

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

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

For the fiscal year ended December 31, 2016

Commission file number: 1-34283

**Rosetta Stone Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State of incorporation)

**1621 North Kent Street, Suite 1200**  
**Arlington, Virginia**  
(Address of principal executive offices)

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

**22209**  
(Zip Code)

Registrant's telephone number, including area code:  
**703-387-5800**

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

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

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

**None**

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

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

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

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$159.3 million as of June 30, 2016 (based on the last sale price of such stock as quoted on the New York Stock Exchange). All executive officers and directors of the registrant and all persons filing a Schedule 13D with the Securities and Exchange Commission in respect of registrant's common stock have been deemed, solely for the purpose of the foregoing calculation, to be "affiliates" of the registrant.

As of March 8, 2017, there were 22,161,289 shares of common stock outstanding.

**Documents incorporated by reference:** Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2017 Annual Meeting of Stockholders to be held on May 19, 2017 are incorporated by reference into Part III.

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**PART I**

**FORWARD-LOOKING STATEMENTS**

*This Annual Report on Form 10-K, including the documents incorporated by reference, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by non-historical statements and often include words such as "outlook," "potential," "believes," "expects," "anticipates," "estimates," "intends," "plans," "seeks" or words of similar meaning, or future-looking or conditional verbs, such as "will," "should," "could," "may," "might," "aims," "intends," or "projects," or similar words and phrases. These statements may include, but are not limited to, statements relating to: our business strategy; guidance or projections related to revenue, Adjusted EBITDA, bookings, and other measures of future economic performance; the contributions and performance of our businesses, including acquired businesses and international operations; projections for future capital expenditures; and other guidance, projections, plans, objectives, and related estimates and assumptions. A forward-looking statement is neither a prediction nor a guarantee of future events or circumstances. In addition, forward-looking statements are based on the Company's current assumptions, expectations and beliefs and are subject to certain risks and uncertainties that could cause actual results to differ materially from our present expectations or projections. Some important factors that could cause actual results, performance or achievement to differ materially from those expressed or implied by these forward-looking statements include, but are not limited to: the risk that we are unable to execute our business strategy; declining demand for our language learning solutions; the risk that we are not able to manage and grow our business; the impact of any revisions to our pricing strategy; the risk that we might not succeed in introducing and producing new products and services; the impact of foreign exchange fluctuations; the adequacy of internally generated funds and existing sources of liquidity, such as bank financing, as well as our ability to raise additional funds; the risk that we cannot effectively adapt to and manage complex and numerous technologies; the risk that businesses acquired by us might not perform as expected; and the risk that we are not able to successfully expand internationally. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by law. These factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements risks and uncertainties that are more fully described in the Company's filings with the U.S. Securities and Exchange Commission (SEC), including those described below in this Annual Report on Form 10-K in Part I, Item 1A: "Risk Factors" and Part II, Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," those described elsewhere in this Annual Report on Form 10-K, and those described from time to time in our future reports filed with the Securities and Exchange Commission.*

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## Item 1. Business

### Overview

Rosetta Stone Inc. (“Rosetta Stone,” “the Company,” “we” or “us”) is dedicated to changing people's lives through the power of language and literacy education. Our innovative digital solutions drive positive learning outcomes for the inspired learner at home or in schools and workplaces around the world.

Founded in 1992, Rosetta Stone's language division uses cloud-based solutions to help all types of learners read, write, and speak more than 30 languages. Lexia Learning, Rosetta Stone's literacy education division, was founded more than 30 years ago and is a leader in the literacy education space. Today, Lexia helps students build fundamental reading skills through its rigorously researched, independently evaluated, and widely respected instruction and assessment programs. Rosetta Stone Inc. was incorporated in Delaware in 2005.

As our Company has evolved, we believe that our Enterprise & Education Language and Literacy segments are our largest opportunities for long-term value creation. The customers in these markets have needs that recur each year, creating a more predictable sales opportunity. This need profile also fits well with our suite of language and literacy products, and the well-known Rosetta Stone brand. We also believe the demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe.

As a result, we are emphasizing the development of products and solutions for Corporate and K-12 learners who need to speak and read English. This focus extends to the Consumer segment, where we continue to make product investments serving the needs of passionate language-learners who are motivated, results focused and willing to pay for a quality language-learning experience.

To position the organization for success, our focus is on the following priorities:

1. Grow literacy sales and market share by providing fully aligned digital instruction and assessment tools for K-12, building a direct distribution sales force to augment our historical reseller model, and continuing to develop our implementation services business;
2. Position our Enterprise & Education Language segment for profitable growth by focusing our direct sales on our best geographies and customer segments, partnering with resellers in other geographies and successfully delivering our Catalyst<sup>TM</sup> product to Corporate customers. Catalyst integrates our Foundations, Advantage, and Advanced English for Business products with enhanced reporting, assessment and administrator tools that offers a simple, more modern, metrics-driven suite of tools that are results-oriented and easily integrated with leading corporate language-learning systems;
3. Maximize the profitability of our Consumer language business by providing an attractive value proposition and a streamlined, mobile-oriented product portfolio focused on consumers' demand, while optimizing our marketing spend appropriately;
4. Seek opportunities to leverage our language assets including our content, tools and pedagogy, as well as our well-known Rosetta Stone brand, through partnerships with leading players in key markets around the world; and
5. Continue to identify opportunities to become more efficient.

