calendar year due to education and government purchasing cycles. We expect these trends to continue.

### ***Cost of Revenue***

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

### ***Operating Expenses***

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

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

*Sales and Marketing.* Our sales and marketing expenses consist primarily of direct advertising expenses related to television, print, radio, online and other direct marketing activities, personnel costs for our sales and marketing staff, rental payments for our kiosks and commissions paid to our sales personnel. Sales and marketing expenses also include amortization expense of intangible assets related to customer relationships associated with the 2006 acquisition of Fairfield & Sons, Ltd. These intangible assets were fully amortized by January 2009. In 2007, we began to make significant investments to expand our sales and marketing operations in Europe and Japan. In 2009, we began to make significant investments to expand our sales and marketing operations in South Korea. In 2010 we established an office in Germany, and in 2011 we established an office in Brazil. In each case we established local sales offices, added employees and launched marketing and public relations campaigns within the region. In 2011, we also established a representative office in China. We intend to continue to invest within strategic regions around the world.

*Research and Development.* Research and development expenses consist primarily of personnel costs and contract development fees associated with the development of our solutions. Our development efforts are primarily based in the United States and are devoted to expanding our product portfolio through the addition of new content and new complimentary products and services to our language-learning solutions.

*General and Administrative.* General and administrative expenses consist primarily of personnel costs of our executive, finance, legal, human resources and other administrative personnel, as well as accounting and legal professional services fees and other corporate expenses. In 2011, there were increases to certain general and administrative expenses to support our expansion into new international markets. During 2012, we plan on taking steps to reduce certain general and administrative expenses as we realign our cost structure to help fund investment in areas of growth.

*Stock Compensation Charge.* Included in the respective operating expense lines for 2009 is an aggregate \$18.8 million expense, consisting of \$18.5 million in stock-based compensation expense and \$0.3 million in payroll tax expense, related to common stock grants awarded to key employees equal to a total of 591,491 shares in April 2009. This grant was net of the number of shares required to be withheld to satisfy the federal, state and local tax withholding obligations. The aggregate grant date fair value of the awards was \$18.5 million, which we recognized as stock-based compensation expense on the grant date, as the awards were immediately vested. We allocated this \$18.8 million aggregate expense among the operating expense line items in accordance with the functions performed by the respective employees who received the grants. No such grant was made in 2011 or 2010.

### ***Other Income (Expense)***

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

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

Income tax expense (benefit) consists of federal, state and foreign income taxes. For the year ended December 31, 2011, our worldwide effective tax rate was approximately 29%. We expect our worldwide rate to be approximately 32-37% in 2012 assuming no general increase in federal, state or foreign income tax rates applicable to companies such as ours.

### **Critical Accounting Policies and Estimates**

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

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

We believe that the critical accounting policies listed below involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements. In addition, we believe that a discussion of these policies is necessary to understand and evaluate the consolidated financial statements contained in this annual report on Form 10-K.

#### ***Revenue Recognition***

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe*. Rosetta Stone *TOTALe* online, which was released in July 2009, combines dedicated conversational coaching and an online software subscription. Rosetta Stone Version 4 *TOTALe*, which was released in September 2010, combines packaged software and dedicated conversational coaching. We recognize revenue for software products and related services in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition* ("ASC 985-605").

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

Revenue is recognized from the sale of packaged software and audio practice products when the product has been delivered, assuming the remaining revenue recognition criteria have been met. Software products include sales to end-user customers and resellers. In most cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products are recognized as the products are shipped and title passes and risks of loss have been transferred. For most of our product sales, these criteria are met at the time the product is shipped. For some sales to resellers and certain other sales, we defer revenue until the customer receives the product because we legally retain a portion of the risk of loss on these sales during transit. A limited amount of packaged software products are sold to resellers on a consignment basis. Revenue is recognized for these consignment transactions once the end-user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with Accounting Standards Codification subtopic 985-605-50,

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*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. We offer 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 us with a six-month right of return. We also allow our retailers to return unsold products, subject to some limitations. In accordance with Accounting Standards Codification subtopic 985-605-15, *Software: Revenue Recognition: Products* ("ASC 985-605-15"), product revenue is reduced for estimated returns, which are based on historical return rates.

Revenue for software license agreements sold via online software subscriptions as hosting agreements are recognized in accordance with Accounting Standards Codification subtopic 985-605-05, *Software: Revenue Recognition: Background* ("ASC 985-605-05"). Revenue for online software subscriptions is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between 3 and 12 months. Some online licensing arrangements include a specified number of licenses that can be activated over a period of time, which typically ranges between 6 and 24 months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement and the subscription services are made available to the customer. In connection with packaged software product sales and online software subscriptions, technical support is provided to customers, including customers of resellers, at no additional cost for one year from date 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.

Revenue for online service subscriptions for dedicated conversational coaching is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically range from three months to 15 months. Rosetta Stone Version 4 *TOTALe* bundles, which include dedicated conversational coaching online services and packaged software, allow customers to begin their online services at any point during a registration window, which is 6 months from the date of purchase from us or an authorized reseller. Dedicated conversational coaching online service subscriptions that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Accounts receivable and deferred revenue are recorded at the time a customer purchases the online services.

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

We have been engaged to develop language-learning software for certain endangered languages under fixed-fee arrangements. These arrangements also include contractual periods of post-contract support ("PCS") and online hosting services ranging from one to ten years. Revenue for multi-element contracts are recognized ratably once the PCS and online hosting periods begin, over the longer of the

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PCS or online hosting period. When the current estimates of total contract revenue and contract cost indicate a loss for a fixed fee arrangement, a provision for the entire loss on the contract is recorded.

### *Revenue Recognition for Arrangements with Multiple Deliverables*

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

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

We have identified two deliverables generally contained in Rosetta Stone Version 4 *TOTALe* software arrangements. The first deliverable is the packaged software, which is delivered at the time of sale, and the second deliverable is the dedicated conversational coaching online services. We allocate revenue between these two deliverables using the residual method based on the existence of VSOE for the undelivered service element. Amounts allocated to the software are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services or upon expiry of the online services. The language-learning software cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

### *Stock-Based Compensation*

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

As of December 31, 2011 and 2010, there were approximately \$7.9 million and \$8.3 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 2.67 and 2.76 years, respectively.

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

	<b>Years Ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
<b>Included in cost of revenue:</b>			
Cost of product revenue	\$ 55	\$ 39	\$ 34
Cost of subscription and service revenue	—	—	—
Total included in cost of revenue	55	39	34
<b>Included in operating expenses:</b>			
Sales and marketing	1,932	774	999
Research and development	2,448	1,181	5,959
General and administrative	7,918	2,393	15,158
Total included in operating expenses	12,298	4,348	22,116
Total	<u>\$ 12,353</u>	<u>\$ 4,387</u>	<u>\$ 22,150</u>

In accordance with ASC topic 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. We use the Black-Scholes pricing model to value our 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. The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model as follows:

	<b>Year Ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
Expected stock price volatility	57% - 64%	58% - 66%	61%
Expected term of options	6 years	6 years	6 years
Expected dividend yield	—	—	—
Risk-free interest rate	1.14% - 2.59%	1.14% - 2.59%	1.71% - 2.46%

Prior to the completion of our initial public offering in April 2009, our stock was not publicly quoted and we had a limited history of stock option activity, so we reviewed a group of comparable industry-related companies to estimate our 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, we also considered the contractual option term and vesting period when determining the expected option life and forfeiture rate. Subsequent to the initial public offering, we continue to review a group of comparable industry-related companies to estimate volatility, but also review the volatility of our own stock since the initial public offering. We consider the volatility of the comparable companies to be the best estimate of future volatility. For the risk-free interest rate, we use a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.



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The following table sets forth a summary of stock option grants since the date of plan inception, through the date of this Annual Report on Form 10-K:

<u>Grant Date</u>	<u>Number of Options Granted</u>	<u>Exercise Price</u>	<u>Common Stock Fair Value Per Share at Grant Date</u>
2006	1,704,950	\$3.85 - \$3.85	\$4.57 - \$5.92
2007	436,254	3.85 - 11.19	6.35 - 11.30
2008	402,805	10.36 - 17.49	10.36 - 17.49
2009	472,589	16.74 - 22.30	16.74 - 22.30
2010	593,017	17.10 - 25.99	17.10 - 25.99
2011	698,327	6.88 - 20.91	6.88 - 20.91

***Stock-based Compensation Expense in Connection with Executive Stock Grants and IPO Option and Restricted Stock Grants***

We made stock grants, restricted stock grants and stock option grants to our employees on April 15, 2009. In connection with these grants, we recorded an aggregate expense of approximately \$18.5 million in the second quarter of 2009, and an additional \$6.3 million that will be recorded over the four-year vesting period of the stock options and restricted stock grants.

***Accounts Receivable and Allowance for Doubtful Accounts***

Accounts receivable consist of amounts due to us from our normal business activities. We provide an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified.

***Intangible Assets***

Intangible assets consist of acquired technology, including developed and core technology, customer related assets, trade name and trademark and other intangible assets. Those intangible assets with finite lives are recorded at cost and amortized on a straight line basis over their expected lives in accordance with Accounting Standards Codification topic 350, *Goodwill and Other Intangible Assets* ("ASC 350"). On an annual basis, we review our indefinite lived intangible assets for impairment based on the fair value of indefinite lived intangible assets as compared to the carrying value in accordance with ASC 350. In the event the carrying value exceeds the fair value of the assets, the assets are written down to their fair value. There has been no impairment of intangible assets during any of the periods presented.

***Goodwill***

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006 and the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009. We test goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of Accounting Standards Codification topic 350, *Intangibles—Goodwill and Other* ("ASC 350") or more frequently, if impairment indicators arise. Such indication occurred during the fourth quarter of 2011 when the fair value of the Company's publicly traded common stock declined; however, after performing Step I of the impairment test under ASC 350 as of December 31, 2011, no impairment was identified as the fair value was greater than the carrying value of each reporting unit. The Company will continue to review indicators and it is possible an impairment charge may need to be recorded if trends do not reverse.

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Goodwill impairment is tested using a two-step process that begins with an estimation of the fair value of each reporting unit. The first step is a screen for potential impairment by comparing the fair value of a reporting unit with its carrying amount. The second step measures the amount of impairment loss, if any, by comparing the implied fair value of the reporting unit goodwill with its carrying amount.

In estimating fair value of our reporting units, we compared our market capitalization of our common stock, distributed between the reporting units to the equivalent carrying value (total assets less total liabilities) of such reporting unit.

These techniques included the income approach (i.e., the discounted cash flow method) and the market approach (i.e., the guideline public company method). Using our adjusted EBITDA projections is a judgment item that can significantly affect the outcome of the analysis, both in basing the allocation on the most relevant time period as well as in allocating fair value between reporting units. As a result of a limited ability to derive future cash flow estimates from historical experience based on internal business plans, which include consideration of industry trends, competitive actions, technology changes and changes in underlying cost structure, we applied only the guideline public company method in estimating the fair value of our reporting units as of December 31, 2011. Based on the fair value calculation, the fair value of the consumer and institutional reporting units exceeded the carrying value by 5% and 22%, respectively. The factors that we consider important, and which could trigger an impairment review, include, but are not limited to: a significant decline in the market value of our common stock for a sustained period; a material adverse change in economic, financial market, industry or sector trends; a material failure to achieve operating results relative to historical levels or projected future levels; and significant changes in operations or business strategy.

### ***Valuation of Long-Lived Assets***

In accordance with Accounting Standards Codification topic 360, *Accounting for the Impairment or Disposal of Long-lived Assets* ("ASC 360"), we evaluate the recoverability of our long-lived assets. ASC 360 requires recognition of impairment of long-lived assets in the event that the net book value of such assets exceeds the future undiscounted net cash flows attributable to such assets. Impairment, if any, is recognized in the period of identification to the extent the carrying amount of an asset exceeds the fair value of such asset. Based on our analysis, we believe that no impairment of our long-lived assets was indicated as of December 31, 2011 and 2010.

### ***Income Taxes***

For the years ended December 31, 2011, 2010 and 2009, we accounted for income taxes in accordance with Accounting Standards Codification topic 740, *Income Taxes* ("ASC 740"), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax bases of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred tax 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.

ASC 740 requires a reduction of the carrying amounts of deferred tax assets by a valuation allowance if, based on available evidence, it is more likely than not that such assets will not be realized. Accordingly, the need to establish valuation allowances for deferred tax assets are assessed periodically based on the ASC 740 more-likely-than-not realization threshold criterion. In the assessment,

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appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carryforward periods, our experience with operating loss and tax credit carryforwards not expiring unused, and tax planning alternatives.

We believe that the accounting estimate for the valuation of deferred tax assets is a critical accounting estimate because judgment is required in assessing the likely future tax consequences of events that have been recognized in our financial statements or tax returns. We base our estimate of deferred tax assets and liabilities on current tax laws and rates and, in certain cases, business plans and other expectations about future outcomes. Changes in existing tax laws or rates could affect actual tax results and future business results may affect the amount of deferred tax liabilities or the valuation of deferred tax assets over time. Our accounting for deferred tax consequences represents our best estimate of future events. Although it is possible there will be changes that are not anticipated in our current estimates, we believe it is unlikely such changes would have a material period-to-period impact on our financial position or results of operations.

Our analysis of the need for a valuation allowance on our U.S. deferred tax assets recognizes that while we have not incurred a cumulative loss over our evaluation period after adjusting for nonrecurring expenses related to our initial public offering in 2009, a substantial loss was incurred in the current year as a result of difficult market conditions. Consideration has also been given to the lengthy period over which these net deferred assets can be realized, and our history of not having tax loss carryforwards in any jurisdiction expire unused.

In 2010, we recognized a tax benefit of \$2.4 million due to the release of the valuation allowance on deferred tax assets of non-US subsidiaries which we believe are more likely than not to be realized. Our effective income tax rate in 2010 benefited from the availability of previously unrealized deferred tax assets which we utilized to reduce tax expense for United Kingdom and Japanese income tax purposes. The release of our valuation allowance was determined in accordance with the provisions of ASC 740, which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Historical operating income and continuing projected income represented sufficient positive evidence that we used to conclude that it is more likely than not that our deferred tax assets will be realized and accordingly, a release of our valuation allowance was recorded in the fourth quarter of 2010.

At December 31, 2011 and 2010, our net deferred tax asset was \$19.0 million and \$17.7 million, respectively. Based on our assessment, it appears more likely than not that the net deferred tax asset will be realized through future taxable earnings. If future results fail to provide objectively verifiable evidence to support the realization of our deferred tax asset, a valuation allowance may be required to reduce the deferred tax assets. However, currently no valuation allowance has been established for the Company's net deferred tax assets. We will continue to assess the need for a valuation allowance in the future.

## Results of Operations

The following table sets forth our consolidated statement of operations for the periods indicated.

	<u>Year Ended December 31,</u>		
	<u>2011</u>	<u>2010</u>	<u>2009</u>
(in thousands, except per share data)			
<b>Statements of Operations Data:</b>			
Revenue			
Product	\$ 195,382	\$ 215,590	\$ 218,549
Subscription and service	73,067	43,278	33,722
Total Revenue	268,449	258,868	252,271
Cost of revenue			
Cost of product revenue	36,497	32,549	30,264
Cost of subscription and service revenue	12,619	6,450	3,163
Total cost of revenue	49,116	38,999	33,427
Gross profit	219,333	219,869	218,844
Operating expenses:			
Sales and marketing	161,491	130,879	114,899
Research and development	24,218	23,437	26,239
General and administrative	62,031	53,239	57,182
Lease abandonment	—	(583)	(8)
Total operating expenses	247,740	206,972	198,312
Income (loss) from operations	(28,407)	12,897	20,532
Other income and expense:			
Interest income	302	262	159
Interest expense	(5)	(66)	(356)
Other (expense) income	142	(220)	112
Interest and other income (expense), net	439	(24)	(85)
Income (loss) before income taxes	(27,968)	12,873	20,447
Income tax expense (benefit)	(7,980)	(411)	7,084
Net income (loss)	(19,988)	13,284	13,363
Income (loss) per share:			
Basic	\$ (0.96)	\$ 0.65	\$ 0.89
Diluted	\$ (0.96)	\$ 0.63	\$ 0.67
Common shares and equivalents outstanding:			
Basic weighted average shares	20,773	20,439	14,990
Diluted weighted average shares	20,773	21,187	19,930
<i>Stock-based compensation included in:</i>			
Cost of sales	\$ 55	\$ 39	\$ 34
Sales and marketing	1,932	774	999
Research and development	2,448	1,181	5,959
General and administrative	7,918	2,393	15,158
	\$ 12,353	\$ 4,387	\$ 22,150

**Comparison of the Year Ended December 31, 2011 and the Year Ended December 31, 2010**

Our revenue increased \$9.6 million to \$268.4 million for the year ended December 31, 2011. The increase in revenue was primarily due to international growth of \$10.1 million over the prior year period. Bookings, calculated as revenue plus the change in deferred revenue, decreased from \$279.9 million for the year ended December 31, 2010 to \$273.2 million for the year ended December 31, 2011. The decrease in bookings was primarily due to a \$16.7 million decrease in U.S. consumer net bookings and a \$1.2 million decrease in worldwide institutional net bookings, offset by an \$11.2 million increase in international consumer net bookings. The U.S. consumer selling price per unit decreased from \$381 to \$310, or 19%, during the year ended December 31, 2011, compared to the prior year period, resulting in a \$36.1 million decrease in revenue. The decrease in revenue per unit was the result of lower prices across all channels in the U.S. market. Our U.S. consumer units sold increased from 455,700 to 506,500, or 11%, during the year ended December 31, 2011 compared to the prior year period, resulting in a \$19.4 million increase in revenue.

We reported an operating loss of \$28.4 million for the year ended December 31, 2011 compared to operating income of \$12.9 million for the year ended December 31, 2010. The operating loss was due to a decrease in gross profit of \$0.6 million, from \$219.9 million to \$219.3 million, and an increase in operating expenses of \$40.8 million. The decrease in gross profit was primarily due to higher direct costs associated with our web-based services offering Version 4 *TOTALe* that include higher direct costs to deliver to customers than our previous software solutions. The increase in operating expenses was primarily due to \$16.2 million in personnel-related costs, \$20.2 million in increased media and marketing activities, primarily outside of the U.S., \$1.8 million increase in professional services and \$2.0 million increase in depreciation and amortization expenses incurred to support the business expansion outside of the U.S., and \$0.6 million increase in lease abandonment due to the reversal of the lease abandonment expenses in the third quarter of 2010.

**Revenue by Operating Segment**

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

	<u>Year Ended December 31,</u>		<u>2011 versus 2010</u>			
	<u>2011</u>	<u>2010</u>	<u>Change</u>	<u>% Change</u>		
	(in thousands, except percentages)					
<i>Consumer:</i>						
Direct-to-Consumer	\$ 136,385	50.8%	\$ 118,164	45.7%	\$ 18,221	15.4%
Kiosk	30,171	11.2%	35,000	13.5%	(4,829)	(13.8)%
Retail	36,616	13.7%	46,054	17.8%	(9,438)	(20.5)%
Homeschool	4,854	1.8%	5,045	1.9%	(191)	(3.8)%
Total consumer revenue	208,026	77.5%	204,263	78.9%	3,763	1.8%
Institutional	60,423	22.5%	54,605	21.1%	5,818	10.7%
Total Revenue	\$ 268,449	100.0%	\$ 258,868	100.0%	\$ 9,581	3.7%

**Consumer Segment**

Consumer revenue was \$208.0 million for the year ended December 31, 2011, an increase of \$3.8 million, or 2%, from the year ended December 31, 2010. Consumer bookings, calculated as revenue plus the change in deferred revenue, decreased to \$211.4 million for the year ended December 31, 2011 from \$217.0 million for the year ended December 31, 2010. The decrease in bookings was due to lower average selling price per unit in the United States. The consumer average revenue per unit decreased from \$392 to \$340, resulting in a \$32.1 million decrease in revenue, which was partially offset by an

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increase in consumer units sold from 553,800 to 621,500, or 12% during the year ended December 31, 2011, compared to the prior year period, resulting in a \$26.5 million increase in revenue. The decrease in average revenue per unit was the result of our ongoing price testing across all channels in the U.S. market.

There was a \$3.4 million increase in consumer deferred revenue during the year ended December 31, 2011 compared to the prior year period, which was primarily related to the continued launch of Rosetta Stone Version 4 *TOTALe* in our international markets.

Product revenue represented 87% of total consumer revenue for the year ended December 31, 2011, with the balance attributable to subscription and service revenue. We began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language-learning solutions in the U.S. consumer market during the third quarter of 2010, in Japan during the first quarter of 2011, in the United Kingdom during the second quarter of 2011, and in Korea during the third quarter of 2011, with the launch of Rosetta Stone Version 4 *TOTALe*. As a result, we defer approximately 10% - 25% of the revenue of each of these bundled sales. We will recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition*.

We are currently testing different price points for our online products. If we fully implement an offering based on our tests, it could result in lower revenues over the next twelve months as customer payments and revenues would be spread over the subscription period.

### *Direct-to-Consumer*

Direct-to-consumer revenue was \$136.4 million for the year ended December 31, 2011, an increase of \$18.2 million, or 15%, from the year ended December 31, 2010. The increase in direct-to-consumer revenue was primarily driven by \$7.2 million in growth in our international direct-to-consumer markets and an \$11.0 million increase in our U.S. direct-to-consumer business. The worldwide average selling price per unit decreased 1% during the year ended December 31, 2011 compared to the prior year period, resulting in a \$1.4 million decrease in revenue. The number of units sold increased 15% during the year ended December 31, 2011 compared to the prior year period, resulting in a \$17.9 million increase in revenue. There was a \$3.1 million increase in direct-to-consumer deferred revenue during the year ended December 31, 2011 compared to the prior year period, which was primarily related to the continued launch of Rosetta Stone Version 4 *TOTALe* in our international markets.

During the third and fourth quarter of 2011, we experienced softness in the direct-to-consumer channel in Japan and we are working to improve our messaging and performance.

### *Kiosk*

Kiosk revenue was \$30.2 million for the year ended December 31, 2011, a decrease of \$4.8 million, or 14%, from the year ended December 31, 2010. The number of worldwide kiosks decreased 33% from 259 as of December 31, 2010 to 174 as of December 31, 2011. The number of units sold decreased 3% during the year ended December 31, 2011 compared to the prior year period, resulting in a \$1.2 million decrease in revenue, primarily related to the decrease in kiosks. The worldwide average selling price per unit decreased 17% as a result of changes to the pricing of our products in the U.S. market during 2011, compared to the prior year period, resulting in a \$6.3 million decrease in revenue. There was a \$0.4 million decrease in kiosk deferred revenue during the year ended December 31, 2011 compared to the prior year period, primarily related to revenue recognized for Version 4 *TOTALe* online services. During 2012, based on our evaluation of historical and forecasted kiosk sales performance, we plan to significantly reduce the size of our worldwide kiosk program, in addition to continually reviewing the performance of remaining kiosk locations.

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### *Retail*

Retail revenue was \$36.6 million for the year ended December 31, 2011, a decrease of \$9.4 million or 20% from the year ended December 31, 2010. The worldwide average selling price per unit decreased 36% during the year ended December 31, 2011 compared to the prior year period, resulting in a \$20.9 million decrease in revenue, which was partially offset by an increase in units sold of 13% during the year ended December 31, 2011, resulting in a \$6.6 million increase in revenue compared to the prior year period. The decrease in average selling price per unit was the result of the company decreasing prices across all channels in the U.S. market. There was a \$0.7 million increase in retail deferred revenue during the year ended December 31, 2011 compared to the prior year period, which was primarily related to the launch of Version 4 *TOTALe* online services in our international markets.

We are actively working to reduce our business and financial exposures by working with key partners on how we could modify the way we do business together. We are considering, among other changes, changes to credit limits, payment terms, SKU reduction, store reduction or a change from terms to consignment. Discussions are ongoing and the ultimate outcome is unknown. Any change in credit limits or payment terms would have no immediate impact, however a change from terms to consignment could result in recording a charge in the period of the change and the issuance of a credit to the retailer for existing inventory previously purchased on terms. Alternatively, a change from terms to consignment could result in a delay in the recognition of revenue on future shipments until existing inventory has been exhausted and sell through materializes. Also, if the credit quality of a partner deteriorates, we may move to delay the recording of bookings until we receive cash.

The majority of our sales in our Korean subsidiary are generated by sales on home shopping television networks. During the third and fourth quarter of 2011, sales of most educational products on home shopping networks were down, including our products. We are working on changes to our go to market strategy, including changes in price and messaging to improve sales in this important channel.

### *Home School*

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

Home school revenue was \$4.9 million for year ended December 31, 2011, a decrease of \$0.2 million or 4% from the year ended December 31, 2010. The average selling price per unit decreased 30% as a result of changes to the pricing of our products in the U.S. market during 2011, compared to the prior year period, resulting in a \$2.1 million decrease in revenue, which was offset by a 39% increase in units sold during 2011, compared to the prior year period, resulting in a \$2.0 million increase in revenue.

### *Institutional*

Institutional revenue was \$60.4 million for the year ended December 31, 2011, an increase of \$5.8 million, or 11%, compared to the year ended December 31, 2010. The increase in institutional revenue was primarily due to the expansion of our direct sales force and a shift from sales of perpetual licenses to sales of renewing online subscriptions. As a result, we had a \$5.8 million increase in education revenue and a \$2.7 million increase in corporate and non-profit revenue in 2011, compared to the prior year period. These increases were partially offset by a \$2.7 million decrease in governmental revenues, primarily as a result of government budget cuts including the non-renewal of the U.S. Army and U.S. Marines Corps contracts.

Institutional bookings, calculated as revenue plus the change in deferred revenue, decreased to \$61.8 million for the year ended December 31, 2011 from \$62.9 million for the year ended

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December 31, 2010. The decrease in bookings was due to an \$8.6 million decrease in government bookings primarily as a result of the non-renewal of the U.S. Army and the U.S. Marines Corps contracts, partially offset by a \$4.5 million increase in education bookings and a \$2.9 million increase in corporate and non-profit bookings in 2011 compared to the prior year period. We have recently added sales representatives to this group to allow greater focus by senior sales executives on regaining some of our key government and armed forces relationships.

Product revenue represented 25% of total institutional revenue for the year ended December 31, 2011, and subscription and service revenue represented 75% for the same period.

**Revenue by Product Revenue and Subscription and Service Revenue**

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

	<u>Year Ended December 31,</u>				<u>2011 versus 2010</u>	
	<u>2011</u>	<u>2010</u>			<u>Change</u>	<u>% Change</u>
	(in thousands, except percentages)					
Product revenue	\$ 195,382	72.8%	\$ 215,590	83.3%	\$ (20,208)	(9.4)%
Subscription and service revenue	73,067	27.2%	43,278	16.7%	29,789	68.8%
Total revenue	268,449	100.0%	258,868	100.0%	9,581	3.7%

**Product Revenue**

Product revenue decreased \$20.2 million, to \$195.4 million during the year ended December 31, 2011 from \$215.6 million during the year ended December 31, 2010. Consumer product revenue decreased \$16.8 million, primarily as a result of the allocation of revenue to the online services component of our software. At the launch of Rosetta Stone Version 4 *TOTALe* in the U.S. consumer market during the third quarter of 2010, we began bundling time-based subscription licenses of our web-based *TOTALe Studio and Rosetta World* services with perpetual licenses of *Rosetta Course*, the product feature which previously comprised our Rosetta Stone Version 3 language-learning solutions. Approximately 10% - 25% of each of these bundled sales is allocated to online services. Institutional product revenues decreased \$3.4 million as a result of a shift from sales of perpetual licenses to sales of renewing online subscriptions.

**Service and Support Revenue**

Subscription and service revenue increased approximately 69%, or \$29.8 million, to \$73.1 million for the year ended December 31, 2011, from \$43.3 million during the year ended December 31, 2010. The increase in subscription and service revenues was due to a \$20.6 million increase in consumer online service revenue related to Version 4 *TOTALe* and a \$9.2 million increase in institutional subscription and service revenue related to growth in the institutional customer base with renewing online subscriptions.



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

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

	Year Ended December 31,		2011 versus 2010	
	2011	2010	Change	% Change
(in thousands, except percentages)				
<b>Revenue</b>				
Product	\$ 195,382	\$ 215,590	\$ (20,208)	(9.4)%
Subscription and service	73,067	43,278	29,789	68.8%
Total revenue	268,449	258,868	9,581	3.7%
<b>Cost of revenue</b>				
Cost of product revenue	36,497	32,549	3,948	12.1%
Cost of subscription and service revenue	12,619	6,450	6,169	95.6%
Total cost of revenue	49,116	38,999	10,117	25.9%
<b>Gross profit</b>	<b>\$ 219,333</b>	<b>\$ 219,869</b>	<b>\$ (536)</b>	<b>(0.2)%</b>
Gross margin percentages	81.7%	84.9%	(3.2)%	

***Cost of Product Revenue***

Cost of product revenue for the year ended December 31, 2011 was \$36.5 million, an increase of \$3.9 million, or 12%, from the year ended December 31, 2010. As a percentage of product revenue, cost of product revenue increased to 19% for the year ended December 31, 2011 compared to 15% for the prior year period. The dollar increase in cost was primarily attributable to a \$2.9 million increase in expense associated with product support activities, a \$0.6 million increase in freight, and a \$0.4 million increase in commission expenses associated with our partners and affiliates. This increase was slightly offset by a \$0.6 million decrease in inventory obsolescence and scrap associated with the U.S. Version 4 *TOTALe* launch in the third quarter of 2010. We are exploring the possibility of moving more of our business online, which should reduce the cost of product revenue as the cost of producing and shipping CD's would decline. However, we could experience a temporary increase in the cost of our product revenue as we scrap existing packaging.

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

Cost of subscription and service revenue for the year ended December 31, 2011 was \$12.6 million, an increase of \$6.2 million, or 96% from the year ended December 31, 2010. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 17% for the year ended December 31, 2011 compared to 15% for the prior year period. The increase in cost was primarily attributable to our web-based service offerings in our Version 4 *TOTALe* and *ReFLEX* products that include a component of dedicated online language conversation coaching and higher direct costs to deliver to customers than our previous software solutions. We expect our cost of subscription and service revenue will increase in future periods, as a percent of revenue, associated with the launch of our Version 4 *TOTALe* and *ReFLEX* solutions in our international markets.

**Operating Expenses**

	Year Ended		2011 versus 2010	
	December 31,		Change	% Change
	2011	2010		
	(in thousands, except percentages)			
Sales and marketing	\$ 161,491	\$ 130,879	\$ 30,612	23.4%
Research and development	24,218	23,437	781	3.3%
General and administrative	62,031	53,239	8,792	16.5%
Lease abandonment	—	(583)	583	100.0%
<b>Total operating expenses</b>	<b>\$ 247,740</b>	<b>\$ 206,972</b>	<b>\$ 40,768</b>	<b>19.7%</b>

**Sales and Marketing Expenses**

Sales and marketing expenses for the year ended December 31, 2011 were \$161.5 million, an increase of \$30.6 million, or 23%, from the year ended December 31, 2010. As a percentage of total revenue, sales and marketing expenses were 60% for the year ended December 31, 2011, compared to 51% for the year ended December 31, 2010. The dollar and percentage increase in sales and marketing expenses were primarily attributable to the continued expansion of our direct marketing activities in the U.S. and international markets. Media and marketing activities grew by \$20.2 million, primarily outside of the U.S., including the launch of our new advertising campaign focused on promoting language learning and our brand, increased media associated with the launch of Version 4 *TOTALe* in the United Kingdom, Japan and Korea as well as *ReFLEX* in Korea, and increased internet marketing due to increased spending in online social media networks. Professional services increased by \$4.7 million over the prior year period as a result of increased consulting related to international brand strategy, segmentation study and market research conducted in 2011, as well as clerical service expenses related to institutional and international retail sales. Personnel-related costs as a result of growth in our institutional sales channel, non-kiosk consumer, and marketing and sales support activities increased by \$6.0 million over the prior year period of which, \$0.8 million related to the addition of the Long Term Incentive Program, or LTIP, which was subsequently cancelled late in 2011. Additionally, travel and training expense increased by \$0.5 million over the prior year period as a result of increased travel in our institutional sales channel and global initiatives, commissions increased by \$0.7 million as a result of increased institutional and international consumer revenue, \$0.5 million increase in depreciation and amortization due to increased capitalized software costs in 2011, \$1.0 million increase in IT related product development and improvement projects, \$0.6 million in recruitment expenses due to our entry into new international markets, as well as \$0.3 million increase in trade shows driven by Korea and U.S. These costs were partially offset by a decrease of \$4.4 million in kiosk related expenses as the number of worldwide kiosks decreased from 259 as of December 31, 2010 to 174 as of December 31, 2011. We plan to continually evaluate our kiosk performance as we balance the positive branding with the profitability of the kiosk, potentially closing additional underperforming kiosk locations.

**Research and Development Expenses**

Research and development expenses were \$24.2 million for the year ended December 31, 2011, an increase of \$0.8 million, or 3%, from the year ended December 31, 2010. As a percentage of revenue, research and development expenses remained flat at 9% for the years ended December 31, 2011 and 2010. The dollar increases were primarily attributable to personnel-related increases in development personnel of \$2.9 million of which, \$1.1 million related to the addition of the LTIP compensation program which was subsequently cancelled in the fourth quarter of 2011. This increase in personnel costs was partially offset by a \$1.3 million decrease in consulting-related costs, \$0.3 million decrease in travel expenses, and \$0.3 million decrease in hardware and software expenses related to the increased costs in 2010 associated with the development of new products and services as we launched our new



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\$0.6 million decrease in expense for the year ended December 31, 2010. For the year ended December 31, 2011, there were no lease abandonment expenses.

**Interest and Other Income (Expense)**

	Year Ended		2011 versus 2010	
	December 31,		Change	% Change
2011	2010	(in thousands, except percentages)		
Interest Income	302	\$ 262	\$ 40	15.3%
Interest Expense	(5)	(66)	61	92.4%
Other Income (Expense)	142	(220)	362	164.5%
Total	<u>\$ 439</u>	<u>\$ (24)</u>	<u>\$ 463</u>	1929.2%

Interest income represents interest earned on our cash and cash equivalents. Interest income for the year ended December 31, 2011 was \$302,000, an increase of \$40,000, or 15%, from the year ended December 31, 2010.

Interest expense is primarily related to our short-term investment account as well as interest related to our capital leases. Interest expense for the year ended December 31, 2011 was \$5,000, a decrease of \$61,000 or 92%, from the year ended December 31, 2010.

We expect interest expense to be minimal in upcoming quarters as we allowed the revolving line of credit with Wells Fargo to expire on January 17, 2011.

Other income for the year ended December 31, 2011 was \$142,000, an increase of \$0.4 million, or 165%, from the year ended December 31, 2010. The increase was primarily due to an increase in foreign exchange gains and an increase in copyright infringement settlements compared to the prior year period.

**Income Tax Expense (Benefit)**

	Year Ended		2011 versus 2010	
	December 31,		Change	% Change
2011	2010	(in thousands, except percentages)		
Income tax expense (benefit)	\$ (7,980)	\$ (411)	\$ (7,569)	1841.6%

Income tax benefit for the year ended December 31, 2011 was \$8.0 million, an increase of \$7.6 million, compared to the year ended December 31, 2010. The increase was the result of a decrease of \$40.8 million in pre-tax income for the year ended December 31, 2011 and a higher effective tax rate, compared to the year ended December 31, 2010. Our effective tax rate increased to 29% for the year ended December 31, 2011 compared to (3%) for the year ended December 31, 2010. The increase in our effective tax rate was a result of changes in the geographic distribution of our income, the non-deductibility of expenses related to the cancellation of the LTIP and the release in the year ended December 31, 2010 of the valuation allowance on net operating loss carryforwards and other deferred tax assets of our United Kingdom and Japan subsidiaries. In 2012, we expect our income tax rate to increase to between 32 - 37%.

**Comparison of the Year Ended December 31, 2010 and the Year Ended December 31, 2009**

Our revenue increased \$6.6 million to \$258.9 million for the year ended December 31, 2010 from \$252.3 million for year ended December 31, 2009. The increase in revenue was primarily due to international growth of \$26.8 million over the prior year period, offset by a decrease in U.S. revenue of

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\$20.2 million. Bookings, calculated as revenue plus the change in deferred revenue, increased from \$262.6 million for the year ended December 31, 2009 to \$279.9 million for the year ended December 31, 2010. The increase in bookings was primarily due to a \$25.7 million increase in international consumer net bookings and \$9.4 million in institutional net bookings, partially offset by a \$17.8 million decrease in U.S. consumer net bookings. The U.S. consumer selling price per unit increased from \$344 to \$381, or 11%, during the year ended December 31, 2010, compared to the prior year period, resulting in a \$17.1 million increase in revenue. Our U.S. consumer units sold decreased from 557,200 to 455,700, or 18%, during the year ended December 31, 2010 compared to the prior year period, resulting in a \$34.9 million decrease in revenue.

We reported operating income of \$12.9 million for the year ended December 31, 2010 compared to operating income of \$20.5 million for the year ended December 31, 2009. The decrease in operating income was due to an increase in operating expenses of \$8.7 million, from \$198.3 million to \$207.0 million, partially offset by an increase in gross profit of \$1.1 million, from \$218.8 million to \$219.9 million. The increase in gross profit was primarily due to increased revenue partially offset by higher direct costs associated with the launch of our web-based services offering Version 4 *TOTALe* in the third quarter of 2010 that included higher direct costs to deliver to customers than our previous software solutions. The increase in operating expenses was primarily due to \$6.0 million in increased media and marketing activities, primarily outside of the U.S., and \$9.4 million increase in professional services, partially offset by a decrease of \$6.1 million in personnel-related costs, and a \$0.6 million decrease in lease abandonment due to the reversal of the lease abandonment expenses in the third quarter of 2010.

**Revenue by Operating Segment**

The following table sets forth revenue for each of our two operating segments for the years ended December 31, 2010 and 2009:

	<u>Year Ended December 31,</u>		<u>2010 versus 2009</u>			
	<u>2010</u>	<u>2009</u>	<u>Change</u>	<u>% Change</u>		
	(in thousands, except percentages)					
<i>Consumer:</i>						
Direct-to-Consumer	\$ 118,164	45.6%	\$ 115,791	45.9%	\$ 2,373	2.0%
Kiosk	35,000	13.5%	40,565	16.1%	(5,565)	(13.7)%
Retail	46,054	17.8%	45,894	18.2%	160	0.3%
Homeschool	5,045	1.9%	6,817	2.7%	(1,772)	(26.0)%
Total consumer revenue	204,263	78.9%	209,067	82.9%	(4,804)	(2.3)%
Institutional	54,605	21.1%	43,204	17.1%	11,401	26.4%
Total Revenue	\$ 258,868	100.0%	\$ 252,271	100.0%	\$ 6,597	2.6%

**Consumer Segment**

Consumer revenue was \$204.3 million for the year ended December 31, 2010, a decrease of \$4.8 million, or 2%, from the year ended December 31, 2009. Consumer bookings, calculated as revenue plus the change in deferred revenue, increased from \$209.1 million for the year ended December 31, 2009 to \$217.0 million for the year ended December 31, 2010. The increase in bookings was due to a \$25.7 million increase in international consumer net bookings, partially offset by a \$17.8 million decrease in U.S. consumer net bookings. The worldwide average selling price per unit increased from \$350 to \$392, resulting in a \$22.9 million increase in revenue, which was partially offset by a decrease in the consumer units sold from 596,800 to 553,800 or 7% during the year ended December 31, 2010, compared to the prior year period, resulting in a \$15.0 million decrease in revenue. There was a \$12.7 million increase in deferred revenue during the year ended December 31, 2010 compared to the prior year period, which was primarily deferred revenue for Version 4 *TOTALe* online services.

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Product revenue represented 97% of total consumer revenue for the year ended December 31, 2010, with the balance attributable to subscription and service revenue. We began bundling time-based subscription licenses of our web-based *TOTALe Studio and Rosetta World* services with perpetual licenses of the *Rosetta Course*, which previously comprised our Rosetta Stone Version 3 language-learning solutions, in the U.S. consumer market during the third quarter of 2010 with the launch of Rosetta Stone Version 4 *TOTALe*. As a result, we defer approximately 10% - 25% of each of these bundled sales. We will recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition*.

### *Direct-to-Consumer*

Direct-to-consumer revenue was \$118.2 million for the year ended December 31, 2010, an increase of \$2.4 million or 2%, from the year ended December 31, 2009. The increase in direct-to-consumer revenue was driven by \$17.9 million in growth in our international direct-to-consumer markets offset by a \$15.5 million decrease in our U.S. direct-to-consumer business. The worldwide average selling price per unit increased 3% during the year ended December 31, 2010 compared to the prior year period, resulting in a \$3.5 million increase in revenue. Units sold increased 4% during the year ended December 31, 2010 compared to the prior year period, resulting in a \$4.1 million increase in revenue. There was a \$4.8 million increase in deferred revenue during the year ended December 31, 2010 compared to the prior year period, which was primarily deferred revenue for Version 4 *TOTALe* online services.

### *Kiosk*

Kiosk revenue was \$35.0 million for the year ended December 31, 2010, a decrease of \$5.6 million, or 14%, from the year ended December 31, 2009. Despite the increase in the number of worldwide kiosks from 242 to 259 during the year ended December 31, 2010, annual net revenue per kiosk declined due to lower foot traffic. The worldwide average selling price per unit increased 5% during the year ended December 31, 2010 compared to the prior year period, resulting in a \$1.9 million increase in revenue. The number of units sold decreased 13% during the year ended December 31, 2010 compared to the prior year period, resulting in a \$5.2 million decrease in revenue, primarily due to the decrease in the number of kiosks. We continually reviewed kiosk performance for the remainder of 2011 and we may continue to close our underperforming kiosk locations. There was a \$2.3 million increase in deferred revenue during the year ended December 31, 2010 compared to the prior year period, which was primarily deferred revenue for Version 4 *TOTALe* online services.

### *Retail*

Retail revenue was \$46.1 million for the year ended December 31, 2010, an increase of \$0.2 million or 0.3% from the year ended December 31, 2009. The worldwide average selling price per unit increased 33% during the year ended December 31, 2010 compared to the prior year period, resulting in a \$12.9 million increase in revenue, partially offset by a 17% decrease in units sold during the year ended December 31, 2010 compared to the prior year period, resulting in a \$7.7 million decrease in revenue. There was a \$5.7 million increase in deferred revenue during the year ended December 31, 2010 compared to the prior year period, which was primarily deferred revenue for Version 4 *TOTALe* online services.

### *Home School*

During the year ended December 31, 2010, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current year presentation.

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Home school revenue was \$5.0 million for the year ended December 31, 2010, a decrease of \$1.8 million, or 26%, from the year ended December 31, 2009. In 2009, we began offering home school edition products through other sales channels, including direct-to-consumer call centers and our retail channels. As the availability of home school products in other sales channels increased during 2010, consumers began utilizing these new channels to make purchases.

*Institutional*

Institutional revenue was \$54.6 million for the year ended December 31, 2010, an increase of \$11.4 million, or 26%, compared to the year ended December 31, 2009. The increase in institutional revenue was primarily due to the expansion of our direct sales force and a shift from sales of perpetual licenses to sales of renewing online subscriptions. As a result, we had a \$4.3 million increase in education revenue, a \$1.3 million increase in government revenue, and \$5.8 million increase in corporate and non-profit revenue in 2010 compared to the prior year period.

Institutional bookings, calculated as revenue plus the change in deferred revenue, increased to \$62.9 million for the year ended December 31, 2010 from \$53.5 million for the year ended December 31, 2009. The increase in bookings was due to a \$6.0 million increase in education bookings and a \$4.8 million increase in corporate and non-profit bookings in 2010 compared to the prior year, partially offset by a \$1.4 million decrease in government bookings.

Product revenue represented 33% of total institutional revenue for the year ended December 31, 2010, and subscription and service revenue represented 67% for the same period.

**Revenue by Product Revenue and Subscription and Service Revenue**

We categorize and report our revenue in two categories—product revenue and subscription and service revenue. The following table sets forth revenue for products and subscription and services for the year ended December 31, 2010 and 2009:

	<u>Year Ended December 31,</u>		<u>2010 versus 2009</u>		
	<u>2010</u>	<u>2009</u>	<u>Change</u>	<u>% Change</u>	
	(in thousands, except percentages)				
Product revenue	\$ 215,590	83.3% \$ 218,549	86.6% \$ (2,959)	(1.4)%	
Subscription and service revenue	43,278	16.7% 33,722	13.4% 9,556	28.3%	
Total revenue	<u>258,868</u>	<u>100.0%</u> <u>252,271</u>	<u>100.0%</u> <u>6,597</u>	<u>2.6%</u>	

**Product Revenue**

Product revenue decreased \$3.0 million, to \$215.6 million during the year ended December 31, 2010 from \$218.5 million during the year ended December 31, 2009. Consumer product revenue decreased \$3.4 million, or 2%, primarily as a result of the allocation of revenue to the online services component of our software. In conjunction with the launch of Rosetta Stone Version 4 *TOTALe* in the U.S. consumer market during the third quarter of 2010, we began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language-learning solutions. Approximately 10% - 25% of the revenues from each of these bundled sales is allocated to online services and recognized over the life of these services. Institutional product revenues increased \$0.4 million during the year ended December 31, 2010 compared to the year ended December 31, 2009.

**Service and Support Revenue**

Subscription and service revenue increased \$9.6 million, or 28%, to \$43.3 million for the year ended December 31, 2010, from \$33.7 million during the year ended December 31, 2009. The increase in subscription and service revenues was due to an \$11.0 million increase in institutional subscription and service revenue related to growth in the institutional customer base with renewing online subscriptions, partially offset by a decrease of \$1.4 million in consumer online service revenue.

**Cost of Revenue and Gross Profit**

	Year Ended December 31,		2010 versus 2009	
	2010	2009	Change	% Change
(in thousands, except percentages)				
<b>Revenue</b>				
Product	\$ 215,590	\$ 218,549	\$ (2,959)	(1.4)%
Subscription and service	43,278	33,722	9,556	28.3%
Total revenue	258,868	252,271	6,597	2.6%
<b>Cost of revenue</b>				
Cost of product revenue	32,549	30,264	2,285	7.6%
Cost of subscription and service revenue	6,450	3,163	3,287	103.9%
Total cost of revenue	38,999	33,427	5,572	16.7%
<b>Gross profit</b>	<b>\$ 219,869</b>	<b>\$ 218,844</b>	<b>\$ 1,025</b>	<b>0.5%</b>
Gross margin percentages	84.9%	86.7%	(1.8)%	

**Cost of Product Revenue**

Cost of product revenue for the year ended December 31, 2010 was \$32.5 million, an increase of \$2.3 million, or 8%, from the year ended December 31, 2009. As a percentage of product revenue, cost of product revenue increased to 15% for the ended December 31, 2010 compared to 14% for the ended December 31, 2009. The increase in cost was primarily attributable to the \$2.2 million increase in expense for inventory scrap of our Version 3 product associated with the launch of Rosetta Stone Version 4 *TOTALe* in the U.S. market.

**Cost of Subscription and Service Revenue**

Cost of subscription and service revenue for the year ended December 31, 2010 was \$6.5 million, an increase of \$3.3 million, or 104%, from the year ended December 31, 2009. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 15% for the year ended December 31, 2010 compared to 9% for the year ended December 31, 2009. The increase in cost was primarily attributable to our web-based service offering in our Version 4 *TOTALe* product that includes a component of dedicated online language conversation coaching and higher direct costs to deliver to customers than our previous software solutions.



**Operating Expenses**

	Year Ended		2010 versus 2009	
	December 31,		Change	% Change
	2010	2009		
	(in thousands, except percentages)			
Sales and marketing	130,879	\$ 114,899	\$ 15,980	13.9%
Research and development	23,437	26,239	(2,802)	(10.7)%
General and administrative	53,239	57,182	(3,943)	(6.9)%
Lease abandonment	(583)	(8)	(575)	7187.5%
Total operating expenses	\$ 206,972	\$ 198,312	\$ 8,660	4.4%

*Sales and Marketing Expenses*

Sales and marketing expenses for the year ended December 31, 2010 were \$130.9 million, an increase of \$16.0 million, or 14%, from the year ended December 31, 2009. As a percentage of total revenue, sales and marketing expenses were 51% for the year ended December 31, 2010, compared to 46% for the year ended December 31, 2009. The dollar and percentage increase in sales and marketing expenses were primarily attributable to the continued expansion of our direct marketing activities in the U.S. and international markets. Personnel costs related to growth in our institutional sales channel and marketing and sales support activities increased by \$6.2 million over the prior year period. Advertising and marketing expenses grew by \$5.9 million and were primarily related to television and radio media and retail visual displays associated with our launch of Rosetta Stone Version 4 *TOTALe*. Travel and training expense increased by \$1.1 million over the prior year period as a result of increased travel in our institutional sales channel and global initiatives. We also expanded the number of our kiosks from 242 as of December 31, 2009 to 259 as of December 31, 2010, which resulted in \$3.3 million of additional kiosk operating expenses, including rent and sales compensation related expenses. These increases were partially offset by a reduction in stock compensation charge related to common stock awarded to key employees in 2009, resulting in a \$0.4 million decrease in sales and marketing expense in the 2010 period.

*Research and Development Expenses*

Research and development expenses were \$23.4 million for the year ended December 31 2010, a decrease of \$2.8 million, or 11%, from the year ended December 31, 2009. As a percentage of revenue, research and development expenses decreased to 9% for the year ended December 31, 2010 compared to 10% for the year ended December 31, 2009. The dollar and percentage decreases were primarily attributable to the absence in 2010 of a stock compensation charge related to common stock awards to key employees during the twelve months ended December 31, 2009 of \$5.0 million. This decrease was partially offset by an increase of \$1.3 million due to the addition of new product development personnel and consulting expense associated with the development of new products and services that are complementary to our existing solutions, and a \$0.4 million increase in travel and training associated with this development.

*General and Administrative Expenses*

General and administrative expenses for the year ended December 31, 2010 were \$53.2 million, a decrease of \$3.9 million, or 7%, from the year ended December 31, 2009. As a percentage of revenue, general and administrative expenses decreased to 21% for the year ended December 31, 2010 compared to 23% for the year ended December 31, 2009. The dollar and percentage decreases were primarily attributable to a stock compensation charge related to common stock awarded to key employees during the twelve months ended December 31, 2009 in connection with our initial public

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offering of \$13.4 million. This decrease was partially offset by a \$5.3 million increase in legal fees primarily attributable to our trademark infringement lawsuit against Google, Inc. and other intellectual property enforcement actions. In addition, personnel related costs increased \$1.1 million due to expansion of our finance, legal, human resources, information technology and other administrative functions which provide continued support of our overall growth and international expansion. Consulting expense increased \$1.0 million primarily the result of increased expenses associated with investment in our IT infrastructure. Liability insurances for directors and officers increased \$0.3 million, business taxes increased by \$0.2 million and audit fees increased \$0.4 million. Bad debt expense increased \$0.8 million primarily due to an additional reserve to limit our financial exposure related to the Chapter 11 bankruptcy reorganization of Borders Group, Inc.

*Stock-Based Compensation*

Included in each of the respective operating expense lines for the year ended December 31, 2009 is a portion of the \$18.8 million charge related to the total of 591,491 shares of common stock awarded to 10 of our key employees in April 2009. The following table presents the stock-based compensation charge by operating expense line item:

	Year Ended December 31,		Change	% Change
	2010	2009		
	(dollars in thousands)			
Sales and marketing	774	\$ 377	\$ 397	105%
Research and development	1,181	5,033	(3,852)	(77)%
General and administrative	2,393	13,393	(11,000)	(82)%
Total	\$ 4,348	\$ 18,803	\$ (14,455)	(77)%

*Lease Abandonment Expenses*

As a result of accelerated growth in our Arlington, Virginia headquarters, the Company exceeded maximum capacity in our leased office space in the third quarter of 2010. At that time, there was no additional space available for lease in the 1919 N. Lynn St. location and additional space was needed to support continued growth. Our previously abandoned office space at 1101 Wilson Blvd was unoccupied, and as a result of its close proximity to the 1919 N. Lynn St. location, we made the decision to reoccupy the formerly abandoned space. As of September 30, 2010, the remaining liability associated with the abandonment of the operating lease at 1101 Wilson Blvd was reversed resulting in a \$0.6 million decrease in expense for the year ended December 31, 2010 compared to December 31, 2009.

*Interest and Other Income (Expense)*

	Year Ended December 31,		2010 versus 2009	
	2010	2009	Change	% Change
	(in thousands, except percentages)			
Interest Income	262	\$ 159	\$ 103	64.8%
Interest Expense	(66)	(356)	290	(81.5)%
Other Income (Expense)	(220)	112	(332)	(296.4)%
Total other income/(expense)	\$ (24)	\$ (85)	\$ 61	71.8%

Interest income represents interest earned on our cash and cash equivalents. Interest income for the year ended December 31, 2010 was \$0.3 million, an increase of \$0.1 million, or 65%, from the year ended December 31, 2009.

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Interest expense is primarily related to our long-term debt, the outstanding balance of which was zero as of December 31, 2010, as well as interest related to our other capital leases. Interest expense for the year ended December 31, 2010 was \$66,000, a decrease of \$0.3 million, or 82% from the year ended December 31, 2009. The decrease was primarily due to the retirement of our previous Madison Capital term loan.

Other expense for the year ended December 31, 2010 was \$0.2 million compared to other income of \$0.1 million for the year ended December 31, 2009, a decrease of \$0.3 million or 296%. The decrease is primarily the result of foreign exchange losses and a decrease in trademark infringement awards.

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

	Year Ended		Change	% Change
	December 31,			
	2010	2009		
				(dollars in thousands)
Income tax expense (benefit)	\$ (411)	\$ 7,084	\$ (7,495)	(105.8)%

Income tax benefit for the year ended December 31, 2010 was \$0.4 million, a decrease of \$7.5 million, or 106%, compared to the year ended December 31, 2009. The decrease was the result of a decrease of \$7.6 million in pre-tax income for the year ended December 31, 2010 and a lower effective tax rate, compared to the year ended December 31, 2009. Our effective tax rate decreased to (3%) for the year ended December 31, 2010 compared to 35% for the year ended December 31, 2009. The reduction in our effective tax rate was a result of changes in the geographic distribution of our income and the release of the valuation allowance on net operating loss carry-forwards and other deferred tax assets of our United Kingdom and Japan subsidiaries.

**Liquidity and Capital Resources**

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

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

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

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

**Cash Flow Analysis**

***Net Cash Provided By (Used In) Operating Activities***

Net cash provided by operating activities was \$3.4 million for the year ended December 31, 2011, compared to net cash provided by operating activities of \$31.7 million for the year ended December 31, 2010, a decrease of \$28.3 million. Net cash provided by operating activities was primarily the result of the net loss as adjusted for depreciation, amortization and stock compensation expense. The net loss totaled \$20.0 million for the year ended December 31, 2011 compared to net income of \$13.3 million for the year ended December 31, 2010. For the year ended December 31, 2011, we incurred depreciation, amortization and stock compensation expense in the amount of \$21.1 million, compared to \$11.0 million for the year ended December 31, 2010. An increase in stock-based compensation expense was primarily the result of \$6.0 million in non cash expense associated with the issuance and then subsequent cancellation of the LTIP in 2011. Accounts receivable increased by \$5.1 million for the year ended December 31, 2011, the result of increased installment sales in the fourth quarter of 2011 compared to an increase of \$12.3 million for the year ended December 31, 2010. We have been providing customers with the option of purchasing our product over time in 3 or 5 month installments in order to increase the number of customers who purchase our product without materially increasing our bad debt exposure. However this option has extended the time for us to collect cash from our customers. Accounts Payable decreased by \$0.4 million for the year ended December 31, 2011 primarily the result of timing of cash expenditures compared to an increase of \$6.0 million for the year ended December 31, 2010. This increase was partially offset by an increase in income tax receivable of \$5.8 million. In the future, our cash flow management may not be successful in extending the timing of payments to vendors, which would then cause this cash flow benefit to reverse. The total amount of cash that was held by foreign subsidiaries as of December 31, 2011 was \$13.2 million. The Company does not plan to initiate any action that would precipitate payment of U.S. income taxes on cash held by foreign subsidiaries, however if we were to repatriate the cash from our foreign subsidiaries, a significant tax liability may result.

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

Net cash used in investing activities was \$13.3 million for the year ended December 31, 2011, compared to \$14.9 million for the year ended December 31, 2010, a decrease of \$1.6 million. Our investing activities during these periods primarily related to the purchase of property and equipment associated with the expansion of our information technology systems and our facilities as a result of our growth and international expansion, and the purchase of short-term investments.

***Net Cash Provided By Financing Activities***

Net cash provided by financing activities was \$0.9 million for the year ended December 31, 2011 compared to net cash provided by financing activities of \$3.4 million for the year ended December 31, 2010. Net cash provided by financing activities during the year ended December 31, 2011 and 2010 primarily related to proceeds received from stock option exercises.

We believe our current cash and cash equivalents, short term investments and funds generated from our operations will be sufficient to meet our working capital and capital expenditure requirements through the foreseeable future, including at least the next 12 months. Thereafter, we may need to raise additional funds through public or private financings or increased borrowings to develop or enhance products, to fund expansion, to respond to competitive pressures or to acquire complementary products, businesses or technologies. If required, additional financing may not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced and these securities might have rights, preferences and privileges senior to those of our current stockholders. No assurance can be given that additional financing will be available or that, if available, such financing can be obtained on terms favorable to our stockholders and us.

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

**Off-Balance Sheet Arrangements**

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

**Contractual Obligations**

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

	<u>Total</u>	<u>Less than 1 Year</u>	<u>1 - 3 Years</u>	<u>3 - 5 Years</u>	<u>More than 5 Years</u>
			(in thousands)		
Long-term debt	\$ —	\$ —	\$ —	\$ —	\$ —
Operating lease obligations	13,086	6,616	6,084	386	—
<b>Total</b>	<b>\$ 13,086</b>	<b>\$ 6,616</b>	<b>\$ 6,084</b>	<b>\$ 386</b>	<b>\$ —</b>

The operating lease obligations reflected in the table above include our corporate office leases and site licenses for our kiosks.

**Recent Accounting Pronouncements**

Accounting Standards Update No. 2011-05—Comprehensive Income (Topic 220). Under the amendments to Topic 220, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This Update eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income, thus the adoption of such standard will not have a material impact on our reported results of operations and financial position.

In September 2011, the FASB issued new guidance on goodwill impairment testing (ASU 2011-08, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*), effective for calendar years beginning after December 15, 2011. Early adoption is permitted. The objective of this standard is to simplify how an entity tests goodwill 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 the fair value of a reporting unit is less than its carrying value as a basis for determining whether it needs to perform the quantitative two-step goodwill impairment test. Only if an entity determines, based on qualitative assessment, that it is more likely than not that a reporting unit's fair value is less than its carrying value will it be required to calculate the fair value of the reporting unit. We intend to adopt this new guidance beginning fiscal year 2012.

**Item 7A. *Quantitative and Qualitative Disclosures About Market Risk***

***Foreign Currency Exchange Risk***

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

***Interest Rate Sensitivity***

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

**Item 8. *Financial Statements and Supplementary Data***

Our consolidated financial statements, together with the related notes and the report of independent registered public accounting firm, are set forth on the pages indicated in Item 15.

**Item 9. *Changes In and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

**Item 9A. *Controls and Procedures***

***Evaluation of Disclosure Controls and Procedures***

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

***Management's annual report on internal control over financial reporting***

We are responsible for establishing and maintaining adequate internal control over our financial reporting. We have assessed the effectiveness of internal control over financial reporting as of December 31, 2011. Our assessment was based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, in Internal Control—Integrated Framework.

Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets;
- (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and board of directors; and
- (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on using the COSO criteria, we believe our internal control over financial reporting as of December 31, 2011 was effective.

Our independent registered public accounting firm, Deloitte & Touche LLP, has audited the financial statements included in this Annual Report on Form 10-K and has issued a report on the effectiveness of our internal control over financial reporting. The attestation report of Deloitte & Touche LLP is included on page F-3 of this Form 10-K.

***Changes in Internal Control over Financial Reporting***

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the quarter ended December 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

***Item 9B. Other Information***

None.

## PART III

Certain information required by Part III is omitted from this Annual Report on Form 10-K as we intend to file our definitive Proxy Statement for the 2011 Annual Meeting of Stockholders pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of the fiscal year covered by this Annual Report, and certain information included in the Proxy Statement is incorporated herein by reference.

### **Item 10. *Directors, Executive Officers and Corporate Governance***

The information required by this Item is incorporated herein by reference to the information provided under the headings "Our Board of Directors and Nominees," "Security Ownership of Certain Beneficial Owners and Management—Section 16(A) Beneficial Ownership Reporting Compliance," "Corporate Governance—Code of Ethics," "Corporate Governance—Composition of our Board of Directors; Classified Board," "Corporate Governance—Committees of our Board of Directors," "Corporate Governance—Audit Committee," and "Corporate Governance—Corporate Governance and Nominating Committee" in our definitive proxy statement for the 2012 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission no later than 120 days after the fiscal year ended December 31, 2011 (the "2012 Proxy Statement").

### **Code of Ethics and Business Conduct**

We have adopted a code of ethics and business conduct ("code of conduct") that applies to all of our employees, officers and directors, including without limitation our principal executive officer, principal financial officer and controller or principal accounting officer. Copies of both the code of conduct, as well as any waiver of a provision of the code of conduct granted to any senior officer or director or material amendment to the code of conduct, if any, are available, without charge, under the "Corporate Governance" tab of the "Investor Relations" section on our website at [www.rosettastone.com](http://www.rosettastone.com). We intend to disclose any amendments or waivers of this code on our website.

### **Item 11. *Executive Compensation***

The information required by this Item is incorporated herein by reference to the information provided under the headings "Compensation Committee Report", "Executive Compensation," "Director Compensation" and "Compensation Committee and "Corporate Governance—Interlocks and Insider Participation" in the 2012 Proxy Statement.

### **Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item is incorporated herein by reference to the information provided under the headings "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation" in the 2012 Proxy Statement.

### **Item 13. *Certain Relationships and Related Transactions, and Director Independence***

The information required by this Item is incorporated herein by reference to the information provided under the headings "Corporate Governance—Director Independence," and "Transactions with Related Persons" in the 2012 Proxy Statement.

### **Item 14. *Principal Accounting Fees and Services***

The information required by this Item is incorporated herein by reference to the information provided under the heading "Principal Accountant Fees and Services" in the 2012 Proxy Statement.



**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a) *Consolidated Financial Statements*

1. *Consolidated Financial Statements.* The consolidated financial statements as listed in the accompanying "Index to Consolidated Financial Information" are filed as part of this Annual Report.
2. *Consolidated Financial Statement Schedules.* Schedules have been omitted because they are not applicable or are not required or the information required to be set forth in those schedules is included in the consolidated financial statements or related notes.

All other schedules not listed in the accompanying index have been omitted as they are either not required or not applicable, or the required information is included in the consolidated financial statements or the notes thereto.

(b) *Exhibits*

The exhibits listed in the Index to Exhibits are filed as part of this Annual Report on Form 10-K.



<u>Signature</u>	<u>Title</u>
<hr/> <i>/s/ THEODORE J. LEONSIS</i> Theodore J. Leonsis	Director
<hr/> <i>/s/ JOHN E. LINDAHL</i> John E. Lindahl	Director
<hr/> <i>/s/ LAURA L. WITT</i> Laura L. Witt	Director

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
Rosetta Stone Inc.  
Arlington, VA

We have audited the accompanying consolidated balance sheets of Rosetta Stone Inc. and subsidiaries (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 13, 2012 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP

McLean, Virginia  
March 13, 2012

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
Rosetta Stone Inc.  
Arlington, VA

We have audited the internal control over financial reporting of Rosetta Stone Inc. and subsidiaries (the "Company") as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's annual report on internal control over financial reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2011 of the Company and our report dated March 13, 2012 expressed an unqualified opinion on those financial statements.

/s/ Deloitte & Touche LLP

McLean, Virginia  
March 13, 2012

## ROSETTA STONE INC.

## CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	As of December 31,	
	2011	2010
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 106,516	\$ 115,756
Restricted cash	74	85
Short term investments	9,711	6,410
Accounts receivable (net of allowance for doubtful accounts of \$1,951 and \$1,761, respectively)	51,997	48,056
Inventory, net	6,723	9,928
Prepaid expenses and other current assets	7,081	7,763
Income tax receivable	7,678	2,210
Deferred income taxes	10,985	11,159
Total current assets	200,765	201,367
Property and equipment, net	20,869	21,073
Goodwill	34,841	34,856
Intangible assets, net	10,865	10,948
Deferred income taxes	8,038	6,498
Other assets	1,803	1,732
Total assets	\$ 277,181	\$ 276,474
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 7,291	\$ 7,631
Accrued compensation	11,703	10,514
Other current liabilities	34,911	32,625
Deferred revenue	49,375	41,965
Total current liabilities	103,280	92,735
Deferred revenue	2,520	5,193
Other long-term liabilities	176	230
Total liabilities	105,976	98,158
Commitments and contingencies (Note 14)		
<b>Stockholders' equity:</b>		
Preferred Stock, \$0.001 par value; 10,000 and 10,000 shares authorized; zero and zero shares issued and outstanding at December 31, 2011 and December 31, 2010, respectively	—	—
Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 21,258 and 20,975 shares issued and outstanding at December 31, 2011 and December 31, 2010, respectively	2	2
Additional paid-in capital	151,823	139,022
Accumulated income	19,082	39,069
Accumulated other comprehensive income	298	223
Total stockholders' equity	171,205	178,316



Total liabilities and stockholders' equity

\$ 277,181 \$ 276,474

See accompanying notes to consolidated financial statements.

## ROSETTA STONE INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands except per share amounts)

	Year Ended December 31,		
	2011	2010	2009
Revenue :			
Product	\$ 195,382	\$ 215,590	\$ 218,549
Subscription and service	73,067	43,278	33,722
Total revenue	268,449	258,868	252,271
Cost of revenue:			
Cost of product revenue	36,497	32,549	30,264
Cost of subscription and service revenue	12,619	6,450	3,163
Total cost of revenue	49,116	38,999	33,427
Gross profit	219,333	219,869	218,844
Operating expenses			
Sales and marketing	161,491	130,879	114,899
Research and development	24,218	23,437	26,239
General and administrative	62,031	53,239	57,182
Lease abandonment	—	(583)	(8)
Total operating expenses	247,740	206,972	198,312
Income (loss) from operations	(28,407)	12,897	20,532
Other income and expense:			
Interest income	302	262	159
Interest expense	(5)	(66)	(356)
Other income (expense)	142	(220)	112
Total other income (expense)	439	(24)	(85)
Income (loss) before income taxes	(27,968)	12,873	20,447
Income tax provision (benefit)	(7,980)	(411)	7,084
Net income (loss)	\$ (19,988)	\$ 13,284	\$ 13,363
Net income (loss) per share:			
Basic	\$ (0.96)	\$ 0.65	\$ 0.89
Diluted	\$ (0.96)	\$ 0.63	\$ 0.67
Common shares and equivalents outstanding:			
Basic weighted average shares	20,773	20,439	14,990
Diluted weighted average shares	20,773	21,187	19,930

See accompanying notes to consolidated financial statements.

ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

	Class A, Series A-1		Class A, Series A-2		Class B		Class A		Class B		Non-Designated		Additional Paid-in Capital	Accumulated Income	Accumulated Other Comprehensive Loss	Total Stockholders' Equity (Deficit)
	Convertible Preferred Stock		Convertible Preferred Stock		Convertible Preferred Stock		Convertible Common Stock		Convertible Common Stock		Common Stock					
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount				
Balance—January 1, 2009	269	\$ 26,876	178	\$ 17,820	111	\$ 11,341	—	\$ —	—	\$ —	1,936	\$ 1	\$ 10,814	\$ 12,422	\$ (203)	\$ 79,071
Stock Issued Upon the Exercise of Stock Options	—	—	—	—	—	—	—	—	—	—	89	—	386	—	—	386
Stock Issued to Key Employees	—	—	—	—	—	—	—	—	—	—	591	—	10,647	—	—	10,647
Stock-based Compensation Expense	—	—	—	—	—	—	—	—	—	—	—	—	3,616	—	—	3,616
Tax Benefit on Stock Option Exercised	—	—	—	—	—	—	—	—	—	—	—	—	336	—	—	336
Conversion of Preferred Stock	(269)	(26,876)	(178)	(17,820)	(111)	(11,341)	—	—	—	—	14,508	1	56,036	—	—	—
Sale of Common Stock	—	—	—	—	—	—	—	—	—	—	3,125	—	49,037	—	—	49,037
Comprehensive income:																
Net income	—	—	—	—	—	—	—	—	—	—	—	—	—	13,363	—	13,363
Foreign currency translation loss, net of tax of \$(8)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	(21)	(21)
Total comprehensive income	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	13,342
Balance—December 31, 2009	—	\$ —	—	\$ —	—	\$ —	—	\$ —	—	\$ —	20,249	\$ 2	\$ 130,872	\$ 25,785	\$ (224)	\$ 156,435
Stock Issued Upon the Exercise of Stock Options	—	—	—	—	—	—	—	—	—	—	364	—	2,387	—	—	2,387
Restricted Stock Award Vesting	—	—	—	—	—	—	—	—	—	—	54	—	—	—	—	54
Stock-based Compensation Expense	—	—	—	—	—	—	—	—	—	—	—	—	4,387	—	—	4,387
Tax Benefit on Stock Option Exercised	—	—	—	—	—	—	—	—	—	—	—	—	1,376	—	—	1,376
Comprehensive income:																
Net income	—	—	—	—	—	—	—	—	—	—	—	—	—	13,284	—	13,284
Foreign currency translation gain, net of tax of \$110	—	—	—	—	—	—	—	—	—	—	—	—	—	—	447	447
Total comprehensive income	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	13,731
Balance—December 31, 2010	—	\$ —	—	\$ —	—	\$ —	—	\$ —	—	\$ —	20,667	\$ 2	\$ 139,022	\$ 39,069	\$ 223	\$ 178,316
Stock Issued Upon the Exercise of Stock Options	—	—	—	—	—	—	—	—	—	—	182	—	800	—	—	800
Restricted Stock Award Vesting	—	—	—	—	—	—	—	—	—	—	87	—	—	—	—	87
Stock-based Compensation Expense	—	—	—	—	—	—	—	—	—	—	—	—	12,353	—	—	12,353
Tax Benefit on Stock Option Exercised	—	—	—	—	—	—	—	—	—	—	—	—	(351)	—	—	(351)
Comprehensive income (loss):																
Net loss	—	—	—	—	—	—	—	—	—	—	—	—	—	(19,988)	—	(19,988)
Foreign currency translation gain, net of tax of \$46	—	—	—	—	—	—	—	—	—	—	—	—	—	—	98	98
Unrealized gain/loss on available-for-sale securities	—	—	—	—	—	—	—	—	—	—	—	—	—	—	(23)	(23)
Total comprehensive income (loss)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	(19,913)
Balance—December 31, 2011	—	\$ —	—	\$ —	—	\$ —	—	\$ —	—	\$ —	20,936	\$ 2	\$ 151,824	\$ 19,081	\$ 298	\$ 171,205

See accompanying notes to consolidated financial statements.

**ROSETTA STONE INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	<b>Year Ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net (loss) income	\$ (19,988)	\$ 13,284	\$ 13,363
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Stock-based compensation expense	12,353	4,387	22,150
Bad debt expense	1,228	1,750	911
Depreciation and amortization	8,724	6,615	5,428
Amortization of deferred financing costs	—	—	209
Deferred income tax benefit	(1,297)	(6,057)	(2,475)
Loss on disposal of equipment	318	37	42
Net change in:			
Restricted cash	11	(30)	(16)
Accounts receivable	(5,058)	(12,260)	(11,779)
Inventory	3,168	(935)	(3,916)
Prepaid expenses and other current assets	659	(236)	(1,006)
Income tax receivable	(5,812)	(5,028)	—
Other assets	(25)	(761)	(429)
Accounts payable	(447)	5,987	(1,604)
Accrued compensation	1,200	(16)	1,905
Other current liabilities	3,979	6,106	5,678
Income tax payable	—	—	3,188
Excess tax benefit from stock options exercised	(365)	(1,377)	(336)
Other long-term liabilities	(52)	(789)	(463)
Deferred revenue	4,777	21,029	10,300
Net cash provided by operating activities	<u>3,373</u>	<u>31,706</u>	<u>41,150</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(9,940)	(8,256)	(8,455)
Purchases of available-for-sale securities	(3,301)	(6,410)	—
Acquisition, net of cash acquired	(75)	(225)	(100)
Net cash used in investing activities	<u>(13,316)</u>	<u>(14,891)</u>	<u>(8,555)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from common stock issuance, net of issuance costs	—	—	49,037
Proceeds from the exercise of stock options	800	2,387	473
Tax benefit of stock options exercised	365	1,377	336
Payment of payroll taxes on net common stock issuance	—	—	(7,887)
Payment of payroll taxes on stock options exercised	—	—	(89)
Proceeds from long-term debt	—	—	9,929
Principal payments under long-term debt	—	—	(19,839)
Payments under capital lease obligations and acquisition liabilities	(285)	(367)	(3)
Net cash provided by financing activities	<u>880</u>	<u>3,397</u>	<u>31,957</u>
(Decrease) increase in cash and cash equivalents	<u>(9,063)</u>	<u>20,212</u>	<u>64,552</u>
Effect of exchange rate changes in cash and cash equivalents	<u>(177)</u>	<u>356</u>	<u>10</u>
Net increase (decrease) in cash and cash equivalents	<u>(9,240)</u>	<u>20,568</u>	<u>64,562</u>
Cash and cash equivalents—beginning of year	<u>115,756</u>	<u>95,188</u>	<u>30,626</u>
Cash and cash equivalents—end of year	<u>\$ 106,516</u>	<u>\$ 115,756</u>	<u>\$ 95,188</u>
<b>Supplemental Cash Flow Disclosure:</b>			
Cash paid during the periods for:			
Interest	<u>\$ 5</u>	<u>\$ 66</u>	<u>\$ 104</u>
Income taxes	<u>\$ 1,683</u>	<u>\$ 9,989</u>	<u>\$ 6,364</u>
Noncash financing and investing activities:			
Accrued liability for purchase of property, equipment and intangibles	<u>\$ 204</u>	<u>\$ 1,567</u>	<u>\$ 546</u>
Equipment acquired under capital lease	<u>\$ 16</u>	<u>\$ —</u>	<u>\$ 14</u>
Contingent liability for acquisition	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 850</u>

See accompanying notes to consolidated financial statements.



## ROSETTA STONE INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. NATURE OF OPERATIONS

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

#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### *Initial Public Offering*

In April 2009, the Company completed an initial public offering consisting of 7,187,500 shares of common stock at \$18.00 per share. The total shares sold in the offering included 4,062,500 sold by selling stockholders and 3,125,000 shares sold by the Company.

After deducting the payment of underwriters' discounts and commissions and offering expenses, the net proceeds to the Company from the sale of shares in the offering were \$49.0 million. The net proceeds from the offering were used to repay a \$9.9 million balance on the revolving credit facility and \$7.9 million to satisfy the federal, state and local withholding tax obligations associated with the net issuance of stock grants made to key employees.

##### *Principles of Consolidation*

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

##### *Use of Estimates*

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

**ROSETTA STONE INC.**

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

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

***Revenue Recognition***

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe*. Rosetta Stone *TOTALe* online, which was released in July 2009, combines dedicated conversational coaching and an online software subscription. Rosetta Stone Version 4 *TOTALe*, which was released in September 2010, combines packaged software and dedicated conversational coaching. The Company recognizes revenue for software products and related services in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition* ("ASC 985-605").

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

Revenue is recognized from the sale of packaged software and audio practice products when the product has been delivered, assuming the remaining revenue recognition criteria have been met. Software products include sales to end-user customers and resellers. In most cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products are recognized as the products are shipped and title passes and risks of loss have been transferred. For most of the Company's product sales, these criteria are met at the time the product is shipped. For some sales to resellers and certain other sales, the Company defers revenue until the customer receives the product because the Company legally retains a portion of the risk of loss on these sales during transit. A limited amount of packaged software products are sold to resellers on a consignment basis. Revenue is recognized for these consignment transactions once the end-user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with Accounting Standards Codification subtopic 985-605-50, *Software: Revenue Recognition: Customer Payments and Incentives* ("ASC 985-605-50"), price protection for changes in the manufacturer suggested retail value granted to resellers for the inventory that they have on hand at the date the price protection is offered is recorded as a reduction to revenue. The Company offers customers the ability to make payments for packaged software purchases in installments over a period of time, which typically ranges between three and five months. Given that these installment payment plans are for periods less than 12 months and a successful collection history has been established, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met. Packaged software is provided to customers who purchase directly from us with a six-month right of return. The company also allows its retailers to return unsold products, subject to some limitations. In accordance with Accounting Standards Codification subtopic 985-605-15, *Software: Revenue Recognition: Products* ("ASC 985-605-15"), product revenue is reduced for estimated returns, which are based on historical return rates.

Revenue for software license agreements sold via online software subscriptions as hosting agreements are recognized in accordance with Accounting Standards Codification subtopic 985-605-05, *Software: Revenue Recognition: Background* ("ASC 985-605-05"). Revenue for online software subscriptions is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between 3 and 12 months. Some online licensing arrangements include a specified number of licenses that can be activated over a period of

**ROSETTA STONE INC.**

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

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

time, which typically ranges between 6 and 24 months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement and the subscription services are made available to the customer. In connection with packaged software product sales and online software subscriptions, technical support is provided to customers, including customers of resellers, at no additional cost from one year 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.

Revenue for online service subscriptions for dedicated conversational coaching is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically range from three months to 15 months. Rosetta Stone Version 4 *TOTALe* bundles, which include dedicated conversational coaching online services and packaged software, allow customers to begin their online services at any point during a registration window, which is 6 months from the date of purchase from the Company or an authorized reseller. Dedicated conversational coaching online service subscriptions that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Accounts receivable and deferred revenue are recorded at the time a customer purchases the online services.

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

The Company has been engaged to develop language-learning software for certain endangered languages under fixed-fee arrangements. These arrangements also include contractual periods of post-contract support ("PCS") and online hosting services ranging from one to ten years. Revenue for multi-element contracts are recognized ratably once the PCS and online hosting periods begin, over the longer of the PCS or online hosting period. When the current estimates of total contract revenue and contract cost indicate a loss for a fixed fee arrangement, a provision for the entire loss on the contract is recorded.

*Revenue Recognition for Arrangements with Multiple Deliverables*

As of January 1, 2010, the Company began to recognize revenue prospectively for new arrangements with multiple deliverables in accordance with ASU No. 2009-13, "*Revenue Recognition (Topic 605)—Multiple Deliverable Revenue Arrangements*" (ASU No. 2009-13"). For multi-element arrangements that include online services and auxiliary items, such as headsets and audio practice products which provide stand-alone value to the customer, the Company allocates revenue to all deliverables based on their relative selling prices in accordance with ASU No. 2009-13. The new accounting principles establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows: (i) vendor-specific objective evidence of fair value ("VSOE"),



**ROSETTA STONE INC.**

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

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

(ii) third-party evidence of selling price ("TPE"), and (iii) best estimate of the selling price ("ESP"). VSOE generally exists only when the Company sells the deliverable separately and is the price actually charged by the Company for that deliverable. ESPs reflect its best estimates of what the selling prices of elements would be if they were sold regularly on a stand-alone basis.

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

The Company has identified two deliverables generally contained in Rosetta Stone Version 4 *TOTALe* software arrangements. The first deliverable is the packaged software, which is delivered at the time of sale, and the second deliverable is the dedicated conversational coaching online services. The Company allocates revenue between these two deliverables using the residual method based on the existence of VSOE for the undelivered service element. Amounts allocated to the software are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services or upon expiry of the online services. The language-learning software cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

***Cash and Cash Equivalents***

Cash and cash equivalents consist of highly liquid investments with original maturities of three months or less and demand deposits with financial institutions.

***Restricted Cash***

Restricted cash is restricted for the reimbursement of funds to employees under the Company's flexible benefit plan and security for a credit card processing vendor.

***Short-Term Investments***

Short-term investments generally consist of highly liquid, fixed-income investments with an original maturity at the time of purchase of greater than three months. Such investments consist of obligations of the U.S. government and government agencies.

Investments are classified as available-for-sale and stated at fair value. The net unrealized gains or losses on available-for-sale securities are reported as a component of comprehensive income. The specific identification method is used to compute the realized gains and losses on investments. Investments are periodically reviewed for impairment. If the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment loss is recognized for the difference.

**ROSETTA STONE INC.**

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

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

***Accounts Receivable and Allowance for Doubtful Accounts***

Accounts receivable consist of amounts due to the Company from its normal business activities. The Company provides an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified.

***Inventories***

Inventories are stated at the lower of cost, determined on a first-in first-out basis, or market. The Company reviews inventory for excess quantities and obsolescence based on its best estimates of future demand, product lifecycle status and product development plans. The Company uses historical information along with these future estimates to reserve for obsolete and potential obsolete inventory.

***Concentrations of Credit Risk***

Accounts receivable and cash and cash equivalents subject the Company to its highest potential concentrations of credit risk. The Company reserves for credit losses and does not require collateral on its trade accounts receivable. In addition, the Company maintains cash and investment balances in accounts at various banks and brokerage firms. The Company is insured by the Federal Deposit Insurance Corporation for up to \$250,000 at each bank. The Company's cash and cash equivalents generally exceed the insured limits. The Company has not experienced any losses on cash and cash equivalent accounts to date and the Company believes it is not exposed to any significant credit risk related to cash. The Company sells products to retailers, resellers, government agencies, and individual consumers and extends credit based on an evaluation of the customer's financial condition, without requiring collateral. Exposure to losses on receivables is principally dependent on each customer's financial condition. The Company monitors its exposure for credit losses and maintains allowances for anticipated losses. No customer accounted for more than 10% of the Company's revenue during the years ended December 31, 2011, 2010 or 2009. The Company had four customers that accounted for 27% of accounts receivable at December 31, 2011 and three customers that accounted for 46% of accounts receivable at December 31, 2010.

***Fair Value of Financial Instruments***

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

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

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

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

**ROSETTA STONE INC.**

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

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

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 Accounting Standards Codification topic 805, *Business Combination* ("ASC 805"). The purchase price consisted of an initial cash payment of \$100,000, followed by three annual cash installment payments, based on revenue performance in South Korea. The terms of the acquisition agreement provide for additional consideration to be paid by the Company in each of the following three years, if the acquired company's revenues exceed certain targeted levels each of these years. The amount is 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 is zero if none of the minimum revenue targets are met, and the maximum additional payment is \$1.1 million. In 2011 and 2010, we made additional payments of \$350,000 and \$400,000 respectively in accordance with the terms of the purchase.

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

	<u>As of December 31,</u>	
	<u>2011</u>	<u>2010</u>
Contingent purchase price accrual, beginning of period	\$ 573	\$ 850
Minimum revenue target met, increase in contingent liability charged to expense in the period	77	123
Payment of contingent purchase liability	(350)	(400)
Contingent purchase price accrual, end of period	<u>\$ 300</u>	<u>\$ 573</u>

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

	<u>Fair Value as of December 31, 2011 using:</u>				<u>Fair Value as of December 31, 2010 using:</u>			
	Quoted Prices in Active Markets Significant for Other Significant Identical Observable Unobservable				Quoted Prices in Active Markets Significant for Other Significant Identical Observable Unobservable			
	December 31, 2011	Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)	December 31, 2010	Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)
<i>Assets:</i>								
Short-term investments	\$ 9,711	\$ 9,711	\$ —	\$ —	\$ 6,410	\$ 6,410	\$ —	\$ —
Total	\$ 9,711	\$ 9,711	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
<i>Liabilities:</i>								
Contingent purchase price accrual	\$ 300	\$ —	\$ —	\$ 300	\$ 573	\$ —	\$ —	\$ 573
Total	\$ 300	\$ —	\$ —	\$ 300	\$ 573	\$ —	\$ —	\$ 573

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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

***Property, Equipment and Software***

Property, equipment, and software are stated at cost, less accumulated depreciation and amortization. Depreciation on property, leasehold improvements, equipment, and software is computed on a straight-line basis over the estimated useful lives of the assets, as follows:

Software	3 years
Computer equipment	3 - 5 years
Automobiles	5 years
Furniture and equipment	5 - 7 years
Building	39 years
Building improvements	15 years
Leasehold improvements	lesser of lease term or economic life
Assets under capital leases	lesser of lease term or economic life

Expenses for repairs and maintenance that do not extend the life of equipment are charged to expense as incurred. Expenses for major renewals and betterments, which significantly extend the useful lives of existing property and equipment, are capitalized and depreciated. Upon retirement or disposition of property and equipment, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is recognized.

***Intangible Assets***

Intangible assets consist of acquired technology, including developed and core technology, customer related assets, trade name and trademark and other intangible assets. Those intangible assets with finite lives are recorded at cost and amortized on a straight line basis over their expected lives in accordance with Accounting Standards Codification topic 350, *Goodwill and Other Intangible Assets* ("ASC 350"). On an annual basis, the Company reviews its indefinite lived intangible assets for impairment based on the fair value of indefinite lived intangible assets as compared to the carrying value in accordance with ASC 350. In the event the carrying value exceeds the fair value of the assets, the assets are written down to their fair value. There has been no impairment of intangible assets during any of the periods presented.