In pursuing these priorities, we will (i) allocate capital to the areas of our business that we believe have the greatest value creation potential, including our Lexia literacy business, (ii) focus our businesses on their best customers, including K-12 learners primarily in North America, Corporate learners primarily in North America and Northern Europe in our Enterprise & Education Language segment, and passionate learners in the U.S. and select non-U.S. geographies in our Consumer language business, and (iii) optimize the sales and marketing costs for these businesses and the costs of our business overall.

### Business Segments

Our business is organized into three operating segments: Enterprise & Education Language, Literacy, and Consumer. The Enterprise & Education Language segment derives language-learning revenues from sales to educational institutions, corporations, and government agencies worldwide under a Software-as-a-Service (“SaaS”) model. The Literacy segment derives revenue under a SaaS model from the sales of literacy solutions to educational institutions serving grades K through 12. The Consumer segment derives revenue from sales to individuals and retail partners worldwide. For additional information regarding our segments, see Note 17 of Item 8, *Financial Statements and Supplementary Data*. Prior periods are presented consistently with our current operating segments and definition of segment contribution.

## Products and Services

### Enterprise & Education Language:

*Enterprise & Education Language-Learning Solutions:* Rosetta Stone provides a series of web-based subscriptions to interactive language-learning solutions for schools, business and other organizations that are primarily available online. Our core language-learning suite offers courses and practice applications in multiple languages, each leveraging our proprietary context-based immersion methodology, speech recognition engine and innovative technology features. Available in 24 languages and designed for beginner to intermediate language learners, Rosetta Stone Foundations builds fundamental language skills. Rosetta Stone Advantage is available for all proficiency levels in 9 of the 24 languages and focuses on improving everyday and business language skills. Our Advanced English for Business solution serves multinational companies seeking to build their employees' English language proficiency so they are able to communicate and operate in a global business environment. In 2016, we completed the development of Catalyst, which consolidates and aligns our Foundations, Advantage and Advanced English for Business products into a single solution for our enterprise customers. Catalyst provides streamlined access and simplified pricing for the full suite of English and world language learning content, along with assessment, placement, ongoing reporting and demonstration of results, all of which address important customer needs to focus and demonstrate payback. Specifically designed for use with our language-learning solutions, our Enterprise & Education Language customers may also purchase our audio practice products and live tutoring sessions to enhance the learning experience.

### Literacy:

*Literacy Solutions:* Our Lexia Learning suite of subscription-based English literacy-learning and assessment solutions provide explicit, systematic, personalized fundamental reading instruction for students of all abilities. This research-proven technology based approach accelerates reading skills development, predicts students' year-end performance and provides teachers with data-driven action plans to help differentiate instruction. Lexia Reading Core5 is available for all abilities from pre-K through grade 5. Our reading intervention program, Lexia Strategies, is designed for struggling readers in grades 6 and above. Lexia RAPID Assessment is a computer-adaptive screener and diagnostic tool for grades K-12 that identifies and monitors reading and language skills to provide actionable data for instructional planning. Lexia's solutions deliver norm-referenced performance data and analysis to enable teachers to monitor and modify their instruction to address specific student needs. These literacy solutions are provided under web-based subscriptions.

Our Enterprise & Education Language and Literacy customers can maximize their learning solutions with administrative tools, professional services and custom solutions.

*Administrative Tools:* Our Enterprise & Education Language and Literacy learning programs come with a set of administrative tools for performance monitoring, and to measure and track learner progress. Administrators can use these tools to access real-time dynamic reports and identify each learner's strengths and weaknesses.

*Professional Services:* Professional services provide our customers with access to experienced training, implementation and support resources. Our team works directly with customers to plan, deploy, and promote the program for each organization, incorporate learning goals into implementation models, prepare and motivate learners, and integrate the Enterprise & Education Language and Literacy solutions into technical infrastructure.

*Custom Solutions:* Rosetta Stone offers tailored solutions to help organizations maximize the success of their learning programs. Our current custom solutions include curriculum development, global collaboration programs that combine language education with business culture training, and language courses for mission-critical government programs.

### Consumer:

Rosetta Stone also offers a broad portfolio of technology-based learning products for personal use to the global consumer. Our interactive portfolio of language-learning solutions is powered by our widely recognized brand, and building on our 24-year heritage in language-learning.

Many of our Rosetta Stone consumer products and services are available in flexible and convenient formats for tablets and smartphones. Our mobile apps enable learners to continue their lessons on the go and extend the learning experience away from a computer. Progress automatically syncs to meet our customers' lifestyles. These apps may be available for download through the Apple App Store, Google Play, and Amazon App Store for Android.

*Rosetta Stone Language-Learning Solutions:* Rosetta Stone provides intuitive, easy-to-use language-learning programs that can be purchased as software subscription or in perpetual formats including digital download, CD, or in-app purchase.

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Our language-learning suite offers courses and practice applications in multiple languages, each leveraging our proprietary immersion methodology, speech recognition engine and innovative technology features. Beginner to intermediate language-learning products are available in 30 languages to build fundamental language skills. More advanced language-learning products are available in 9 of the 30 languages. We also offer online services to enhance and augment our learners' capabilities. Our Online Tutoring is an online service that provides conversational coaching sessions with native speakers to practice skills and experience direct interactive dialogue. Our Online Games and Activities are online services that provide a world-wide community for users around the world with games, online chat, read-along stories, and other features to improve language skills. Our current suite of mobile language-learning apps includes companions to our computer-based language-learning apps which enables learners to access their language program anytime anywhere.

### **Software Developments:**

Our offering portfolio is a result of significant investment in software development. Our software development efforts include the design and build of software solutions across a variety of devices, pedagogy and curriculum development, and the creation of learning content. Our development team builds new solutions and enhances or maintains existing solutions. We have specific expertise in speech recognition technology, iterative and customer-focused software development, instructional design, and language acquisition. We continue to evaluate changes to our solutions to strengthen our brand and improve the relevance of our offering portfolio.

Our research and development expenses were \$26.3 million, \$29.9 million, and \$33.2 million for the years ended December 31, 2016, 2015 and 2014, respectively.

### **Customers and Distribution Channels**

No customer accounted for more than 10% of the Company's revenue during the years ended December 31, 2016, 2015 or 2014. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

#### **Enterprise & Education Language:**

Our Enterprise & Education Language distribution channel is focused on targeted sales activity primarily through a direct sales force in five markets: K-12 schools, colleges and universities, government agencies, not-for-profit organizations, and corporations. Our Enterprise & Education language-learning customers include the following:

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

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

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

*Third-party Resellers and Partners.* We utilize third-party resellers and partners to provide our language-learning solutions to businesses, schools, and public-sector organizations in markets predominantly outside the U.S.

#### **Literacy:**

Our Literacy distribution channel utilizes a direct sales force as well as relationships with third-party resellers focused on the sale of Lexia solutions to K-12 schools.

#### **Consumer:**

Our Consumer distribution channel comprises a mix of our call centers, websites, third party e-commerce websites, app-stores, consignment distributors, select retail resellers, and daily deal partners. We believe these channels complement each other, as consumers who have seen our direct-to-consumer advertising may purchase at our retailers, and vice versa.

*Direct to consumer.* Sales generated through either our call centers, our e-commerce website at [www.rosettastone.com](http://www.rosettastone.com), and app stores.

*Indirect to consumer.* Sales generated through arrangements with third-party e-commerce websites such as the Apple App Store, and consignment distributors such as Wynit Distribution and Software Packaging Associates.

*Retailers.* Our retailers enable us to provide additional points of contact to educate consumers about our solutions, expand our presence beyond our own websites, and further strengthen and enhance our brand image. Our retail relationships

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include Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Sam's Club, Staples, and others in and outside of the U.S. We also partner with daily deal resellers.

*Home School.* We promote interest in the language-learning market through advertising in publications focused on home schooling and attending local trade shows.

### **Sourcing and Fulfillment**

Consistent with the SaaS model in our Enterprise & Education Language and Literacy segments, our strategy in the Consumer segment is to shift the sales mix away from CD-based product sales toward a cloud-based software subscription in order to reduce costs associated with physical packaging and distribution.

Our physical inventory utilizes a flexible, diversified and low-cost manufacturing base. We use third-party contract manufacturers and suppliers to obtain substantially all of 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.

### **Competition**

Rosetta Stone competes in several categories within the technology-based learning industry, including consumer, enterprise and educational language learning, and literacy.

The language-learning market is highly fragmented globally and consists of a variety of instructional and learning modes: classroom instruction utilizing the traditional approach of memorization, grammar and translation; immersion-based classroom instruction; self-study books, audio recordings and software that rely primarily on grammar and translation; and free online and mobile offerings that provide content and opportunities to practice writing and speaking. In the enterprise and education-focused language market, we compete with EF English Live (formerly EF Englishtown), Global English, Wall Street English (Pearson), inlingua, Imagine Learning, Transparent Language, Duolingo, Middlebury Interactive Languages, Speexx as well as many private language schools and other classroom-based courses. Within consumer-focused language learning, our competitors include Berlitz (Benesse Holdings), Pimsleur (Simon & Schuster, part of CBS Corporation), Living Language (Penguin Random House, a joint venture of Pearson and Bertelsmann), McGraw-Hill Education, Duolingo, Inc., Fluenz, Busuu Ltd., Babbel (operated by Lesson Nine GmbH) and many other small and regionally-focused participants. In addition there are several competitors that are primarily focused on teaching English including Open English (Open English LLC), EF English Live and Inglés Sin Barreras.