***Goodwill***

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006 and the acquisition of certain assets of SGLC in November 2009. The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of Accounting Standards Codification topic 350, *Intangibles—Goodwill and Other* ("ASC 350") or more frequently, if impairment indicators arise. Subsequent to performing the annual test as of June 30, 2011, such indication occurred during the fourth quarter of 2011 when the fair value of the Company's publicly traded common stock dropped; however, after performing Step 1 of the impairment test under ASC 350, no impairment was identified as the fair value was greater than the book value of each reporting unit.

**ROSETTA STONE INC.**

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

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

The Company will continue to review indicators and it is possible an impairment charge may need to be recorded if trends do not reverse. For income tax purposes, the goodwill balance is amortized over a period of 15 years. Beginning in 2011, the Company began reporting its results in two reportable segments, which resulted in two reporting units for goodwill impairment purposes—Consumer and Institutional. The Company's annual testing results in no impairments of goodwill since the dates of acquisition.

***Valuation of Long-Lived Assets***

In accordance with Accounting Standards Codification topic 360, *Accounting for the Impairment or Disposal of Long-lived Assets* ("ASC 360"), the Company evaluates the recoverability of its long-lived assets. ASC 360 requires recognition of impairment of long-lived assets in the event that the net book value of such assets exceeds the future undiscounted net cash flows attributable to such assets. Impairment, if any, is recognized in the period of identification to the extent the carrying amount of an asset exceeds the fair value of such asset. Based on its analysis, the Company believes that no impairment of its long-lived assets was indicated as of December 31, 2011 and 2010.

***Financial Instruments with Characteristics of Both Liabilities and Equity***

The Company issues financial instruments that have characteristics of both liabilities and equity. The Company accounts for these arrangements in accordance with Accounting Standards Codification topic 480, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* ("ASC 480"), as well as related interpretations of this standard.

***Derivative Instruments***

The Company enters into financing arrangements that consist of freestanding derivative instruments or are hybrid instruments that contain embedded derivative features. The Company accounts for these arrangements in accordance with Accounting Standards Codification topic 815, *Accounting for Derivative Instruments and Hedging Activities* ("ASC 815") as well as related interpretation of this standard. In accordance with this standard, derivative instruments are recognized as either assets or liabilities in the balance sheet and are measured at fair values with gains or losses recognized in earnings. Embedded derivatives that are not clearly and closely related to the host contract are bifurcated and are recognized at fair value with changes in fair value recognized as either a gain or loss in earnings. The Company determines the fair value of derivative instruments and hybrid instruments based on available market data using appropriate valuation models, giving consideration to all of the rights and obligations of each instrument.

***Guarantees***

Indemnifications are provided of varying scope and size to certain institutional customers against claims of intellectual property infringement made by third parties arising from the use of its products. The Company has not incurred any costs or accrued any liabilities as a result of such obligations.

***Cost of Revenue***

Cost of product revenue consists of the direct and indirect materials and labor costs to produce and distribute our products. Such costs include packaging materials, computer headsets, freight,

**ROSETTA STONE INC.**

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

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

inventory receiving, personnel costs associated with product assembly, third-party royalty fees and inventory storage, obsolescence and shrinkage. Cost of subscription and service revenue primarily represents costs associated with supporting our online language-learning service, which includes hosting costs and depreciation. We also include the cost of credit card processing and customer technical support in both cost of product revenue and cost of subscription and service revenue.

***Research and Development***

Research and development expenses include employee compensation costs, professional services fees and overhead costs associated with product development. Software products are developed for sale to external customers. The Company considers technological feasibility to be established when all planning, designing, coding, and testing has been completed according to design specifications. The Company has determined that technological feasibility for its software products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established have not been material, and accordingly, the Company has expensed all research and development costs when incurred.

***Software Developed for Internal Use***

Product development also includes certain software products for internal use. Development costs for internal use software are expensed as incurred until the project reaches the application development stage, in accordance with Accounting Standards Codification topic 350, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* ("ASC 350"). Internal-use software is defined to have the following characteristics: (a) the software is internally developed, or modified solely to meet the entity's internal needs, and (b) during the software's development or modification, no substantive plan exists or is being developed to market the software externally. Internally developed software is amortized over a three-year useful life.

For the years ended December 31, 2011, 2010 and 2009, the Company capitalized \$2.5 million, zero, and zero in internal-use software, respectively.

For the years ended December 31, 2011, 2010 and 2009, the Company recorded amortization expense relating to internal-use software of \$0.4 million, \$0.3 million, and \$0.5 million, respectively.

***Income Taxes***

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

**ROSETTA STONE INC.**

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

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

ASC 740 requires a reduction of the carrying amounts of deferred tax assets by a valuation allowance if, based on available evidence, it is more likely than not that such assets will not be realized. Accordingly, the need to establish valuation allowances for deferred tax assets are assessed periodically based on the ASC 740 more-likely-than-not realization threshold criterion. In the assessment for a valuation allowance, appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carryforward periods, the Company's experience with operating loss and tax credit carryforwards not expiring unused, and tax planning alternatives.

Analysis of the need for a valuation allowance on US deferred tax assets recognizes that while the Company has not incurred a cumulative loss over the evaluation period after adjusting for nonrecurring expenses related to the initial public offering in 2009, a substantial loss was incurred in the current year as a result of difficult market conditions. Consideration has also been given to the lengthy period over which these net deferred assets can be realized, and the Company's history of not having tax loss carryforwards in any jurisdiction expire unused.

In 2010, the Company concluded that it is more likely than not that its deferred tax assets will be utilized and thus recognized a tax benefit of \$2.4 million due to the release of the valuation allowance. The effective income tax rate in 2010 benefited from the availability of previously unrealized deferred tax assets which have been utilized to reduce tax expense for United Kingdom and Japanese income tax purposes. The release of the valuation allowance was determined in accordance with the provisions of ASC 740, which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Historical operating income and continuing projected income represented sufficient positive evidence that the Company used to conclude that it is more likely than not that the deferred tax assets will be realized and accordingly, released the valuation allowance in the fourth quarter of 2010.

Based on the assessment, it appears more likely than not that the net deferred tax asset will be realized through future taxable earnings. If future results fail to provide objectively verifiable evidence to support the realization of the deferred tax asset, a valuation allowance may be required to reduce the deferred tax assets. However, currently no valuation allowance has been established for the Company's net deferred tax assets. The Company will continue to assess the need for a valuation allowance in the future.

***Stock-Based Compensation***

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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

*Net Income Per Share*

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

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

	Year Ended December 31,		
	2011	2010	2009
	(dollars in thousands, except per share amounts)		
<i>Numerator:</i>			
Net Income (loss)	\$ (19,988)	\$ 13,284	\$ 13,363
<i>Denominator:</i>			
Weighted average number of common shares:			
Basic	20,773	20,439	14,990
Diluted	20,773	21,187	19,930
<i>Income (loss) per common share:</i>			
Basic	\$ (0.96)	\$ 0.65	\$ 0.89
Diluted	\$ (0.96)	\$ 0.63	\$ 0.67

The following table sets forth common stock equivalent shares included in the calculation of the Company's diluted net income (loss) per share (in thousands):

	Year Ended December 31,		
	2011	2010	2009
<i>Equity Instruments:</i>			
Convertible preferred stock	—	—	4,134
Restricted common stock units	—	11	7
Restricted common stock	—	86	93
Stock options	—	651	706
Total common stock equivalent shares	—	748	4,940



**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Share-based awards to purchase approximately 540,000, 470,000 and 15,000 shares of common stock that had an exercise price in excess of the average market price of the common stock during the years ended December 31, 2011, 2010 and 2009, respectively, were not included in the calculation of diluted earnings per share because they were anti-dilutive.

***Comprehensive Income (Loss)***

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income refers to revenues, expenses, gains, and losses that are not included in net income, but rather are recorded directly in stockholders' equity. For the years ended December 31, 2011, 2010 and 2009, the Company's comprehensive income consisted of net income, foreign currency translation gains (losses) and the net unrealized gains or losses on available-for-sale securities.

***Foreign Currency Translation and Transactions***

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

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

	Year Ended December 31,		
	2011	2010	2009
Net Income (loss)	\$ (19,988)	\$ 13,284	\$ 13,363
Foreign currency translation gain (loss)	98	447	(21)
Unrealized gain (loss) on available-for-sale securities	(23)	—	—
Total comprehensive income (loss)	\$ (19,913)	\$ 13,731	\$ 13,342

***Advertising Costs***

Costs for advertising are expensed as incurred. Advertising expense for the years ended December 31, 2011, 2010, and 2009 were \$74.4 million, \$54.2 million and \$48.2 million, respectively.

***Recently Issued Accounting Standards***

Accounting Standards Update No. 2011-05—Comprehensive Income (Topic 220). Under the amendments to Topic 220, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income,

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

and a total amount for comprehensive income. This Update eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income, thus the adoption of such standard will not have a material impact on the Company's reported results of operations and financial position, but there will be a qualitative impact of adding an additional statement to the Company's consolidated financial statements.

In September 2011, the FASB issued new guidance on goodwill impairment testing (ASU 2011-08, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*), effective for calendar years beginning after December 15, 2011. Early adoption is permitted. The objective of this standard is to simplify how an entity tests goodwill 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 the fair value of a reporting unit is less than its carrying value as a basis for determining whether it needs to perform the quantitative two-step goodwill impairment test. Only if an entity determines, based on qualitative assessment, that it is more likely than not that a reporting unit's fair value is less than its carrying value will it be required to calculate the fair value of the reporting unit. The Company intends to adopt this new guidance beginning fiscal year 2012.

**3. INVENTORY**

Inventory consisted of the following (in thousands):

	As of	
	December 31,	
	2011	2010
Raw materials	\$ 2,458	\$ 4,423
Finished goods	4,265	5,505
Total inventory	<u>\$ 6,723</u>	<u>\$ 9,928</u>

**4. ACQUISITIONS**

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 Accounting Standards Codification topic 805, *Business Combination* ("ASC 805"). The purchase price consisted of an initial cash payment of \$100,000, followed by three annual cash installment payments, based on revenue performance in South Korea. The terms of the acquisition agreement provide for additional consideration to be paid by the Company in each of the following three years, if the acquired company's revenues exceed certain targeted levels each of these years. The amount is 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 is zero if none of the minimum revenue targets are met, and the maximum additional payment is \$1.1 million. Management determined that the total contingent consideration for inclusion in the purchase price was the maximum of \$1.1 million, the fair value of which is \$850,000. Including the cash paid upon the acquisition date of

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. ACQUISITIONS (Continued)**

\$100,000, the total purchase price was \$950,000. In 2011 and 2010, we made additional payments of \$350,000 and \$400,000 respectively in accordance with the terms of the purchase.

Under the purchase method of accounting, the total purchase price was allocated to the tangible and intangible assets acquired on the basis of their respective estimated fair values at the date of acquisition. The valuation of the identifiable intangible assets and their useful lives acquired reflects management's estimates.

The summary of fair value of assets acquired in the asset acquisition is as follows (in thousands):

<i>Tangible assets:</i>	
Inventory	\$ 135
Property and equipment	95
<i>Intangible assets:</i>	
Customer relationships	100
Goodwill	620
Total assets acquired	<u>\$ 950</u>

A total of \$100,000 was allocated to amortizable intangible assets consisting of customer relationships, and a total of \$620,257 was allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of tangible and amortizable intangible assets acquired.

**5. PROPERTY AND EQUIPMENT**

Property and equipment consisted of the following (in thousands):

	<u>As of December 31,</u>	
	<u>2011</u>	<u>2010</u>
Land	\$ 390	\$ 390
Buildings and improvements	8,120	8,110
Leasehold improvements	1,739	1,682
Computer equipment	14,534	12,046
Software	17,168	13,723
Furniture and equipment	5,980	4,158
	<u>47,931</u>	<u>40,109</u>
Less: accumulated depreciation	<u>(27,062)</u>	<u>(19,036)</u>
Property and equipment, net	<u>\$ 20,869</u>	<u>\$ 21,073</u>

The Company leases certain computer equipment, software and machinery under capital lease agreements. As of December 31, 2011 and 2010, leased computer equipment and software included in property and equipment above was \$72,000 and \$56,000, respectively.

The Company recorded depreciation expense for the years ended December 31, 2011, 2010 and 2009 in the amount of \$8.6 million, \$6.6 million and \$5.4 million, respectively.

**ROSETTA STONE INC.**

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

**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 and the acquisition of certain assets of SGLC in November 2009. The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of Accounting Standards Codification topic 350, *Intangibles—Goodwill and Other* ("ASC 350") or more frequently, if impairment indicators arise. Subsequent to performing the annual test as of June 30, 2011, such indication occurred during the fourth quarter of 2011 when the fair value of the Company's publicly traded common stock dropped; however, after performing Step 1 of the impairment test under ASC 350, no impairment was identified as the fair value was greater than the book value of each reporting unit. The Company will continue to review indicators and it is possible an impairment charge may need to be recorded if trends do not reverse. Beginning in 2011, the Company began reporting its results in two reportable segments, which resulted in two reporting units for goodwill impairment purposes—Consumer and Institutional. The Company's annual testing resulted in no impairments of goodwill since the dates of acquisition.

The following table represents the balance and changes in goodwill for the years ended December 31, 2011 and 2010 (in thousands):

	Consumer Operating Segment	Institutional Operating Segment	Total
Balance as of January 1, 2010	15,669	19,150	34,819
No acquisition activity	—	—	—
Balance as of December 31, 2010	15,669	19,150	34,819
No acquisition activity	—	—	—
Balance as of December 31, 2011	15,669	19,150	34,819
Effect of change in foreign currency rate	10	12	22
Balance as of December 31, 2011	<u>15,679</u>	<u>19,162</u>	<u>34,841</u>

**7. INTANGIBLE ASSETS**

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

	December 31, 2011			December 31, 2010		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trade						
name / trademark	\$ 10,608	\$ —	\$ 10,608	\$ 10,607	\$ —	\$ 10,607
Core technology	2,453	(2,453)	—	2,453	(2,453)	—
Customer						
relationships	10,842	(10,842)	—	10,844	(10,800)	44
Website	12	(12)	—	12	(12)	—
Patents	300	(43)	257	300	(3)	297
Total	<u>\$ 24,215</u>	<u>\$ (13,350)</u>	<u>\$ 10,865</u>	<u>\$ 24,216</u>	<u>\$ (13,268)</u>	<u>\$ 10,948</u>

The Company recorded intangible assets of \$23.8 million, associated with the acquisition of Rosetta Stone Ltd. in January 2006, and \$0.1 million with the acquisition of certain assets of SGLC in November 2009. During 2010, the Company recorded the purchase of two patents associated with the

**ROSETTA STONE INC.**

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

**7. INTANGIBLE ASSETS (Continued)**

development of new products in the amount of \$0.3 million. The estimated lives of the acquired core technology and customer relationships are between 18 to 36 months. The intangible asset associated with the trade name and trademark has an indefinite useful life. The estimated life of the website rights is 60 months, and estimated useful life of the patents are based on the effective date of the purchase agreement through the expiration date of the patents. The Company computes amortization of intangible assets on a straight-line basis over the estimated useful life. Below are the estimated useful lives of the intangible assets acquired:

	<b>Weighted Average Life</b>
Trade name / trademark	Indefinite
Core technology	24 months
Customer relationships	24 months
Website	60 months
Patents	72 - 100 months

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

Amortization expense consisted of the following (in thousands):

	<b>Years Ended</b>		
	<b>December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
Included in cost of revenue:			
Cost of product revenue	\$ —	\$ —	\$ —
Cost of subscription and service revenue	—	—	—
Total included in cost of revenue	—	—	—
Included in operating expenses:	\$ 85	\$ 58	\$ 42
Total	<u>\$ 85</u>	<u>\$ 58</u>	<u>\$ 42</u>

The following table summarizes the estimated future amortization expense related to intangible assets as of December 31, 2011 (in thousands):

	<b>As of</b>
	<b>December 31, 2011</b>
2012	\$ 40
2013	40
2014	40
2015	40
2016	40
Thereafter	57
Total	<u>\$ 257</u>

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. OTHER CURRENT LIABILITIES**

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

	<u>December 31,</u>	
	<u>2011</u>	<u>2010</u>
Marketing expenses	\$ 12,726	\$ 11,075
Professional and consulting fees	3,322	2,820
Sales return reserve	9,931	8,391
Taxes payable	2,413	2,722
Other	6,519	7,617
	<u>\$ 34,911</u>	<u>\$ 32,625</u>

**9. BORROWING AGREEMENT**

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

Interest expense for the year ended December 31, 2011 and 2010 was \$5,000 and \$66,000, respectively.

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

**10. STOCK-BASED COMPENSATION***2006 Stock Incentive Plan*

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

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. STOCK-BASED COMPENSATION (Continued)***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.

Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants. At December 31, 2011 there were 1,562,010 shares available for future grant under the 2009 Plan.

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

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model as follows:

	Year Ended December 31,		
	2011	2010	2009
Expected stock price volatility	57% - 64%	58% - 66%	61%
Expected term of options	6 years	6 years	6 years
Expected dividend yield	—	—	—
Risk-free interest rate	1.14% - 2.59%	1.14% - 2.59%	1.71% - 2.46%

Prior to the completion of the Company's initial public offering in April 2009, the Company's stock was not publicly quoted and the Company had a limited history of stock option activity, so 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. Subsequent to the initial public offering, the Company continues to review a group of comparable industry-related companies to estimate volatility, but also reviews the volatility of its own stock since the initial public offering. The Company considers the volatility of the comparable companies to be the best estimate of future volatility. For the risk-free interest rate, the Company uses a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

*Stock Options*—The following table summarizes the Company's stock option activity from January 1, 2011 to December 31, 2011:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2011	2,020,927	\$ 13.25	\$ 7.36	\$ 17,733,080
Options granted	698,327	13.37		
Options exercised	(181,843)	4.37		
Options cancelled	(313,662)	18.36		
Options Outstanding, December 31, 2011	<u>2,223,749</u>	13.29	7.14	2,288,131
Vested and expected to vest at December 31, 2011	<u>2,052,059</u>	13.05	6.99	2,282,767
Exercisable at December 31, 2011	<u>1,167,404</u>	9.92	5.75	2,263,592

As of December 31, 2011 and 2010, there was approximately \$8.2 million and \$8.3 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 2.75 and 2.76 years, respectively.

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

The weighted average remaining contractual term and the aggregate intrinsic value for options outstanding at December 31, 2011 was 7.14 years and \$2.3 million, respectively. The weighted average remaining contractual term and the aggregate intrinsic value for options exercisable at December 31, 2010 was 7.36 years and \$17.7 million, respectively. As of December 31, 2011, options that were vested and exercisable totaled 1,167,404 shares of common stock with a weighted average exercise price per share of \$9.92.

The weighted average grant-date fair value per share of stock options granted was \$7.35, \$13.60 and \$10.32 for the years ended December 31, 2011, 2010 and 2009, respectively.

The aggregate intrinsic value disclosed above represents the total intrinsic value (the difference between the fair market value of the Company's common stock as of December 31, 2011, and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2011. This amount is subject to change based on changes to the fair market value of the Company's common stock.



## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's restricted stock activity for the years ended December 31, 2011 and 2010, respectively:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2010	179,802	\$ 18.67	\$ 3,356,903
Awards granted	211,757	23.33	
Awards vested	(54,363)	18.34	
Awards cancelled	(29,672)	19.89	
Nonvested Awards, December 31, 2010	307,524	21.69	6,670,196
Awards granted	170,260	14.09	
Awards vested	(87,436)	21.58	
Awards cancelled	(67,338)	19.26	
Nonvested Awards, December 31, 2011	323,010	18.22	5,885,242

During 2011 and 2010, 170,260 and 211,757 shares of restricted stock were granted, respectively. The aggregate grant date fair value of the awards in 2011 and 2010 was \$2.4 million and \$4.9 million, respectively, which will be recognized as expense on a straight-line basis over the requisite service period of the awards, which is also the vesting period. The Company's restricted stock grants are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant. The Company did not grant any restricted stock prior to April 2009.

During year ended December 31, 2011, 67,338 shares of restricted stock were forfeited. As of December 31, 2011, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the statement of operations was \$4.3 million and is expected to be recognized over a period of 2.55 years.

Restricted stock awards are considered outstanding at the time of grant as the stock holders are entitled to voting rights and to receive any dividends declared subject to the loss of the right to receive accumulated dividends if the award is forfeited prior to vesting. Unvested restricted stock awards are not considered outstanding in the computation of basic earnings per share.

**Restricted Stock Units**—During 2011 and 2010, 22,227 and 12,096 restricted stock units were granted, respectively. The aggregate grant date fair value of the awards in 2011 and 2010 was \$0.3 million and \$0.2 million, respectively, which was recognized as expense on the grant date, as the awards were immediately vested. The Company's restricted stock units are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant. The Company did not grant any restricted stock units prior to April 2009.

**Common Stock Grant**—In May 2006, the Company adopted the Rosetta Stone Inc. Liquidity Performance Award Plan. The Company amended this plan by resolution dated December 31, 2008. This plan provides a bonus to its key employees in the event of an acquisition of the Company, an acquisition of substantially all of the assets of the Company, a liquidation of the Company or any other transaction resulting in liquidating distributions to any holders of its preferred stock. This plan

**ROSETTA STONE INC.**

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

**10. STOCK-BASED COMPENSATION (Continued)**

terminates upon completion of an initial public offering. In April 2009, the Company's Board of Directors awarded 10 of the Company's key employees a total of 591,491 shares of common stock. This grant is net of the number of shares required to be withheld to satisfy the federal, state and local tax withholding obligations, which were paid by the Company to the respective taxing authorities in cash. Thus, the grant is referred to as a "net issuance." The aggregate grant date fair value of the awards was \$18.5 million, which was recognized as expense on the grant date, as the grants were immediately vested.

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

In accordance with the agreements communicated to the executives after the approval of the plan by the Board of Directors, the LTIP participants were granted minimum participation percentages of each tranche of shares issued at each milestone level reached. Throughout the year ended December 31, 2011, the target market capitalization required to trigger the first issuance of shares was below the minimum threshold, and no shares were issued. The minimum participation percentages given to plan participants were considered grants in accordance with the provisions of ASC 718. The grant date fair value of the minimum awards was \$6.1 million which was derived using a Monte Carlo valuation model. This value would have been amortized as stock-based compensation expense over the derived service period of 5 years.

On November 30, 2011, as a result of the substantial reduction in incentive and retentive value of the plan, the board of directors cancelled the LTIP. As a result of the cancellation, the company recognized \$4.9 million in stock-based compensation expense equal to the total unamortized value of the awards. There were no grants of shares issued from the LTIP to any executive prior to its cancellation.

Stock-based compensation expense related to the LTIP was \$6.0 million for the year ended December 31, 2011. As of December 31, 2011, there was no unrecognized stock-based compensation expense related to awards under the LTIP.

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. STOCK-BASED COMPENSATION (Continued)**

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

	Years Ended December 31,		
	2011	2010	2009
<b>Included in cost of revenue:</b>			
Cost of product revenue	\$ 55	\$ 39	\$ 34
Cost of subscription and service revenue	—	—	—
Total included in cost of revenue	55	39	34
<b>Included in operating expenses:</b>			
Sales and marketing	1,932	774	999
Research & development	2,448	1,181	5,959
General and administrative	7,918	2,393	15,158
Total included in operating expenses	12,298	4,348	22,116
Total	\$ 12,353	\$ 4,387	\$ 22,150

**11. COMMON STOCK**

At December 31, 2011, the Company's Board of Directors had the authority to issue 200,000,000 shares of stock, of which 190,000,000 were designated as Common Stock, with a par value of \$0.00005 per share, and 10,000,000 were designated as Preferred Stock, with a par value of \$0.001 per share. At December 31, 2011 and 2010, the Company had shares of Common Stock issued and outstanding of 21,258,249 and 20,975,379, respectively.

**12. CONVERTIBLE PREFERRED STOCK**

On April 21, 2009, in conjunction with the Company's qualified underwritten initial public offering of common stock, its total outstanding preferred shares in the amount of 557,989 automatically converted at a ratio of 26:1 into 14,507,714 shares of Common Stock and the then-existing classes of preferred stock ceased to exist. At December 31, 2011 and 2010, the Company had no preferred shares outstanding and the authorized preferred stock was undesignated blank check preferred.

**13. EMPLOYEE BENEFIT PLAN**

The Company maintains a defined contribution 401(k) Plan (the "Plan"). The Company matches employee contributions to the Plan up to 4% of their compensation that vest immediately. The Company recorded expenses for the Plan totaling \$1.4 million and \$1.4 million for the years ended December 31, 2011 and 2010, respectively.

**14. COMMITMENTS AND CONTINGENCIES*****Operating Leases***

The Company leases many kiosks, copiers, parking spaces, buildings, a warehouse and office space under operating lease and site license arrangements, some of which contain renewal options. The rental payments under some kiosk site licenses are based on a minimum rental plus a percentage of the

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****14. COMMITMENTS AND CONTINGENCIES (Continued)**

kiosk's sales in excess of stipulated amounts. Kiosk site licenses range from a period of one month to 89 months. Building, warehouse and office space leases range from twelve months to 89 months. Certain leases also include lease renewal options.

The following table summarizes future minimum operating lease payments as of December 31, 2011 and the years thereafter (in thousands):

	As of December 31, 2011
Periods Ending December 31,	
2012	\$ 6,616
2013	4,256
2014	1,828
2015	386
2016	—
2017 and thereafter	—
	<u>\$ 13,086</u>

Total expenses under operating leases were \$13.5 million and \$13.0 million during the years ended December 31, 2011 and 2010, respectively.

The Company accounts for its leases under the provisions of Accounting Standards Codification topic 840, *Accounting for Leases* ("ASC 840"), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense. The deferred rent liability was \$0.5 million at December 31, 2011. The deferred rent asset was \$0.1 at December 31, 2011. The deferred rent asset is classified in prepaid and other assets as all associated leases have less than one year remaining on their term.

The Company exited its facility at 1101 Wilson Boulevard, Arlington, Virginia in December 2008 as a result of a relocation of its headquarters to 1919 North Lynn St., Arlington, Virginia. The Company estimated its liability under operating lease agreements and accrued exit costs in accordance with Accounting Standards Codification topic 420, *Exit or Disposal Cost Obligations* ("ASC 420") as the leases associated with this facility did not terminate until December 31, 2009 and August 31, 2013, respectively. Accrued exit costs associated with our headquarters relocation were charged to general and administrative expense in December 2008.

As a result of accelerated growth in its Arlington headquarters, the Company exceeded maximum capacity in its headquarters facility during the third quarter of 2010. At that time, there was no additional space available for lease in the 1919 North Lynn St. location and additional space was needed to support continued growth. The office space currently under lease at 1101 Wilson Blvd, Suite 1130 was unoccupied, and as a result of its close proximity to the 1919 North Lynn Street location, management made the decision to reoccupy the formerly abandoned space. During the

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****14. COMMITMENTS AND CONTINGENCIES (Continued)**

quarter ended September 30, 2010, the remaining liability associated with the abandonment of the operating lease at 1101 Wilson Blvd. was reversed.

The following table summarizes the accrued exit costs for the 1101 Wilson Boulevard facility (in thousands):

	As of December 31, 2011	As of December 31, 2010
Accrued exit costs, beginning of period	\$ —	\$ 1,019
Costs incurred and charged/(credited) to expense	—	(583)
Principal reductions	—	(436)
Accrued exit costs, end of period	<u>\$ —</u>	<u>\$ —</u>
Accrued exit cost liability:		
Short-term	\$ —	\$ —
Long-term	—	—
Total	<u>\$ —</u>	<u>\$ —</u>

***Royalty Agreement***

On December 28, 2006 the Company entered into an agreement to license software from a vendor for incorporation in software products that the Company is developing. The agreement required a one-time, non-refundable payment of \$0.3 million, which was expensed in full as research and development costs during 2006 because the products in which the licensed software were to be incorporated into had not yet reached technological feasibility. In addition, the agreement specifies that, in the event the software is incorporated into specified Company software products, royalties will be due at a rate of 20% of sales for those products up to an additional amount totaling \$0.4 million. There were no additional royalty payments made under this agreement in 2011 or 2010.

***Employment Agreements***

The Company has agreements with certain of its executives and key employees which provide guaranteed severance payments upon termination of their employment without cause. The severance payments range from six to eighteen months of base salary.

***Litigation***

In July 2009, the Company filed a lawsuit in the United States District Court for the Eastern District of Virginia against Google Inc., seeking, among other things, to prevent Google from infringing upon its trademarks. In August 2010, the U.S. District Court for the Eastern District of Virginia issued its final order dismissing our trademark infringement lawsuit against Google. The Company appealed the District Court's decision to the U.S. Court of Appeals for the Fourth Circuit. The U.S. Court of Appeals heard oral argument on the Company's appeal on September 22, 2011 and the decision is pending. The Company has incurred, and may continue to incur material legal fees and other costs and expenses in pursuit of our claims against Google.

**ROSETTA STONE INC.**

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

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

On or about April 28, 2010, a purported class action lawsuit was filed against the Company in the Superior Court of the State of California, County of Alameda for damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and other persons similarly situated who are or were employed as salaried managers by the Company in its retail locations in California are due unpaid wages and other relief for the Company's violations of state wage and hour laws. Plaintiffs moved to amend their complaint to include a nationwide class on January 21, 2011. In November 2011, the plaintiffs' attorneys and the Company agreed to the mediator's proposed settlement terms, and as a result, as of September 30, 2011, the Company reserved \$0.6 million for the proposed settlement amount. Approval of the proposed settlement by the court is pending. The Company disputes the plaintiffs' claims and it has not admitted any wrongdoing with respect to the case.

On June 23, 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG ("Langenscheidt") in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone's use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. Langenscheidt is seeking, among other things, to enjoin Rosetta Stone GmbH from using the color yellow in Germany, a declaratory judgment that Rosetta Stone GmbH is liable for damages based on our activities in Germany, and the award of costs and attorneys' fees associated with the legal proceeding. A hearing was held on October 27, 2011 and the presiding judge indicated his opinion that Rosetta Stone GmbH has infringed on Langenscheidt's German trademark. On January 19, 2012, the District Court of Cologne ordered an injunction of Rosetta Stone GmbH's use of the color yellow in packaging, on its website and in television commercials and declared Rosetta Stone liable for damages, attorneys' fees and costs to Langenscheidt. However, no dollar amounts have been specified yet for the award of damages by the District Court of Cologne. In its decision, the District Court of Cologne also ordered the destruction of Rosetta Stone GmbH's product and packaging which utilized the color yellow and which was deemed to have infringed Langenscheidt's trademark. The decision is immediately enforceable upon Langenscheidt posting of a bond. To date, Langenscheidt has not posted a bond. It is required in this jurisdiction for a plaintiff to post a bond in order for a decision to be immediately enforced because if the decision were reversed upon appeal, the defendant would be awarded the bond amount for costs and damages incurred. Langenscheidt has not yet pled the amount of its damages and the court has not yet made any determination as to the amount of damages. The Company intends to vigorously defend this matter and has filed a notice of appeal with the Court of Appeals in Cologne. In addition, the Company commenced a separate proceeding directed at the cancellation of Langenscheidt's German trademark registration of yellow as an abstract color mark. However, the range of any potential loss is not reasonably estimable at this time. Even if the plaintiff is unsuccessful in its claims against the Company, the Company will incur legal fees and other costs in the defense of these claims.

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

**ROSETTA STONE INC.**

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

**15. INCOME TAXES**

The following table summarizes the significant components of the Company's deferred tax assets and liabilities as of December 31, 2011 and 2010 (in thousands):

	As of	
	December 31,	
	2011	2010
<b>Deferred tax assets:</b>		
Inventory	\$ 478	\$ 1,015
Amortization and depreciation	509	1,995
Net operating loss carryforwards	1,002	1,105
Deferred revenue	1,826	2,026
Accrued liabilities	9,117	8,714
Stock-based compensation	4,271	2,926
Bad debt reserve	770	698
Foreign currency translation	77	59
Foreign and other tax credits	1,704	—
	<u>19,754</u>	<u>18,538</u>
Valuation allowance	—	—
	<u>19,754</u>	<u>18,538</u>
<b>Deferred tax liabilities:</b>		
Prepaid expenses	727	876
Foreign currency translation loss	—	—
Other	4	5
	<u>731</u>	<u>881</u>
<b>Net deferred tax assets</b>	<b><u>\$ 19,023</u></b>	<b><u>\$ 17,657</u></b>
Net deferred tax assets as of December 31 are classified as follows:		
Current	\$ 10,985	\$ 11,159
Non-current	8,038	6,498
<b>Total</b>	<b><u>\$ 19,023</u></b>	<b><u>\$ 17,657</u></b>

During the quarter ended December 31, 2010, the Company determined that the relative weight of positive and negative evidence supported that it is more likely than not that the deferred tax assets relating to foreign operations will be realized and accordingly the Company released its valuation allowance. The Company had evaluated the valuation allowance on its foreign deferred tax assets quarterly prior to making the determination to release the valuation allowance during the quarter ended December 31, 2010. As of December 31, 2011, the Company had fully utilized the net operating loss ("NOL") carryforwards for United Kingdom income tax purposes and the NOL carryforwards for Japanese income tax purposes upon which the valuation allowance had been released.

At December 31, 2011, the Company had estimated state tax NOL carryforwards in the amount of \$12.5 million in the United States that if unutilized, would begin to expire in 2017. The state NOL's have a tax value of \$0.6 million. Additionally, the Company has \$0.4 million related to certain U.S. tax

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****15. INCOME TAXES (Continued)**

credit carryforwards which if unutilized, would expire between 2031 and 2032, foreign tax credit carryforwards of \$1.2 million which if unutilized, would expire in 2022, and a minimum tax credit carryforward of \$0.1 million which has an unlimited carryforward period.

If future events change the outcome of the Company's projected return to profitability, a valuation allowance may be required to reduce the deferred tax assets. However, currently no valuation allowance has been established for the Company's deferred tax assets as the Company believes such assets will more likely than not be realized. The company will continue to assess the need for a valuation allowance in the future.

The components of income (loss) before income taxes are as follows (in thousands):

	<b>Year Ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
United States	\$ (33,199)	\$ 1,683	\$ 19,030
Foreign	5,231	11,190	1,417
Income (loss) before income taxes	<u>\$ (27,968)</u>	<u>\$ 12,873</u>	<u>\$ 20,447</u>
The provision for taxes on income consists of the following (in thousands):			
Federal	\$ (8,758)	\$ 2,739	\$ 7,555
State	(582)	1,066	1,864
Foreign	3,458	1,738	140
Total current	<u>\$ (5,882)</u>	<u>\$ 5,543</u>	<u>\$ 9,559</u>
Deferred:			
Federal	\$ (682)	\$ (3,099)	\$ (1,917)
State	(870)	(456)	(430)
Foreign	(546)	(2,399)	(128)
Total deferred	<u>(2,098)</u>	<u>(5,954)</u>	<u>(2,475)</u>
Provision (benefit) for income taxes	<u>\$ (7,980)</u>	<u>\$ (411)</u>	<u>\$ 7,084</u>



ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. INCOME TAXES (Continued)

Reconciliation of income tax provision (benefit) computed at the U.S. federal statutory rate to income tax expense is as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Income tax expense at statutory federal rate	\$ (9,789)	\$ 4,506	\$ 7,157
State income tax expense, net of federal income tax effect	(869)	229	809
Domestic production activities deduction	580	(315)	(481)
Nondeductible LTIP expense	2,062	—	—
Nondeductible intercompany interest	29	134	205
Other nondeductible expenses	698	161	143
Tax rate differential on foreign operations	(206)	16	(192)
Increase (decrease) in valuation allowance	—	(4,872)	(566)
Other tax credits	(619)	—	—
Other	134	(270)	9
Income tax expense (benefit)	<u>\$ (7,980)</u>	<u>\$ (411)</u>	<u>\$ 7,084</u>

The Company adopted Accounting Standards Codification topic 740-10-25, *Income Taxes: Overall: Recognition*, ("ASC 740-10-25") on January 1, 2007, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Accounting Standards Codification topic 740, *Income Taxes*. 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 de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

A reconciliation of the beginning and ending amount of unrecognized tax benefits, excluding interest and penalties, is as follows (in thousands):

	2011
Balance at January 1,	\$ —
Increases for tax positions taken during prior period	—
Increases for tax positions taken during current period	165
Balance at December 31,	<u>\$ 165</u>

During the twelve months ended December 31, 2011 the Company established a liability under ASC 740-10 of \$165,000 for unrecognized tax benefits associated with certain tax credits and foreign withholding taxes. Interest and penalties related to uncertain tax positions are recorded as part of the provision for income taxes, which were zero at the adoption date and \$25,000 for the year ended December 31, 2011. These liabilities for unrecognized tax benefits are included in "Other Long Term Liabilities". As of December 31, 2011 and 2010, the Company had \$165,000 and zero of unrecognized tax benefits, respectively, which if recognized, would affect income tax expense. The Company does not expect that the amounts of unrecognized tax benefits will change significantly within the next twelve months.

**ROSETTA STONE INC.**

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

**15. INCOME TAXES (Continued)**

The Company is subject to taxation in the United States and various states and foreign jurisdictions. The Company's tax years 2010, 2009, 2008 and 2007 are subject to examination by the tax authorities. As of December 31, 2011, the Company is under audit in the United States for the tax year 2008 and Japan for tax years 2008, 2009 and 2010. While the ultimate results cannot be predicted with certainty, the Company believes that adjustments resulting from examinations, if any, will not have a material adverse effect on its consolidated financial condition or results of operations, and that the accrued tax liabilities are adequate for all years. No provision was made in 2011 for United States income taxes on undistributed earnings of the foreign subsidiaries as it is the Company's intention to utilize those earnings in the foreign operations for an indefinite period of time or to repatriate such earnings only when it is tax effective to do so.

The Company made income tax payments of \$1.7 million, \$10.0 million and \$6.4 million in 2011, 2010 and 2009, respectively.

**16. SEGMENT INFORMATION**

Beginning in 2011, the company was managed in two operating segments—Consumer and Institutional. These segments also represent our reportable segments. Management, specifically the chief operating decision maker, began to measure the performance of our operating segments in the first quarter of 2011 based upon operating segment revenue and operating segment contribution. Operating segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, research and development and selling, marketing, and administrative expenses. We do not allocate certain expenses, which include the majority of general and administrative expenses, facilities and communication expenses, purchasing expenses, manufacturing support and logistic expenses, depreciation and amortization, amortization of capitalized software development costs, and stock-based compensation. These expenses are included in the unallocated expenses section of the table presented below. Revenue from transactions between our operating segments is not material.

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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. SEGMENT INFORMATION (Continued)

Operating results by segment for the years ended December 31, 2011, 2010 and 2009, respectively were as follows (in thousands):

	Years Ended December 31,		
	2011	2010	2009
<b>Revenue:</b>			
Consumer	\$ 208,026	\$ 204,263	\$ 209,065
Institutional	60,423	54,605	43,206
Total Revenue	<u>\$ 268,449</u>	<u>\$ 258,868</u>	<u>\$ 252,271</u>
<b>Segment contribution:</b>			
Consumer	\$ 69,857	\$ 81,544	\$ 96,859
Institutional	35,620	37,069	29,892
Total segment contribution	<u>105,477</u>	<u>118,613</u>	<u>126,751</u>
<b>Unallocated expenses, net:</b>			
Amortization of acquired intangibles	36	3	—
Stock-based compensation	11,157	4,021	21,847
Unallocated cost of sales	22,337	12,130	9,115
Unallocated sales and marketing	25,822	18,795	13,871
Unallocated research and development	21,646	22,254	20,280
Unallocated general and administrative	52,886	48,513	41,106
Total unallocated expenses, net	<u>133,884</u>	<u>105,716</u>	<u>106,219</u>
<b>Operating income (loss)</b>	<u>(28,407)</u>	<u>12,897</u>	<u>20,532</u>
Other income, net	439	(24)	(85)
Income (loss) before provision for income taxes	<u>\$ (27,968)</u>	<u>\$ 12,873</u>	<u>\$ 20,447</u>

*Geographic Information*

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

The information below summarizes revenue from customers by geographic area for the years ended December 31, 2011, 2010 and 2009, respectively (in thousands):

	Years Ended December 31,		
	2011	2010	2009
United States	\$ 212,122	\$ 212,629	\$ 232,805
International	56,327	46,239	19,466
Total Revenue	<u>\$ 268,449</u>	<u>\$ 258,868</u>	<u>\$ 252,271</u>

**ROSETTA STONE INC.**

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

**16. SEGMENT INFORMATION (Continued)**

The information below summarizes long-lived assets by geographic area for the years ended December 31, 2011, 2010 and 2009, respectively (in thousands):

	As of December 31,		
	2011	2010	2009
United States	\$ 18,417	\$ 18,802	\$ 17,412
International	2,452	2,271	962
<b>Total</b>	<b>\$ 20,869</b>	<b>\$ 21,073</b>	<b>\$ 18,374</b>

**17. RELATED PARTIES**

As of December 31, 2011 and 2010, the Company had outstanding receivables from stockholders of zero, and outstanding receivables from employees in the amount of \$10,000 and \$8,000, respectively.