In the literacy category, we compete primarily in the K-12 digital reading space in the U.S. with Imagine Learning, Scientific Learning, Odyssey (Compass Learning), Renaissance, Houghton Mifflin Harcourt, Curriculum Associates, and iStation.

### **Seasonality**

Our business is affected by variations in seasonal trends. Within our Enterprise & Education Language segment, sales in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Literacy segment sales are seasonally stronger in the second and third quarters of the calendar year corresponding to the end and beginning of school district budget years. Consumer sales are affected by seasonal trends associated with the holiday shopping season. In particular, we generate a significant portion of our Consumer sales in the fourth quarter during the period beginning on Black Friday through the end of the calendar year.

Our operating segments are affected by different sales-to-cash patterns. Consumer sales typically turn to cash more quickly than Enterprise & Education Language and Literacy sales, which tend to have longer collection cycles. Historically, in the first half of the year we have been a net user of cash and in the second half of the year we have been a net generator of cash.

### **Intellectual Property**

Our 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. In certain circumstances, we may sub-license our intellectual property including our trademarks and software for use in certain markets.

We have ten U.S. patents, fourteen foreign patents and several U.S. and foreign patent applications pending that cover various aspects of our language-learning and literacy technologies.



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We have registered a variety of trademarks, including our primary or house marks, *Rosetta Stone*, The Blue Stone Logo, *Lexia Learning*, *Lexia*, *Fit Brains*, and *Catalyst*. These trademarks are the subject of either registrations or pending applications in the U.S., as well as numerous countries worldwide where we do business. We have been issued trademark registrations for our yellow color from the U.S. Patent and Trademark Office. We intend to continue to strategically register, both domestically and internationally, trademarks we use today and those we develop in the future. We believe that the distinctive marks that we use in connection with our solutions are important in building our brand image and distinguishing our offerings from those of our competitors. These marks are among our most valuable assets.

In addition to our distinctive marks, we own numerous registered and unregistered copyrights, and trade dress rights, to our products and packaging. We intend to continue to strategically register copyrights in our various products. We also place significant value on our trade dress, which is the overall image and appearance of our products, as we believe that our trade dress helps to distinguish our products in the marketplace from our competitors.

Since 2006, we have held a perpetual, irrevocable and worldwide license from the University of Colorado allowing us to use speech recognition technology for language-learning solutions. Since 2014, we have also held a commercial license from the Florida State University Research Foundation allowing us to use certain computer software and technology in our literacy offerings. These types of arrangements are often subject to royalty or license fees.

We diligently protect our intellectual property through the use of patents, trademarks and copyrights and through enforcement efforts in litigation. We routinely monitor for potential infringement in the countries where we do business. In addition, our employees, contractors and other parties with access to our confidential information are required to sign agreements that prohibit the unauthorized disclosure of our proprietary rights, information and technology.

### **Employees**

As of December 31, 2016, we had 1,012 total employees, consisting of 717 full-time and 295 part-time employees. We have employees in France and Spain who are represented by a collective bargaining agreement. We believe that we have good relations with our employees.

### **Financial Information by Segment and Geographic Area**

For a discussion of financial information by segment and geographic area, see Note 17 of Item 8, *Financial Statements and Supplementary Data* 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 information contained in, or that can be accessed through, our website is not part of, and is not incorporated into, this Annual Report on Form 10-K.

The SEC maintains a website that contains reports, proxy statements and other information regarding issuers that file electronically with the SEC. These materials may be obtained electronically by accessing the SEC's website at [www.sec.gov](http://www.sec.gov).

### **Item 1A. Risk Factors**

The following description of risk factors includes any material changes to, and supersedes the description of, risk factors associated with our business previously disclosed in our Quarterly Report on Form 10-Q filed on November 7, 2016 with the SEC for the period ended September 30, 2016. An investment in our common stock involves a substantial risk of loss. Investors should carefully consider these risk factors, together with all of the other information included herewith, before deciding to purchase shares of our common stock. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially adversely affected. In such case, the market price of our common stock could decline and all or part of an investment may be lost.

The risks described below are not the only ones facing us. Our business is also subject to the risks that affect many other companies, such as general economic conditions and geopolitical events. Further, additional risks not currently known to us or that we currently believe are immaterial could have a material adverse effect on our business, financial condition, cash flows and results of operations. 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 SEC that could materially affect our business, financial condition, cash flows or future results.

***We might not be successful in executing our strategy of focusing on the Enterprise & Education Language and Literacy segments and on more passionate language learners in the Consumer segment, and our company reorganization and realignment might not produce the desired results.***

We are continuing to undertake a strategic reorganization and realignment of our business to maximize profitable growth in our Enterprise & Education Language segment by serving the needs of corporate and K-12 language learners, and prioritizing those who wish to speak and read English. In addition, we are now focusing on the needs of more passionate language learners in our Consumer segment, rather than addressing the needs of the mass marketplace. If we do not successfully execute our strategy, our revenue and profitability could decline. Our recent strategy changes include actions to reduce headcount, exit unprofitable geographies, and other savings initiatives. These cost reduction efforts could harm our business and results of operations by distracting management and employees, causing difficulty in hiring, motivating and retaining talented and skilled personnel, and creating uncertainty among our customers and vendors that could lead to delays or unexpected costs. Also, our ability to achieve anticipated cost savings and other benefits from these efforts is subject to many estimates and assumptions, which are subject to significant business, economic, and competitive uncertainties and contingencies, some of which are beyond our control. If these estimates and assumptions are incorrect, or if other unforeseen events occur, our business and financial results could be adversely affected.

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

Historically, our practice has been to release guidance regarding our future performance that represents management's estimates as of the date of release. This guidance, which includes forward-looking statements, is based on projections prepared by 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 confirms 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 or as single point estimates, but actual results could differ materially. The principal reason that we release guidance is to provide a basis for 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 in 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 may vary from our guidance and the variations may be material. We expressly disclaim any obligations to update or revise any guidance, whether as a result of new information, future events or otherwise, except as required by law. 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 strategy or the occurrence of any of the events or circumstances set forth in these "Risk Factors" and elsewhere 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.

***Intense competition in our industry may hinder our ability to attract and retain customers and generate revenue, and may diminish our margins.***

The business environment in which we operate is rapidly evolving, highly fragmented and intensely competitive, and we expect competition to persist and intensify. Increased competition could adversely affect operating results by causing lower demand for our products and services, reduced revenue, more product returns, price reductions or concessions, reduced gross margins and loss of customers.

Many of our current and potential domestic and international competitors have substantially greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition in some locations, as well as in some cases, lower costs. Some competitors offer more differentiated products (for example, online learning as well as physical classrooms and textbooks) that may allow them to more flexibly meet changing customer preferences. The resources of our competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements and preferences and to offer lower prices than ours or to offer free language-learning software or online services. We may not be able to compete successfully against current or future competitors.

There are a number of free online language-learning opportunities to learn grammar, pronunciation, vocabulary (including specialties in areas such as medicine and business), reading, and conversation by means of podcasts and MP3s,

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mobile applications, audio courses and lessons, videos, games, stories, news, digital textbooks, and through other means. We estimate that there are thousands of free mobile applications on language-learning; free products are provided in at least 50 languages by private companies, universities, and government agencies. Low barriers to entry allow start-up companies with lower costs and less pressure for profitability to compete with us. Competitors that are focused more on user acquisition rather than profitability and funded by venture capital may be able to offer products at significantly lower prices or for free. As free online translation services improve and become more widely available and used, people may generally become less interested in language learning. Although we also offer free products such as mobile apps, if we cannot successfully attract users of these free products and convert a sufficient portion of these free users into paying customers, our business could be adversely affected. If free products become more engaging and competitive or gain widespread acceptance by the public, demand for our products could decline or we may have to lower our prices, which could adversely impact our revenue and other results.

***Historically a substantial portion of our revenue has been generated from our Consumer business. If we fail to accurately anticipate consumer demand and trends in consumer preferences, our brands, sales and customer relationships may be harmed.***

Demand for our consumer focused language-learning software products and related services 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;
- adapt and offer our products and services using rapidly evolving, widely varying and complex technologies;
- 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 and other sales outlets where interested consumers will buy our products;
- anticipate and respond to consumer price sensitivity and pricing changes of competitive products; and
- identify and successfully implement ways of building brand loyalty and reputation.

We anticipate having to make investments in new products in the future and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Customers might not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably impacting revenue. We might not achieve significant revenue from new product and service investments for a number of years, if at all. We also might not be able to develop new solutions or enhancements in time to capture business opportunities or achieve sustainable acceptance in new or existing marketplaces. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors. 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.

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

Our success depends in part upon the continued adoption by organizations 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 could result from offering courses online. If the acceptance of technology-based education does not continue to grow, our ability to continue to grow our Enterprise & Education Language business could be impaired.

***We depend on discretionary consumer spending in the Consumer segment of our business. Adverse trends in general economic conditions, including retail and online shopping patterns or consumer confidence, as well as 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, which could adversely affect our sales and profitability.

***Because a significant portion of our Consumer sales are made to or through retailers and distributors, none of which has any obligation to sell our products, the failure or inability of these parties to sell our products effectively could reduce 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 concentrated on a key group that is comprised of a mix of websites, such as Amazon.com and the Apple App Store, select retail resellers such as Barnes & Noble, Best Buy, Target, Books-a-Million, Staples, and Sam's Club, and consignment distributors such as Wynit Distribution and Software Packaging Associates.

We have no control over the quantity 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 our 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 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.