**18. VALUATION AND QUALIFYING ACCOUNTS**

The following table includes the Company's valuation and qualifying accounts for the respective periods (in thousands):

	Year Ended December 31,		
	2011	2010	2009
<b>Allowance for doubtful accounts:</b>			
Beginning balance	\$ 1,761	\$ 1,349	\$ 1,103
Charged to costs and expenses	1,228	1,750	911
Deductions—accounts written off	(1,038)	(1,338)	(665)
<b>Ending balance</b>	<b>1,951</b>	<b>1,761</b>	<b>1,349</b>
<b>Sales return reserve:</b>			
Beginning balance	8,391	4,708	3,229
Charged to costs and expenses	24,922	36,348	18,340
Deductions—reserves utilized	(23,382)	(32,665)	(16,861)
<b>Ending balance</b>	<b>9,931</b>	<b>8,391</b>	<b>4,708</b>
<b>Reserve for excess and obsolete inventory:</b>			
Beginning balance	2,388	765	470
Charged to costs and expenses	1,693	2,454	1,090
Deductions—reserves utilized	(2,833)	(831)	(795)
<b>Ending balance</b>	<b>1,248</b>	<b>2,388</b>	<b>765</b>
<b>Deferred income tax asset valuation allowance:</b>			
Beginning balance	—	5,012	5,263
Charged to costs and expenses	—	—	—
Deductions	—	(5,012)	(251)
<b>Ending balance</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 5,012</b>

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****19. SUPPLEMENTAL QUARTERLY FINANCIAL INFORMATION (Unaudited)**

Summarized quarterly supplemental consolidated financial information for 2011 and 2010 are as follows (in thousands, except per share amounts):

	Three Months Ended			
	March 31,	June 30,	September 30,	December 31,
<b>2011</b>				
Revenue	\$ 56,978	\$ 66,743	\$ 64,202	\$ 80,527
Gross profit	\$ 45,516	\$ 55,223	\$ 52,893	\$ 65,702
Net income (loss)	\$ (9,281)	\$ (4,550)	\$ (1,177)	\$ (4,979)
Basic loss per share	\$ (0.45)	\$ (0.22)	\$ (0.06)	\$ (0.24)
Shares used in basic per share computation	20,675	20,716	20,780	20,920
Diluted loss per share	\$ (0.45)	\$ (0.22)	\$ (0.06)	\$ (0.24)
Shares used in diluted per share computation	20,675	20,716	20,780	20,920
<b>2010</b>				
Revenue	\$ 63,014	\$ 60,648	\$ 60,926	\$ 74,280
Gross profit	\$ 54,372	\$ 53,046	\$ 50,497	\$ 61,954
Net income (loss)	\$ 5,005	\$ 3,699	\$ (385)	\$ 4,965
Basic income per share	\$ 0.25	\$ 0.18	\$ (0.02)	\$ 0.24
Shares used in basic per share computation	20,258	20,346	20,490	20,652
Diluted income per share	\$ 0.24	\$ 0.17	\$ (0.02)	\$ 0.23
Shares used in diluted per share computation	21,060	21,220	20,490	21,265

**20. SUBSEQUENT EVENTS**

On January 9, 2012, the Board of Directors of Rosetta Stone Inc. (the "Company") granted to certain executive officers and other key executives of the Company ("Executive") a special retention cash bonus and shares of restricted common stock of the Company. The special retention cash bonus will be paid to Executives in a single payment no later than January 31, 2013, in each case contingent upon the applicable Executive remaining an employee of the Company or one of its subsidiaries until December 31, 2012, or the earlier termination of the applicable Executive's employment by the Company or one of its subsidiaries without cause. The special retention restricted common stock of the Company will vest 50% on January 1, 2013, and 50% on January 1, 2014. The award of shares of restricted stock of the Company is subject to accelerated vesting upon the termination of an Executive's employment by the Company or one of its subsidiaries without cause. The objective of the retention awards is to provide an incentive for the Executives to remain with, and provide valuable leadership

**ROSETTA STONE INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****20. SUBSEQUENT EVENTS (Continued)**

and services to, the Company. The executive officers of the Company who will receive the retention awards are Michael S. Fulkerson, Chief Technology Officer, Pragnesh N. Shah, President, Global Consumer, Stephen M. Swad, Chief Financial Officer, Judy K. Verses, President, Global Institutions and Michael C. Wu, General Counsel and Secretary. The amounts of the special retention awards are set out in the table below:

<u>Executive Officer</u>	<u>Special Retention Cash Bonus Amount</u>	<u>Number of Shares of Restricted Stock Awarded</u>
Michael S. Fulkerson	\$ 150,000.00	21,246
Pragnesh N. Shah	\$ 25,000.00	3,541
Stephen M. Swad	\$ 150,000.00	63,739
Judy K. Verses	\$ 25,000.00	3,541
Michael C. Wu	\$ 100,000.00	14,164

In addition to the above named executives, fifteen other key employees were granted a special retention cash bonus and shares of restricted common stock of the Company. The total retention cash bonus was \$1.4 million and a total of 233,711 shares of restricted common stock with a grant date fair value of \$1.6 million were granted.

On January 9, 2012, the Board also granted to Stephen M. Swad 70,822 shares of restricted common stock of the Company in recognition of Mr. Swad's expanded operational role and overall responsibilities. The restricted common stock of the Company will vest 50% on January 1, 2013, and 50% on January 1, 2014. The award of shares of restricted stock of the Company is subject to accelerated vesting upon the termination of Mr. Swad's employment by the Company or one of its subsidiaries without cause.

The grants of restricted stock of the Company are made pursuant to the Rosetta Stone Inc. 2009 Omnibus Incentive Plan.

On February 22, 2012, the Board promoted Chief Financial Officer Stephen M. Swad, age 50, to President and Chief Executive Officer.

In connection with Mr. Swad's appointment as President and Chief Executive Officer, the Board increased Mr. Swad's base salary to \$500,000 and his target annual bonus to 100% of his base salary. The Board also awarded Mr. Swad 48,500 shares of restricted common stock and 125,000 stock options issued pursuant to the Company's 2009 Omnibus Incentive Plan.

## EXHIBIT INDEX

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- 2.1(1) Stock Purchase Agreement dated as of January 4, 2006, by and among Fairfield & Sons, Ltd., Rosetta Stone Inc., Rosetta Stone Holdings Inc., the Shareholders of Fairfield & Sons, Ltd., Tom Adams, and Eugene Stoltzfus
- 3.1(1) Second Amended and Restated Certificate of Incorporation
- 3.2(1) Second Amended and Restated Bylaws
- 4.1(1) Specimen certificate evidencing shares of common stock
- 4.2(1) Subscription Agreement dated as of January 4, 2006, by and among Rosetta Stone Inc., ABS Capital Partners IV, L.P., ABS Capital Partners IV A, L.P., ABS Capital Partners Offshore, L.P., ABS Capital Partners Special Offshore, L.P., Norwest Equity Partners VIII, L.P., Madison Capital Funding LLC, and Tom Adams
- 4.3(1) Registration Rights Agreement dated as of January 4, 2006 among Rosetta Stone Inc. and the Investor Shareholders and other Shareholders listed on Exhibit A Thereto
- 10.1+(1) 2006 Incentive Option Plan
- 10.2+(1) 2009 Omnibus Incentive Plan
- 10.3+(1) Director Form of Option Award Agreement under the 2006 Plan
- 10.4+(1) Executive Form of Option Award Agreement under the 2006 Plan
- 10.5+(1) Standard Form of Option Award Agreement under the 2006 Plan
- 10.6+(1) Form of Option Award Agreement under the 2009 Plan
- 10.7(1) Form of Indemnification Agreement entered into with each director and executive officer
- 10.8+(1) Executive Employment Agreement between Rosetta Stone Ltd. and Tom Adams dated February 20, 2009
- 10.9(1) Lease Agreement dated as of February 26, 2006, by and between Premier Flex Condos, LLC and Fairfield Language Technologies, Inc., as amended
- 10.10(1) Sublease Agreement dated as of October 6, 2008, by and between The Corporate Executive Board Company and Rosetta Stone Ltd.
- 10.11(1) Software License Agreement by and between The Regents of the University of Colorado and Fairfield & Sons, Ltd. dated as of December 22, 2006\*\*\*
- 10.12+(1) Form of Restricted Stock Award under the 2009 Plan
- 10.13(1) Credit Agreement dated as of January 16, 2009 between Rosetta Stone Ltd. and Wells Fargo Bank N.A.
- 10.14+(1) Executive Employment Agreement between Rosetta Stone Ltd. and Michael Wu dated February 20, 2009
- 10.15+(2) Executive Employment Agreement between Rosetta Stone Ltd. and Stephen Swad effective as of November 9, 2010

- 10.16+(3) Executive Employment Agreement between Rosetta Stone Ltd. and Helena Wong effective as of January 25, 2011
- 10.17+(4) Executive Employment Agreement between Rosetta Stone Ltd. and Michael Fulkerson effective as of May 31, 2011
- 10.18+ Executive Employment Agreement between Rosetta Stone Ltd. and Judy Verses effective as of October 5, 2011
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- 10.19+ Executive Employment Agreement between Rosetta Stone Ltd. and Pragnesh Shah effective as of November 14, 2011
- 10.20+ Amendment to Executive Employment Agreement between Rosetta Stone Ltd. and Michael Fulkerson effective as of December 22, 2011
- 10.21+ Amendment to Executive Employment Agreement between Rosetta Stone Ltd. and Michael Wu effective as of December 22, 2011
- 10.22+ Amendment to Executive Employment Agreement between Rosetta Stone Ltd. and Stephen Swad effective as of December 22, 2011
- 10.23+ Second Amendment to Executive Employment Agreement between Rosetta Stone Ltd. and Stephen Swad effective as of February 22, 2012
- 10.24+ Letter Agreement between Rosetta Stone Ltd. and Tom Adams dated October 12, 2011.
- 10.25+ Amended Executive Form of Option Award Agreement under 2009 Plan effective for awards after October 1, 2011.
- 10.26+ Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards after October 1, 2011.
- 10.27+ Amended Employee Form of Option Award Agreement Under 2009 Plan effective for awards after March 1, 2012.
- 10.28+ Amended Employee Form of Restricted Stock Award Agreement under 2009 Plan effective for awards after March 1, 2012.
- 10.29+ Severance and Release Agreement between Helena Wong and Rosetta Stone Ltd. effective as of October 17, 2011.
- 21.1 Rosetta Stone Inc. Subsidiaries
- 23.1 Consent of Deloitte & Touche LLP, independent registered public accounting firm
- 24.1 The Power of Attorney with Board of Directors' Signatures
- 31.1 Certifications of Principal Executive Officer and Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certifications of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101++ Interactive Data Files

\*\*\* Portions of this exhibit have been omitted pursuant to a request for confidential treatment.

+ Identifies management contracts and compensatory plans or arrangements.

++ Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or

prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

- (1) Incorporated by reference to exhibit filed with Registrant's registration statement on Form S-1 (File No. 333-153632), as amended.
  - (2) Incorporated by reference to exhibit filed with Rosetta Stone's Current Report on Form 8-K dated October 13, 2010.
  - (3) Incorporated by reference to exhibit filed with Rosetta Stone Form 10-K for the fiscal year ended December 31, 2010.
  - (4) Incorporated by reference to exhibit filed with Rosetta Stone Form 10-Q for the quarterly period ended June 30, 2011.
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**EXECUTIVE EMPLOYMENT AGREEMENT**

THIS EXECUTIVE EMPLOYMENT AGREEMENT (this “**Agreement**”) is made as of December 22, 2011, with an effective date of October 5, 2011, between Rosetta Stone Ltd., a Delaware corporation (together with its successors and assigns, the “**Company**”), and Judy Verses (“**Executive**”).

**Recitals**

A. The Company and Executive desire to enter into an agreement pursuant to which the Company will employ Executive as its President, Global Institutions subject to the terms and conditions of this Agreement.

**Agreement**

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants and promises contained herein, the parties agree as follows:

**1. Employment.**

The Company hereby engages Executive to serve as the President, Global Institutions of the Company, and Executive agrees to serve the Company, during the Service Term (as defined in Section 4 below) in the capacities, and subject to the terms and conditions, set forth in this Agreement.

**2. Duties.**

During the Service Term, Executive, as President, Global Institutions of the Company, shall have all the duties and responsibilities customarily rendered by President, Sales of companies of similar size and nature and such other duties and responsibilities as may be delegated from time to time by the Board or the Chief Executive Officer of the Company (“**Chief Executive Officer**”) in their sole discretion. Executive will report to the Chief Executive Officer.

Executive will devote her best efforts and substantially all of her business time and attention (except for vacation periods and periods of illness or other incapacity) to the business of the Company and its Affiliates. With the prior consent of the Chief Executive Officer, Executive will be permitted to serve on the boards of other companies so long as such service does not unreasonably interfere with her duties to the Company.

**3. Salary, Bonus and Benefits.**

The Board shall make all decisions related to Executive’s base salary and the payment of bonuses, if any. Executive’s Annual Base Salary and other compensation will be reviewed by the Board at least annually.

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(a) **Base Salary.** During the Service Term, the Company will pay Executive a base salary (the “**Annual Base Salary**”) as the Board may designate from time to time. The initial Annual Base Salary shall be at the rate of \$300,000 per annum paid in accordance with the Company’s customary payroll practices (minus all applicable withholdings and deductions). Executive’s Annual Base Salary for any partial year will be prorated based upon the number of days elapsed in such year. The Annual Base Salary may be increased (but not decreased) from time to time during the Service Term by the Board based upon the Company’s and Executive’s performance.

(b) **Bonus Plan.** Executive shall be eligible to receive an annual bonus in accordance with Company bonus policy to be established by the Board from time to time (the “**Annual Bonus**”). The Annual Bonus, if any, will be determined by the Board based upon the Company’s annual achievement of financial performance goals and other annual objectives as determined by the Board in good faith for each fiscal year of the Company. The Company will pay Executive the Annual Bonus for a given year, if any, in accordance with the terms of the then-current Company bonus policy. For 2011, Executive will be eligible to receive an Annual Bonus of up to seventy five percent (75%) of her 2011 Annual Base Salary upon 100% achievement of 2011 annual objectives. For subsequent years, the Annual Bonus target as a percentage of then-current Annual Base Salary, may be adjusted, but may not be less than 75% of the Executive’s then-current Annual Base Salary.

(c) **Benefits.**

(i) Executive and, to the extent eligible, her dependents, shall be entitled to participate in and receive all benefits under any welfare or pension benefit plans and programs made available to the Company’s senior level executives or to its employees generally (including, without limitation, medical, disability and life insurance programs, accidental death and dismemberment protection, leave and participation in retirement plans and deferred compensation plans), subject, however, to the generally applicable eligibility and other provisions of the various plans and programs and laws and regulations in effect from time to time.

(ii) The Company shall reimburse Executive for all reasonable, ordinary and necessary business, travel or entertainment expenses incurred during the Service Term in the performance of her services hereunder in accordance with the policies of the Company as they are from time to time in effect. Executive, as a condition precedent to obtaining such payment or reimbursement, shall provide to the Company any and all statements, bills or receipts evidencing the travel or out-of-pocket expenses for which Executive seeks payment or reimbursement, and any other information or materials, which the Company may from time to time reasonably require. The Company

shall reimburse Executive the amount of such an expense in accordance with the Company's expense reimbursement policy as in effect from time to time, but no later than two and one-half months following the end of the year in which Executive incurred the expense.

(iii) Executive shall be entitled to 22 paid vacation days and 3 paid sick days per annum which shall accrue pro rata during the applicable year and shall be

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entitled to medical, disability, family and other leave in accordance with Company policies as in effect from time to time for senior executives. Paid vacation and sick days not used by calendar year end shall be forfeited unless otherwise provided in the Company's vacation and sick leave policy.

(iv) Notwithstanding anything to the contrary contained above, the Company shall be entitled to terminate or reduce any employee benefit enjoyed by Executive pursuant to the provisions of this Section 3(c), but only if such reduction is part of an across-the-board reduction applicable to all executives of the Company who are entitled to such benefit and is permissible under the Code and the Employee Retirement Income Security Act of 1974, as amended.

#### 4. Employment Term.

Unless Executive's employment under this Agreement is sooner terminated as a result of Executive's resignation or termination in accordance with the provisions of Section 5 below, Executive's term of employment ("**Service Term**") under this Agreement shall commence on the date hereof and shall continue for a period of one (1) year, and at the end of each day it shall renew and extend automatically for an additional day so that the remaining Service Term is always one year; provided, however, that either party may terminate this Agreement pursuant to Section 5 below for any reason, with or without Cause or with or without Good Reason, as the case may be, at any time upon thirty (30) days prior written notice to the other party of its decision to terminate (except in the event of termination for Cause, whereupon Executive's termination shall be effective immediately upon written notice thereof except for any required grace periods for "Cause" as otherwise set forth below).

#### 5. Termination.

Executive's employment with the Company shall cease upon the first of the following events to occur:

(a) Executive's death.

(b) Executive's voluntary retirement at age 65 or older.

(c) Executive's "**Disability**", which means Executive is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, or (ii) Executive is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, receiving income replacement benefits for a period of not less than three (3) months under an accident and health plan covering employees of the Company. A determination of disability may be made by a physician selected or approved by the Chief Executive Officer and, in this respect, Executive shall submit to an examination by such physician upon request by the Chief Executive Officer. Any such termination for disability shall be only as expressly permitted by the Americans with Disabilities Act.

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(d) Termination by the Company by the delivery to Executive of a written notice from the Chief Executive Officer that Executive has been terminated ("**Notice of Termination**") with or without Cause. "**Cause**" shall mean termination for any of the following:

(i) Executive (A) commits a felony or a crime involving moral turpitude or commits any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of her employment by the Company which conduct damages the Company or an Affiliate; (b) substantially and repeatedly fails to perform duties of the office held by Executive as reasonably directed by the Board and/or Chief Executive Officer, (c) commits gross negligence or willful misconduct with respect to the Company or an Affiliate; (d) commits a material breach of this Agreement that is not cured within ten (10) days after receipt of written notice thereof from the Board and/or Chief Executive Officer; (e) fails, within ten (10) days after receipt by Executive of written notice thereof from the Board and/or Chief Executive Officer, to correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board and/or Chief Executive Officer reasonably believes does or may materially or adversely affect the Company's or an Affiliate's business or operations, (f) commits misconduct which is of such a serious or substantial nature that a reasonable likelihood exists that such misconduct will materially injure the reputation of the Company or an Affiliate, (g) harasses or discriminates against the Company's or an Affiliate's employees, customers or vendors in violation of the Company's policies with respect to such matters, (h) misappropriates funds or assets of the Company or an Affiliate for personal use or willfully violates the Company policies or standards of business conduct as determined in good faith by the Board and/or Chief Executive Officer, (i) fails, due to some action or inaction on the part of Executive, to have immigration status that permits Executive to maintain full-time employment with the Company in the United States in compliance with all applicable immigration law, or (j) discloses trade secrets of the Company or an Affiliate.

(e) Executive's voluntary resignation by the delivery to the Chief Executive Officer of a written notice from Executive that Executive has resigned with or without Good Reason. "Good Reason" shall mean Executive's resignation from employment with the Company within thirty (30) days after (i) a material diminution in Executive's annual salary, duties, authority or responsibilities from the annual salary, duties, authority or responsibilities as in effect at the commencement of the Service Term, (ii) the Company's failure to perform any material obligation undertaken by the Company to Executive hereunder after Executive has provided the Company with written notice of such failure and such failure has not thereafter been cured within ten (10) days of the delivery of such written notice or (iii) notice by the Company to Executive that her primary place of employment is to be relocated to a geographic area more than 50 miles from the Company's office in Arlington, Virginia, without Executive's consent.

## 6. Rights on Termination.

(a) If during the Service Term Executive's employment is terminated under Section 5 above (x) by the Company without Cause or (y) by Executive with Good Reason, then:

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(i) The Company shall pay to Executive, at the times specified in Section 6(a)(vii) below, the following amounts:

- (1) the Accrued Obligation;
- (2) a lump sum in cash equal to the product of (x) 1/12 of the amount of the Annual Base Salary in effect immediately prior to the Termination Date and (y) 12; and
- (3) a lump sum in cash equal to the product of (x) the monthly basic life insurance premium applicable to Executive's basic life insurance coverage immediately prior to the Termination Date and (y) 12. To the extent then available under the life insurance program, Executive may, at her option, convert her basic life insurance coverage to an individual policy after the Termination Date by completing the forms required by the Company for this purpose.

The amounts described in Section 6(a)(2) and (3) above shall be referred to herein as the "Severance Payments."

(ii) The Company will pay Executive the pro rata portion, if any, of Executive's Annual Bonus earned up until such Termination Date in accordance with the terms of the then-current Company bonus policy.

(iii) Upon Executive's termination, Executive and her spouse and eligible dependents, as applicable, may elect health care coverage for up to 18 months from her last day of work at the Company pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended ("COBRA"). Subject to Section 6(a)(vii) below, the Company will pay for up to twelve (12) months, on an after-tax basis, the portion of Executive's COBRA premiums for such coverage that exceeds the amount that Executive would have incurred in premiums for such coverage under the Company's health plan if then employed by the Company; provided, however, the Company's obligation shall only apply to the extent COBRA coverage is elected and in effect during such period. Following the twelve (12) months of coverage, Executive will be responsible for the full amount of all future premium payments should she wish to continue COBRA coverage. However, if Executive or her spouse becomes eligible for group health coverage sponsored by another employer (regardless of whether such coverage is actually elected) or for any other reason her COBRA coverage terminates, the Company shall not be obligated to pay any portion of the premiums provided hereunder for periods after she becomes eligible for such other coverage or her COBRA coverage terminates.

(iv) Subject to Executive's group health plan coverage continuation rights under COBRA the benefits listed in clause (iii) of this Section 6(a) shall be reduced to the extent benefits of the same type are received by or made available to Executive during such period, and provided, further, that Executive shall have the obligation to notify the Company that she is entitled to or receiving such benefits.

(v) Payments and benefits provided to Executive under this Section 6 (other than Accrued Obligations) are contingent upon Executive's execution of a release substantially in the form of **Exhibit A** hereto and such release becoming irrevocable.

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(vi) Executive shall not be permitted to specify the taxable year in which a payment described in this Section 6 shall be made to her.

(vii) The Company shall pay Executive the amounts specified in Sections 6(a)(i)(1), (2) and (3) within thirty (30) days after the Termination Date. Notwithstanding the forgoing, if the Executive is deemed on the Termination Date to be a Specified Employee, then with regard to any Severance Payment that is "deferred compensation" within the meaning of Section 409A and which is paid as a result of the Executive's Separation from Service such payment or benefit shall be made or provided at the date which is the earlier of (A) the expiration of the six (6)-month period measured from the date of such Separation from Service of the Executive, and (B) the date of the Executive's death (the "Delay Period"). Upon the expiration of the Delay Period, all payments and benefits delayed pursuant to the preceding sentence (whether they would have otherwise been payable in a single sum or in installments in the absence of such delay) shall be paid or reimbursed to the Executive in a lump sum with interest at the six (6)-month U.S. Treasury Rate in effect on the date of Executive's Separation From Service, and any remaining payments and benefits due under this Agreement shall be paid or provided in accordance with the normal payment dates specified for them herein. To the extent subject to a mandatory six-month delay in payment under Section 409A, the Company shall pay the amounts specified in Section 6(a)(iii) for the first six (6) month period commencing on the date of Executive's Separation From Service on the date that is six (6) months following the date of Executive's Separation From Service and shall also pay Executive the amount of interest that

would be earned on this amount until the date of payment calculated using an interest rate equal to the six (6) month U.S. Treasury Rate in effect on the date of Executive's Separation From Service.

(b) If the Company terminates Executive's employment for Cause, if Executive dies or is Disabled, or if Executive resigns without Good Reason, the Company's obligations to pay any compensation or benefits under this Agreement will cease effective as of the Termination Date and the Company shall pay to Executive the Accrued Obligation within thirty (30) days following the Termination Date. Following such payments, the Company shall have no further obligations to Executive other than as may be required by law or the terms of an employee benefit plan of the Company.

(c) Notwithstanding the foregoing, the Company's obligation to Executive for Severance Payments or other rights under either Sections 6(a) or (b) above shall cease if Executive is in violation of the provisions of Sections 8 or 9 below.

(d) If the Executive retires at age 65 or older, the Company shall pay the Executive's Annual Base Salary through the retirement date and shall also pay Executive the pro rata portion of any Annual Bonus that may have been earned by the Executive through the retirement date in accordance with the terms of the then-current Company bonus policy. No other amounts will be payable by the Company.

## 7. Representations of Executive.

Executive hereby represents and warrants to the Company that the statements contained in this Section 7 are true and accurate as of the date of this Agreement.

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(a) **Legal Proceedings.** Executive has not been (i) the subject of any criminal proceeding (other than a minor traffic violation or other minor offense) which has resulted in a conviction against Executive, nor is Executive the subject of any pending criminal proceeding (other than a minor traffic violation or other minor offense), (ii) indicted for, or charged in a court of competent jurisdiction with, any felony or crime of moral turpitude, (iii) the defendant in any civil complaint alleging damages in excess of \$50,000, or (iv) the defendant in any civil complaint alleging sexual harassment, unfair labor practices or discrimination in the work place.

(b) **Securities Law.** Executive has not been found in a civil action by the Securities and Exchange Commission, Commodity Futures Trading Commission, a state securities authority or any other regulatory agency to have violated any federal, state or other securities or commodities law.

(c) **Work History; Immigration Status.** Executive's resume, previously provided by Executive to the Company, is complete and correct in all material respects, and accurately reflects Executive's prior work history. Executive has the full legal right to be employed on a full-time basis by the Company in the United States under all applicable immigration laws on the basis of the Company's continued willingness to employ her on a full-time basis, and has provided the Company with evidence of legal immigration status and will do so at any time upon request. The Company will, if applicable, continue to cooperate with Executive in maintaining Executive's work visa status and/or any mutually agreeable adjustment of status.

(d) **Employment Restrictions.** Executive is not currently a party to any non competition, non-solicitation, confidentiality or other work-related agreement that limits or restricts Executive's ability to work in any particular field or in any particular geographic region, whether or not such agreement would be violated by this Agreement.

## 8. Confidential Information; Proprietary Information, etc.

(a) **Obligation to Maintain Confidentiality.** Executive acknowledges that any Proprietary Information disclosed or made available to Executive or obtained, observed or known by Executive as a direct or indirect consequence of her employment with or performance of services for the Company or any of its Affiliates during the course of her performance of services for, or employment with, any of the foregoing Persons (whether or not compensated for such services) and during the period in which Executive is receiving Severance Payments, are the property of the Company and its Affiliates. Therefore, Executive agrees that, other than in the course of performance of her duties as an employee of the Company, she will not at any time (whether during or after Executive's term of employment) disclose or permit to be disclosed to any Person or, directly or indirectly, utilize for her own account or permit to be utilized by any Person any Proprietary Information or records pertaining to the Company, its Affiliates and their respective business for any reason whatsoever without the Chief Executive Officer's consent, unless and to the extent that (except as otherwise provided in the definition of Proprietary Information) the aforementioned matters become generally known to and available for use by the public other than as a direct or indirect result of Executive's acts or omissions to act. Executive agrees to deliver to the Company at the termination of her employment, as a condition to receipt of the next or final payment of compensation, or at any other time the Company may request in writing (whether during or after Executive's term of employment), all records pertaining to the

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Company, its Affiliates and their respective business which she may then possess or have under her control. Executive further agrees that any property situated on the Company's or its Affiliates' premises and owned by the Company or its Affiliates, including disks and other storage media, filing cabinets or other work areas, is subject to inspection by Company or its Affiliates and their personnel at any time with or without notice. Nothing in this Section 8(a) shall be construed to prevent Executive from using her general knowledge and experience in future employment so long as Executive complies with this Section 8(a) and the other restrictions contained in this Agreement.

(b) **Ownership of Property.** Executive acknowledges that all inventions, innovations, improvements, developments, methods, processes, programs, designs, analyses, drawings, reports and all similar or related information (whether or not patentable) that relate to the Company's or any of its

Affiliates' actual or anticipated business, research and development, or existing or future products or services and that are conceived, developed, contributed to, made, or reduced to practice by Executive (either solely or jointly with others) while employed by the Company or any of its Affiliates (including any of the foregoing that constitutes any Proprietary Information or records) ("Work Product") belong to the Company or such Affiliate and Executive hereby assigns, and agrees to assign, all of the above Work Product to the Company or such Affiliate. Any copyrightable work prepared in whole or in part by Executive in the course of her work for any of the foregoing entities shall be deemed a "work made for hire" under the copyright laws, and the Company or such Affiliate shall own all rights therein. To the extent that any such copyrightable work is not a "work made for hire," Executive hereby assigns and agrees to assign to Company or such Affiliate all right, title and interest, including without limitation, copyright in and to such copyrightable work. Executive shall promptly disclose such Work Product and copyrightable work to the Chief Executive Officer and perform all actions reasonably requested by the Chief Executive Officer (whether during or after Executive's term of employment) to establish and confirm the Company's or its Affiliate's ownership (including, without limitation, execution of assignments, consents, powers of attorney and other instruments). Notwithstanding anything contained in this Section 8(b) to the contrary, the Company's ownership of Work Product does not apply to any invention that Executive develops entirely on her own time without using the equipment, supplies or facilities of the Company or Affiliates or any Proprietary Information (including trade secrets), except that the Company's ownership of Work Product does include those inventions that: (i) relate to the business of the Company or its Affiliates or to the actual or demonstrably anticipated research or development relating to the Company's business; or (ii) result from any work that Executive performs for the Company or its Affiliates.

(c) **Third Party Information.** Executive understands that the Company and its Affiliates will receive from third parties confidential or proprietary information ("Third Party Information") subject to a duty on the Company's and its Affiliates' part to maintain the confidentiality of such information and to use it only for certain limited purposes. During the term of Executive's employment and thereafter, and without in any way limiting the provisions of Sections 8(a) and 8(b) above, Executive shall hold Third Party Information in the strictest confidence and shall not disclose to anyone (other than personnel of the Company or its Affiliates who need to know such information in connection with their work for the Company or its Affiliates) or use, except in connection with her work for the Company or its Affiliates, Third Party Information unless expressly authorized by the Chief Executive Officer in writing.

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(d) **Use of Information of Prior Employers, etc.** Executive will abide by any enforceable obligations contained in any agreements that Executive has entered into with her prior employers or other parties to whom Executive has an obligation of confidentiality.

(e) **Compelled Disclosure.** If Executive is required by law or governmental regulation or by subpoena or other valid legal process to disclose any Proprietary Information or Third Party Information to any Person, Executive will immediately provide the Company with written notice of the applicable law, regulation or process so that the Company may seek a protective order or other appropriate remedy. Executive will cooperate fully with the Company and the Company's representatives in any attempt by the Company, at its sole cost and expense, to obtain any such protective order or other remedy. If the Company elects not to seek, or is unsuccessful in obtaining, any such protective order or other remedy in connection with any requirement that Executive disclose Proprietary Information or Third Party Information then Executive may disclose such Proprietary Information or Third Party Information to the extent legally required; provided, however, that Executive will use her reasonable best efforts to ensure that such Proprietary Information is treated confidentially by each Person to whom it is disclosed.

**9. Noncompetition and Nonsolicitation.**

(a) **Noncompetition and Nonsolicitation.**

During Executive's employment, and for a period of twelve (12) months following the termination of Executive's employment, Executive will not, within any geographic area served or supervised by Executive during the 12-month period immediately preceding the Termination Date:

- (1) render or offer any Competing Service or Product to any client or customer for whom Executive provided a Competing Service/Product on behalf of Company;
- (2) render or offer any Competing Service or Product to any Prospective Customer of Company; or,
- (3) participate in the recruitment or hiring of any Company employee to provide any Competing Service or Product.

"Competing Service or Product" means producing or selling software or services used for learning foreign languages, including English as a foreign language, and any other business carried on by the Company during Executive's employment. A "Prospective Customer" means any Person that the Executive, or other employee working under the Executive, has entertained discussions with to become a client or customer of Company at any time during the 12-month period immediately preceding the Termination Date and who has not explicitly rejected a business relationship with the Company. For purposes of this paragraph 9(a), "Company" includes Company and any Affiliate to which Executive provided services during her employment.

(b) **Acknowledgment.** Executive acknowledges that in the course of her employment with the Company and its Affiliates, she has and will become familiar with the trade

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secrets and other Proprietary Information of the Company and its Affiliates. Executive further acknowledges that as the President, Global Institutions of the Company, Executive has and will have direct or indirect responsibility, oversight or duties with respect to the businesses of the Company and its Affiliates



and its and their current and prospective employees, vendors, customers, clients and other business relations, and that, accordingly, the geographical restriction contained in this Section 9 is reasonable in all respects and necessary to protect the goodwill and Proprietary Information of the Company and that without such protection the Company's customer and client relations and competitive advantage would be materially adversely affected. It is specifically recognized by Executive that her services to the Company and its Affiliates are special, unique and of extraordinary value, that the Company has a protectable interest in prohibiting Executive as provided in this Section 9, that Executive is responsible for the growth and development of the Company and the creation and preservation of the Company's goodwill, that money damages are insufficient to protect such interests, that there is adequate consideration being provided to Executive hereunder, that such prohibitions are necessary and appropriate without regard to payments being made to Executive hereunder and that the Company would not enter this Agreement with Executive without the restriction of this Section 9. Executive further acknowledges that the restrictions contained in this Section 9 do not impose an undue hardship on her and, since she has general business skills that may be used in industries other than that in which the Company and its Affiliates conduct their business, do not deprive Executive of her livelihood. Executive further acknowledges that the provisions of this Section 9 are separate and independent of the other sections of this Agreement.

(c) **Enforcement, etc.** If, at the time of enforcement of Section 8 or 9 of this Agreement, a court concludes that the restrictions stated herein are unenforceable or unreasonable under circumstances then existing, the parties hereto agree that the unenforceable or unreasonable restriction should be severed from the Agreement and shall not affect the validity of enforceability of the other restrictions in Section 8 or 9. Because Executive's services are unique, because Executive has access to Proprietary Information and for the other reasons set forth herein, the parties hereto agree that money damages would be an inadequate remedy for any breach of this Agreement. Therefore, without limiting the generality of Section 12(f), in the event of a breach or threatened breach of this Agreement, the Company or its successors or assigns may, in addition to other rights and remedies existing in their favor, apply to any court of competent jurisdiction for specific performance and/or injunctive or other relief in order to enforce, or prevent any violations of, the provisions hereof (without posting a bond or other security).

(d) **Submission to Jurisdiction.** The parties hereby: (i) submit to the jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding arising out of or relating to Section 8 and/or 9 of this Agreement; (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court; and (iii) agree not to bring any action or proceeding arising out of or relating to Section 8 and/or 9 of this Agreement in any other court. The parties hereby waive any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law.

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## GENERAL PROVISIONS

### 10. **Definitions.**

**"Accrued Obligation"** means the sum of (a) Executive's Annual Base Salary through the Termination Date for periods through but not following her Separation From Service and (b) any accrued vacation pay earned by Executive, in each case, to the extent not theretofore paid.

**"Affiliate"** means, with respect to any particular Person, any other Person controlling, controlled by or under common control with such particular Person. A Subsidiary of the Company shall be an Affiliate of the Company.

**"Board"** means the Board of Directors of the Company or any committee of the Board, such as the Compensation Committee, to which the Board has delegated applicable authority.

**"Code"** means the Internal Revenue Code of 1986, as amended.

**"Person"** means any individual or corporation, association, partnership, limited liability company, joint venture, joint stock or other company, business trust, trust, organization, university, college, governmental authority or other entity of any kind.

**"Proprietary Information"** means any and all data and information concerning the business affairs of the Company or any of its Affiliates and not generally known in the industry in which the Company or any of its Affiliates is or may become engaged, and any other information concerning any matters affecting or relating to the Company's or its Affiliates businesses, but in any event Proprietary Information shall include, any of the Company's and its Affiliates' past, present or prospective business opportunities, including information concerning acquisition opportunities in or reasonably related to the Company's or its Affiliates' businesses or industries, customers, customer lists, clients, client lists, the prices the Company and its Affiliates obtain or have obtained from the sale of, or at which they sell or have sold, their products, unit volume of sales to past or present customers and clients, or any other information concerning the business of the Company and its Affiliates, their manner of operation, their plans, processes, figures, sales figures, projections, estimates, tax records, personnel history, accounting procedures, promotions, supply sources, contracts, know-how, trade secrets, information relating to research, development, inventions, technology, manufacture, purchasing, engineering, marketing, merchandising or selling, or other data without regard to whether all of the foregoing matters will be deemed confidential, material or important. Proprietary Information does not include any information that Executive has obtained from a Person other than an employee of the Company or an Affiliate, which was disclosed to her without a breach of a duty of confidentiality.

**"Section 409A"** means Section 409A of the Code and the final Department of Treasury regulations and formal guidance issued thereunder.

**"Separation From Service"** shall have the meaning ascribed to such term in Section 409A.

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“**Specified Employee**” means a person who is a “specified employee” within the meaning of Section 409A, taking into account the elections made and procedures established in resolutions adopted by the Board.

“**Subsidiary**” means any company of which the Company owns securities having a majority of the ordinary voting power in electing the board of directors directly or through one or more subsidiaries.

“**Termination Date**” means the effective date of the termination of Executive’s employment.

**11. Notices.**

Any notice provided for in this Agreement must be in writing and must be mailed, personally delivered or sent by reputable overnight courier service (charges prepaid) to the recipient at the address below indicated:

If to the Company:

Rosetta Stone Ltd.  
1919 North Lynn Street  
7<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: Chief Executive Officer

With a copy to:

Rosetta Stone Ltd.  
1919 North Lynn Street  
7<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: General Counsel

If to Executive:

Judy Verses  
c/o Rosetta Stone Ltd.  
1919 North Lynn Street  
7<sup>th</sup> Floor  
Arlington, VA 22209

or such other address or to the attention of such other person as the recipient party shall have specified by prior written notice to the sending party. Any notice under this Agreement will be deemed to have been given when delivered or, if mailed, five (5) business days after deposit in the U.S. mail.

**12. Miscellaneous.**

(a) **Severability.** Whenever possible, each provision of this Agreement will be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be invalid, illegal or unenforceable in any respect under any applicable law or rule in any jurisdiction, such invalidity, illegality or unenforceability will not affect any other provision or any other jurisdiction, but this Agreement will be reformed, construed and enforced in such jurisdiction as if such invalid, illegal or unenforceable provision had never been contained herein.

(b) **Complete Agreement.** This Agreement, those documents expressly referred to herein and other documents of even date herewith embody the complete agreement and understanding among the parties and supersede and preempt any prior understandings, agreements or representations by or among the parties, written or oral, which may have related to the subject matter hereof in any way.

(c) **Counterparts; Facsimile Transmission.** This Agreement may be executed in separate counterparts, each of which is deemed to be an original and all of which taken together constitute one and the same agreement. Each party to this Agreement agrees that its own telecopied signature will bind it and that it accepts the telecopied signature of each other party to this Agreement.

(d) **Successors and Assigns.** Except as otherwise provided herein, this Agreement shall bind and inure to the benefit of and be enforceable by Executive, the Company and their respective successors and assigns; provided that the rights and obligations of the parties under this Agreement shall not be assignable without the prior written consent of the other party, except for assignments by operation of law and assignments by the Company to any successor of the Company by merger, consolidation, combination or sale of assets. Any purported assignment in violation of these provisions shall be void *ab initio*.

(e) **Choice of Law; Jurisdiction.** All questions or disputes concerning this Agreement and the exhibits hereto will be governed by and construed in accordance with the internal laws of the Commonwealth of Virginia, without giving effect to any choice of law or conflict of law provision or

rule (whether of the Commonwealth of Virginia or any other jurisdiction) that would cause the application of the laws of any jurisdiction other than the Commonwealth of Virginia. The parties hereby: (i) submit to the non-exclusive jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding arising out of or relating to this Agreement; and (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court. Each party hereby waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law.

(f) **Remedies.** Each of the parties to this Agreement will be entitled to enforce its rights under this Agreement specifically, to recover damages and costs (including attorney's fees) caused by any breach of any provision of this Agreement and to exercise all other rights existing in its favor. The parties hereto agree and acknowledge that money damages may not be

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an adequate remedy for any breach of the provisions of this Agreement and that any party may in its sole discretion apply to any court of law or equity of competent jurisdiction (without posting any bond or deposit) for specific performance and/or other injunctive relief in order to enforce or prevent any violations of the provisions of this Agreement.

(g) **Amendment and Waiver.** The provisions of this Agreement may be amended or waived only with the prior written consent of the Company and Executive.

(h) **Business Days.** If any time period for giving notice or taking action hereunder expires on a day which is a Saturday, Sunday or holiday in the state in which the Company's chief executive office is located, the time period shall be automatically extended to the business day immediately following, such Saturday, Sunday or holiday. The provisions of this Section 12(h) shall not apply to determine the date an amount is payable under Section 3(c)(ii) or 6.

(i) **Termination.** This Agreement (except for the provisions of Sections 1, 2, 3, and 4) shall survive the termination of Executive's employment with the Company and shall remain in full force and effect after such termination.

(j) **No Waiver.** A waiver by any party hereto of any right or remedy hereunder on any one occasion shall not be construed as a bar to any right or remedy that such party would otherwise have on any future occasion. Neither failure to exercise nor any delay in exercising on the part of any party hereto, any right, power or privilege hereunder shall preclude any other or further exercise thereof or the exercise of any other right, power or privilege. The rights and remedies herein provided are cumulative and may be exercised singly or concurrently, and are not exclusive of any rights or remedies provided by law.

(k) **Insurance.** The Company, at its discretion, may apply for and procure in its own name for its own benefit life and/or disability insurance with respect to Executive in any amount or amounts considered available provided, however, that such procurement of insurance does not restrict the amount of insurance that Executive may obtain for her own personal use. Executive agrees to cooperate in any medical or other examination, supply any information, and to execute and deliver any applications or other instruments in writing as may be reasonably necessary to obtain and constitute such insurance. Executive hereby represents that she has no reason to believe that her life is not insurable at rates now prevailing for healthy men of her age.

(l) **Taxes; Withholding of Taxes on Behalf of Executive.** Executive shall be solely responsible for any and all taxes imposed on Executive by reason of any compensation and benefits provided under this Agreement, and all such compensation and benefits shall be subject to applicable withholding. Without limiting the scope of the preceding sentence, the Company and its Affiliates shall be entitled to deduct or withhold from any amounts owing from the Company or any of its Affiliates to Executive any federal, state, provincial, local or foreign withholding taxes, excise taxes, or employment taxes imposed with respect to Executive's compensation or other payments from the Company or any of its Affiliates or Executive's ownership interest in the Company, including, but not limited to, wages, bonuses, dividends, the receipt or exercise of stock options and/or the receipt or vesting of restricted stock.

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(m) **Waiver of Jury Trial.** BOTH PARTIES TO THIS AGREEMENT AGREE THAT ANY ACTION, DEMAND, CLAIM OR COUNTERCLAIM RELATING TO THE TERMS AND PROVISIONS OF THIS AGREEMENT, OR TO ITS BREACH, MAY BE COMMENCED IN THE COMMONWEALTH OF VIRGINIA IN A COURT OF COMPETENT JURISDICTION. BOTH PARTIES TO THIS AGREEMENT FURTHER AGREE THAT ANY ACTION, DEMAND, CLAIM OR COUNTERCLAIM SHALL BE RESOLVED BY A JUDGE ALONE, AND BOTH PARTIES HEREBY WAIVE AND FOREVER RENOUNCE THAT RIGHT TO A TRIAL BEFORE A CIVIL JURY.

### 13. **Certain Additional Payments by the Company; Code Section 280G.**

(a) Anything in this Agreement to the contrary notwithstanding, if any payment or benefit Executive would receive pursuant to this Agreement ("Payment") would (i) constitute a "parachute payment" within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the "Excise Tax"), then such Payment shall be reduced to the Reduced Amount. The "Reduced Amount" shall be either (x) the largest portion of the Payment that would result in no portion of the Payment being subject to the Excise Tax or (y) the largest portion, up to and including the total, of the Payment, whichever amount, after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate), results in Executive's receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting

“parachute payments” is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (B) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced.