Many traditional physical retailers are experiencing diminished foot traffic and sales. For our retail business, even though online sales have increased in popularity and are growing in importance, we continue to depend on sales that take place in physical stores and shopping malls. Reduced customer foot traffic in these stores and malls is likely to reduce their sales of our products. In addition, if one or more of these retailers or distributors are unable to meet their obligations with respect to accounts payable to us, we could be forced to write off accounts receivable with 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.

***Price changes and other concessions could reduce our revenue.***

We continue to test and offer changes to the pricing of our products. If we reduce our prices in an effort to increase our sales, this could have an adverse impact on our revenue to the extent that unit sales do not increase in a sufficient amount to compensate for the lower pricing. Reducing our pricing to individual consumers could also cause us to have to lower pricing to our Enterprise & Education Language customers. Any increase in the taxation of online sales could have the effect of a price increase to consumers and could cause us to have to lower our prices or could cause sales to decline. It is uncertain whether we will need to lower prices to effectively compete and what other short-term or long-term impacts could be.

We also may provide our retailers and distributors with price protection on existing inventories, which would entitle these retailers and distributors to credit against amounts owed with respect to unsold packaged product under certain conditions. These price protection reserves could be material in future periods.

In the U.S. and Canada, we offer consumers who purchase our packaged software and audio practice products directly from us a 30-day, unconditional, full money-back refund. 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 adversely affect our reported financial results.

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

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

- appropriately and efficiently allocate our marketing for multiple products;

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- accurately identify, target and reach our audience of potential customers with our marketing messages;
- select the right marketplace, media and specific media vehicle in which to advertise;
- identify the most effective and efficient level of spending in each marketplace, 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;
- differentiate our products as compared to other products;
- create greater awareness of our new products our brands and learning solutions;
- drive traffic to our e-commerce website, call centers, distribution channels and retail partners; and
- convert customer inquiries into actual orders.

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

Some of our radio, television, print, and online 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 it cannot be assured that we can increase the amount of remnant advertising at the discounted prices we have obtained in the past. If any of these events occur, we may purchase time slots and publication dates at higher prices, which would increase our costs.

We engage in an active public relations program, including through social media sites such as Facebook and Twitter. We also seek new customers through our online marketing efforts, including paid search listings, banner ads, text links and permission-based e-mails, as well as our affiliate and reseller programs. If one or more of the search engines or other online sources on which we rely for website traffic were to modify their general methodology for how they display 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.

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

### ***Our international businesses may not succeed and impose additional and unique risks.***

Our business strategy contemplates stabilizing and reducing the losses we have experienced internationally. In March 2016, as part of the 2016 Restructuring Plan, we initiated actions to withdraw our direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings. These operations added sales, but at too high a cost and without the near-term ability to capture scale efficiencies. We continuously review and optimize certain of our website sales channels in Europe, Asia and Latin America. In addition, we continue to optimize our indirect sales channels in Europe, Asia and Latin America through reseller and other arrangements with third parties. If we are unable to stabilize and reduce losses in our international operations successfully and in a timely manner, our business, revenue and financial results could be harmed. Such stabilization and reduction 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.

***If we are unable to continually adapt our products and services to mobile devices and technologies other than personal computers and laptops, and to adapt to other technological changes and customer needs generally, we may be unable to attract and retain customers, and our revenue and 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

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could significantly harm our ability to attract and retain customers and our results of operations. For example, the number of individuals who access the Internet through devices other than a personal computer, such as tablet computers, mobile devices, televisions and set-top box devices, has increased dramatically and this trend is likely to continue. Our products and services may not work or be viewable on these devices because each manufacturer or distributor may establish unique technical standards for such devices. 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 on a cost-effective basis that respond to these or other technological developments and changing customer needs, we may be harmed in our ability to attract and retain customers, and our revenue and business could suffer. Furthermore, our customers who view our advertising via mobile devices might not buy our products to the same extent that they do when viewing our advertising via personal computers or laptops. Accordingly, if we cannot convince customers to purchase our products via mobile devices, our business and results of operations could be harmed to the extent that the trend to mobile devices continues.

We offer our software products on operating systems and platforms including Windows, Macintosh, Apple OS, Android, and Amazon apps. The demand for traditional desktop computers has been declining, while the demand for mobile devices such as notebook computers, smartphones and tablets has been increasing, which means that we must be able to market to potential customers and to provide customers with access to and use of our products and services on many platforms and operating systems, as they may be changed from time to time. 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 use alternative technologies, our business could be harmed.

***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 the network, security devices and settings, and student learning management systems of our Enterprise & Education Language and Literacy customers. As a result, we must continually ensure that our products interoperate properly with these varied and customized systems. Changes in operating systems, the technologies we incorporate into our products or the computer systems our customers use may damage our business.