(b) The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is (i) not be serving as accountant or auditor for the person who acquires ownership or effective control or ownership of a substantial portion of the Company’s assets (within the meaning of Section 280G of the Code) or any Affiliate of such person, and (ii) agreed upon by the Company and Executive (the “ **Accounting Firm**”) The Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder.

(c) The Accounting Firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and Eligible Employee within fifteen (15) business days after the date on which right to a Payment is triggered (if requested at that time by the Company or Executive) or such other time as requested by the Company or Executive. Any good faith determinations of the accounting firm made hereunder shall be final, binding and conclusive upon the Company and Executive.

**14. Indemnification.**

During and following the employment period, the Company shall indemnify Executive and hold Executive harmless from and against any claim, loss or cause of action arising from or out of Executive’s performance as an officer, director or employee of the Company or any of its Affiliates or in any other capacity, including any fiduciary capacity, in which Executive serves at the request of Company to the maximum extent permitted by applicable law and the Company’s By-Laws. Expenses incurred in defending or investigating a threatened or pending action, suit or proceeding shall be paid directly by the Company in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of Executive to repay such amount if it shall ultimately be determined that she is not entitled to be indemnified by the Company. To the extent that the Company reduces the indemnity rights provided for under its By-Laws after execution of this Agreement, the Company’s indemnity obligations hereunder shall be unaffected (to the extent permitted by applicable law).

*[Signature pages follow]*

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date first written above.

**EXECUTIVE**

By: /s/ Judy Verses  
Judy Verses

**ROSETTA STONE LTD.**

By: /s/ Tom Adams  
Title: Chief Executive Officer

**EXHIBIT A**

**Form of Release**

**CONSULT WITH AN ATTORNEY PRIOR TO SIGNING THIS AGREEMENT AND GENERAL RELEASE. BY SIGNING THIS AGREEMENT AND GENERAL RELEASE YOU GIVE UP AND WAIVE IMPORTANT LEGAL RIGHTS.**

This Agreement and General Release (“**Release**”) is between Rosetta Stone Ltd. (the “**Company**”) and Judy Verses (“**Executive**”) (each a “**Party**,” and together, the “**Parties**”). For purposes of this Release “Effective Date” shall mean the date that is the eighth day after the date on which Executive signs this Release, provided Executive has not revoked this Release pursuant to Section 2(c) below.

#### *Recitals*

- A. Executive and the Company are parties to an Employment Agreement to which this Release is appended as Exhibit A (the “**Employment Agreement**”).
- B. Executive wishes to receive the Severance Payments described Section 6(a) of the Employment Agreement.
- C. Executive and the Company wish to resolve, except as specifically set forth herein, all claims between them arising from or relating to any act or omission predating the Separation Date defined below.

#### *Agreement*

The Parties agree as follows:

1. Confirmation of Severance Benefit Obligation. The Company shall pay or provide to Executive the entire Severance Payments, as, when and on the terms and conditions specified in the Employment Agreement.

2. Legal Releases

(a) Executive, on behalf of Executive and Executive’s heirs, personal representatives and assigns, and any other person or entity that could or might act on behalf of Executive, including, without limitation, Executive’s counsel (all of whom are collectively referred to as “Executive Releasers”), hereby fully and forever releases and discharges the Company, its present and future affiliates and subsidiaries, and each of their past, present and future officers, directors, employees, shareholders, independent contractors, attorneys, insurers and any and all other persons or entities that are now or may become liable to any Executive Releaser due to any Executive Releasee’s act or omission, (all of whom are collectively referred to as “Executive Releasees”) of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys’ fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that Executive Releasers, or any person acting under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission occurring on or before the Effective Date, without regard to present actual knowledge of such acts or omissions, including specifically, but not by way of limitation, matters

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which may arise at common law, such as breach of contract, express or implied, promissory estoppel, wrongful discharge, tortious interference with contractual rights, infliction of emotional distress, defamation, or under federal, state or local laws, such as the Fair Labor Standards Act, the Employee Retirement Income Security Act, the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Equal Pay Act, the Americans with Disabilities Act, the Family and Medical Leave Act, and any civil rights law of any state or other governmental body; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Release, the release set forth in this Section shall not extend to: (i) any rights arising under this Release; (ii) any vested rights under any pension, retirement, profit sharing or similar plan; (iii) any rights Executive has under any grants of stock options, restricted stock, or other forms of equity that may have been provided to Executive during Executive’s employment (such grants to be governed by the applicable equity plan and grant agreement); (iv) any rights Executive has under applicable workers compensation laws; (v) Executive’s rights, if any, to indemnification, and/or defense under any Company certificate of incorporation, bylaw and/or policy or procedure, or under any insurance contract or any indemnification agreement with the Company, in connection with Executive’s acts or omissions within the course and scope of Executive’s employment with the Company; (vi) Executive’s ability to communicate with the Equal Employment Opportunity Commission (EEOC) or any other governmental agency, provided Executive does not seek any personal relief for any claims released herein; (vii) any claims arising after the date of Executive’s execution of this Release; (viii) any obligations of the Company under the Employment Agreement which survive Executive’s termination of employment; or (viii) any other claims that cannot lawfully be released. Executive hereby warrants that Executive has not assigned or transferred to any person any portion of any claim which is released, waived and discharged above. Executive further states and agrees that Executive has not experienced any illness, injury, or disability that is compensable or recoverable under the worker’s compensation laws of any state that was not reported to the Company by Executive before the Effective Date, and Executive agrees not to file a worker’s compensation claim asserting the existence of any such previously undisclosed illness, injury, or disability. Executive has specifically consulted with counsel with respect to the agreements, representations, and declarations set forth in the previous sentence. Executive understands and agrees that by signing this Release Executive is giving up any right to bring any legal claim against the Company concerning, directly or indirectly, Executive’s employment relationship with the Company, including Executive’s separation from employment. Executive agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of the Company, to include all actual or potential legal claims that Executive may have against the Company, except as specifically provided otherwise in this Release.

(b) In order to provide a full and complete release, each of the Parties understands and agrees that this Release is intended to include all claims, if any, covered under this Section 2 that such Party may have and not now know or suspect to exist in her or its favor against any other Party and that this Release extinguishes such claims. Thus, each of the Parties expressly waives all rights under any statute or common law principle in any jurisdiction that provides, in effect, that a general release does not extend to claims which the releasing party does not know or suspect to exist in her favor at the time of executing the release, which if known by her must have materially affected her settlement with the party being released.

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(c) Executive acknowledges that she consulted with an attorney of her choosing before signing this the Employment Agreement and this Release, and that the Company provided her with no fewer than twenty-one (21) days during which to consider the provisions of the Employment Agreement and this Release and, specifically the release set forth at Section 2(a) above, although Executive may sign and return the Release sooner if she so chooses. Executive further acknowledges that she has the right to revoke this Release for a period of seven (7) days after signing it and that this Release shall not become effective until such seven (7)-day period has expired. Executive acknowledges and agrees that if she wishes to revoke this Release, she must do so in writing, and that such revocation must be signed by Executive and received by the Company in care of the Chief Executive Officer no later than 5 p.m. (Eastern Time) on the seventh (7th) day after Executive has signed this Release. Executive acknowledges and agrees that, in the event that she revokes this Release, she shall have no right to receive the Severance Payments. Executive represents that she has read this Release, including the release set forth in Section 2(a), above, affirms that this Release and the Employment Agreement provide her with benefits to which she would not otherwise be entitled, and understands its terms and that she enters into this Release freely, voluntarily, and without coercion.

3. Executive acknowledges that she has received all compensation to which she is entitled for her work up to her last day of employment with the Company, and that she is not entitled to any further pay or benefit of any kind, for services rendered or any other reason, other than the Severance Payments.

4. Executive agrees that the only thing of value that she will receive by signing this Release is the Severance Payments.

5. The Parties agree that their respective rights and obligations under the Employment Agreement shall survive the execution of this Release.

6. The parties understand and agree that this Release shall not be construed as an admission of liability on the part of any person or entity, liability being expressly denied.

7. Executive represents and warrants to the Company that, prior to the Effective Date, Executive did not disclose to any person, other than to Executive's spouse, tax advisor and counsel, the terms of this Release or the circumstances under which the matter that is the subject of this Release has been resolved. After the Effective Date, neither Executive, counsel for Executive, nor any other person under Executive's control shall disclose any term of this Release or the circumstances of Executive's separation from the Company, except that Executive may disclose such information to Executive's spouse, or as required by subpoena or court order, or to an attorney or accountant to the extent necessary to obtain professional advice. Executive shall not be entitled to rely upon the foregoing exception for disclosures pursuant to subpoena or court order unless Executive has given the Company written notice, within three business days following service of the subpoena or court order.

8. Executive covenants never to disparage or speak ill of the Company or any the Company product or service, or of any past or present employee, officer or director of the Company, nor shall Executive at any time harass or behave unprofessionally toward any past, present or future the Company employee, officer or director.

9. Executive acknowledges that because of Executive's position with the Company, Executive may possess information that may be relevant to or discoverable in connection with claims, litigation or judicial, arbitral or investigative proceedings initiated by a private party or by a regulator, governmental entity, or self-regulatory organization, that relates to or arises from matters with which Executive was involved during Executive's employment with the Company, or that concern matters of which Executive has information or knowledge (collectively, a "Proceeding"). Executive agrees that Executive shall testify truthfully in connection with any such Proceeding, shall cooperate with the Company in connection with every such Proceeding, and that Executive's duty of cooperation shall include an obligation to meet with the Company representatives and/or counsel concerning all such Proceedings for such purposes, and at such times and places, as the Company reasonably requests, and to appear for deposition and/or testimony upon the Company's request and without a subpoena. The Company shall reimburse Executive for reasonable out-of-pocket expenses that Executive incurs in honoring Executive's obligation of cooperation under this Section 9.

10. Miscellaneous Terms and Conditions

(a) Each party understands and agrees that Executive or it assumes all risk that the facts or law may be, or become, different than the facts or law as believed by the party at the time Executive or it executes this Release. Executive and the Company acknowledge that their relationship precludes any affirmative obligation of disclosure, and expressly disclaim all reliance upon information supplied or concealed by the adverse party or its counsel in connection with the negotiation and/or execution of this Release.

(b) The parties warrant and represent that they have been offered no promise or inducement except as expressly provided in this Release, and that this Release is not in violation of or in conflict with any other agreement of either party.

(c) All covenants and warranties contained in this Release are contractual and shall survive the closing of this Release.

(d) This Release shall be binding in all respects upon, and shall inure to the benefit of, the parties' heirs, successors and assigns.

(e) This Release shall be governed by the internal laws of the Commonwealth of Virginia, irrespective of the choice of law rules of any jurisdiction.

(f) Should any provision of this Release be declared illegal or unenforceable by any court of competent jurisdiction and cannot be

modified to be enforceable, such provision shall immediately become null and void, leaving the remainder of this Release in full force and effect. Notwithstanding the foregoing, if Section 2(a), above, is declared void or unenforceable, then this Release shall be null and void and both parties shall be restored to the positions that they occupied before the Release's execution (meaning that, among other things, all sums paid by the Company pursuant to Section 1, above, shall be immediately refunded to the Company); provided that in such circumstances this Release and the facts and circumstances relating to its execution shall be inadmissible in any later proceeding between the parties, and the statutes of limitations applicable to claims asserted in the proceeding shall be deemed to have been tolled

for the period between the Effective Date and 10 days after the date on which Section 2(a) is declared unenforceable.

- (g) This Release constitutes the entire agreement of the parties and a complete merger of prior negotiations and agreements.
- (h) This Release shall not be modified except in a writing signed by the parties.
- (i) No term or condition of this Release shall be deemed to have been waived, nor shall there be an estoppel against the enforcement of any provision of this Release, except by a writing signed by the party charged with the waiver or estoppel. No waiver of any breach of this Release shall be deemed a waiver of any later breach of the same provision or any other provision of this Release.
- (j) Headings are intended solely as a convenience and shall not control the meaning or interpretation of any provision of this Release.
- (k) Pronouns contained in this Release shall apply equally to the feminine, neuter and masculine genders. The singular shall include the plural, and the plural shall include the singular.
- (l) Each party shall promptly execute, acknowledge and deliver any additional document or agreement that the other party reasonably believes is necessary to carry out the purpose or effect of this Release.
- (m) Any party contesting the validity or enforceability of any term of this Release shall be required to prove by clear and convincing evidence fraud, concealment, failure to disclose material information, unconscionability, misrepresentation or mistake of fact or law.
- (n) The parties acknowledge that they have reviewed this Release in its entirety and have had a full and fair opportunity to negotiate its terms and to consult with counsel of their own choosing concerning the meaning and effect of this Release. Each party therefore waives all applicable rules of construction that any provision of this Release should be construed against its drafter, and agrees that all provisions of the agreement shall be construed as a whole, according to the fair meaning of the language used.
- (o) Every dispute arising from or relating to this Release shall be tried only in the state or federal courts situated in the Commonwealth of Virginia. The parties consent to venue in those courts, and agree that those courts shall have personal jurisdiction over them in, and subject matter jurisdiction concerning, any such action.
- (p) In any action relating to or arising from this Release, or involving its application, the party substantially prevailing shall recover from the other party the expenses incurred by the prevailing party in connection with the action, including court costs and reasonable attorneys' fees.

(q) This Release may be executed in counterparts, or by copies transmitted by telecopier, all of which shall be given the same force and effect as the original.

[SIGNATURES FOLLOW]

**NOTE: DO NOT SIGN THIS SUPPLEMENTAL LEGAL RELEASE UNTIL AFTER EXECUTIVE'S FINAL DAY OF EMPLOYMENT.**

ROSETTA STONE LTD.

EXECUTIVE

By: \_\_\_\_\_  
[name, title]

\_\_\_\_\_  
Judy Verses

Date: \_\_\_\_\_

Date: \_\_\_\_\_





**EXECUTIVE EMPLOYMENT AGREEMENT**

THIS EXECUTIVE EMPLOYMENT AGREEMENT (this “**Agreement**”) is made as of February 24, 2012 with an effective date of November 14, 2011, between Rosetta Stone Ltd., a Delaware corporation (together with its successors and assigns, the “**Company**”), and Pragnesh Shah (“**Executive**”).

**Recitals**

A. The Company and Executive desire to enter into an agreement pursuant to which the Company will employ Executive as its President, Global Consumer subject to the terms and conditions of this Agreement.

**Agreement**

NOW, THEREFORE, in consideration of the foregoing and the mutual covenants and promises contained herein, the parties agree as follows:

**1. Employment.**

The Company hereby engages Executive to serve as the President, Global Consumer of the Company, and Executive agrees to serve the Company, during the Service Term (as defined in Section 4 below) in the capacities, and subject to the terms and conditions, set forth in this Agreement.

**2. Duties.**

During the Service Term, Executive, as President, Global Consumer of the Company, shall have all the duties and responsibilities customarily rendered by President, Marketing and Sales of companies of similar size and nature and such other duties and responsibilities as may be delegated from time to time by the Board or the Chief Executive Officer of the Company (“**Chief Executive Officer**”) in their sole discretion. Executive will report to the Chief Executive Officer.

Executive will devote his best efforts and substantially all of his business time and attention (except for vacation periods and periods of illness or other incapacity) to the business of the Company and its Affiliates. With the prior consent of the Chief Executive Officer, Executive will be permitted to serve on the boards of other companies so long as such service does not unreasonably interfere with his duties to the Company.

**3. Salary, Bonus and Benefits.**

The Board shall make all decisions related to Executive’s base salary and the payment of bonuses, if any. Executive’s Annual Base Salary and other compensation will be reviewed by the Board at least annually.

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(a) **Base Salary.** During the Service Term, the Company will pay Executive a base salary (the “**Annual Base Salary**”) as the Board may designate from time to time. The initial Annual Base Salary shall be at the rate of \$275,000 per annum paid in accordance with the Company’s customary payroll practices (minus all applicable withholdings and deductions). Executive’s Annual Base Salary for any partial year will be prorated based upon the number of days elapsed in such year. The Annual Base Salary may be increased (but not decreased) from time to time during the Service Term by the Board based upon the Company’s and Executive’s performance.

(b) **Bonus Plan.** Executive shall be eligible to receive an annual bonus in accordance with Company bonus policy to be established by the Board from time to time (the “**Annual Bonus**”). The Annual Bonus, if any, will be determined by the Board based upon the Company’s annual achievement of financial performance goals and other annual objectives as determined by the Board in good faith for each fiscal year of the Company. The Company will pay Executive the Annual Bonus for a given year, if any, in accordance with the terms of the then-current Company bonus policy. For 2011, Executive will be eligible to receive an Annual Bonus of up to seventy five percent (75%) of his Annual Base Salary upon 100% achievement of annual objectives. For subsequent years, the Annual Bonus target as a percentage of then-current Annual Base Salary, may be adjusted, but may not be less than 75% of the Executive’s then-current Annual Base Salary.

(c) **Equity.** Executive shall be eligible to receive annual grants of stock options and other equity awards in accordance with equity compensation arrangements established by the Board. The grants shall have such terms as are determined by the Board in accordance with the current stock plan in place at time of grant.

(d) **Benefits.**

(i) Executive and, to the extent eligible, his dependents, shall be entitled to participate in and receive all benefits under any welfare or pension benefit plans and programs made available to the Company’s senior level executives or to its employees generally (including, without limitation, medical, disability and life insurance programs, accidental death and dismemberment protection, leave and participation in retirement plans and deferred compensation plans), subject, however, to the generally applicable eligibility and other provisions of the various plans and programs and laws and regulations in effect from time to time.

(ii) The Company shall reimburse Executive for all reasonable, ordinary and necessary business, travel or entertainment expenses incurred during the Service Term in the performance of his services hereunder in accordance with the policies of the Company as they are from time to time in effect. Executive, as a condition precedent to obtaining such payment or reimbursement, shall provide to the Company any and all statements, bills or receipts evidencing the travel or out-of-pocket expenses for which Executive seeks payment or reimbursement, and any other information or materials, which the Company may from time to time reasonably require. The Company shall reimburse Executive the amount of such an expense in accordance with the Company's expense reimbursement policy as

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in effect from time to time, but no later than two and one-half months following the end of the year in which Executive incurred the expense.

(iii) Executive shall be entitled to 22 paid vacation days and 3 paid sick days per annum which shall accrue pro rata during the applicable year and shall be entitled to medical, disability, family and other leave in accordance with Company policies as in effect from time to time for senior executives. Paid vacation and sick days not used by calendar year end shall be forfeited unless otherwise provided in the Company's vacation and sick leave policy.

(iv) Notwithstanding anything to the contrary contained above, the Company shall be entitled to terminate or reduce any employee benefit enjoyed by Executive pursuant to the provisions of this Section 3(c), but only if such reduction is part of an across-the-board reduction applicable to all executives of the Company who are entitled to such benefit and is permissible under the Code and the Employee Retirement Income Security Act of 1974, as amended.

#### 4. Employment Term.

Unless Executive's employment under this Agreement is sooner terminated as a result of Executive's resignation or termination in accordance with the provisions of Section 5 below, Executive's term of employment ("**Service Term**") under this Agreement shall commence on the date hereof and shall continue for a period of one (1) year, and at the end of each day it shall renew and extend automatically for an additional day so that the remaining Service Term is always one year; provided, however, that either party may terminate this Agreement pursuant to Section 5 below for any reason, with or without Cause or with or without Good Reason, as the case may be, at any time upon thirty (30) days prior written notice to the other party of its decision to terminate (except in the event of termination for Cause, whereupon Executive's termination shall be effective immediately upon written notice thereof except for any required grace periods for "Cause" as otherwise set forth below).

#### 5. Termination.

Executive's employment with the Company shall cease upon the first of the following events to occur:

(a) Executive's death.

(b) Executive's voluntary retirement at age 65 or older.

(c) Executive's "**Disability**", which means Executive is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, or (ii) Executive is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, receiving income replacement benefits for a period of not less than three (3) months under an accident and health plan covering employees of the Company. A determination of disability may be made by a physician selected or approved

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by the Chief Executive Officer and, in this respect, Executive shall submit to an examination by such physician upon request by the Chief Executive Officer. Any such termination for disability shall be only as expressly permitted by the Americans with Disabilities Act.

(d) Termination by the Company by the delivery to Executive of a written notice from the Chief Executive Officer that Executive has been terminated ("**Notice of Termination**") with or without Cause. "**Cause**" shall mean termination for any of the following:

(i) Executive (A) commits a felony or a crime involving moral turpitude or commits any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of his employment by the Company which conduct damages the Company or an Affiliate; (b) substantially and repeatedly fails to perform duties of the office held by Executive as reasonably directed by the Board and/or Chief Executive Officer, (c) commits gross negligence or willful misconduct with respect to the Company or an Affiliate; (d) commits a material breach of this Agreement that is not cured within ten (10) days after receipt of written notice thereof from the Board and/or Chief Executive Officer; (e) fails, within ten (10) days after receipt by Executive of written notice thereof from the Board and/or Chief Executive Officer, to correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board and/or Chief Executive Officer reasonably believes does or may materially or adversely affect the Company's or an Affiliate's business or operations, (f) commits misconduct which is of such a serious or substantial nature that a reasonable likelihood exists that such misconduct will materially injure the reputation of the Company or an Affiliate, (g) harasses or discriminates against the Company's or an Affiliate's

employees, customers or vendors in violation of the Company's policies with respect to such matters, (h) misappropriates funds or assets of the Company or an Affiliate for personal use or willfully violates the Company policies or standards of business conduct as determined in good faith by the Board and/or Chief Executive Officer, (i) fails, due to some action or inaction on the part of Executive, to have immigration status that permits Executive to maintain full-time employment with the Company in the United States in compliance with all applicable immigration law, or (j) discloses trade secrets of the Company or an Affiliate.

(e) Executive's voluntary resignation by the delivery to the Chief Executive Officer of a written notice from Executive that Executive has resigned with or without Good Reason. "**Good Reason**" shall mean Executive's resignation from employment with the Company within thirty (30) days after (i) a material diminution in Executive's annual salary, duties, authority or responsibilities from the annual salary, duties, authority or responsibilities as in effect at the commencement of the Service Term, (ii) the Company's failure to perform any material obligation undertaken by the Company to Executive hereunder after Executive has provided the Company with written notice of such failure and such failure has not thereafter been cured within ten (10) days of the delivery of such written notice or (iii) notice by the Company to Executive that his primary place of employment is to be relocated to a geographic area more than 50 miles from the Company's office in Arlington, Virginia, without Executive's consent.

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## 6. **Rights on Termination.**

(a) If during the Service Term Executive's employment is terminated under Section 5 above (x) by the Company without Cause or (y) by Executive with Good Reason, then:

(i) The Company shall pay to Executive, at the times specified in Section 6(a)(vii) below, the following amounts:

- (1) the Accrued Obligation;
- (2) a lump sum in cash equal to the product of (x) 1/12 of the amount of the Annual Base Salary in effect immediately prior to the Termination Date and (y) 12; and
- (3) a lump sum in cash equal to the product of (x) the monthly basic life insurance premium applicable to Executive's basic life insurance coverage immediately prior to the Termination Date and (y) 12. To the extent then available under the life insurance program, Executive may, at his option, convert his basic life insurance coverage to an individual policy after the Termination Date by completing the forms required by the Company for this purpose.

The amounts described in Section 6(a) (i) (2) and (3) above shall be referred to herein as the "**Severance Payments.**"

(ii) The Company will pay Executive the pro rata portion, if any, of Executive's Annual Bonus earned up until such Termination Date, subject to the other terms and conditions of the then-current Company bonus policy (i.e., payment date, payment form, components of bonus policy, bonus target, etc.).

(iii) Upon Executive's termination, Executive and his spouse and eligible dependents, as applicable, may elect health care coverage for up to 18 months from his last day of work at the Company pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended ("**COBRA**"). Subject to Section 6(a)(vii) below, the Company will pay for up to twelve (12) months, on an after-tax basis, the portion of Executive's COBRA premiums for such coverage that exceeds the amount that Executive would have incurred in premiums for such coverage under the Company's health plan if then employed by the Company; provided, however, the Company's obligation shall only apply to the extent COBRA coverage is elected and in effect during such period. Following the twelve (12) months of coverage, Executive will be responsible for the full amount of all future premium payments should he wish to continue COBRA coverage. However, if Executive or his spouse becomes eligible for group health coverage sponsored by another employer (regardless of whether such coverage is actually elected) or for any other reason his COBRA coverage terminates, the Company shall not be obligated to pay any portion of the premiums provided hereunder for periods after he becomes eligible for such other coverage or his COBRA coverage terminates.

(iv) Subject to Executive's group health plan coverage continuation rights under COBRA the benefits listed in clause (iii) of this Section 6(a) shall be reduced to the extent benefits of the same type are received by or made available to Executive during such period, and

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provided, further, that Executive shall have the obligation to notify the Company that he is entitled to or receiving such benefits.

(v) Payments and benefits provided to Executive under this Section 6 (other than Accrued Obligations) are contingent upon Executive's execution of a release substantially in the form of **Exhibit A** hereto and such release becoming irrevocable.

(vi) Executive shall not be permitted to specify the taxable year in which a payment described in this Section 6 shall be made to him.

(vii) The Company shall pay Executive the amounts specified in Sections 6(a)(i)(1), (2) and (3) within thirty (30) days after the Termination Date. Notwithstanding the forgoing, if the Executive is deemed on the Termination Date to be a Specified Employee, then with regard to any Severance Payment that is "deferred compensation" within the meaning of Section 409A and which is paid as a result of the Executive's Separation from

Service such payment or benefit shall be made or provided at the date which is the earlier of (A) the expiration of the six (6)-month period measured from the date of such Separation from Service of the Executive, and (B) the date of the Executive's death (the "**Delay Period**"). Upon the expiration of the Delay Period, all payments and benefits delayed pursuant to the preceding sentence (whether they would have otherwise been payable in a single sum or in installments in the absence of such delay) shall be paid or reimbursed to the Executive in a lump sum with interest at the six (6)-month U.S. Treasury Rate in effect on the date of Executive's Separation From Service, and any remaining payments and benefits due under this Agreement shall be paid or provided in accordance with the normal payment dates specified for them herein. To the extent subject to a mandatory six-month delay in payment under Section 409A, the Company shall pay the amounts specified in Section 6(a)(iii) for the first six (6) month period commencing on the date of Executive's Separation From Service on the date that is six (6) months following the date of Executive's Separation From Service and shall also pay Executive the amount of interest that would be earned on this amount until the date of payment calculated using an interest rate equal to the six (6) month U.S. Treasury Rate in effect on the date of Executive's Separation From Service.

(b) If the Company terminates Executive's employment for Cause, if Executive dies or is Disabled, or if Executive resigns without Good Reason, the Company's obligations to pay any compensation or benefits under this Agreement will cease effective as of the Termination Date and the Company shall pay to Executive the Accrued Obligation within thirty (30) days following the Termination Date. Following such payments, the Company shall have no further obligations to Executive other than as may be required by law or the terms of an employee benefit plan of the Company.

(c) Notwithstanding the foregoing, the Company's obligation to Executive for Severance Payments or other rights under either Sections 6(a) or (b) above shall cease if Executive is in violation of the provisions of Sections 8 or 9 below.

(d) If the Executive retires at age 65 or older, the Company shall pay the Executive's Annual Base Salary through the retirement date and shall also pay Executive the pro rata portion of any Annual Bonus that may have been earned by the Executive through the retirement date in

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accordance with the terms of the then-current Company bonus policy. No other amounts will be payable by the Company.

## 7. Representations of Executive.

Executive hereby represents and warrants to the Company that the statements contained in this Section 7 are true and accurate as of the date of this Agreement.

(a) **Legal Proceedings.** Executive has not been (i) the subject of any criminal proceeding (other than a minor traffic violation or other minor offense) which has resulted in a conviction against Executive, nor is Executive the subject of any pending criminal proceeding (other than a minor traffic violation or other minor offense), (ii) indicted for, or charged in a court of competent jurisdiction with, any felony or crime of moral turpitude, (iii) the defendant in any civil complaint alleging damages in excess of \$50,000, or (iv) the defendant in any civil complaint alleging sexual harassment, unfair labor practices or discrimination in the work place.

(b) **Securities Law.** Executive has not been found in a civil action by the Securities and Exchange Commission, Commodity Futures Trading Commission, a state securities authority or any other regulatory agency to have violated any federal, state or other securities or commodities law.

(c) **Work History; Immigration Status.** Executive's resume, previously provided by Executive to the Company, is complete and correct in all material respects, and accurately reflects Executive's prior work history. Executive has the full legal right to be employed on a full-time basis by the Company in the United States under all applicable immigration laws on the basis of the Company's continued willingness to employ him on a full-time basis, and has provided the Company with evidence of legal immigration status and will do so at any time upon request. The Company will, if applicable, continue to cooperate with Executive in maintaining Executive's work visa status and/or any mutually agreeable adjustment of status.

(d) **Employment Restrictions.** Executive is not currently a party to any non competition, non-solicitation, confidentiality or other work-related agreement that would be violated by the terms and conditions of this Agreement.

## 8. Confidential Information; Proprietary Information, etc.

(a) **Obligation to Maintain Confidentiality.** Executive acknowledges that any Proprietary Information disclosed or made available to Executive or obtained, observed or known by Executive as a direct or indirect consequence of his employment with or performance of services for the Company or any of its Affiliates during the course of his performance of services for, or employment with, any of the foregoing Persons (whether or not compensated for such services) and during the period in which Executive is receiving Severance Payments, are the property of the Company and its Affiliates. Therefore, Executive agrees that, other than in the course of performance of his duties as an employee of the Company, he will not at any time (whether during or after Executive's term of employment) disclose or permit to be disclosed to any Person or, directly or indirectly, utilize for his own account or permit to be utilized by any Person any Proprietary Information or records pertaining to the Company, its Affiliates and their respective business for any reason whatsoever without the Chief Executive Officer's consent,

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unless and to the extent that (except as otherwise provided in the definition of Proprietary Information) the aforementioned matters become generally known to and available for use by the public other than as a direct or indirect result of Executive's acts or omissions to act. Executive agrees to deliver to the Company at

the termination of his employment, as a condition to receipt of the next or final payment of compensation, or at any other time the Company may request in writing (whether during or after Executive's term of employment), all records pertaining to the Company, its Affiliates and their respective business which he may then possess or have under his control. Executive further agrees that any property situated on the Company's or its Affiliates' premises and owned by the Company or its Affiliates, including disks and other storage media, filing cabinets or other work areas, is subject to inspection by Company or its Affiliates and their personnel at any time with or without notice. Nothing in this Section 8(a) shall be construed to prevent Executive from using his general knowledge and experience in future employment so long as Executive complies with this Section 8(a) and the other restrictions contained in this Agreement.

**(b) Ownership of Property.** Executive acknowledges that all inventions, innovations, improvements, developments, methods, processes, programs, designs, analyses, drawings, reports and all similar or related information (whether or not patentable) that relate to the Company's or any of its Affiliates' actual or anticipated business, research and development, or existing or future products or services and that are conceived, developed, contributed to, made, or reduced to practice by Executive (either solely or jointly with others) while employed by the Company or any of its Affiliates (including any of the foregoing that constitutes any Proprietary Information or records) ("**Work Product**") belong to the Company or such Affiliate and Executive hereby assigns, and agrees to assign, all of the above Work Product to the Company or such Affiliate. Any copyrightable work prepared in whole or in part by Executive in the course of his work for any of the foregoing entities shall be deemed a "work made for hire" under the copyright laws, and the Company or such Affiliate shall own all rights therein. To the extent that any such copyrightable work is not a "work made for hire," Executive hereby assigns and agrees to assign to Company or such Affiliate all right, title and interest, including without limitation, copyright in and to such copyrightable work. Executive shall promptly disclose such Work Product and copyrightable work to the Chief Executive Officer and perform all actions reasonably requested by the Chief Executive Officer (whether during or after Executive's term of employment) to establish and confirm the Company's or its Affiliate's ownership (including, without limitation, execution of assignments, consents, powers of attorney and other instruments). Notwithstanding anything contained in this Section 8(b) to the contrary, the Company's ownership of Work Product does not apply to any invention that Executive develops entirely on his own time without using the equipment, supplies or facilities of the Company or Affiliates or any Proprietary Information (including trade secrets), except that the Company's ownership of Work Product does include those inventions that: (i) relate to the business of the Company or its Affiliates or to the actual or demonstrably anticipated research or development relating to the Company's business; or (ii) result from any work that Executive performs for the Company or its Affiliates.

**(c) Third Party Information.** Executive understands that the Company and its Affiliates will receive from third parties confidential or proprietary information ("**Third Party Information**") subject to a duty on the Company's and its Affiliates' part to maintain the confidentiality of such information and to use it only for certain limited purposes. During the

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term of Executive's employment and thereafter, and without in any way limiting the provisions of Sections 8(a) and 8(b) above, Executive shall hold Third Party Information in the strictest confidence and shall not disclose to anyone (other than personnel of the Company or its Affiliates who need to know such information in connection with their work for the Company or its Affiliates) or use, except in connection with his work for the Company or its Affiliates, Third Party Information unless expressly authorized by the Chief Executive Officer in writing.

**(d) Use of Information of Prior Employers, etc.** Executive will abide by any enforceable obligations contained in any agreements that Executive has entered into with his prior employers or other parties to whom Executive has an obligation of confidentiality.

**(e) Compelled Disclosure.** If Executive is required by law or governmental regulation or by subpoena or other valid legal process to disclose any Proprietary Information or Third Party Information to any Person, Executive will immediately provide the Company with written notice of the applicable law, regulation or process so that the Company may seek a protective order or other appropriate remedy. Executive will cooperate fully with the Company and the Company's representatives in any attempt by the Company, at its sole cost and expense, to obtain any such protective order or other remedy. If the Company elects not to seek, or is unsuccessful in obtaining, any such protective order or other remedy in connection with any requirement that Executive disclose Proprietary Information or Third Party Information then Executive may disclose such Proprietary Information or Third Party Information to the extent legally required; provided, however, that Executive will use his reasonable best efforts to ensure that such Proprietary Information is treated confidentially by each Person to whom it is disclosed.

## **9. Noncompetition and Nonsolicitation.**

### **(a) Noncompetition and Nonsolicitation.**

During Executive's employment, and for a period of twelve (12) months following the termination of Executive's employment, Executive will not, within any geographic area served or supervised by Executive during the 12-month period immediately preceding the Termination Date:

- (1) render or offer any Competing Service or Product to any client or customer for whom Executive provided a Competing Service/Product on behalf of Company;
- (2) render or offer any Competing Service or Product to any Prospective Customer of Company; or,
- (3) participate in the recruitment or hiring of any Company employee to provide any Competing Service or Product.

"Competing Service or Product" means producing or selling software or services used for learning foreign languages, including English as a foreign language, and any other business carried on by the Company during Executive's employment. A "Prospective Customer" means any Person that the Executive, or other employee working under the Executive, has entertained discussions with to become a client or customer of Company at any time during the 12-month

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period immediately preceding the Termination Date and who has not explicitly rejected a business relationship with the Company. For purposes of this paragraph 9(a), "Company" includes Company and any Affiliate to which Executive provided services during his employment.

(b) **Acknowledgment.** Executive acknowledges that in the course of his employment with the Company and its Affiliates, he has and will become familiar with the trade secrets and other Proprietary Information of the Company and its Affiliates. Executive further acknowledges that as the President, Global Consumer of the Company, Executive has and will have direct or indirect responsibility, oversight or duties with respect to the businesses of the Company and its Affiliates and its and their current and prospective employees, vendors, customers, clients and other business relations, and that, accordingly, the geographical restriction contained in this Section 9 is reasonable in all respects and necessary to protect the goodwill and Proprietary Information of the Company and that without such protection the Company's customer and client relations and competitive advantage would be materially adversely affected. It is specifically recognized by Executive that his services to the Company and its Affiliates are special, unique and of extraordinary value, that the Company has a protectable interest in prohibiting Executive as provided in this Section 9, that Executive is responsible for the growth and development of the Company and the creation and preservation of the Company's goodwill, that money damages are insufficient to protect such interests, that there is adequate consideration being provided to Executive hereunder, that such prohibitions are necessary and appropriate without regard to payments being made to Executive hereunder and that the Company would not enter this Agreement with Executive without the restriction of this Section 9. Executive further acknowledges that the restrictions contained in this Section 9 do not impose an undue hardship on him and, since he has general business skills that may be used in industries other than that in which the Company and its Affiliates conduct their business, do not deprive Executive of his livelihood. Executive further acknowledges that the provisions of this Section 9 are separate and independent of the other sections of this Agreement.

(c) **Enforcement, etc.** If, at the time of enforcement of Section 8 or 9 of this Agreement, a court concludes that the restrictions stated herein are unenforceable or unreasonable under circumstances then existing, the parties hereto agree that the unenforceable or unreasonable restriction should be severed from the Agreement and shall not affect the validity of enforceability of the other restrictions in Section 8 or 9. Because Executive's services are unique, because Executive has access to Proprietary Information and for the other reasons set forth herein, the parties hereto agree that money damages would be an inadequate remedy for any breach of this Agreement. Therefore, without limiting the generality of Section 12(f), in the event of a breach or threatened breach of this Agreement, the Company or its successors or assigns may, in addition to other rights and remedies existing in their favor, apply to any court of competent jurisdiction for specific performance and/or injunctive or other relief in order to enforce, or prevent any violations of, the provisions hereof (without posting a bond or other security).

(d) **Submission to Jurisdiction.** The parties hereby: (i) submit to the jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding arising out of or relating to Section 8 and/or 9 of this Agreement; (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court; and (iii)

agree not to bring any action or proceeding arising out of or relating to Section 8 and/or 9 of this Agreement in any other court. The parties hereby waive any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law.

## GENERAL PROVISIONS

### 10. **Definitions.**

"**Accrued Obligation**" means the sum of (a) Executive's Annual Base Salary through the Termination Date for periods through but not following his Separation From Service and (b) any accrued vacation pay earned by Executive, in each case, to the extent not theretofore paid.

"**Affiliate**" means, with respect to any particular Person, any other Person controlling, controlled by or under common control with such particular Person. A Subsidiary of the Company shall be an Affiliate of the Company.

"**Board**" means the Board of Directors of the Company or any committee of the Board, such as the Compensation Committee, to which the Board has delegated applicable authority.

"**Code**" means the Internal Revenue Code of 1986, as amended.

"**Person**" means any individual or corporation, association, partnership, limited liability company, joint venture, joint stock or other company, business trust, trust, organization, university, college, governmental authority or other entity of any kind.

"**Proprietary Information**" means any and all data and information concerning the business affairs of the Company or any of its Affiliates and not generally known in the industry in which the Company or any of its Affiliates is or may become engaged, and any other information concerning any matters affecting or relating to the Company's or its Affiliates' businesses, but in any event Proprietary Information shall include, any of the Company's and its Affiliates' past, present or prospective business opportunities, including information concerning acquisition opportunities in or reasonably related to the Company's or its Affiliates' businesses or industries, customers, customer lists, clients, client lists, the prices the Company and its Affiliates obtain or have obtained from the sale of, or at which they sell or have sold, their products, unit volume of sales to past or present customers and clients, or any other information concerning the business of the Company and its Affiliates, their manner of operation, their plans, processes, figures, sales figures, projections, estimates, tax records, personnel history, accounting procedures, promotions, supply sources, contracts, know-how, trade secrets, information relating to

research, development, inventions, technology, manufacture, purchasing, engineering, marketing, merchandising or selling, or other data without regard to whether all of the foregoing matters will be deemed confidential, material or important. Proprietary Information does not include any information that Executive has obtained from a Person other than an employee of the Company or an Affiliate, which was disclosed to him without a breach of a duty of confidentiality.

“**Section 409A**” means Section 409A of the Code and the final Department of Treasury regulations and formal guidance issued thereunder.

“**Separation From Service**” shall have the meaning ascribed to such term in Section 409A.

“**Specified Employee**” means a person who is a “specified employee” within the meaning of Section 409A, taking into account the elections made and procedures established in resolutions adopted by the Board.

“**Subsidiary**” means any company of which the Company owns securities having a majority of the ordinary voting power in electing the board of directors directly or through one or more subsidiaries.

“**Termination Date**” means the effective date of the termination of Executive’s employment.

**11. Notices.**

Any notice provided for in this Agreement must be in writing and must be mailed, personally delivered or sent by reputable overnight courier service (charges prepaid) to the recipient at the address below indicated:

If to the Company:

Rosetta Stone Ltd.  
1919 North Lynn Street  
7<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: Chief Executive Officer

With a copy to:

Rosetta Stone Ltd.  
1919 North Lynn Street  
7<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: General Counsel

If to Executive:

Pragnesh Shah  
7279 Evans Mill Rd  
McLean, VA 22101

With a Copy to:  
Venable LLP

c/o Mr. Art Cirulnick  
575 7th St Northwest  
Washington D.C. 20004

or such other address or to the attention of such other person as the recipient party shall have specified by prior written notice to the sending party. Any notice under this Agreement will be deemed to have been given when delivered or, if mailed, five (5) business days after deposit in the U.S. mail.

**12. Miscellaneous.**

(a) **Severability.** Whenever possible, each provision of this Agreement will be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be invalid, illegal or unenforceable in any respect under any applicable law or rule in any jurisdiction, such invalidity, illegality or unenforceability will not affect any other provision or any other jurisdiction, but this Agreement will be reformed, construed and enforced in such jurisdiction as if such invalid, illegal or unenforceable provision had never been contained herein.

(b) **Complete Agreement.** This Agreement, those documents expressly referred to herein and other documents of even date herewith embody

the complete agreement and understanding among the parties and supersede and preempt any prior understandings, agreements or representations by or among the parties, written or oral, which may have related to the subject matter hereof in any way.

(c) **Counterparts; Facsimile Transmission.** This Agreement may be executed in separate counterparts, each of which is deemed to be an original and all of which taken together constitute one and the same agreement. Each party to this Agreement agrees that its own telecopied signature will bind it and that it accepts the telecopied signature of each other party to this Agreement.

(d) **Successors and Assigns.** Except as otherwise provided herein, this Agreement shall bind and inure to the benefit of and be enforceable by Executive, the Company and their respective successors and assigns; provided that the rights and obligations of the parties under this Agreement shall not be assignable without the prior written consent of the other party, except for assignments by operation of law and assignments by the Company to any successor of the Company by merger, consolidation, combination or sale of assets. Any purported assignment in violation of these provisions shall be void *ab initio*.

(e) **Choice of Law; Jurisdiction.** All questions or disputes concerning this Agreement and the exhibits hereto will be governed by and construed in accordance with the internal laws of the Commonwealth of Virginia, without giving effect to any choice of law or conflict of law provision or rule (whether of the Commonwealth of Virginia or any other jurisdiction) that would cause the application of the laws of any jurisdiction other than the Commonwealth of Virginia. The parties hereby: (i) submit to the non-exclusive jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding

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arising out of or relating to this Agreement; and (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court. Each party hereby waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law.

(f) **Remedies.** Each of the parties to this Agreement will be entitled to enforce its rights under this Agreement specifically, to recover damages and costs (including attorney's fees) caused by any breach of any provision of this Agreement and to exercise all other rights existing in its favor. The parties hereto agree and acknowledge that money damages may not be an adequate remedy for any breach of the provisions of this Agreement and that any party may in its sole discretion apply to any court of law or equity of competent jurisdiction (without posting any bond or deposit) for specific performance and/or other injunctive relief in order to enforce or prevent any violations of the provisions of this Agreement.

(g) **Amendment and Waiver.** The provisions of this Agreement may be amended or waived only with the prior written consent of the Company and Executive.

(h) **Business Days.** If any time period for giving notice or taking action hereunder expires on a day which is a Saturday, Sunday or holiday in the state in which the Company's chief executive office is located, the time period shall be automatically extended to the business day immediately following, such Saturday, Sunday or holiday. The provisions of this Section 12(h) shall not apply to determine the date an amount is payable under Section 3(c)(ii) or 6.

(i) **Termination.** This Agreement (except for the provisions of Sections 1, 2, 3, and 4) shall survive the termination of Executive's employment with the Company and shall remain in full force and effect after such termination.

(j) **No Waiver.** A waiver by any party hereto of any right or remedy hereunder on any one occasion shall not be construed as a bar to any right or remedy that such party would otherwise have on any future occasion. Neither failure to exercise nor any delay in exercising on the part of any party hereto, any right, power or privilege hereunder shall preclude any other or further exercise thereof or the exercise of any other right, power or privilege. The rights and remedies herein provided are cumulative and may be exercised singly or concurrently, and are not exclusive of any rights or remedies provided by law.

(k) **Insurance.** The Company, at its discretion, may apply for and procure in its own name for its own benefit life and/or disability insurance with respect to Executive in any amount or amounts considered available provided, however, that such procurement of insurance does not restrict the amount of insurance that Executive may obtain for his own personal use. Executive agrees to cooperate in any medical or other examination, supply any information, and to execute and deliver any applications or other instruments in writing as may be reasonably necessary to obtain and constitute such insurance. Executive hereby represents that he has no reason to believe that his life is not insurable at rates now prevailing for healthy men of his age.

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(l) **Taxes; Withholding of Taxes on Behalf of Executive.** Executive shall be solely responsible for any and all taxes imposed on Executive by reason of any compensation and benefits provided under this Agreement, and all such compensation and benefits shall be subject to applicable withholding. Without limiting the scope of the preceding sentence, the Company and its Affiliates shall be entitled to deduct or withhold from any amounts owing from the Company or any of its Affiliates to Executive any federal, state, provincial, local or foreign withholding taxes, excise taxes, or employment taxes imposed with respect to Executive's compensation or other payments from the Company or any of its Affiliates or Executive's ownership interest in the Company, including, but not limited to, wages, bonuses, dividends, the receipt or exercise of stock options and/or the receipt or vesting of restricted stock.

(m) **Waiver of Jury Trial. BOTH PARTIES TO THIS AGREEMENT AGREE THAT ANY ACTION, DEMAND, CLAIM OR COUNTERCLAIM RELATING TO THE TERMS AND PROVISIONS OF THIS AGREEMENT, OR TO ITS BREACH, MAY BE**



COMMENCED IN THE COMMONWEALTH OF VIRGINIA IN A COURT OF COMPETENT JURISDICTION. BOTH PARTIES TO THIS AGREEMENT FURTHER AGREE THAT ANY ACTION, DEMAND, CLAIM OR COUNTERCLAIM SHALL BE RESOLVED BY A JUDGE ALONE, AND BOTH PARTIES HEREBY WAIVE AND FOREVER RENOUNCE THAT RIGHT TO A TRIAL BEFORE A CIVIL JURY.

**13. Certain Additional Payments by the Company; Code Section 280G.**

(a) Anything in this Agreement to the contrary notwithstanding, if any payment or benefit Executive would receive pursuant to this Agreement (“Payment”) would (i) constitute a “parachute payment” within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the “Excise Tax”), then such Payment shall be reduced to the Reduced Amount. The “Reduced Amount” shall be either (x) the largest portion of the Payment that would result in no portion of the Payment being subject to the Excise Tax or (y) the largest portion, up to and including the total, of the Payment, whichever amount, after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate), results in Executive’s receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting “parachute payments” is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (B) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced.

(b) The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is (i) not be serving as accountant or auditor for the person who acquires ownership or effective control or ownership of a substantial portion of the Company’s assets (within the meaning of Section 280G of the Code) or any Affiliate of such person, and (ii) agreed upon by the Company and Executive (the “Accounting Firm”) The

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Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder.

(c) The Accounting Firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and Eligible Employee within fifteen (15) business days after the date on which right to a Payment is triggered (if requested at that time by the Company or Executive) or such other time as requested by the Company or Executive. Any good faith determinations of the accounting firm made hereunder shall be final, binding and conclusive upon the Company and Executive.

**14. Indemnification.**

During and following the employment period, the Company shall indemnify Executive and hold Executive harmless from and against any claim, loss or cause of action arising from or out of Executive’s performance as an officer, director or employee of the Company or any of its Affiliates or in any other capacity, including any fiduciary capacity, in which Executive serves at the request of Company to the maximum extent permitted by applicable law and the Company’s By-Laws. Expenses incurred in defending or investigating a threatened or pending action, suit or proceeding shall be paid directly by the Company in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of Executive to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the Company. To the extent that the Company reduces the indemnity rights provided for under its By-Laws after execution of this Agreement, the Company’s indemnity obligations hereunder shall be unaffected (to the extent permitted by applicable law).

*[Signature pages follow]*

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IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date first written above.

**Rosetta Stone Ltd.**

By: /s/ Stephen Swad  
Stephen Swad, President and CEO

**EXECUTIVE**

By: /s/ Pragnesh Shah  
Pragnesh Shah

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EXHIBIT A

Form of Release

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**CONSULT WITH AN ATTORNEY PRIOR TO SIGNING THIS AGREEMENT AND GENERAL RELEASE. BY SIGNING THIS AGREEMENT AND GENERAL RELEASE YOU GIVE UP AND WAIVE IMPORTANT LEGAL RIGHTS.**

**Agreement and General Release**

This Agreement and General Release (“**Release**”) is between Rosetta Stone Ltd. (the “**Company**”) and Pragnesh Shah (“**Executive**”) (each a “**Party**,” and together, the “**Parties**”). For purposes of this Release “Effective Date” shall mean the date that is the eighth day after the date on which Executive signs this Release, provided Executive has not revoked this Release pursuant to Section 2(d) below.

*Recitals*

- A. Executive and the Company are parties to an Employment Agreement to which this Release is appended as Exhibit A (the “**Employment Agreement**”).
- B. Executive wishes to receive the Severance Payments described Section 6(a) of the Employment Agreement.
- C. Executive and the Company wish to resolve, except as specifically set forth herein, all claims between them arising from or relating to any act or omission predating the Separation Date defined below.

*Agreement*

The Parties agree as follows:

- 1. Confirmation of Severance Benefit Obligation. The Company shall pay or provide to Executive the entire Severance Payments, as, when and on the terms and conditions specified in the Employment Agreement.
- 2. Legal Releases

(a) Executive, on behalf of Executive and Executive’s heirs, personal representatives and assigns, and any other person or entity that could or might act on behalf of Executive, including, without limitation, Executive’s counsel (all of whom are collectively referred to as “Executive Releasers”), hereby fully and forever releases and discharges the Company, its present and future affiliates and subsidiaries, and each of their past, present and future officers, directors, employees, shareholders, independent contractors, attorneys, insurers and any and all other persons or entities that are now or may become liable to any Executive Releaser due to any Executive Releasee’s act or omission, (all of whom are collectively referred to as “Executive Releasees”) of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys’ fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that Executive Releasers, or any person acting under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission occurring on or before the Effective Date, without regard to present actual knowledge of such acts or omissions, including specifically, but not by way of limitation, matters

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which may arise at common law, such as breach of contract, express or implied, promissory estoppel, wrongful discharge, tortious interference with contractual rights, infliction of emotional distress, defamation, or under federal, state or local laws, such as the Fair Labor Standards Act, the Employee Retirement Income Security Act, the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Equal Pay Act, the Americans with Disabilities Act, the Family and Medical Leave Act, and any civil rights law of any state or other governmental body; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Release, the release set forth in this Section shall not extend to: (i) any rights arising under this Release; (ii) any vested rights under any pension, retirement, profit sharing or similar plan; (iii) any rights Executive has under any grants of stock options, restricted stock, or other forms of equity that may have been provided to Executive during Executive’s employment (such grants to be governed by the applicable equity plan and grant agreement); (iv) any rights Executive has under applicable workers compensation laws; (v) Executive’s rights, if any, to indemnification, and/or defense under any Company certificate of incorporation, bylaw and/or policy or procedure, or under any insurance contract or any indemnification agreement with the Company, in connection with Executive’s acts or omissions within the course and scope of Executive’s employment with the Company; (vi) Executive’s ability to communicate with the Equal Employment Opportunity Commission (EEOC) or any other governmental agency, provided Executive does not seek any personal relief for any claims released herein; (vii) any claims arising after the date of Executive’s execution of this Release; (viii) any obligations of the Company under the Employment Agreement which survive Executive’s termination of employment; or (viii) any other claims that cannot lawfully be released. Executive hereby warrants that Executive has not assigned or transferred to any person any portion of any claim which is released, waived and discharged above. Executive further states and agrees that Executive has not experienced any illness, injury, or disability that is compensable or recoverable under the worker’s compensation laws of any state that was not reported to the Company by Executive before the Effective Date, and Executive agrees not to not file a worker’s compensation claim asserting the existence of any such

previously undisclosed illness, injury, or disability. Executive has specifically consulted with counsel with respect to the agreements, representations, and declarations set forth in the previous sentence. Executive understands and agrees that by signing this Release Executive is giving up any right to bring any legal claim against the Company concerning, directly or indirectly, Executive's employment relationship with the Company, including Executive's separation from employment. Executive agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of the Company, to include all actual or potential legal claims that Executive may have against the Company, except as specifically provided otherwise in this Release.

(b) The Company, for itself, its affiliates, and any other person or entity that could or might act on behalf of it including, without limitation, its attorneys (all of whom are collectively referred to as "Company Releasers"), hereby fully and forever release and discharge Executive, Executive's heirs, representatives, assigns, attorneys, and any and all other persons or entities that are now or may become liable to any Company Releaser on account of Executive's employment with the Company or separation there from (all of whom are collectively referred to as "Company Releasees") of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys' fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that the Company Releasers, or any person acting

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under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission relating to Employee's employment with the Company or separation there from, without regard to present actual knowledge of such acts or omissions; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Release, the release set forth in this Section shall not extend to: (i) any rights arising under this Release; (ii) a breach of fiduciary duty or other misconduct that renders Executive ineligible for indemnification by the Company under applicable law, or any right of recovery by the Company for Executive's breach of fiduciary duty or misconduct in his capacity as an officer and/or director of the Company under applicable law; or (iii) any claim or claims that the Company may have against Executive as of the Effective Date of which the Company is not aware as of the Effective Date because of willful concealment by Executive. The Company understands and agrees that by signing this Release, it is giving up its right to bring any legal claim against Executive concerning, directly or indirectly, Executive's employment relationship with the Company. The Company agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of Executive, to include all actual or potential legal claims that the Company may have against Executive relating to Employee's employment with the Company or separation therefrom, except as specifically provided otherwise in this Release.

(c) In order to provide a full and complete release, each of the Parties understands and agrees that this Release is intended to include all claims, if any, covered under this Section 2 that such Party may have and not now know or suspect to exist in his or its favor against any other Party and that this Release extinguishes such claims. Thus, each of the Parties expressly waives all rights under any statute or common law principle in any jurisdiction that provides, in effect, that a general release does not extend to claims which the releasing party does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the party being released.

(d) Executive acknowledges that he consulted with an attorney of his choosing before signing this the Employment Agreement and this Release, and that the Company provided him with no fewer than twenty-one (21) days during which to consider the provisions of the Employment Agreement and this Release and, specifically the release set forth at Section 2(a) above, although Executive may sign and return the Release sooner if he so chooses. Executive further acknowledges that he has the right to revoke this Release for a period of seven (7) days after signing it and that this Release shall not become effective until such seven (7)-day period has expired. Executive acknowledges and agrees that if he wishes to revoke this Release, he must do so in writing, and that such revocation must be signed by Executive and received by the Company in care of the Chief Executive Officer no later than 5 p.m. (Eastern Time) on the seventh (7th) day after Executive has signed this Release. Executive acknowledges and agrees that, in the event that he revokes this Release, he shall have no right to receive the Severance Payments. Executive represents that he has read this Release, including the release set forth in Section 2(a), above, affirms that this Release and the Employment Agreement provide him with benefits to which he would not otherwise be entitled, and understands its terms and that he enters into this Release freely, voluntarily, and without coercion.

3. Executive acknowledges that he has received all compensation to which he is entitled for his work up to his last day of employment with the Company, and that he is not

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entitled to any further pay or benefit of any kind, for services rendered or any other reason, other than the Severance Payments.

4. Executive agrees that the only thing of value that he will receive by signing this Release is the Severance Payments.
5. The Parties agree that their respective rights and obligations under the Employment Agreement shall survive the execution of this Release.
6. The parties understand and agree that this Release shall not be construed as an admission of liability on the part of any person or entity, liability being expressly denied.
7. Executive represents and warrants to the Company that, prior to the Effective Date, Executive did not disclose to any person, other than to Executive's spouse, tax advisor and counsel, the terms of this Release or the circumstances under which the matter that is the subject of this Release has been resolved. After the Effective Date, neither Executive, counsel for Executive, nor any other person under Executive's control shall disclose any term of this Release or the circumstances of Executive's separation from the Company, except that Executive may disclose such information to Executive's spouse, or as required by subpoena or court order, or to an attorney or accountant to the extent necessary to obtain professional advice. Executive shall not be entitled to rely upon the foregoing exception for disclosures pursuant to subpoena or court order unless Executive has given the Company written notice, within three business

days following service of the subpoena or court order.

8. Executive covenants never to disparage or speak ill of the Company or any the Company product or service, or of any past or present employee, officer or director of the Company, nor shall Executive at any time harass or behave unprofessionally toward any past, present or future the Company employee, officer or director.

9. Executive acknowledges that because of Executive's position with the Company, Executive may possess information that may be relevant to or discoverable in connection with claims, litigation or judicial, arbitral or investigative proceedings initiated by a private party or by a regulator, governmental entity, or self-regulatory organization, that relates to or arises from matters with which Executive was involved during Executive's employment with the Company, or that concern matters of which Executive has information or knowledge (collectively, a "Proceeding"). Executive agrees that Executive shall testify truthfully in connection with any such Proceeding, shall cooperate with the Company in connection with every such Proceeding, and that Executive's duty of cooperation shall include an obligation to meet with the Company representatives and/or counsel concerning all such Proceedings for such purposes, and at such times and places, as the Company reasonably requests, and to appear for deposition and/or testimony upon the Company's request and without a subpoena. The Company shall reimburse Executive for reasonable out-of-pocket expenses that Executive incurs in honoring Executive's obligation of cooperation under this Section 9.

10. Miscellaneous Terms and Conditions

(a) Each party understands and agrees that Executive or it assumes all risk that the facts or law may be, or become, different than the facts or law as believed by the party at

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the time Executive or it executes this Release. Executive and the Company acknowledge that their relationship precludes any affirmative obligation of disclosure, and expressly disclaim all reliance upon information supplied or concealed by the adverse party or its counsel in connection with the negotiation and/or execution of this Release.

(b) The parties warrant and represent that they have been offered no promise or inducement except as expressly provided in this Release, and that this Release is not in violation of or in conflict with any other agreement of either party.

(c) All covenants and warranties contained in this Release are contractual and shall survive the closing of this Release.

(d) This Release shall be binding in all respects upon, and shall inure to the benefit of, the parties' heirs, successors and assigns.

(e) This Release shall be governed by the internal laws of the Commonwealth of Virginia, irrespective of the choice of law rules of any jurisdiction.

(f) Should any provision of this Release be declared illegal or unenforceable by any court of competent jurisdiction and cannot be modified to be enforceable, such provision shall immediately become null and void, leaving the remainder of this Release in full force and effect. Notwithstanding the foregoing, if Section 2(a), above, is declared void or unenforceable, then this Release shall be null and void and both parties shall be restored to the positions that they occupied before the Release's execution (meaning that, among other things, all sums paid by the Company pursuant to Section 1, above, shall be immediately refunded to the Company); provided that in such circumstances this Release and the facts and circumstances relating to its execution shall be inadmissible in any later proceeding between the parties, and the statutes of limitations applicable to claims asserted in the proceeding shall be deemed to have been tolled for the period between the Effective Date and 10 days after the date on which Section 2(a) is declared unenforceable.

(g) This Release constitutes the entire agreement of the parties and a complete merger of prior negotiations and agreements.

(h) This Release shall not be modified except in a writing signed by the parties.

(i) No term or condition of this Release shall be deemed to have been waived, nor shall there be an estoppel against the enforcement of any provision of this Release, except by a writing signed by the party charged with the waiver or estoppel. No waiver of any breach of this Release shall be deemed a waiver of any later breach of the same provision or any other provision of this Release.

(j) Headings are intended solely as a convenience and shall not control the meaning or interpretation of any provision of this Release.

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(k) Pronouns contained in this Release shall apply equally to the feminine, neuter and masculine genders. The singular shall include the plural, and the plural shall include the singular.

(l) Each party shall promptly execute, acknowledge and deliver any additional document or agreement that the other party reasonably believes is necessary to carry out the purpose or effect of this Release.

(m) Any party contesting the validity or enforceability of any term of this Release shall be required to prove by clear and convincing

evidence fraud, concealment, failure to disclose material information, unconscionability, misrepresentation or mistake of fact or law.

(n) The parties acknowledge that they have reviewed this Release in its entirety and have had a full and fair opportunity to negotiate its terms and to consult with counsel of their own choosing concerning the meaning and effect of this Release. Each party therefore waives all applicable rules of construction that any provision of this Release should be construed against its drafter, and agrees that all provisions of the agreement shall be construed as a whole, according to the fair meaning of the language used.

(o) Every dispute arising from or relating to this Release shall be tried only in the state or federal courts situated in the Commonwealth of Virginia. The parties consent to venue in those courts, and agree that those courts shall have personal jurisdiction over them in, and subject matter jurisdiction concerning, any such action.

(p) In any action relating to or arising from this Release, or involving its application, the party substantially prevailing shall recover from the other party the expenses incurred by the prevailing party in connection with the action, including court costs and reasonable attorneys' fees.

(q) This Release may be executed in counterparts, or by copies transmitted by telecopier, all of which shall be given the same force and effect as the original.

[SIGNATURES FOLLOW]

**NOTE: DO NOT SIGN THIS SUPPLEMENTAL LEGAL RELEASE UNTIL AFTER EXECUTIVE'S FINAL DAY OF EMPLOYMENT.**

ROSETTA STONE LTD.

EXECUTIVE

By: \_\_\_\_\_  
Stephen Swad, President & CEO

\_\_\_\_\_  
Pragnesh Shah

Date: \_\_\_\_\_

Date: \_\_\_\_\_

**AMENDMENT  
TO  
EXECUTIVE EMPLOYMENT AGREEMENT**

**AMENDMENT** (“Amendment”) made effective on December 22, 2011 to the Executive Employment Agreement, dated as of May 31, 2011 (the “Employment Agreement”), among Rosetta Stone Ltd., a Delaware corporation (together with its successors and assigns, the “Company”), and Michael Fulkerson (the “Executive”).

**WHEREAS**, the Company and the Executive have previously entered into the Employment Agreement; and

**WHEREAS**, the Company and the Executive desire to amend the Employment Agreement to modify the excise tax gross-up provision in the Employment Agreement.

**NOW, THEREFORE**, in consideration for continued employment by the Company and for other good and valuable consideration as described below, the Executive and the Company agree that the Employment Agreement shall be amended as follows, effective on the date set forth above.

**Recitals**

- A. If the Executive signs this Amendment, then the Company shall pay the Executive the sum of \$1.00, which will be subject to all applicable taxes and withholdings. This amount shall be paid in a single payment on the Company’s normal and customary payroll date which is coincident with, or immediately follows, the execution of this Amendment.
- B. The Executive acknowledges that he must sign this Amendment as a condition of continued employment with the Company.
- C. The Executive further agrees and acknowledges that the consideration stated in this Amendment is adequate and sufficient consideration for this Amendment.

1.

Section [13] of the Employment Agreement is amended by deleting it in its entirety and substituting the following therefor:

“[13.] **Certain Additional Payments by the Company; Code Section 280G.**

(a) Anything in this Agreement to the contrary notwithstanding, if any payment or benefit Executive would receive pursuant to this Agreement (“Payment”) would (i) constitute a “parachute payment” within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the “Excise Tax”), then such Payment shall be reduced to the Reduced Amount. The “Reduced Amount” shall be either (x) the largest portion of the Payment that would result in no portion of the Payment being subject to the Excise Tax or (y) the largest portion, up to and

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including the total, of the Payment, whichever amount, after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate), results in Executive’s receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting “parachute payments” is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (B) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced.

(b) The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is (i) not be serving as accountant or auditor for the person who acquires ownership or effective control or ownership of a substantial portion of the Company’s assets (within the meaning of Section 280G of the Code) or any Affiliate of such person, and (ii) agreed upon by the Company and Executive (the “Accounting Firm”). The Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder.

(c) The Accounting Firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and Eligible Executive within fifteen (15) business days after the date on which right to a Payment is triggered (if requested at that time by the Company or Executive) or such other time as requested by the Company or Executive. Any good faith determinations of the accounting firm made hereunder shall be final, binding and conclusive upon the Company and Executive.”

2.

Except with respect to the subject matters covered herein, this Amendment does not otherwise amend, supplement, modify, or terminate the

Employment Agreement, which remains in full force and effect.

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**IN WITNESS WHEREOF**, the parties hereto have executed this Amendment on the date set forth below.

**EXECUTIVE**

By: /s/ Michael Fulkerson  
Michael Fulkerson

Date: 12/22/2012

**ROSETTA STONE LTD.**

By: /s/ Tom Adams  
Tom Adams

Title: Chief Executive Officer

Date: 12/22/2012

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**AMENDMENT  
TO  
EXECUTIVE EMPLOYMENT AGREEMENT**

**AMENDMENT** (“Amendment”) made effective on December 22, 2011 to the Executive Employment Agreement, dated as of February 20, 2009 (the “Employment Agreement”), among Rosetta Stone Ltd., a Delaware corporation (together with its successors and assigns, the “Company”), and Michael Wu (the “Executive”).

**WHEREAS**, the Company and the Executive have previously entered into the Employment Agreement; and

**WHEREAS**, the Company and the Executive desire to amend the Employment Agreement to modify the excise tax gross-up provision in the Employment Agreement.

**NOW, THEREFORE**, in consideration for continued employment by the Company and for other good and valuable consideration as described below, the Executive and the Company agree that the Employment Agreement shall be amended as follows, effective on the date set forth above.

**Recitals**

A. If the Executive signs this Amendment, then the Company shall pay the Executive the sum of \$1.00, which will be subject to all applicable taxes and withholdings. This amount shall be paid in a single payment on the Company’s normal and customary payroll date which is coincident with, or immediately follows, the execution of this Amendment.

B. The Executive acknowledges that he must sign this Amendment as a condition of continued employment with the Company.

C. The Executive further agrees and acknowledges that the consideration stated in this Amendment is adequate and sufficient consideration for this Amendment.

1.

Section [13] of the Employment Agreement is amended by deleting it in its entirety and substituting the following therefor:

“[13.] **Certain Additional Payments by the Company; Code Section 280G.**

(a) Anything in this Agreement to the contrary notwithstanding, if any payment or benefit Executive would receive pursuant to this Agreement (“Payment”) would (i) constitute a “parachute payment” within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the “Excise Tax”), then such Payment shall be reduced to the Reduced Amount. The “Reduced Amount” shall be either (x) the largest portion of the Payment that would result in no portion of the Payment being subject to the Excise Tax or (y) the largest portion, up to and

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including the total, of the Payment, whichever amount, after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate), results in Executive’s receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting “parachute payments” is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (B) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced.

(b) The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is (i) not be serving as accountant or auditor for the person who acquires ownership or effective control or ownership of a substantial portion of the Company’s assets (within the meaning of Section 280G of the Code) or any Affiliate of such person, and (ii) agreed upon by the Company and Executive (the “Accounting Firm”). The Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder.

(c) The Accounting Firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and Eligible Executive within fifteen (15) business days after the date on which right to a Payment is triggered (if requested at that time by the Company or Executive) or such other time as requested by the Company or Executive. Any good faith determinations of the accounting firm made hereunder shall be final, binding and conclusive upon the Company and Executive.”

2.

Except with respect to the subject matters covered herein, this Amendment does not otherwise amend, supplement, modify, or terminate the



Employment Agreement, which remains in full force and effect.

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**IN WITNESS WHEREOF**, the parties hereto have executed this Amendment on the date set forth below.

**EXECUTIVE**

By: /s/ Michael Wu  
Michael Wu

Date: 12/22/2011

**ROSETTA STONE LTD.**

By: /s/ Tom Adams  
Tom Adams

Title: Chief Executive Officer

Date: 12/22/2011

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**AMENDMENT  
TO  
EXECUTIVE EMPLOYMENT AGREEMENT**

**AMENDMENT** (“Amendment”) made effective on December 22, 2011 to the Executive Employment Agreement, dated as of November 9, 2010 (the “Employment Agreement”), among Rosetta Stone Ltd., a Delaware corporation (together with its successors and assigns, the “Company”), and Stephen Swad (the “Executive”).

**WHEREAS**, the Company and the Executive have previously entered into the Employment Agreement; and

**WHEREAS**, the Company and the Executive desire to amend the Employment Agreement to modify the excise tax gross-up provision in the Employment Agreement.

**NOW, THEREFORE**, in consideration for continued employment by the Company and for other good and valuable consideration as described below, the Executive and the Company agree that the Employment Agreement shall be amended as follows, effective on the date set forth above.

**Recitals**

A. If the Executive signs this Amendment, then the Company shall pay the Executive the sum of \$1.00, which will be subject to all applicable taxes and withholdings. This amount shall be paid in a single payment on the Company’s normal and customary payroll date which is coincident with, or immediately follows, the execution of this Amendment.

B. The Executive acknowledges that he must sign this Amendment as a condition of continued employment with the Company.

C. The Executive further agrees and acknowledges that the consideration stated in this Amendment is adequate and sufficient consideration for this Amendment.

1.

Section [13] of the Employment Agreement is amended by deleting it in its entirety and substituting the following therefor:

“[13.] **Certain Additional Payments by the Company; Code Section 280G.**

(a) Anything in this Agreement to the contrary notwithstanding, if any payment or benefit Executive would receive pursuant to this Agreement (“Payment”) would (i) constitute a “parachute payment” within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the “Excise Tax”), then such Payment shall be reduced to the Reduced Amount. The “Reduced Amount” shall be either (x) the largest portion of the Payment that would result in no portion of the Payment being subject to the Excise Tax or (y) the largest portion, up to and

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including the total, of the Payment, whichever amount, after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate), results in Executive’s receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting “parachute payments” is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (B) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced.

(b) The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is (i) not be serving as accountant or auditor for the person who acquires ownership or effective control or ownership of a substantial portion of the Company’s assets (within the meaning of Section 280G of the Code) or any Affiliate of such person, and (ii) agreed upon by the Company and Executive (the “Accounting Firm”). The Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder.

(c) The Accounting Firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and Eligible Executive within fifteen (15) business days after the date on which right to a Payment is triggered (if requested at that time by the Company or Executive) or such other time as requested by the Company or Executive. Any good faith determinations of the accounting firm made hereunder shall be final, binding and conclusive upon the Company and Executive.”

2.

Except with respect to the subject matters covered herein, this Amendment does not otherwise amend, supplement, modify, or terminate the

Employment Agreement, which remains in full force and effect.

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**IN WITNESS WHEREOF**, the parties hereto have executed this Amendment on the date set forth below.

**EXECUTIVE**

By: /s/ Stephen Swad  
Stephen Swad

Date: 12/22/2011

**ROSETTA STONE LTD.**

By: /s/ Tom Adams  
Tom Adams

Title: Chief Executive Officer

Date: 12/22/2011

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**SECOND AMENDMENT  
TO  
EXECUTIVE EMPLOYMENT AGREEMENT**

**THIS SECOND AMENDMENT** (the "Amendment") made effective on February 22, 2012 to the Executive Employment Agreement, dated as of November 9, 2010 ("Employment Agreement"), as amended by the Amendment to the Executive Employment Agreement, dated December 22, 2011, among Rosetta Stone Ltd., a Virginia corporation (together with its successors and assigns, the "Company"), and Stephen M. Swad (the "Executive").

**WHEREAS**, the Company and the Executive have previously entered into the Employment Agreement; and

**WHEREAS**, the Company and the Executive desire to amend the Employment Agreement in connection with Executive's promotion to President and Chief Executive Officer.

**NOW, THEREFORE**, in consideration of the foregoing and the mutual covenants and promises contained herein, the parties agree as follows:

1. Recital A. of the Employment Agreement is amended by deleting it in its entirety and substituting the following therefor:

A. The Company and Executive desire to enter into an agreement pursuant to which the Company will employ Executive as its President and Chief Executive Officer subject to the terms and conditions of this Agreement.

2. Section 1. of the Employment Agreement is amended by deleting the reference to "Chief Financial Officer" and substituting the position with "President and Chief Executive Officer."

3. Section 2. of the Employment Agreement is amended by deleting it in its entirety and substituting the following therefor:

2. **Duties.**

During the Service Term, Executive, as President and Chief Executive Officer of the Company, shall have all the duties and responsibilities customarily rendered by chief executive officers of companies of similar size and nature and such other duties and responsibilities as may be delegated from time to time by the Board in its sole discretion. Executive will report to the Board.

Executive will devote his best efforts and substantially all of his business time and attention (except for vacation periods and periods of illness or other incapacity) to the business of the Company and its Affiliates. With the prior consent of the Board, Executive will be permitted to serve on the boards of other companies so long as such service does not unreasonably interfere with his duties to the Company.

4. Section 3. of the Employment Agreement is amended by deleting the first paragraph in its entirety and substituting the following thereof.

3. **Salary, Bonus and Benefits.**

The Board shall make all decisions related to Executive's base salary and the payment of bonuses, if any. Executive's Annual Base Salary and other compensation will be reviewed by the Board at least annually.

5. Section 3. (a) of the Employment Agreement is amended by deleting the words "the CEO and" from the second line and replacing "\$400,000" with "\$500,000" in the third line of the section.

6. Section 3. (b) of the Employment Agreement is amended by replacing "60%" with "100%" in the eighth line of the section.

7. Section 3. (d) of the Employment Agreement is amended by deleting the following sentences: "The grants shall have such terms as are determined by the Board in accordance with the current stock plan in place at time of grant. Executive will be eligible to participate in a pending executive long-term performance plan that will be approved by the Board. Executive will receive a minimum of 12.5% of the executive grant pool pursuant to the terms of the long term incentive program."

8. Section 5. (c) of the Employment Agreement is amended by replacing "CEO" with "Board" in the fifth line of the section.

9. Section 5. (d) of the Employment Agreement is amended by replacing "CEO" with "Board" in the second line of the section.

10. Section 5. (d) (i) is amended by deleting "or the CEO" from the fifth, eleventh, and twentieth lines of the subsection.

11. Section 5. (e) is amended by deleting "the CEO or" from the sixth line of the section.

12. Section 6. (a) (i) (3) and (4) are amended by replacing "(y) 12" with "(y) 18" in the third line of each subsection.

13. Section 6. (a) (iii) is amended by replacing “twelve” with “eighteen” in the fourth and seventh lines on the subsection.
14. Section 8. (a) is amended by replacing “CEO’s” with “Board’s” in the twelfth line of the section.
15. Section 8. (b) is amended by replacing “CEO” with “Board” in the sixteenth and seventeenth lines of the section.
16. Section 8. (c) is amended by replacing “CEO” with “Board” in the eleventh line of the section.

17. Section 9. (a) is amended by replacing “twelve (12)” with “eighteen (18)” in the second line of the section and replacing “12-month” with “18-month” in the tenth line of the section.
18. Section 9. (c) is amended by replacing “Chief Financial Officer” with “President and Chief Executive Officer” in the fourth line of the section.
19. Section 11. is amended so that notices to the Company shall be addressed to the Chairman of the Board of Directors.
20. Section 12. (b) is amended by deleting it in its entirety and substituting the following therefor:

(b) **Complete Agreement.** This Agreement, those documents expressly referred to herein and other documents of even date herewith embody the complete agreement and understanding among the parties and supersede and preempt any prior understandings, agreements or representations by or among the parties, written or oral, which may have related to the subject matter hereof in any way.

21. Except as amended or modified hereby, all terms and conditions in the Employment Agreement, as amended, shall remain in full force and effect.

**IN WITNESS WHEREOF**, the parties hereto have executed this Amendment on the date set forth below.

**EXECUTIVE**

By: /s/ Stephen Swad  
Stephen Swad

Title: President and Chief Executive Officer

Date: 2/22/2012

**ROSETTA STONE LTD.**

By: /s/ Tom P.H. Adams  
Tom P.H. Adams

Title: Chairman of the Board of Directors

Date: 2/22/2012

October 12, 2011

Dear Tom:

This will confirm our discussions about a leadership change at Rosetta Stone.

After review and discussions, the BOD together with you has agreed on the following:

1. The company will hire a search firm to undertake the search for the new CEO. The BOD will appoint the new CEO and you will participate and cooperate in that process.
2. Until your successor is identified and able to begin filling the CEO role, you will continue to serve as the Company's CEO and remain a Board member, subject to the terms of your various agreements.
3. At the time you step down as CEO, it is the BOD's intention to elect you to the role of Chairman of the Board, subject to condition 3 below.
4. At the time you step down as CEO, your employment agreement will be terminated, and you will receive a transition bonus of \$575,000, and those benefits you would have received if your employment had been terminated under the employment agreement without "Cause" (subject to your execution of a release in the form attached to your employment agreement).
5. For as long as you continue to serve on the Board, any unvested equity will continue to vest, and there will be no requirement to exercise your vested options within any specific time frame - just as if you were continuing in your employee role.
6. On an ongoing basis, Pat Gross as lead director, will assist in the transition and provide the BOD with sufficient visibility and access to Management.
7. We will announce this change after the US stock markets close today.

Items 2 - 5 above are subject to the following conditions:

1. While you continue to serve as an officer, you continue to perform in good faith customary duties and obligations.
2. While you continue to serve as a director, you perform in good faith your board duties.
3. The incoming CEO does not oppose your appointment as Chairman. As we have discussed, we cannot make your appointment as Chairman a mandatory condition of his/her employment.

Thanks for all and I look forward to continuing building Rosetta Stone as the global leader in language and learning technology with you,

Laurence Franklin,

/s/ Laurence Franklin  
Chairman of the Board  
Rosetta Stone

AGREED:  
/s/ Tom Adams  
Tom Adams

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OPTION NO.:

**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED  
NONQUALIFIED STOCK OPTION AWARD AGREEMENT**

Rosetta Stone Inc., a Delaware corporation (the "Company"), hereby grants an option to purchase shares of its Class B Common Stock, \$.00005 par value, (the "Stock") to the optionee named below. The terms and conditions of the Option are set forth in the Nonqualified Stock Option Award Agreement and in the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the "Plan").

Grant Date:

Name of Optionee:

Optionee's Employee Identification Number:

Number of Shares Covered by Option:

Option Price per Share:

Recipient understands and agrees that this Non-Qualified Stock Option Award is granted subject to and in accordance with the terms of the Rosetta Stone, Inc. %%EQUITY\_PLAN%% (the "Plan"). Recipient further agrees to be bound by the terms of the Plan and the terms of the Non-Qualified Stock Option Award as set forth in the Non-Qualified Stock Option Agreement and any Addenda to such Non-Qualified Stock Option Agreement. A copy of the Plan is available on www.Etrade.com.

Nothing in this Notice or in the Non-Qualified Stock Option Agreement or in the Plan shall confer upon Recipient any right to continue in service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining Recipient) or of Recipient, which rights are hereby expressly reserved by each, to terminate Recipient's Service at any time for any reason, with or without cause.

Definitions. All capitalized terms in this Notice shall have the meaning assigned to them in this Notice or in the Non-Qualified Stock Option Agreement.

ROSETTA STONE INC.

**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED  
NONQUALIFIED STOCK OPTION AWARD AGREEMENT**

This **NONQUALIFIED STOCK OPTION AWARD AGREEMENT** (this "*Agreement*") and the Cover Sheet to which this Agreement is attached (the "*Cover Sheet*") are entered into between Rosetta Stone Inc., a Delaware corporation (the "*Company*"), and Optionee (as that term is defined in the Covered Sheet). The Board of Directors of the Company has adopted, and the stockholders of the Company have approved, the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the "*Plan*"), the terms of which are incorporated by reference herein in their entirety. Any term used in this Agreement that is not specifically defined herein shall have the meaning specified in the Plan.

**IT IS AGREED:**

1. **Grant of Option.** Subject to the terms of the Plan, this Agreement and the Cover Sheet, on the Grant Date set forth on the Cover Sheet (the "*Grant Date*"), the Company granted to Optionee an option (the "*Option*") to purchase that number of shares of the Company's common stock, \$.00005 par value (the "*Stock*"), at the Option Price per Share of Stock set forth on the Cover Sheet (the "*Option Price*"), subject to adjustment as provided in the Plan.
2. **Type of Option.** The Option is a nonqualified stock option which is not intended to be governed by section 422 of the Code and will be interpreted accordingly.
3. **Optionee's Agreement.** In accepting the Option, Optionee accepts and agrees to be bound by all the terms and conditions of the Plan which pertain to nonqualified stock options granted under the Plan.
4. **Vesting of Option.** Subject to the provisions of the Plan and the provision of this Agreement (including the requirement in Section 6 that Optionee continue to be employed by the Company or a Subsidiary Corporation on the dates set forth below), the Option will vest and become exercisable in accordance with the following terms:
  - (a) on the first anniversary of the Vesting Start Date (as set forth on the Cover Sheet), and on each succeeding anniversary date of the

Vesting Start Date, the Option will vest with respect to, and may be exercised for up to, one-fourth (1/4<sup>th</sup>) of the total number of shares of the Stock subject to the Option as set forth on the Cover Sheet (the “*Option Shares*”), rounded to the nearest whole number of shares, except that on the fourth anniversary of the Vesting Start Date the Option shall vest with respect to the remaining number of Option Shares for which the Option has not previously vested;

(b) upon the termination of employment of the Optionee by the Company without Cause or by the Optionee for Good Reason, in either case, within one year following the occurrence of a Change in Control, any portion of the Option Shares that have not previously vested will vest and the Option shall be exercisable in full; and

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(c) to the extent not exercised, installments of vested Option Shares shall be cumulative and may be exercised in whole or in part.

5. ***Manner of Exercise.***

(a) To the extent that the Option is vested and exercisable in accordance with Section 4 of this Agreement, the Option may be exercised by Optionee at any time, or from time to time, in whole or in part, on or prior to the termination of the Option (as set forth in Section 6 of this Agreement) upon payment of the Option Price for the Option Shares to be acquired in accordance with the terms and conditions of this Agreement and the Plan.

(b) If Optionee is entitled to exercise the vested and exercisable portion of the Option, and wishes to do so, in whole or part, Optionee shall (i) deliver to the Company a fully completed and executed notice of exercise, in such form as may be designated by the Company in its sole discretion, specifying the exercise date and the number of Option Shares to be purchased pursuant to such exercise and (ii) remit to the Company in a form satisfactory to the Company, in its sole discretion, the Option Price for the Option Shares to be acquired on exercise of the Option, plus an amount sufficient to satisfy any withholding tax obligations of the Company that arise in connection with such exercise (as determined by the Company) in accordance with the provisions of the Plan.

(c) The Company’s obligation to deliver shares of the Stock to Optionee under this Agreement is subject to and conditioned upon Optionee satisfying all tax obligations associated with Optionee’s receipt, holding and exercise of the Option. Unless otherwise approved by the Committee, all such tax obligations shall be payable in accordance with the provisions of the Plan.

(d) The Company and its Affiliates and subsidiaries, as applicable, shall be entitled to deduct from any compensation otherwise due to Optionee the amount necessary to satisfy all such taxes.

(e) Upon full payment of the Option Price and satisfaction of all applicable tax obligations, and subject to the applicable terms and conditions of the Plan and the terms and conditions of this Agreement, the Company shall cause certificates for the shares purchased hereunder to be delivered to Optionee or cause an uncertificated book-entry representing such shares to be made.

6. ***Termination of Option.*** Unless the Option terminates earlier as provided in this Section 6 the Option shall terminate and become null and void at the close of business at the Company’s principal business office on the day before the date of the tenth anniversary of the Grant Date (the “*Option General Expiration Date*”). If Optionee ceases to be an employee of the Company or any Subsidiary Corporation for any reason the Option shall not continue to vest after such cessation of service as an employee of the Company or Subsidiary Corporation.

(a) If Optionee ceases to be an employee of the Company or any Subsidiary Corporation due to death or Disability, (i) the portion of the Option that was exercisable on the date of such cessation shall remain exercisable for, and shall otherwise terminate and become null and void at the close of business at the Company’s principal business office on the day that

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is six (6) months after the date of such death or Disability, but in no event after the Option General Expiration Date; and (ii) the portion of the Option that was not exercisable on the date of such cessation shall be forfeited and become null and void immediately upon such cessation.

(b) If Optionee ceases to be an employee of the Company or a Subsidiary Corporation due to Cause, all of the Option shall be forfeited and become null and void immediately upon such cessation, whether or not then exercisable.

(c) If Optionee ceases to be an employee of the Company or a Subsidiary Corporation for any reason other than death, Disability, or Cause, (i) the portion of the Option that was exercisable on the date of such cessation shall remain exercisable for, and shall otherwise terminate and become null and void at the close of business at the Company’s principal business office on the later of (x) the day that is sixty (60) days after the date of such cessation, or (y) the day that is thirty (30) after any blackout period(s) under the Company’s Insider Trading Compliance Policy (as in effect from time to time) to the extent Optionee is then subject to any such blackout period(s), but in no event after the Option General Expiration Date, and (ii) the portion of the Option that was not exercisable on the date of such cessation shall be forfeited and become null and void immediately upon such cessation.