***Our products and internal systems rely on software that is highly technical and maintained by third parties and if such third-party software contains undetected errors or vulnerabilities or if it not supported or updated to keep pace with current computer hardware, our business could be adversely affected.***

Our products and internal systems rely on software, including software developed or maintained internally and/or by third parties, that is highly technical and complex. In addition, our products and internal systems depend on the ability of such software to store, retrieve, process, and manage immense amounts of data. Such software has contained, and may now or in the future contain, undetected errors, bugs, or vulnerabilities. Some errors may only be discovered after the code has been released for external or internal use. Errors, vulnerabilities, or other design defects within the software on which we rely may result in a negative experience for users and marketers who use our products, delay product introductions or enhancements, result in measurement or billing errors, compromise our ability to protect the data of our users and/or our intellectual property or lead to reductions in our ability to provide some or all of our services.

For example, we rely on Adobe Flash as a platform for our software. Adobe Flash is one of the most versatile programming systems available and is unique in its ability to allow the integration of many forms of electronic formatted media into an interactive and user friendly system. However, in July 2015, certain vulnerabilities discovered in Adobe Flash led to temporary interruption of support for Adobe Flash by popular web browsers. As a result, some software makers are opting to exclude Adobe Flash from their web browsers. If similar interruptions occur in the future and disrupt our ability to provide our products to some or all of our users, our ability to generate revenue would be harmed. Additionally, if Adobe Flash were to become deleted from Adobe's product line or become not supported or updated to keep pace with current computer hardware, then our software products would become obsolete very quickly. Any errors, bugs, vulnerabilities, or defects discovered in the software on which we rely, and any associated degradations or interruptions of service, could result in damage to our reputation, loss of users, loss of revenue, or liability for damages, any of which could adversely affect our business and financial results.

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

Many of our Enterprise & Education Language or Literacy customers are colleges, universities, primary and secondary schools and school districts, 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 and school districts, or other education providers or government agencies that use

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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 adversely affect our overall gross margins.

***Some of our Enterprise & Education Language and Literacy business is characterized by a lengthy and unpredictable sales cycle, which could delay new sales.***

We face a lengthy sales cycle between our initial contact with some potential Enterprise & Education Language and Literacy 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 Enterprise & Education Language and Literacy 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 Enterprise & Education Language and Literacy 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 administrators and faculties; and
- the length and timing of customers' approval processes.

***As we pursue a 100% SaaS-based model for our Consumer business and sell our solutions as subscriptions, rather than packaged software, our revenue, results of operations and cash flow could be negatively impacted.***

Historically, we have predominantly sold our packaged software programs under a perpetual license for a single upfront fee and recognized 65-90% of the revenue at the time of sale. Certain of our online products are sold under different subscription terms, from short-term (less than one year) to long-term (typically 36-months) subscriptions with a corresponding license term. Typically, long-term subscriptions include substantially higher discounts, resulting in less cash and revenue from the initial sale to the customer and selling a higher proportion of long-term subscriptions could have a substantially negative impact on our revenue, results of operations and cash flow in any quarterly reporting period. Furthermore, to the extent that customers use our products and services for only a short time after purchase, online subscription customers could be less likely to renew their subscriptions beyond the initial term with the effect that we could earn less revenue over time from each customer than historically.

***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, cash flows and net income. These variations are primarily related to increased sales of our Consumer products and services in the fourth quarter, especially during the holiday selling season, as well as higher sales to governmental, educational institutions, and corporations in the second half of the calendar year. We sell to a significant number of our retailers, distributors and Enterprise & Education Language 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 Enterprise & Education Language and Literacy 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. Any seasonal or quarterly fluctuations that we report in the future may differ from the expectations of market analysts and investors, which could cause the price of our common stock to fluctuate significantly.

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

We have made and may continue to make acquisitions or enter into joint ventures and strategic alliances as part of our long-term business strategy. Such transactions may result in use of our cash resources, dilutive issuances of our equity securities, or incurrence of debt. Such transactions also 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 technology, employees, and business systems, that we divert 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 more customers, or those benefits may ultimately be smaller than anticipated, or may not be realized. These events and circumstances could harm our operating results or financial condition.

***Our possession and use of personal information presents risks and expenses that could harm our business. If we are unable to protect our information technology network against service interruption or failure, misappropriation or unauthorized disclosure or manipulation of data, whether through breach of our network security or otherwise, we could be subject to costly government enforcement actions and litigation and our reputation may be damaged.***

Our business involves the collection, storage and transmission of personal, financial or other information that is entrusted to us by our customers and employees. Our information systems also contain the Company's proprietary and other confidential information related to our business. Our efforts to protect such information may be unsuccessful due to the actions of third parties, computer viruses, physical or electronic break-ins, catastrophic events, employee error or malfeasance or other attempts to harm our systems. Possession and use of personal information in conducting our business subjects us to legislative and regulatory obligations 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. Some of our commercial partners may receive or store information provided by us or our users through our websites. If these third parties fail to adopt or adhere to adequate information security practices, or fail to comply with our online policies, or in the event of a breach of their networks, our customers' data may be improperly accessed, used or disclosed. As our business and the regulatory environment evolve in the U.S. and internationally, we may become subject to additional and even more stringent legal obligations concerning our treatment of customer information. 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.