(d) Upon the death of Optionee prior to the expiration of the Option, Optionee’s executors, administrators or any person or persons to whom the Option may be transferred by will or by the laws of descent and distribution, shall have the right, at any time prior to the termination of the Option to exercise the Option with respect to the number of shares that Optionee would have been entitled to exercise if he were still alive.



7. **Tax Withholding.** To the extent that the receipt of the Option, this Agreement or the Cover Sheet, the vesting of the Option or the exercise of the Option results in income to Optionee for federal, state, local or foreign income, employment or other tax purposes with respect to which the Company or its subsidiaries or any Affiliate has a withholding obligation, Optionee shall deliver to the Company at the time of such receipt, vesting or exercise, as the case may be, such amount of money as the Company or its subsidiaries or any Affiliate may require to meet its obligation under applicable tax laws or regulations, and, if Optionee fails to do so, the Company or its subsidiaries or any Affiliate is authorized to withhold from the shares subject to the Option (based on the Fair Market Value of such shares as of the date the amount of tax to be withheld is determined) or from any cash or stock remuneration then or thereafter payable to Optionee any tax required to be withheld by reason of such taxable income, sufficient to satisfy the withholding obligation.

8. **Capital Adjustments and Reorganizations.** The existence of the Option shall not affect in any way the right or power of the Company or any company the stock of which is awarded pursuant to this Agreement to make or authorize any adjustment, recapitalization, reorganization or other change in its capital structure or its business, engage in any merger or consolidation, issue any debt or equity securities, dissolve or liquidate, or sell, lease, exchange or otherwise dispose of all or any part of its assets or business, or engage in any other corporate act or proceeding.

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9. **Employment Relationship.** For purposes of this Agreement, Optionee shall be considered to be in the employment of the Company, any Subsidiary Corporation or any Affiliates as long as Optionee has an employment relationship with the Company, any Subsidiary Corporation or any Affiliates. The Committee shall determine any questions as to whether and when there has been a termination of such employment relationship, and the cause of such termination, under the Plan and the Committee's determination shall be final and binding on all persons.

10. **Not an Employment Agreement.** This Agreement is not an employment or service agreement, and no provision of this Agreement shall be construed or interpreted to create an employment or other service relationship between Optionee and the Company, its subsidiaries or any of its Affiliates or guarantee the right to remain employed by the Company, its subsidiaries or any of its Affiliates, for any specified term or require the Company, its subsidiaries or any Affiliate to employ Employee for any period of time.

11. **No Rights As Stockholder.** Optionee shall not have any rights as a stockholder with respect to any Option Shares until the date of the issuance of such shares following Optionee's exercise of the Option pursuant to its terms and conditions and payment of all amounts for and with respect to the shares. No adjustment shall be made for dividends or other rights for which the record date is prior to the date a certificate or certificates are issued for such shares or an uncertificated book-entry representing such shares is made.

12. **Legend.** Optionee consents to the placing on the certificate for any Option Shares of an appropriate legend restricting resale or other transfer of such shares except in accordance with the Securities Act of 1933 and all applicable rules thereunder.

13. **Notices.** Any notice, instruction, authorization, request, demand or other communications required hereunder shall be in writing, and shall be delivered either by personal delivery, by telegram, telex, telecopy or similar facsimile means, by certified or registered mail, return receipt requested, or by courier or delivery service, addressed to the Company at the Company's principal business office address to the attention of the Company's General Counsel and to Optionee at Optionee's residential address as it appears on the books and records of the Company, or at such other address and number as a party shall have previously designated by written notice given to the other party in the manner hereinabove set forth. Notices shall be deemed given when received, if sent by facsimile means (confirmation of such receipt by confirmed facsimile transmission being deemed receipt of communications sent by facsimile means); and when delivered (or upon the date of attempted delivery where delivery is refused), if hand-delivered, sent by express courier or delivery service, or sent by certified or registered mail, return receipt requested.

14. **Amendment and Waiver.** Except as otherwise provided herein or in the Plan or as necessary to implement the provisions of the Plan, this Agreement may be amended, modified or superseded only by written instrument executed by the Company and Optionee. Only a written instrument executed and delivered by the party waiving compliance hereof shall waive any of the terms or conditions of this Agreement. Any waiver granted by the Company shall be effective only if executed and delivered by a duly authorized director or officer of the Company other than Optionee. The failure of any party at any time or times to require performance of any provisions

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hereof shall in no manner effect the right to enforce the same. No waiver by any party of any term or condition, or the breach of any term or condition contained in this Agreement, in one or more instances, shall be construed as a continuing waiver of any such condition or breach, a waiver of any other condition, or the breach of any other term or condition.

15. **Dispute Resolution.** In the event of any difference of opinion concerning the meaning or effect of the Plan or this Agreement, such difference shall be resolved by the Committee.

16. **Governing Law and Severability.** The validity, construction and performance of this Agreement shall be governed by the laws of the State of Delaware, excluding any conflicts or choice of law rule or principle that might otherwise refer construction or interpretation of this Agreement to the substantive law of another jurisdiction. The invalidity of any provision of this Agreement shall not affect any other provision of this Agreement, which shall remain in full force and effect.

17. **Transfer Restrictions.** The Option Shares may not be sold or otherwise disposed of in any manner that would constitute a violation of any applicable federal or state securities laws. Optionee also agrees (a) that the Company may refuse to cause the transfer of Option Shares to be registered on the applicable stock transfer records if such proposed transfer would in the opinion of counsel satisfactory to the Company constitute a violation of any

applicable securities law and (b) that the Company may give related instructions to the transfer agent, if any, to stop registration of the transfer of the Option Shares.

18. **Successors and Assigns.** This Agreement shall, except as herein stated to the contrary, inure to the benefit of and bind the legal representatives, successors and assigns of the parties hereto.

19. **Counterparts.** This Agreement may be executed in one or more counterparts, each of which shall be an original for all purposes but all of which taken together shall constitute but one and the same instrument.

20. **Option Transfer Prohibitions.** The Option granted to Optionee under this Agreement shall not be transferable or assignable by Optionee other than by will or the laws of descent and distribution, and shall be exercisable during Optionee's lifetime only by him.

21. **Definitions.** The words and phrases defined in this Section 21 shall have the respective meanings set forth below throughout this Agreement, unless the context in which any such word or phrase appears reasonably requires a broader, narrower or different meaning.

(a) "Cause" shall mean Optionee (i) committed a felony or a crime involving moral turpitude or committed any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of his employment by the Company or an Affiliate which conduct damaged the Company or an Affiliate; (ii) substantially and repeatedly failed to perform duties of the office held by him or her as reasonably directed by the Company or an Affiliate; (iii) committed gross negligence or willful misconduct with respect to the Company or an Affiliate; (iv) committed a material breach of any employment agreement between the Optionee and the Company or an Affiliate that is not cured within ten (10) days after receipt of written

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notice thereof from the Company or the Affiliate, as applicable; (v) failed, within ten (10) days after receipt by the Optionee of written notice thereof from the Company or an Affiliate, to correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board reasonably believes does or may materially or adversely affect the Company's or an Affiliate's business or operations; (vi) committed misconduct which is of such a serious or substantial nature that a reasonable likelihood exists that such misconduct will materially injure the reputation of the Company or an Affiliate; (vii) harassed or discriminated against the Company's or an Affiliate's employees, customers or vendors in violation of the Company's policies with respect to such matters; (viii) misappropriated funds or assets of the Company or an Affiliate for personal use or willfully violated the Company policies or standards of business conduct as determined in good faith by the Board; (ix) failed, due to some action or inaction on the part of the Optionee, to have immigration status that permits the Optionee to maintain full-time employment with the Company or an Affiliate in the United States in compliance with all applicable immigration law; or (x) disclosed trade secrets of the Company or an Affiliate.

(b) "Change in Control" means (i) the liquidation, dissolution or winding-up of the Company, (ii) the sale, license or lease of all or substantially all of the assets of the Company, or (iii) a share exchange, reorganization, recapitalization, or merger or consolidation of the Company with or into any other corporation or corporations (or other form of business entity) or of any other corporation or corporations (or other form of business entity) with or into the Company, but excluding any merger effected exclusively for the purpose of changing the domicile of the Company; provided, however, that a Change in Control shall not include any of the aforementioned transactions listed in clauses (i), (ii) and (iii) involving the Company or a Subsidiary Corporation in which the holders of shares of the Company voting stock outstanding immediately prior to such transaction or any Affiliate of such holders continue to hold at least a majority, by voting power, of the capital stock or, by a majority, based on fair market value as determined in good faith by the Board, of the assets, in each case in substantially the same proportion, of (x) the surviving or resulting corporation (or other form of business entity), (y) if the surviving or resulting corporation (or other form of business entity) is a wholly owned subsidiary of another corporation (or other form of business entity) immediately following such transaction, the parent corporation (or other form of business entity) of such surviving or resulting corporation (or other form of business entity) or (z) a successor entity holding a majority of the assets of the Company. In addition, a Change in Control shall not include a bona fide, firm commitment underwritten public offering of the Stock pursuant to a registration statement declared effective under the Securities Act of 1933, as amended.

(c) "Disability" shall have the meaning ascribed to such term in the Plan, as it may be amended from time to time.

(d) "Good Reason" shall have the meaning ascribed to such term in the Optionee's employment agreement with the Company, or, if none, the Optionee's resignation from employment with the Company due to (i) a material diminution in Optionee's annual base salary, duties, authority or responsibilities or (ii) relocation of the Optionee's primary place of employment to a geographic area more than fifty (50) miles from Optionee's then-current primary place of employment, without the Optionee's consent; provided that the Optionee has given thirty (30) days advance written notice to the Company of the initial existence of the

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condition described in (i) and/or (ii) and the Company has not within such thirty (30) day period remedied the condition.

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**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED**

**COVER SHEET TO  
RESTRICTED STOCK AWARD AGREEMENT**

Rosetta Stone Inc., a Delaware corporation (the “*Company*”), has granted to the individual whose name is set forth below on the “Name of Executive” line (“*Executive*”) the shares of the Company’s common stock, \$.00005 par value, specified herein, subject to the terms and conditions set forth in this Cover Sheet, in the attached Restricted Stock Award Agreement and in the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the “*Plan*”).

Grant Date:

Name of Executive:

Executive’s Employee Identification Number:

Number of Shares of Restricted Stock Granted:

Vesting Start Date:

Executive understands and agrees that this Restricted Stock Award is granted subject to and in accordance with the terms of the Rosetta Stone, Inc. %%EQUITY\_PLAN%-% (the “*Plan*”). Executive further agrees to be bound by the terms of the Plan and the terms of the Restricted Stock Award as set forth in the Restricted Stock Award Agreement and any Addenda to such Restricted Stock Award Agreement.

Nothing in this Notice or in the Restricted Stock Award Agreement or in the Plan shall confer upon Executive any right to continue in service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining Recipient) or of Executive, which rights are hereby expressly reserved by each, to terminate Executive’s Service at any time for any reason, with or without cause.

Definitions. All capitalized terms in this Notice shall have the meaning assigned to them in this Notice or in the Restricted Stock Award Agreement.

Attachment

***THIS AGREEMENT IS NOT A STOCK CERTIFICATE OR A NEGOTIABLE INSTRUMENT***

**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED**

**RESTRICTED STOCK AWARD AGREEMENT**

This **RESTRICTED STOCK AWARD AGREEMENT** (this “*Agreement*”) and the Cover Sheet to which this Agreement is attached (the “*Cover Sheet*”) is made by and between Rosetta Stone Inc., a Delaware corporation (the “*Company*”), and Executive (as that term is defined in the Covered Sheet), effective as of the Grant Date set forth on the Cover Sheet (the “*Grant Date*”), pursuant to the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the “*Plan*”), a copy of which previously has been made available to Executive and the terms and provisions of which are incorporated by reference herein.

**WHEREAS**, the Company desires to grant to Executive the shares of the Company’s common stock, \$.00005 par value, set forth on the “Number of Shares of Restricted Stock Granted” line on the Cover Sheet (the “*Shares*”), subject to the terms and conditions of this Agreement; and

**WHEREAS**, Executive desires to have the opportunity to hold the Shares subject to the terms and conditions of this Agreement;

**NOW, THEREFORE**, in consideration of the premises, mutual covenants and agreements contained herein, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto, intending to be legally bound hereby, agree as follows:

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1. **Definitions.** For purposes of this Agreement, the following terms shall have the meanings indicated:

(a) “*Change in Control*” means (i) the liquidation, dissolution or winding-up of the Company, (ii) the sale, license or lease of all or substantially all of the assets of the Company, or (iii) a share exchange, reorganization, recapitalization, or merger or consolidation of the Company with or into any other corporation or corporations (or other form of business entity) or of any other corporation or corporations (or other form of business entity) with or into the Company, but excluding any merger effected exclusively for the purpose of changing the domicile of the Company; provided, however, that a

Change in Control shall not include any of the aforementioned transactions listed in clauses (i), (ii) and (iii) involving the Company or a Subsidiary Corporation in which the holders of shares of the Company voting stock outstanding immediately prior to such transaction or any Affiliate of such holders continue to hold at least a majority, by voting power, of the capital stock or, by a majority, based on fair market value as determined in good faith by the Board, of the assets, in each case in substantially the same proportion, of (x) the surviving or resulting corporation (or other form of business entity), (y) if the surviving or resulting corporation (or other form of business entity) is a wholly owned subsidiary of another corporation (or other form of business entity) immediately following such transaction, the parent corporation (or other form of business entity) of such surviving or resulting corporation (or other form of business entity) or (z) a successor entity holding a majority of the assets of the Company. In addition, a Change in Control shall not include a bona fide, firm commitment underwritten public offering of the Stock pursuant to a registration statement declared effective under the Securities Act of 1933, as amended.

(b) “*Forfeiture Restrictions*” shall mean the prohibitions and restrictions set forth herein with respect to the sale or other disposition of the Shares issued to Executive hereunder and the obligation to forfeit and surrender such Shares to the Company.

(c) “*Period of Restriction*” shall mean the period during which Restricted Shares are subject to Forfeiture Restrictions and during which Restricted Shares may not be sold, assigned, transferred, pledged or otherwise encumbered.

(d) “*Restricted Shares*” shall mean the Shares that are subject to the Forfeiture Restrictions under this Agreement.

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(e) “*Cause*” shall mean Executive (i) committed a felony or a crime involving moral turpitude or committed any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of his employment by the Company or an Affiliate which conduct damaged the Company or an Affiliate; (ii) substantially and repeatedly failed to perform duties of the office held by him or her as reasonably directed by the Company or an Affiliate; (iii) committed gross negligence or willful misconduct with respect to the Company or an Affiliate; (iv) committed a material breach of any employment agreement between the Executive and the Company or an Affiliate that is not cured within ten (10) days after receipt of written notice thereof from the Company or the Affiliate, as applicable; (v) failed, within ten (10) days after receipt by the Executive of written notice thereof from the Company or an Affiliate, to correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board reasonably believes does or may materially or adversely affect the Company’s or an Affiliate’s business or operations; (vi) committed misconduct which is of such a serious or substantial nature that a reasonable likelihood exists that such misconduct will materially injure the reputation of the Company or an Affiliate; (vii) harassed or discriminated against the Company’s or an Affiliate’s employees, customers or vendors in violation of the Company’s policies with respect to such matters; (viii) misappropriated funds or assets of the Company or an Affiliate for personal use or willfully violated the Company policies or standards of business conduct as determined in good faith by the Board (ix) failed, due to some action or inaction on the part of the Executive, to have immigration status that permits the Executive to maintain full-time employment with the Company or an Affiliate in the United States in compliance with all applicable immigration law; or (x) disclosed trade secrets of the Company or an Affiliate.

(f) “*Disability*” shall have the meaning ascribed to such term in the Plan, as it may be amended from time to time.

(g) “*Good Reason*” shall have the meaning ascribed to such term in the Executive’s employment agreement with the Company, or, if none, the Executive’s resignation from employment with the Company due to (i) a material diminution in Executive’s annual base salary, duties, authority or responsibilities or (ii) relocation of the Executive’s primary place of employment to a geographic area more than fifty (50) miles from Executive’s then-current primary place of employment, without the Executive’s consent; provided that the Executive has given thirty (30) days advance written notice to the Company of the initial existence of the condition described in (i) and/or (ii) and the Company has not within such thirty (30) day period remedied the condition.

Capitalized terms not otherwise defined in this Agreement shall have the meanings given to such terms in the Plan.

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2. ***Grant of Restricted Shares.*** Effective as of the Grant Date, the Company shall cause to be issued in Executive’s name the Shares as Restricted Shares. The Company shall cause electronic book entries evidencing the Restricted Shares, and any shares of the Stock or rights to acquire shares of the Stock distributed by the Company in respect of Restricted Shares during any Period of Restriction (the “*Retained Stock Distributions*”), to be issued in Executive’s name. During the Period of Restriction such electronic book entries shall contain a restrictive legend notation to the effect that ownership of such Restricted Shares (and any Retained Stock Distributions), and the enjoyment of all rights appurtenant thereto, are subject to the restrictions, terms, and conditions provided in the Plan and this Agreement. During the Period of Restriction any regular dividends paid in cash or property (other than Retained Stock Distributions) with respect to the Restricted Shares and Retained Stock Distributions (the “*Retained Cash Distributions*”) shall not be paid to Executive but instead shall be accumulated by the Company until the date the Forfeiture Restrictions applicable to the Restricted Shares and Retained Stock Distributions with respect to which such Retained Cash Distributions shall have been made, paid, or declared shall have become vested and then on that date such Retained Cash Distributions shall be paid to Executive. Executive shall have the right to vote the Restricted Shares awarded to Executive and to exercise all other rights, powers and privileges of a holder of the Shares, with respect to such Restricted Shares, with the exception that (a) Executive shall not be entitled to delivery of such Restricted Shares until the Forfeiture Restrictions applicable thereto shall have expired, (b) the Company shall retain custody of all Retained Stock Distributions made or declared with respect to the Restricted Shares and Retained Cash Distributions made or declared with respect to the Restricted Shares and the Retained Stock Distributions (and such Retained Stock Distributions and Retained Cash Distributions shall be subject to the same restrictions, terms and conditions as are applicable to the Restricted Shares) until such time, if ever, as the Restricted Shares with respect to which such Retained Stock Distributions and Restricted Cash Distributions shall have been made, paid, or declared shall have become vested, and such Retained Stock Distributions and Retained Cash Distributions shall not bear interest or be segregated in separate accounts and (c) Executive may not sell, assign, transfer, pledge, exchange, encumber, or dispose of the Restricted Shares or any Retained Stock Distributions or any Restricted Cash Distributions during the Period of Restriction.

Upon issuance the book entry representing the Restricted Shares shall be delivered to such depository as may be designated by the Committee as a depository for safekeeping until the forfeiture of such Restricted Shares occurs or the Forfeiture Restrictions lapse, together with stock powers or other instruments of assignment, each endorsed in blank, which will permit transfer to the Company of all or any portion of the Restricted Shares and any securities constituting Retained Stock Distributions which shall be forfeited in accordance with the Plan and this Agreement. In accepting the award of the Shares set forth in this Agreement Executive accepts and agrees to be bound by all the terms and conditions of the Plan and this Agreement.

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3. **Transfer Restrictions.** The Shares granted hereby may not be sold, assigned, pledged, exchanged, hypothecated or otherwise transferred, encumbered or disposed of, to the extent then subject to the Forfeiture Restrictions. Any such attempted sale, assignment, pledge, exchange, hypothecation, transfer, encumbrance or disposition in violation of this Agreement shall be void and the Company shall not be bound thereby. Further, the Shares granted hereby that are no longer subject to Forfeiture Restrictions may not be sold or otherwise disposed of in any manner that would constitute a violation of any applicable securities laws. Executive also agrees that the Company may (a) refuse to cause the transfer of the Shares to be registered on the applicable stock transfer records of the Company if such proposed transfer would, in the opinion of counsel satisfactory to the Company, constitute a violation of any applicable securities law and (b) give related instructions to the transfer agent, if any, to stop registration of the transfer of the Shares. The Shares are registered with the Securities and Exchange Commission under a Registration Statement on Form S-8. A Prospectus describing the Plan and the Shares is available from the Company.

4. **Vesting.**

(a) The Shares that are granted hereby shall be subject to the Forfeiture Restrictions. The Forfeiture Restrictions shall lapse as to the Shares that are granted hereby in accordance with the following sentence, provided that Employee's employment with the Company or any subsidiaries or Affiliates has not terminated prior to the applicable lapse date. On the first anniversary of the Vesting Start Date (as set forth on the Cover Sheet), and on each succeeding anniversary of the Vesting Start Date (each such anniversary date being referred to as a "lapse date"), the Forfeiture Restrictions shall lapse with respect to one-fourth (1/4<sup>th</sup>) of the total number of Shares granted hereby, rounded to the nearest whole number, except that on the fourth anniversary of the Vesting Start Date the Forfeiture Restrictions shall lapse with respect to the then remaining number of Shares granted hereby for which the Forfeiture Restrictions have not previously lapsed.

(b) Notwithstanding any other provision of this Agreement to the contrary, if a Change in Control occurs and Executive's employment is terminated by the Company without Cause or by Executive with Good Reason, in either case, within one (1) year following the occurrence of the Change in Control, then all remaining Forfeiture Restrictions shall lapse as to the Shares that are granted hereby upon the date the Executive's employment terminates. Notwithstanding any other provision in this Agreement to the contrary, if (i) Executive's employment is terminated by the Company without Cause or by Executive with Good Reason or (ii) Executive dies or incurs a Disability, all remaining Forfeiture Restrictions shall lapse as to the Shares that are granted hereby upon the date the Executive's employment terminates.

(c) Upon the lapse of the Forfeiture Restrictions with respect to the Shares granted hereby the Company shall cause to be delivered to Executive such Shares in electronic book entry form, and such Shares shall be transferable by Executive (except to the extent that any proposed transfer would, in the opinion of counsel satisfactory to the Company, constitute a violation of applicable securities law).

(d) If Executive ceases to be employed by the Company or a subsidiary for any reason before the applicable lapse date, the Forfeiture Restrictions then applicable to the Restricted Shares shall not lapse and all the Restricted Shares shall be forfeited to the Company.

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5. **Capital Adjustments and Reorganizations.** The existence of the Restricted Shares shall not affect in any way the right or power of the Company or any company the stock of which is awarded pursuant to this Agreement to make or authorize any adjustment, recapitalization, reorganization or other change in its capital structure or its business, engage in any merger or consolidation, issue any debt or equity securities, dissolve or liquidate, or sell, lease, exchange or otherwise dispose of all or any part of its assets or business, or engage in any other corporate act or proceeding.

6. **Tax Withholding.** To the extent that the receipt of the Restricted Shares or the lapse of any Forfeiture Restrictions results in income to Executive for federal, state, local or foreign income, employment or other tax purposes with respect to which the Company or its Affiliates or subsidiaries have a withholding obligation, Executive shall deliver to the Company at the time of such receipt or lapse, as the case may be, such amount of money as the Company or any Affiliate may require to meet such obligation under applicable tax laws or regulations, and, if Executive fails to do so, the Company and its Affiliates and subsidiaries are authorized to withhold from the Shares granted hereby or from any cash or stock remuneration then or thereafter payable to Executive in any capacity any tax required to be withheld by reason of such taxable income, sufficient to satisfy the withholding obligation.

7. **Section 83(b) Election.** Executive shall not exercise the election permitted under section 83(b) of the Internal Revenue Code of 1986, as amended, with respect to the Restricted Shares without the prior written approval of the General Counsel of the Company (if Executive is the General Counsel of the Company, Executive must seek the prior written approval of the Chief Financial Officer or the Chief Executive Officer). If the election is permitted as provided in the prior sentence, Executive shall timely pay the Company the amount necessary to satisfy the Company's attendant tax withholding obligations, if any.

8. **No Fractional Shares.** All provisions of this Agreement concern whole Shares. If the application of any provision hereunder would yield a fractional share, such fractional share shall be rounded down to the next whole share if it is less than 0.5 and rounded up to the next whole share if it is 0.5 or more.

9. **Employment Relationship.** For purposes of this Agreement, Executive shall be considered to be in the employment of the Company and its Affiliates as long as Executive has an employment relationship with the Company and its Affiliates. The Committee shall determine any questions as to whether and when there has been a termination of such employment relationship, and the cause of such termination, under the Plan and the Committee's determination shall be final and binding on all persons.

10. **Not an Employment Agreement.** This Agreement is not an employment agreement, and no provision of this Agreement shall be construed or interpreted to create an employment relationship between Executive and the Company or any Affiliate, to guarantee the right to remain employed by the Company or any Affiliate for any specified term or require the Company or any Affiliate to employ Executive for any period of time.

11. **Legend.** Executive consents to the placing of an appropriate legend notation on the electronic book entry representing the Shares restricting resale or other transfer of the Shares except in accordance with all applicable securities laws and rules thereunder.

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12. **Notices.** Any notice, instruction, authorization, request, demand or other communications required hereunder shall be in writing, and shall be delivered either by personal delivery, by telegram, telex, telecopy or similar facsimile means, by certified or registered mail, return receipt requested, or by courier or delivery service, addressed to the Company at the Company's principal business office address to the attention of the Company's General Counsel and to Executive at Executive's residential address as it appears on the books and records of the Company, or at such other address and number as a party shall have previously designated by written notice given to the other party in the manner hereinabove set forth. Notices shall be deemed given when received, if sent by facsimile means (confirmation of such receipt by confirmed facsimile transmission being deemed receipt of communications sent by facsimile means); and when delivered (or upon the date of attempted delivery where delivery is refused), if hand-delivered, sent by express courier or delivery service, or sent by certified or registered mail, return receipt requested.

13. **Amendment and Waiver.** Except as otherwise provided herein or in the Plan or as necessary to implement the provisions of the Plan, this Agreement may be amended, modified or superseded only by written instrument executed by the Company and Executive. Only a written instrument executed and delivered by the party waiving compliance hereof shall waive any of the terms or conditions of this Agreement. Any waiver granted by the Company shall be effective only if executed and delivered by a duly authorized officer of the Company other than Executive. The failure of any party at any time or times to require performance of any provisions hereof shall in no manner effect the right to enforce the same. No waiver by any party of any term or condition, or the breach of any term or condition contained in this Agreement, in one or more instances, shall be construed as a continuing waiver of any such condition or breach, a waiver of any other condition, or the breach of any other term or condition.

14. **Dispute Resolution.** In the event of any difference of opinion concerning the meaning or effect of the Plan or this Agreement, such difference shall be resolved by the Compensation Committee of the Board of Directors.

15. **Governing Law and Severability.** The validity, construction and performance of this Agreement shall be governed by the laws of the State of Delaware, excluding any conflicts or choice of law rule or principle that might otherwise refer construction or interpretation of this Agreement to the substantive law of another jurisdiction. The invalidity of any provision of this Agreement shall not affect any other provision of this Agreement, which shall remain in full force and effect.

16. **Successors and Assigns.** Subject to the limitations which this Agreement imposes upon the transferability of the Shares granted hereby, this Agreement shall bind, be enforceable by and inure to the benefit of the Company and its successors and assigns, and to Executive, Executive's permitted assigns, executors, administrators, agents, legal and personal representatives.

17. **Counterparts.** This Agreement may be executed in one or more counterparts, each of which shall be an original for all purposes but all of which taken together shall constitute but one and the same instrument.

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#### **Irrevocable Stock Power**

**KNOW ALL MEN BY THESE PRESENTS**, that the undersigned, **For Value Received**, has bargained, sold, assigned and transferred and by these presents does bargain, sell, assign and transfer unto Rosetta Stone Inc., a Delaware corporation (the "**Company**"), the Shares transferred pursuant to the Restricted Stock Award Agreement dated effective %OPTION\_DATE%, between the Company and the undersigned; **and** subject to and in accordance with such Restricted Stock Award Agreement the undersigned does hereby constitute and appoint the Secretary of the Company the undersigned's true and lawful attorney, IRREVOCABLY, to sell, assign, transfer, hypothecate, pledge and make over all or any part of such Shares and for that purpose to make and execute all necessary acts of assignment and transfer thereof, and to substitute one or more persons with like full power, hereby ratifying and confirming all that said attorney or his substitutes shall lawfully do by virtue hereof.

**In Witness Whereof**, the undersigned has executed this Irrevocable Stock Power effective the \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_.

Signature: \_\_\_\_\_

Name: %%FIRST\_NAME%-% %%LAST\_NAME%-%

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OPTION NO.:

**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED  
NONQUALIFIED STOCK OPTION AWARD AGREEMENT**

Rosetta Stone Inc., a Delaware corporation (the "Company"), hereby grants an option to purchase shares of its Class B Common Stock, \$.00005 par value, (the "Stock") to the optionee named below. The terms and conditions of the Option are set forth in the Nonqualified Stock Option Award Agreement and in the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the "*Plan*").

Grant Date:

Name of Optionee:

Optionee's Employee Identification Number:

Number of Shares Covered by Option:

Option Price per Share:

Vesting Start Date:

Recipient understands and agrees that this Non-Qualified Stock Option Award is granted subject to and in accordance with the terms of the Rosetta Stone, Inc. EQUITY\_PLAN (the "*Plan*"). Recipient further agrees to be bound by the terms of the Plan and the terms of the Non-Qualified Stock Option Award as set forth in the Non-Qualified Stock Option Agreement and any Addenda to such Non-Qualified Stock Option Agreement. A copy of the Plan is available on www.Etrade.com.

Nothing in this Notice or in the Non-Qualified Stock Option Agreement or in the Plan shall confer upon Recipient any right to continue in service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining Recipient) or of Recipient, which rights are hereby expressly reserved by each, to terminate Recipient's Service at any time for any reason, with or without cause.

Definitions. All capitalized terms in this Notice shall have the meaning assigned to them in this Notice or in the Non-Qualified Stock Option Agreement.

ROSETTA STONE INC.

Revised February 2012

**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED  
NONQUALIFIED STOCK OPTION AWARD AGREEMENT**

This **NONQUALIFIED STOCK OPTION AWARD AGREEMENT** (this "*Agreement*") and the Cover Sheet to which this Agreement is attached (the "*Cover Sheet*") are entered into between Rosetta Stone Inc., a Delaware corporation (the "*Company*"), and Optionee (as that term is defined in the Covered Sheet). The Board of Directors of the Company has adopted, and the stockholders of the Company have approved, the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the "*Plan*"), the terms of which are incorporated by reference herein in their entirety. Any term used in this Agreement that is not specifically defined herein shall have the meaning specified in the Plan.

**IT IS AGREED:**

1. **Grant of Option.** Subject to the terms of the Plan, this Agreement and the Cover Sheet, on the Grant Date set forth on the Cover Sheet (the "*Grant Date*"), the Company granted to Optionee an option (the "*Option*") to purchase that number of shares of the Company's common stock, \$.00005 par value (the "*Stock*"), at the Option Price per Share of Stock set forth on the Cover Sheet (the "*Option Price*"), subject to adjustment as provided in the Plan.
2. **Type of Option.** The Option is a nonqualified stock option which is not intended to be governed by section 422 of the Code and will be interpreted accordingly.
3. **Optionee's Agreement.** In accepting the Option, Optionee accepts and agrees to be bound by all the terms and conditions of the Plan which pertain to nonqualified stock options granted under the Plan.
4. **Vesting of Option.** Subject to the provisions of the Plan and the provision of this Agreement (including the requirement in Section 6 that



Optionee continue to be employed by the Company or a Subsidiary Corporation on the dates set forth below), the Option will vest and become exercisable in accordance with the following terms:

(a) on the first anniversary of the Vesting Start Date (as set forth on the Cover Sheet), and on each succeeding anniversary date of the Vesting Start Date, the Option will vest with respect to, and may be exercised for up to, one-fourth (1/4<sup>th</sup>) of the total number of shares of the Stock subject to the Option as set forth on the Cover Sheet (the “*Option Shares*”), rounded to the nearest whole number of shares, except that on the fourth anniversary of the Vesting Start Date the Option shall vest with respect to the remaining number of Option Shares for which the Option has not previously vested;

(b) to the extent not exercised, installments of vested Option Shares shall be cumulative and may be exercised in whole or in part.

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## 5. *Manner of Exercise.*

(a) To the extent that the Option is vested and exercisable in accordance with Section 4 of this Agreement, the Option may be exercised by Optionee at any time, or from time to time, in whole or in part, on or prior to the termination of the Option (as set forth in Section 6 of this Agreement) upon payment of the Option Price for the Option Shares to be acquired in accordance with the terms and conditions of this Agreement and the Plan.

(b) If Optionee is entitled to exercise the vested and exercisable portion of the Option, and wishes to do so, in whole or part, Optionee shall (i) deliver to the Company a fully completed and executed notice of exercise, in such form as may be designated by the Company in its sole discretion, specifying the exercise date and the number of Option Shares to be purchased pursuant to such exercise and (ii) remit to the Company in a form satisfactory to the Company, in its sole discretion, the Option Price for the Option Shares to be acquired on exercise of the Option, plus an amount sufficient to satisfy any withholding tax obligations of the Company that arise in connection with such exercise (as determined by the Company) in accordance with the provisions of the Plan.

(c) The Company’s obligation to deliver shares of the Stock to Optionee under this Agreement is subject to and conditioned upon Optionee satisfying all tax obligations associated with Optionee’s receipt, holding and exercise of the Option. Unless otherwise approved by the Committee, all such tax obligations shall be payable in accordance with the provisions of the Plan.

(d) The Company and its Affiliates and subsidiaries, as applicable, shall be entitled to deduct from any compensation otherwise due to Optionee the amount necessary to satisfy all such taxes.

(e) Upon full payment of the Option Price and satisfaction of all applicable tax obligations, and subject to the applicable terms and conditions of the Plan and the terms and conditions of this Agreement, the Company shall cause certificates for the shares purchased hereunder to be delivered to Optionee or cause an uncertificated book-entry representing such shares to be made.

6. *Termination of Option.* Unless the Option terminates earlier as provided in this Section 6 the Option shall terminate and become null and void at the close of business at the Company’s principal business office on the day before the date of the tenth anniversary of the Grant Date (the “*Option General Expiration Date*”). If Optionee ceases to be an employee of the Company or any Subsidiary Corporation for any reason the Option shall not continue to vest after such cessation of service as an employee of the Company or Subsidiary Corporation.

(a) If Optionee ceases to be an employee of the Company or any Subsidiary Corporation due to death or Disability, (i) the portion of the Option that was exercisable on the date of such cessation shall remain exercisable for, and shall otherwise terminate and become null and void at the close of business at the Company’s principal business office on the day that is six (6) months after the date of such death or Disability, but in no event after the Option

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General Expiration Date; and (ii) the portion of the Option that was not exercisable on the date of such cessation shall be forfeited and become null and void immediately upon such cessation.

(b) If Optionee ceases to be an employee of the Company or a Subsidiary Corporation due to Cause, all of the Option shall be forfeited and become null and void immediately upon such cessation, whether or not then exercisable.

(c) If Optionee ceases to be an employee of the Company or a Subsidiary Corporation for any reason other than death, Disability, or Cause, (i) the portion of the Option that was exercisable on the date of such cessation shall remain exercisable for, and shall otherwise terminate and become null and void at the close of business at the Company’s principal business office on the later of (x) the day that is sixty (60) days after the date of such cessation, or (y) the day that is thirty (30) days after any blackout period(s) under the Company’s Insider Trading Compliance Policy (as in effect from time to time) to the extent Optionee is then subject to any such blackout period(s), but in no event after the Option General Expiration Date, and (ii) the portion of the Option that was not exercisable on the date of such cessation shall be forfeited and become null and void immediately upon such cessation.

(d) Upon the death of Optionee prior to the expiration of the Option, Optionee’s executors, administrators or any person or persons to whom the Option may be transferred by will or by the laws of descent and distribution, shall have the right, at any time prior to the termination of the Option to exercise the Option with respect to the number of shares that Optionee would have been entitled to exercise if he were still alive.

7. **Tax Withholding.** To the extent that the receipt of the Option, this Agreement or the Cover Sheet, the vesting of the Option or the exercise of the Option results in income to Optionee for federal, state, local or foreign income, employment or other tax purposes with respect to which the Company or its subsidiaries or any Affiliate has a withholding obligation, Optionee shall deliver to the Company at the time of such receipt, vesting or exercise, as the case may be, such amount of money as the Company or its subsidiaries or any Affiliate may require to meet its obligation under applicable tax laws or regulations, and, if Optionee fails to do so, the Company or its subsidiaries or any Affiliate is authorized to withhold from the shares subject to the Option (based on the Fair Market Value of such shares as of the date the amount of tax to be withheld is determined) or from any cash or stock remuneration then or thereafter payable to Optionee any tax required to be withheld by reason of such taxable income, sufficient to satisfy the withholding obligation.

8. **Capital Adjustments and Reorganizations.** The existence of the Option shall not affect in any way the right or power of the Company or any company the stock of which is awarded pursuant to this Agreement to make or authorize any adjustment, recapitalization, reorganization or other change in its capital structure or its business, engage in any merger or consolidation, issue any debt or equity securities, dissolve or liquidate, or sell, lease, exchange or otherwise dispose of all or any part of its assets or business, or engage in any other corporate act or proceeding.

9. **Employment Relationship.** For purposes of this Agreement, Optionee shall be considered to be in the employment of the Company, any Subsidiary Corporation or any

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Affiliates as long as Optionee has an employment relationship with the Company, any Subsidiary Corporation or any Affiliates. The Committee shall determine any questions as to whether and when there has been a termination of such employment relationship, and the cause of such termination, under the Plan and the Committee's determination shall be final and binding on all persons.

10. **Not an Employment Agreement.** This Agreement is not an employment or service agreement, and no provision of this Agreement shall be construed or interpreted to create an employment or other service relationship between Optionee and the Company, its subsidiaries or any of its Affiliates or guarantee the right to remain employed by the Company, its subsidiaries or any of its Affiliates, for any specified term or require the Company, its subsidiaries or any Affiliate to employ Employee for any period of time.

11. **No Rights As Stockholder.** Optionee shall not have any rights as a stockholder with respect to any Option Shares until the date of the issuance of such shares following Optionee's exercise of the Option pursuant to its terms and conditions and payment of all amounts for and with respect to the shares. No adjustment shall be made for dividends or other rights for which the record date is prior to the date a certificate or certificates are issued for such shares or an uncertificated book-entry representing such shares is made.

12. **Legend.** Optionee consents to the placing on the certificate for any Option Shares of an appropriate legend restricting resale or other transfer of such shares except in accordance with the Securities Act of 1933 and all applicable rules thereunder.

13. **Notices.** Any notice, instruction, authorization, request, demand or other communications required hereunder shall be in writing, and shall be delivered either by personal delivery, by telegram, telex, telecopy or similar facsimile means, by certified or registered mail, return receipt requested, or by courier or delivery service, addressed to the Company at the Company's principal business office address to the attention of the Company's General Counsel and to Optionee at Optionee's residential address as it appears on the books and records of the Company, or at such other address and number as a party shall have previously designated by written notice given to the other party in the manner hereinabove set forth. Notices shall be deemed given when received, if sent by facsimile means (confirmation of such receipt by confirmed facsimile transmission being deemed receipt of communications sent by facsimile means); and when delivered (or upon the date of attempted delivery where delivery is refused), if hand-delivered, sent by express courier or delivery service, or sent by certified or registered mail, return receipt requested.

14. **Amendment and Waiver.** Except as otherwise provided herein or in the Plan or as necessary to implement the provisions of the Plan, this Agreement may be amended, modified or superseded only by written instrument executed by the Company and Optionee. Only a written instrument executed and delivered by the party waiving compliance hereof shall waive any of the terms or conditions of this Agreement. Any waiver granted by the Company shall be effective only if executed and delivered by a duly authorized director or officer of the Company other than Optionee. The failure of any party at any time or times to require performance of any provisions hereof shall in no manner effect the right to enforce the same. No waiver by any party of any term or condition, or the breach of any term or condition contained in this Agreement, in one or

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more instances, shall be construed as a continuing waiver of any such condition or breach, a waiver of any other condition, or the breach of any other term or condition.

15. **Dispute Resolution.** In the event of any difference of opinion concerning the meaning or effect of the Plan or this Agreement, such difference shall be resolved by the Committee.

16. **Governing Law and Severability.** The validity, construction and performance of this Agreement shall be governed by the laws of the State of Delaware, excluding any conflicts or choice of law rule or principle that might otherwise refer construction or interpretation of this Agreement to the substantive law of another jurisdiction. The invalidity of any provision of this Agreement shall not affect any other provision of this Agreement, which shall remain in full force and effect.

17. **Transfer Restrictions.** The Option Shares may not be sold or otherwise disposed of in any manner that would constitute a violation of any applicable federal or state securities laws. Optionee also agrees (a) that the Company may refuse to cause the transfer of Option Shares to be registered on the applicable stock transfer records if such proposed transfer would in the opinion of counsel satisfactory to the Company constitute a violation of any applicable securities law and (b) that the Company may give related instructions to the transfer agent, if any, to stop registration of the transfer of the Option Shares.

18. **Successors and Assigns.** This Agreement shall, except as herein stated to the contrary, inure to the benefit of and bind the legal representatives, successors and assigns of the parties hereto.

19. **Counterparts.** This Agreement may be executed in one or more counterparts, each of which shall be an original for all purposes but all of which taken together shall constitute but one and the same instrument.

20. **Option Transfer Prohibitions.** The Option granted to Optionee under this Agreement shall not be transferable or assignable by Optionee other than by will or the laws of descent and distribution, and shall be exercisable during Optionee's lifetime only by him.

21. **Definitions.** The words and phrases defined in this Section 21 shall have the respective meanings set forth below throughout this Agreement, unless the context in which any such word or phrase appears reasonably requires a broader, narrower or different meaning.

(a) "Cause" shall mean Optionee (i) committed a felony or a crime involving moral turpitude or committed any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of his employment by the Company or an Affiliate which conduct damaged the Company or an Affiliate; (ii) substantially and repeatedly failed to perform duties of the office held by him or her as reasonably directed by the Company or an Affiliate; (iii) committed gross negligence or willful misconduct with respect to the Company or an Affiliate; (iv) committed a material breach of any employment agreement between the Optionee and the Company or an Affiliate that is not cured within ten (10) days after receipt of written notice thereof from the Company or the Affiliate, as applicable; (v) failed, within ten (10) days after receipt by the Optionee of written notice thereof from the Company or an Affiliate, to

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correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board reasonably believes does or may materially or adversely affect the Company's or an Affiliate's business or operations; (vi) committed misconduct which is of such a serious or substantial nature that a reasonable likelihood exists that such misconduct will materially injure the reputation of the Company or an Affiliate; (vii) harassed or discriminated against the Company's or an Affiliate's employees, customers or vendors in violation of the Company's policies with respect to such matters; (viii) misappropriated funds or assets of the Company or an Affiliate for personal use or willfully violated the Company policies or standards of business conduct as determined in good faith by the Board; (ix) failed, due to some action or inaction on the part of the Optionee, to have immigration status that permits the Optionee to maintain full-time employment with the Company or an Affiliate in the United States in compliance with all applicable immigration law; or (x) disclosed trade secrets of the Company or an Affiliate.

(b) "Disability" shall have the meaning ascribed to such term in the Plan, as it may be amended from time to time.

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**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED**

**COVER SHEET TO  
RESTRICTED STOCK AWARD AGREEMENT**

Rosetta Stone Inc., a Delaware corporation (the “*Company*”), has granted to the individual whose name is set forth below on the “Name of Employee” line (“*Employee*”) the shares of the Company’s common stock, \$.00005 par value, specified herein, subject to the terms and conditions set forth in this Cover Sheet, in the Restricted Stock Award Agreement and in the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the “*Plan*”).

Grant Date:

Name of Employee:

Employee’s Employee Identification Number:

Number of Shares of Restricted Stock Granted:

Vesting Start Date:

Recipient understands and agrees that this Restricted Stock Award is granted subject to and in accordance with the terms of the Rosetta Stone, Inc. %%EQUITY\_PLAN%% (the “*Plan*”). Recipient further agrees to be bound by the terms of the Plan and the terms of the Restricted Stock Award as set forth in the Restricted Stock Award Agreement and any Addenda to such Restricted Stock Award Agreement. A copy of the Plan is available on www.etrade.com.

Nothing in this Notice or in the Restricted Stock Award Agreement or in the Plan shall confer upon Recipient any right to continue in service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining Recipient) or of Recipient, which rights are hereby expressly reserved by each, to terminate Recipient’s Service at any time for any reason, with or without cause.

Definitions. All capitalized terms in this Notice shall have the meaning assigned to them in this Notice or in the Restricted Stock Award Agreement.

ROSETTA STONE INC.

**ROSETTA STONE INC.  
2009 OMNIBUS INCENTIVE PLAN, AS AMENDED**

**RESTRICTED STOCK AWARD AGREEMENT**

This **RESTRICTED STOCK AWARD AGREEMENT** (this “*Agreement*”) and the Cover Sheet to which this Agreement is attached (the “*Cover Sheet*”) is made by and between Rosetta Stone Inc., a Delaware corporation (the “*Company*”), and Employee (as that term is defined in the Covered Sheet), effective as of the Grant Date set forth on the Cover Sheet (the “*Grant Date*”), pursuant to the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, (the “*Plan*”), a copy of which previously has been made available to Employee and the terms and provisions of which are incorporated by reference herein.

**WHEREAS**, the Company desires to grant to Employee the shares of the Company’s common stock, \$.00005 par value, set forth on the “Number of Shares of Restricted Stock Granted” line on the Cover Sheet (the “*Shares*”), subject to the terms and conditions of this Agreement; and

**WHEREAS**, Employee desires to have the opportunity to hold the Shares subject to the terms and conditions of this Agreement;

**NOW, THEREFORE**, in consideration of the premises, mutual covenants and agreements contained herein, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto, intending to be legally bound hereby, agree as follows:

1. **Definitions.** For purposes of this Agreement, the following terms shall have the meanings indicated:

(a) “*Forfeiture Restrictions*” shall mean the prohibitions and restrictions set forth herein with respect to the sale or other disposition of the Shares issued to Employee hereunder and the obligation to forfeit and surrender such Shares to the Company.

(b) “*Period of Restriction*” shall mean the period during which Restricted Shares are subject to Forfeiture Restrictions and during which Restricted Shares may not be sold, assigned, transferred, pledged or otherwise encumbered.

(c) “*Restricted Shares*” shall mean the Shares that are subject to the Forfeiture Restrictions under this Agreement.

(d) “*Disability*” shall have the meaning ascribed to such term in the Plan, as it may be amended from time to time.

Capitalized terms not otherwise defined in this Agreement shall have the meanings given to such terms in the Plan.

2. **Grant of Restricted Shares.** Effective as of the Grant Date, the Company shall cause to be issued in Employee's name the Shares as Restricted Shares. The Company shall cause electronic book entries evidencing the Restricted Shares, and any shares of the Stock or

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rights to acquire shares of the Stock distributed by the Company in respect of Restricted Shares during any Period of Restriction (the "*Retained Stock Distributions*"), to be issued in Employee's name. During the Period of Restriction such electronic book entries shall contain a restrictive legend notation to the effect that ownership of such Restricted Shares (and any Retained Stock Distributions), and the enjoyment of all rights appurtenant thereto, are subject to the restrictions, terms, and conditions provided in the Plan and this Agreement. During the Period of Restriction any regular dividends paid in cash or property (other than Retained Stock Distributions) with respect to the Restricted Shares and Retained Stock Distributions (the "*Retained Cash Distributions*") shall not be paid to Employee but instead shall be accumulated by the Company until the date the Forfeiture Restrictions applicable to the Restricted Shares and Retained Stock Distributions with respect to which such Retained Cash Distributions shall have been made, paid, or declared shall have become vested and then on that date such Retained Cash Distributions shall be paid to Employee. Employee shall have the right to vote the Restricted Shares awarded to Employee and to exercise all other rights, powers and privileges of a holder of the Shares, with respect to such Restricted Shares, with the exception that (a) Employee shall not be entitled to delivery of such Restricted Shares until the Forfeiture Restrictions applicable thereto shall have expired, (b) the Company shall retain custody of all Retained Stock Distributions made or declared with respect to the Restricted Shares and Retained Cash Distributions made or declared with respect to the Restricted Shares and the Retained Stock Distributions (and such Retained Stock Distributions and Retained Cash Distributions shall be subject to the same restrictions, terms and conditions as are applicable to the Restricted Shares) until such time, if ever, as the Restricted Shares with respect to which such Retained Stock Distributions and Restricted Cash Distributions shall have been made, paid, or declared shall have become vested, and such Retained Stock Distributions and Retained Cash Distributions shall not bear interest or be segregated in separate accounts and (c) Employee may not sell, assign, transfer, pledge, exchange, encumber, or dispose of the Restricted Shares or any Retained Stock Distributions or any Restricted Cash Distributions during the Period of Restriction. Upon issuance the book entry representing the Restricted Shares shall be delivered to such depository as may be designated by the Committee as a depository for safekeeping until the forfeiture of such Restricted Shares occurs or the Forfeiture Restrictions lapse, together with stock powers or other instruments of assignment, each endorsed in blank, which will permit transfer to the Company of all or any portion of the Restricted Shares and any securities constituting Retained Stock Distributions which shall be forfeited in accordance with the Plan and this Agreement. In accepting the award of the Shares set forth in this Agreement Employee accepts and agrees to be bound by all the terms and conditions of the Plan and this Agreement.

3. **Transfer Restrictions.** The Shares granted hereby may not be sold, assigned, pledged, exchanged, hypothecated or otherwise transferred, encumbered or disposed of, to the extent then subject to the Forfeiture Restrictions. Any such attempted sale, assignment, pledge, exchange, hypothecation, transfer, encumbrance or disposition in violation of this Agreement shall be void and the Company shall not be bound thereby. Further, the Shares granted hereby that are no longer subject to Forfeiture Restrictions may not be sold or otherwise disposed of in any manner that would constitute a violation of any applicable securities laws. Employee also agrees that the Company may (a) refuse to cause the transfer of the Shares to be registered on the applicable stock transfer records of the Company if such proposed transfer would, in the opinion of counsel satisfactory to the Company, constitute a violation of any applicable securities law and (b) give related instructions to the transfer agent, if any, to stop registration of the transfer of the Shares. The Shares are registered with the Securities and Exchange Commission under a

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Registration Statement on Form S-8. A Prospectus describing the Plan and the Shares is available from the Company.

4. **Vesting.**

(a) The Shares that are granted hereby shall be subject to the Forfeiture Restrictions. The Forfeiture Restrictions shall lapse as to the Shares that are granted hereby in accordance with the following schedule, provided that Employee's employment with the Company or its direct or indirect subsidiaries has not terminated prior to the applicable lapse date. On the first anniversary of the Vesting Start Date (as set forth in the Cover Sheet), and on each succeeding anniversary of the Vesting Start Date (each such anniversary date being referred to as a "lapse date"), the Forfeiture Restrictions shall lapse with respect to one-fourth (1/4<sup>th</sup>) of the total number of Restricted Shares granted hereby, rounded to the nearest whole number, except that on the fourth anniversary of the Vesting Start Date the Forfeiture Restrictions shall lapse with respect to the then remaining number of Restricted Shares granted hereby for which the Forfeiture Restrictions have not previously lapsed.

(b) Upon the lapse of the Forfeiture Restrictions with respect to the Shares granted hereby the Company shall cause to be delivered to Employee such Shares in electronic book entry form, and such Shares shall be transferable by Employee (except to the extent that any proposed transfer would, in the opinion of counsel satisfactory to the Company, constitute a violation of applicable securities law).

(c) If Employee ceases to be employed by the Company or a subsidiary for any reason before the applicable lapse date including death or disability of Employee, the Forfeiture Restrictions then applicable to the Restricted Shares shall not lapse and all the Restricted Shares shall be forfeited to the Company.

5. **Capital Adjustments and Reorganizations.** The existence of the Restricted Shares shall not affect in any way the right or power of the Company or any company the stock of which is awarded pursuant to this Agreement to make or authorize any adjustment, recapitalization, reorganization or other change in its capital structure or its business, engage in any merger or consolidation, issue any debt or equity securities, dissolve or liquidate, or sell, lease, exchange or otherwise dispose of all or any part of its assets or business, or engage in any other corporate act or proceeding.

6. **Tax Withholding.** To the extent that the receipt of the Restricted Shares or the lapse of any Forfeiture Restrictions results in income to Employee for federal, state, local or foreign income, employment or other tax purposes with respect to which the Company or its Affiliates or subsidiaries have a withholding obligation, Employee shall deliver to the Company at the time of such receipt or lapse, as the case may be, such amount of money as the Company or any Affiliate may require to meet such obligation under applicable tax laws or regulations, and, if Employee fails to do so, the Company and its Affiliates and subsidiaries are authorized to withhold from the Shares granted hereby or from any cash or stock remuneration then or thereafter payable to Employee in any capacity any tax required to be withheld by reason of such taxable income, sufficient to satisfy the withholding obligation.

7. **Section 83(b) Election.** Employee shall not exercise the election permitted under section 83(b) of the Internal Revenue Code of 1986, as amended, with respect to the Restricted

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Shares without the prior written approval of the General Counsel of the Company. If the election is permitted as provided in the prior sentence, Employee shall timely pay the Company the amount necessary to satisfy the Company's attendant tax withholding obligations, if any.

8. **No Fractional Shares.** All provisions of this Agreement concern whole Shares. If the application of any provision hereunder would yield a fractional share, such fractional share shall be rounded down to the next whole share if it is less than 0.5 and rounded up to the next whole share if it is 0.5 or more.

9. **Employment Relationship.** For purposes of this Agreement, Employee shall be considered to be in the employment of the Company and its Affiliates as long as Employee has an employment relationship with the Company and its Affiliates. The Committee shall determine any questions as to whether and when there has been a termination of such employment relationship, and the cause of such termination, under the Plan and the Committee's determination shall be final and binding on all persons.

10. **Not an Employment Agreement.** This Agreement is not an employment agreement, and no provision of this Agreement shall be construed or interpreted to create an employment relationship between Employee and the Company or any Affiliate, to guarantee the right to remain employed by the Company or any Affiliate for any specified term or require the Company or any Affiliate to employ Employee for any period of time.

11. **Legend.** Employee consents to the placing of an appropriate legend notation on the electronic book entry representing the Shares restricting resale or other transfer of the Shares except in accordance with all applicable securities laws and rules thereunder.

12. **Notices.** Any notice, instruction, authorization, request, demand or other communications required hereunder shall be in writing, and shall be delivered either by personal delivery, by telegram, telex, telecopy or similar facsimile means, by certified or registered mail, return receipt requested, or by courier or delivery service, addressed to the Company at the Company's principal business office address to the attention of the Company's General Counsel and to Employee at Employee's residential address as it appears on the books and records of the Company, or at such other address and number as a party shall have previously designated by written notice given to the other party in the manner hereinabove set forth. Notices shall be deemed given when received, if sent by facsimile means (confirmation of such receipt by confirmed facsimile transmission being deemed receipt of communications sent by facsimile means); and when delivered (or upon the date of attempted delivery where delivery is refused), if hand-delivered, sent by express courier or delivery service, or sent by certified or registered mail, return receipt requested.

13. **Amendment and Waiver.** Except as otherwise provided herein or in the Plan or as necessary to implement the provisions of the Plan, this Agreement may be amended, modified or superseded only by written instrument executed by the Company and Employee. Only a written instrument executed and delivered by the party waiving compliance hereof shall waive any of the terms or conditions of this Agreement. Any waiver granted by the Company shall be effective only if executed and delivered by a duly authorized officer of the Company other than Employee. The failure of any party at any time or times to require performance of any provisions hereof shall in no manner effect the right to enforce the same. No waiver by any party of any term or condition, or the breach of any term or condition contained in this

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Agreement, in one or more instances, shall be construed as a continuing waiver of any such condition or breach, a waiver of any other condition, or the breach of any other term or condition.

14. **Dispute Resolution.** In the event of any difference of opinion concerning the meaning or effect of the Plan or this Agreement, such difference shall be resolved by the Compensation Committee of the Board of Directors.

15. **Governing Law and Severability.** The validity, construction and performance of this Agreement shall be governed by the laws of the State of Delaware, excluding any conflicts or choice of law rule or principle that might otherwise refer construction or interpretation of this Agreement to the substantive law of another jurisdiction. The invalidity of any provision of this Agreement shall not affect any other provision of this Agreement, which shall remain in full force and effect.

16. **Successors and Assigns.** Subject to the limitations which this Agreement imposes upon the transferability of the Shares granted hereby, this Agreement shall bind, be enforceable by and inure to the benefit of the Company and its successors and assigns, and to Employee, Employee's permitted assigns, executors, administrators, agents, legal and personal representatives.

17. **Counterparts.** This Agreement may be executed in one or more counterparts, each of which shall be an original for all purposes but all of which taken together shall constitute but one and the same instrument.

***Irrevocable Stock Power***

***KNOW ALL MEN BY THESE PRESENTS***, that the undersigned, ***For Value Received***, has bargained, sold, assigned and transferred and by these presents does bargain, sell, assign and transfer unto Rosetta Stone Inc., a Delaware corporation (the “*Company*”), the Shares transferred pursuant to the Restricted Stock Award Agreement dated effective \_\_\_\_\_, 20\_\_\_\_, between the Company and the undersigned; ***and*** subject to and in accordance with such Restricted Stock Award Agreement the undersigned does hereby constitute and appoint the Secretary of the Company the undersigned’s true and lawful attorney, IRREVOCABLY, to sell, assign, transfer, hypothecate, pledge and make over all or any part of such Shares and for that purpose to make and execute all necessary acts of assignment and transfer thereof, and to substitute one or more persons with like full power, hereby ratifying and confirming all that said attorney or his substitutes shall lawfully do by virtue hereof.

***In Witness Whereof***, the undersigned has executed this Irrevocable Stock Power effective the \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_.

Name: \_\_\_\_\_

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September 16, 2011

REVISED October 3, 2011

**Helena Wong**

1800 N Oak Street  
Apt. 907  
Arlington, VA 22209

Dear Helena,

This letter will serve as confirmation that your employment with Rosetta Stone Ltd. (the "Company") is being terminated. Set forth in this letter and the attached Legal Release (Exhibit A) (collectively, the "Agreement") is the complete agreement between you and the Company regarding the terms of your separation from employment.

**Separation Date**

Your employment with the Company will terminate at the close of business on **October 17, 2011** (your "Separation Date"). The Company, in its sole discretion, reserves the right to change your Separation Date, but you will be notified in writing of any such change.

**Vacation**

On the next regularly scheduled pay date following your Separation Date, or sooner if required by law, you will receive a check for all unpaid wages and, if applicable, any unused vacation or paid time off which has accrued to your account pursuant to Company policies through your Separation Date (i.e. 131.94 hours), less applicable deductions and withholdings.

**Health Benefits**

If you or your covered dependents are covered under the Company's group health insurance (medical, dental, and/or vision), that coverage will continue through the end of the month in which your Separation Date occurs or until such coverage terminates in accordance with the terms of the governing plan documents. Following your Separation Date, you will receive separate information regarding your rights under the Consolidated Omnibus Budget Reconciliation Act ("COBRA") to continue your group coverage after your Separation Date for yourself and any covered dependents, as applicable. This information will describe the rules related to continuation of coverage under COBRA, the cost for you or your covered dependents to continue coverage, and a COBRA election form.

*Separation Agreement and Release*

**Life Insurance**

Your Company-paid life insurance will continue through the end of the month in which your Separation Date occurs. You may have the right to elect to convert your life insurance into individual policies pursuant to applicable law and the terms of the life insurance policy.

**Retirement Plan**

You will retain your vested benefits, if any, under any applicable qualified retirement plans of the Company, as determined under the terms of the governing plan documents.

**Additional Benefit Information**

Except as specifically set forth in this Agreement or required by applicable law, as of your Separation Date, you shall cease to participate in all employee benefit plans, policies, and practices provided by the Company, and you shall not be entitled to any other compensation and/or benefits other than as set forth in this Agreement.

**Company Property and Continuing Obligations to the Company**

Prior to your departure on your last day worked, you must return to your department manager all the Company property in your possession, including, but not limited to, your identification badge, keys, computers, corporate credit cards, telephones, parking permits and the original and all copies of any written, recorded, or computer readable information about Company practices, procedures, trade secrets, customer lists or product marketing associated with the Company's business and any other information deemed proprietary or confidential in accordance with Company policies or your Executive Employment Agreement dated January 25, 2011 (the "Employment Agreement"). By signing this Agreement, you represent that you have returned all Company confidential or proprietary information in your possession and that you took all reasonable steps to protect the confidentiality of such Company information



during your employment. You agree that you are bound by (a) all the terms of the Company's Code of Ethics and Business Conduct through your Separation Date and (b) your Employment Agreement, which remains in full force and effect after your Separation Date, and includes, among other obligations, the continuing duty not to disclose confidential and proprietary information after your Separation Date and the continuing duty not to compete with the Company or its affiliates or solicit its or its subsidiaries or affiliates employees or customers within the parameters detailed in your Employment Agreement.

## Severance Benefits

In addition, under the terms and conditions as detailed below, the Company will provide you additional payments and benefits, which you acknowledge are payments and benefits to which you are otherwise not entitled, if you sign and submit this Agreement (within the required time period described in the "Decision Period" section below) and do not thereafter revoke it. Please carefully read and consider the provisions of this Agreement. If you do not sign this Agreement within the required time period, or if you later revoke this Agreement, you will not receive the additional payments and benefits described below. The release contained in **Exhibit A** hereto is an integral part of this Agreement. For purposes of clarity, you should understand that the payments and benefits provided under this Agreement are contingent upon executing of a release in the form of **Exhibit A**.

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In exchange for your timely execution of this Agreement, and allowing such Agreement to become effective without thereafter revoking it (which includes executing and not revoking the release contained in Exhibit A), the Company will provide you the following (the "Severance Benefits"):

- The Company will provide you with a lump sum payment of **\$300,000.00** which is equal to approximately **twelve (12)** months of your current regular base pay (the "Severance Payment"). The Severance Payment will be reduced by required withholdings and deductions. In addition, to the extent allowed under the law, the Severance Payment will be further reduced by any amount that you are obligated to pay to (1) the Company pursuant to any relevant Company policy and/or (2) to any third party pursuant to the terms of the Company Corporate Card Program, if applicable. Your Severance Payment will be paid to you in a lump sum no later than January 31, 2012, provided that you signed this Agreement (including **Exhibit A**) and did not revoke it. As your active service as an employee will end on your Separation Date, this payment is not eligible for deferrals in the Company's 401(k) plan.
- The company will provide you relocation assistance from Arlington, VA ("VA"), to New York, NY ("NY"), as follows:
  - Reimbursement for breakage of your car lease up to a maximum \$7,500.00 upon receiving applicable receipts, or proof of payment, no later than October 31, 2011.
  - Reimbursement for a limited shipment of personal items, from VA to NY, upon receiving the Company's prior approval of costs prior to any arrangement for shipment, and, upon receiving applicable receipts or proof of payment no later than October 31, 2011.
  - Arranging and purchasing 14 days in advance of departure a one-way economy class plane ticket, from VA to NY, scheduled no later than October 17, 2011.
- The Company will provide you with a lump sum payment of \$1,260, which is equal to 12 months of the basic life insurance and AD&D premium applicable to Executive's basic life insurance coverage immediately prior to the Separation Date. It will be paid within 30 days after your Separation Date. You may at your option convert your basic life insurance coverage to an individual policy after the Separation Date by completing the forms required by the Company for this purpose.
- The Company will pay, when due and payable under the Annual Bonus plan, the pro rata portion, if any, of your Annual Bonus earned up until such Separation Date within 30 days of the date the Company pays annual bonuses, if any, under the 2011 Rosetta Stone Executive Bonus Plan.
- The Company shall provide the services of a professional outplacement and counseling firm, as designated by the Company, for **twelve (12)** months to assist you in securing other employment following your Separation Date. If you do not wish to utilize the services of the outplacement firm as designated by the Company, you may exercise the option to receive a lump sum payment of \$8,500.00 less applicable deductions and withholdings, within 30 days after your Separation Date, provided that you have informed the Company of your choice no later than on your Separation Date.

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- Upon separation you will have the opportunity to continue your current health benefits coverage under Company's group health plans through COBRA. If you timely elect to enroll to continue such coverage under COBRA, the Company shall pay for up to **twelve (12)** months, on an after tax basis, for the portion of your COBRA premiums for such coverage that exceeds the amount that you would have incurred in premiums for coverage under the Company's health plan if then employed by the Company. Following the twelve (12) months of coverage, you will be responsible for all future premium payments should you wish to continue your COBRA coverage. However, if you or your spouse becomes eligible for group health coverage sponsored by another employer or for any other reason your COBRA coverage terminates, the Company shall not be obligated to pay any portion of the premiums provided hereunder for periods after you become eligible for such other coverage or your COBRA coverage terminates.

You will not be permitted to specify the taxable year in which payments described in this Agreement are made to you. The payments and other benefits set forth in this Agreement are being offered solely in consideration for your timely execution of this Agreement (including a release of all claims against the Company in Exhibit A) without revoking it. The payments made to you pursuant to this Agreement are not an admission of any wrongdoing by the Company.

**Decision Period**

Pursuant to the Older Workers Benefit Protection Act of 1990 (“OWBPA”), you are advised: (1) to consult an attorney regarding this Agreement before executing the Agreement; (2) that you are waiving rights or claims which may be waived by law in exchange for consideration which is not otherwise due to you; (3) that rights or claims, including those arising under the Age Discrimination in Employment Act of 1967 (ADEA), that may arise after the date this Agreement is executed, are not waived; (4) that you have twenty one (21) days from your Separation Date in which to sign and return the Agreement, although you may, at your discretion, knowingly and voluntarily, sign and return the Agreement at any earlier time after your Separation Date; (5) that at any time within seven (7) days after executing this Agreement, you may revoke the Agreement; and (6) that this Agreement is not enforceable until the revocation period has passed without a revocation. You acknowledge that by signing this Agreement, you are giving up claims and rights under the Age Discrimination in Employment Act of 1967 as amended, as described above.

To revoke, you must send a written statement of revocation delivered by certified mail to Rosetta Stone, Attn: **Laurie Iannamico**. The revocation must be received no later than 5:00 p.m. Eastern on the seventh calendar day following the date you sign this Agreement. If you do not so revoke, the eighth day following your acceptance will be the “Effective Date” of this Agreement. If you have not returned the executed Agreement within the time permitted, then the Company’s offer will expire by its own terms at the conclusion of the time permitted.

To accept the Agreement, you must sign below on or after your Separation Date (but no later than the deadlines stated above) and return one entire copy to:

Laurie Iannamico  
135 W. Market St.  
Harrisonburg, Virginia 22801 (An extra copy for your files is enclosed.)

This letter constitutes the entire agreement between you and Rosetta Stone with respect to the subject matter hereof and supersedes any and all prior or contemporaneous oral or written representations, understandings, agreements or communications between you and the Company concerning those subject matters.

This letter in no way changes the “at-will” nature of your employment with Rosetta Stone. Please contact me or Human Resources with any questions you may have.

Best regards,  
ROSETTA STONE LTD.

By:  
Michaela Oliver, SVP Human Resources

By signing this Agreement, I acknowledge that: I have had the opportunity to review this Agreement carefully with legal or other personal advisors of my own choice; I have been advised to consult with an attorney regarding the legal effect of this Agreement; I understand that by signing this Agreement I am releasing the Company of all claims against it; I have read this Agreement and understand its terms; I have been given a reasonable period of time to consider its terms and effect and to ask any questions I may have; I voluntarily agree to the terms of this Agreement.

Note: Do not sign this Agreement until your Separation Date.

Name: /s/ Helena Wong Date: 11/3/2011  
Helena Wong

Receipt Acknowledged:

/s/ Laurie Iannamico Date: 11/3/2011  
Laurie Iannamico

## EXHIBIT A

### Release of Claims

#### Legal Release

This Legal Release (this “**Agreement**” or “**Release**”) is between Rosetta Stone Ltd. (the “**Company**”) and Helena Wong (“**Executive**”) (each a “**Party**,” and together, the “**Parties**”). For purposes of this Agreement “Effective Date” shall mean the date on which Executive signs this Agreement.

#### Recitals

- A. Executive and the Company are parties to a Separation Agreement to which this Release is appended as Exhibit A (the “**Separation Agreement**”).
- B. Executive wishes to receive the Severance Benefit described in the Separation Agreement.
- C. Executive and the Company wish to resolve, except as specifically set forth herein, all claims between them arising from or relating to any act or omission predating the Separation Date defined below.

#### Agreement

The Parties agree as follows:

1. Confirmation of Severance Benefit Obligation. The Company shall pay or provide to Executive the entire Severance Benefit, as, when and on the terms and conditions specified in the Separation Agreement.
2. Legal Releases
  - (a) Executive, on behalf of Executive and Executive’s heirs, personal representatives and assigns, and any other person or entity that could or might act on behalf of Executive, including, without limitation, Executive’s counsel (all of whom are collectively referred to as “Executive Releasers”), hereby fully and forever releases and discharges the Company, its present and future affiliates and subsidiaries, and each of their past, present and future officers, directors, employees, shareholders, independent contractors, attorneys, insurers and any and all other persons or entities that are now or may become liable to any Releaser due to any Executive Releasee’s act or omission, (all of whom are collectively referred to as “Executive Releasees”) of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys’ fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that Executive Releasers, or any person acting under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission occurring on or before the Effective Date, without regard to present actual knowledge of such acts or omissions, including specifically, but not by way of limitation, matters which may arise at common law, such as breach of contract, express or implied, promissory estoppel, wrongful discharge, tortious interference with contractual rights, infliction of emotional distress, defamation, or under federal, state or local laws, such as the Fair Labor Standards Act, the Employee Retirement Income Security Act, the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Equal Pay Act, the Americans with Disabilities Act, the Family and Medical Leave Act, and any civil rights law of any state or other governmental body; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Agreement, the release set forth in this Section shall not extend to: (i) any rights arising under this Agreement; (ii) any vested

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rights under any pension, retirement, profit sharing or similar plan; or (iii) Executive’s rights, if any, to indemnification, and/or defense under any Company certificate of incorporation, bylaw and/or policy or procedure, or under any insurance contract or any indemnification agreement with the Company, in connection with Executive’s acts and omissions within the course and scope of Executive’s employment with the Company. Executive hereby warrants that Executive has not assigned or transferred to any person any portion of any claim which is released, waived and discharged above. Executive further states and agrees that Executive has not experienced any illness, injury, or disability that is compensable or recoverable under the worker’s compensation laws of any state that was not reported to the Company by Executive before the Effective Date, and Executive agrees not to file a worker’s compensation claim asserting the existence of any such previously undisclosed illness, injury, or disability. Executive has specifically consulted with counsel with respect to the agreements, representations, and declarations set forth in the previous sentence. Executive understands and agrees that by signing this Agreement Executive is giving up any right to bring any legal claim against the Company concerning, directly or indirectly, Executive’s employment relationship with the Company, including Executive’s separation from employment. Executive agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of the Company, to include all actual or potential legal claims that Executive may have against the Company, except as specifically provided otherwise in this Agreement.

- (b) The Company, for itself, its affiliates, and any other person or entity that could or might act on behalf of it including, without limitation, its attorneys (all of whom are collectively referred to as “Company Releasers”), hereby fully and forever release and discharge Executive, Executive’s heirs, representatives, assigns, attorneys, and any and all other persons or entities that are now or may become liable to any Company Releaser on account of Executive’s employment with the Company or separation therefrom (all of whom are collectively referred to as “Company Releasees”) of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys’

fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that the Company Releasers, or any person acting under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission relating to Employee's employment with the Company or separation therefrom, without regard to present actual knowledge of such acts or omissions; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Agreement, the release set forth in this Section shall not extend to: (i) any rights arising under this Agreement; (ii) a breach of fiduciary duty or other misconduct that renders Executive ineligible for indemnification by the Company under applicable law, or any right of recovery by the Company for Executive's breach of fiduciary duty or misconduct in her capacity as a director of the Company under applicable law; or (iii) any claim or claims that the Company may have against Executive as of the Effective Date of which the Company is not aware as of the Effective Date because of willful concealment by Executive. The Company understands and agrees that by signing this Agreement, it is giving up its right to bring any legal claim against Executive concerning, directly or indirectly, Executive's employment relationship with the Company. The Company agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of Executive, to include all actual or potential legal claims that the Company may have against Executive relating to Employee's employment with the Company or separation therefrom, except as specifically provided otherwise in this Agreement.

- (c) In order to provide a full and complete release, each of the Parties understands and agrees that this Release is intended to include all claims, if any, covered under this Paragraph 2 that such Party may have and not now know or suspect to exist in her or its favor against any other Party and that this Release extinguishes such claims. Thus, each of the Parties expressly waives all rights under any statute or

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common law principle in any jurisdiction that provides, in effect, that a general release does not extend to claims which the releasing party does not know or suspect to exist in her favor at the time of executing the release, which if known by her must have materially affected her settlement with the party being released.

- (d) Executive acknowledges that she consulted with an attorney of her choosing before signing this the Separation Agreement and this Release, and that the Company provided her with no fewer than twenty-one (21) days during which to consider the provisions of the Separation Agreement and this Release and, specifically the release set forth at Paragraph 2(a), above, although Executive may sign and return the Release sooner if she so chooses. Executive further acknowledges that she has the right to revoke this Release for a period of seven (7) days after signing it and that this Release shall not become effective until such seven (7)-day period has expired. Executive acknowledges and agrees that if she wishes to revoke this Release, she must do so in writing, and that such revocation must be signed by Executive and received by the Company in care of the Chair of the Board of Directors no later than 5 p.m. (Eastern Time) on the seventh (7th) day after Executive has signed this Release. Executive acknowledges and agrees that, in the event that she revokes this Release, she shall have no right to receive the Severance Benefit. Executive represents that she has read this Release, including the release set forth in Paragraph 2(a), above, affirms that this Release and the Separation Agreement provide her with benefits to which she would not otherwise be entitled, and understands its terms and that she enters into this Release freely, voluntarily, and without coercion.
3. Executive acknowledges that she has received all compensation to which she is entitled for her work up to her last day of employment with the Company, and that she is not entitled to any further pay or benefit of any kind, for services rendered or any other reason, other than the Severance Benefit.
4. Executive agrees that the only thing of value that she will receive by signing this Release is the Severance Benefit.
5. The Parties agree that their respective rights and obligations under the Separation Agreement and the Executive Employment Agreement shall survive the execution of this Release.
6. The parties understand and agree that this Agreement shall not be construed as an admission of liability on the part of any person or entity, liability being expressly denied.
7. Executive represents and warrants to the Company that, prior to the Effective Date, Executive did not disclose to any person, other than to Executive's spouse, tax advisor and counsel, the terms of this Agreement or the circumstances under which the matter that is the subject of this Agreement has been resolved. After the Effective Date, neither Executive, counsel for Executive, nor any other person under Executive's control shall disclose any term of this Agreement or the circumstances of Executive's separation from the Company, except that Executive may disclose such information to Executive's spouse, or as required by subpoena or court order, or to an attorney or accountant to the extent necessary to obtain professional advice. Executive shall not be entitled to rely upon the foregoing exception for disclosures pursuant to subpoena or court order unless Executive has given the Company written notice, within three business days following service of the subpoena or court order.
8. Executive covenants never to disparage or speak ill of the Company or any the Company product or service, or of any past or present employee, officer or director of the Company, nor shall Executive at any time harass or behave unprofessionally toward any past, present or future the Company employee, officer or director.

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9. Executive acknowledges that because of Executive's position with the Company, Executive may possess information that may be relevant to or discoverable in connection with claims, litigation or judicial, arbitral or investigative proceedings initiated by a private party or by a regulator,

governmental entity, or self-regulatory organization, that relates to or arises from matters with which Executive was involved during Executive's employment with the Company, or that concern matters of which Executive has information or knowledge (collectively, a "Proceeding"). Executive agrees that Executive shall testify truthfully in connection with any such Proceeding, shall cooperate with the Company in connection with every such Proceeding, and that Executive's duty of cooperation shall include an obligation to meet with the Company representatives and/or counsel concerning all such Proceedings for such purposes, and at such times and places, as the Company reasonably requests, and to appear for deposition and/or testimony upon the Company's request and without a subpoena. The Company shall reimburse Executive for reasonable out-of-pocket expenses that Executive incurs in honoring Executive's obligation of cooperation under this Section 9.

10. Miscellaneous Terms and Conditions

- (a) Each party understands and agrees that Executive or it assumes all risk that the facts or law may be, or become, different than the facts or law as believed by the party at the time Executive or it executes this Agreement. Executive and the Company acknowledge that their relationship precludes any affirmative obligation of disclosure, and expressly disclaim all reliance upon information supplied or concealed by the adverse party or its counsel in connection with the negotiation and/or execution of this Agreement.
- (b) The parties warrant and represent that they have been offered no promise or inducement except as expressly provided in this Agreement, and that this Agreement is not in violation of or in conflict with any other agreement of either party.
- (c) All covenants and warranties contained in this Agreement are contractual and shall survive the closing of this Agreement.
- (d) Successors and Assigns. This Agreement shall be binding in all respects upon, and shall inure to the benefit of, the parties' heirs, successors and assigns.
- (e) Governing Law; Jurisdiction. All questions or disputes concerning this Agreement and the exhibits hereto will be governed by and construed in accordance with the internal laws of the Commonwealth of Virginia, without giving effect to any choice of law or conflict of law provision or rule (whether of the Commonwealth of Virginia or any other jurisdiction) that would cause the application of the laws of any jurisdiction other than the Commonwealth of Virginia. The parties hereby: (i) submit to the non-exclusive jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding arising out of or relating to this Agreement; and (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court. Each party hereby waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law..
- (f) Should any provision of this Agreement be declared illegal or unenforceable by any court of competent jurisdiction and cannot be modified to be enforceable, such provision shall immediately become null and void, leaving the remainder of this Agreement in full force and effect. Notwithstanding the foregoing, if Section 2(a), above, is declared void or unenforceable, then this Agreement shall be null and void and both parties shall be restored to the positions that they occupied before the Agreement's execution (meaning that, among other things, all sums paid by the Company pursuant to Section 1,

above, shall be immediately refunded to the Company); provided that in such circumstances this Agreement and the facts and circumstances relating to its execution shall be inadmissible in any later proceeding between the parties, and the statutes of limitations applicable to claims asserted in the proceeding shall be deemed to have been tolled for the period between the Effective Date and 10 days after the date on which Section 2(a) is declared unenforceable.

- (g) This Agreement constitutes the entire agreement of the parties and a complete merger of prior negotiations and agreements.
- (h) This Agreement shall not be modified except in a writing signed by the parties.
- (i) Waiver. No term or condition of this Agreement shall be deemed to have been waived, nor shall there be an estoppel against the enforcement of any provision of this Agreement, except by a writing signed by the party charged with the waiver or estoppel. No waiver of any breach of this Agreement shall be deemed a waiver of any later breach of the same provision or any other provision of this Agreement.
- (j) Headings are intended solely as a convenience and shall not control the meaning or interpretation of any provision of this Agreement.
- (k) Pronouns contained in this Agreement shall apply equally to the feminine, neuter and masculine genders. The singular shall include the plural, and the plural shall include the singular.
- (l) Each party shall promptly execute, acknowledge and deliver any additional document or agreement that the other party reasonably believes is necessary to carry out the purpose or effect of this Agreement.
- (m) Any party contesting the validity or enforceability of any term of this Agreement shall be required to prove by clear and convincing evidence fraud, concealment, failure to disclose material information, unconscionability, misrepresentation or mistake of fact or law.
- (n) The parties acknowledge that they have reviewed this Agreement in its entirety and have had a full and fair opportunity to negotiate its terms and to consult with counsel of their own choosing concerning the meaning and effect of this Agreement. Each party therefore waives

all applicable rules of construction that any provision of this Agreement should be construed against its drafter, and agrees that all provisions of the agreement shall be construed as a whole, according to the fair meaning of the language used.

- (o) Every dispute arising from or relating to this Agreement shall be tried only in the state or federal courts situated in the Commonwealth of Virginia. The parties consent to venue in those courts, and agree that those courts shall have personal jurisdiction over them in, and subject matter jurisdiction concerning, any such action.
- (p) In any action relating to or arising from this Agreement, or involving its application, the party substantially prevailing shall recover from the other party the expenses incurred by the prevailing party in connection with the action, including court costs and reasonable attorneys' fees.
- (q) This Agreement may be executed in counterparts, or by copies transmitted by telecopier, all of which shall be given the same force and effect as the original.

ROSETTA STONE LTD.

By: /s/ Michaela Oliver  
Michaela Oliver, SVP Human Resources

Date: 11/3/2011

EXECUTIVE

/s/ Helena Wong  
Helena Wong

Date: 11/3/2011

[QuickLinks](#) -- Click here to rapidly navigate through this document

Exhibit 21.1

**ROSETTA STONE INC. SUBSIDIARIES**

<u>Entity</u>	<u>Jurisdiction of Incorporation</u>
Rosetta Stone Holdings Inc.	Delaware
Rosetta Stone Brazil Holding, LLC	Delaware
Rosetta Stone Ltd. (Formerly Fairfield & Sons Ltd., d/b/a Fairfield Language Technologies)	Virginia
Rosetta Stone (UK) Limited (Formerly Fairfield & Sons Limited)	England and Wales
Rosetta Stone Japan Inc. (Formerly Rosetta World K.K.)	Japan
Rosetta Stone International Inc.	Delaware
Rosetta Stone GmbH	Germany
Rosetta Stone Korea Ltd.	Republic of Korea
Rosetta Stone Canada Inc.	Canada
Rosetta Stone Hong Kong Limited	Hong Kong
Rosetta Stone Ensino de Linguas Ltda.	Brazil

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QuickLinks

[Exhibit 21.1](#)

[ROSETTA STONE INC. SUBSIDIARIES](#)



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**Exhibit 23.1**

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement No. 333-158828 on Form S-8 of our reports dated March 13, 2012, relating to the consolidated financial statements of Rosetta Stone Inc. and subsidiaries (the "Company"), and the effectiveness of the Company's internal control over financial reporting, appearing in this Annual Report on Form 10-K of Rosetta Stone Inc. and subsidiaries for the year ended December 31, 2011.

/s/ Deloitte & Touche LLP  
McLean, Virginia  
March 13, 2012

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[Exhibit 23.1](#)

[CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM](#)

**ROSETTA STONE INC.**

***POWER OF ATTORNEY***

Each person whose signature appears below hereby constitutes and appoints Stephen M. Swad and Michael C. Wu, or either of them, each with power to act without the other, his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign the Annual Report on Form 10-K of Rosetta Stone Inc. (the "**Company**") and any or all subsequent amendments and supplements to the Annual Report on Form 10-K, and to file the same, or cause to be filed the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto each said attorney-in-fact and agent full power to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby qualifying and confirming all that said attorney-in-fact and agent or his substitute or substitutes may lawfully do or cause to be done by virtue hereof.

Each person whose signature appears below may at any time revoke this power of attorney as to himself or herself only by an instrument in writing specifying that this power of attorney is revoked as to him or her as of the date of execution of such instrument or at a subsequent specified date. This power of attorney shall be revoked automatically with respect to any person whose signature appears below effective on the date he or she ceases to be a member of the Board of Directors or an officer of the Company. Any revocation hereof shall not void or otherwise affect any acts performed by any attorney-in-fact and agent named herein pursuant to this power of attorney prior to the effective date of such revocation.

Dated: March 13, 2012

<u>Signature</u>	<u>Title</u>
<u>/s/ STEPHEN M. SWAD</u> Stephen M. Swad	Chief Executive Officer, Chief Financial Officer and Director (Principal Executive, Financial and Accounting Officer)
<u>/s/ TOM P.H. ADAMS</u> Tom P.H. Adams	Chairman of the Board, Director
<u>/s/ PHILLIP A. CLOUGH</u> Phillip A. Clough	Director
<u>/s/ JOHN T. COLEMAN</u> John T. Coleman	Director
<u>/s/ LAURENCE FRANKLIN</u> Laurence Franklin	Director
<u>/s/ PATRICK W. GROSS</u> Patrick W. Gross	Director
<u>/s/ MARGUERITE W. KONDRACKE</u> Marguerite W. Kondracke	Director
<u>/s/ THEODORE J. LEONSIS</u> Theodore J. Leonsis	Director

*/s/ JOHN E. LINDAHL*

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John E. Lindahl

Director

*/s/ LAURA L. WITT*

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Laura L. Witt

Director

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[Exhibit 24.1](#)

[ROSETTA STONE INC. POWER OF ATTORNEY](#)



Stephen M. Swad  
*Principal Executive Officer and  
Principal Financial Officer*

Date: March 13, 2012

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[Exhibit 31.1](#)

[CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER OF ROSETTA STONE INC.  
PURSUANT TO 15 U.S.C. SECTION 7241, AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002](#)



**CERTIFICATION OF  
PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER  
OF ROSETTA STONE INC.  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED  
PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Annual Report on Form 10-K for the calendar year ended December 31, 2011 filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Stephen M. Swad, Chief Executive Officer of Rosetta Stone Inc. (the "Company"), hereby certify, to my knowledge, that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 13, 2012

/s/ STEPHEN M. SWAD

\_\_\_\_\_  
Stephen M. Swad

*(Principal Executive Officer and Principal Financial Officer)*

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[Exhibit 32.1](#)

[CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER OF ROSETTA STONE INC.  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002](#)