Despite our precautions and significant ongoing investments to protect against security risks, data protection breaches, cyber-attacks and other intentional disruptions of our products and offerings, we may be a target of attacks specifically designed to impede the performance of our products and offerings and harm our reputation as a company. If our systems are harmed or fail to function properly or if third parties improperly obtain and use the personal information of our customers or employees, we may be required to expend significant resources to repair or replace systems or to otherwise protect against security breaches or to address problems caused by the breaches. 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. Any such access, disclosure or other loss of information could result in legal claims or proceedings and regulatory penalties, disrupt our operations and result in a loss of confidence in our products and services, which could lead to a material and adverse effect on our business, reputation or financial results.

***We may incur significant costs related to maintaining data security and in the event of any data security breaches that could compromise our information technology network security, trade secrets and customer data.***

The secure processing, maintenance and transmission of personal, financial or other information that is entrusted to us by our customers is critical to our operations and business strategy, and we devote significant resources to protecting such information. The expenses associated with protecting such information could reduce our operating margins. Additionally, threats to our information technology network security can take a variety of forms. Individual hackers and groups of hackers, and sophisticated organizations or individuals may threaten our information technology network security. Cyber attackers may develop and deploy malicious software to attack our services and gain access to our networks or data centers, hold access to critical systems or information for ransom, or act in a coordinated manner to launch distributed denial of service or other coordinated attacks. Cyber threats and attacks are constantly evolving, thereby increasing the difficulty of detecting and successfully implementing measures to defend against them. We may be unable to anticipate potential techniques or implement adequate preventative measures in time. Cyber threats and attacks can have cascading impacts that unfold with increasing speed across internal networks and systems. Breaches of our network, credit card processing information, or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, cause product development delays, compromise confidential or technical business information harming our competitive position, result in theft or misuse of our intellectual property or other assets, expose us to contractual or regulatory audit or investigation, require us to allocate additional resources to alternative and potentially more costly technologies more frequently than anticipated, or otherwise adversely affect our business. We maintain cyber risk insurance, but our policy coverage limits may not be sufficient to cover all of our losses caused by any future information security-related breaches or events.



***Our business is subject to complex and evolving U.S. and foreign laws and regulations regarding privacy and data protection. Changes in regulations or customer concerns regarding privacy and protection of customer data, or any failure to comply with such laws, could adversely affect our business.***

Federal, state, and international laws and regulations govern the collection, use, retention, disclosure, sharing and security of data that we receive from and about our customers. The use of consumer data by online service providers and advertising networks is a topic of active interest among federal, state, and international regulatory bodies, and the regulatory environment is unsettled and rapidly evolving. Many states have passed new laws impacting required notifications to customers and/or state agencies where there is a security breach involving personal data, such as California's Information Practices Act.

We also face similar risks in international markets where our products, services and apps are offered. Foreign data protection, privacy, competition, and other laws and regulations can impose different obligations or be more restrictive than those in the United States. We are subject to international laws and regulations that dictate whether, how, and under what circumstances we can transfer, process and/or receive transnational data that is critical to our operations and ability to provision our products and perform services for our customers, including data relating to users, customers, or partners outside the United States, and those laws and regulations are uncertain and subject to change.

Recent legal developments in Europe have created complexity and compliance uncertainty regarding certain transfers of information from Europe to the U.S. For example, in October 2015, the European Court of Justice invalidated the 2000 US-EU Safe Harbor program as a legitimate and legally authorized basis on which U.S. companies, including Rosetta Stone, could rely for the transfer of personal data from the European Union to the United States. The European Union and United States recently agreed to an alternative transfer framework for data transferred from the European Union to the United States, called the Privacy Shield Framework. Rosetta Stone participates and has certified to its compliance to the Privacy Shield Framework. However, this new framework also faces a number of legal challenges, is subject to an annual review that could result in changes to our obligations, and also may be challenged by national regulators or private parties. In addition, other available bases on which to rely for the transfer of EU personal data outside of the European Economic Area, such as standard Model Contractual Clauses (MCCs), have also been subjected to regulatory or judicial scrutiny. This has resulted in some uncertainty, and compliance obligations could cause us to incur costs or require us to change our business practices in a manner adverse to our business.

If one or more of the legal bases for transferring personal data from Europe to the United States is invalidated, or if we are unable to transfer personal data between and among countries and regions in which Rosetta Stone operates, it could affect the manner in which we provide our services or adversely affect our financial results. Any failure, or perceived failure, by us to comply with or make effective modifications to our policies, or to comply with any federal, state, or international privacy, data-retention or data-protection-related laws, regulations, orders or industry self-regulatory principles could result in proceedings or actions against us by governmental entities or others, a loss of customer confidence, damage to the Rosetta Stone brands, and a loss of customers, which could potentially have an adverse effect on our business. In addition, various federal, state and foreign legislative or regulatory bodies may enact new or additional laws and regulations concerning privacy, data-retention and data-protection issues, including laws or regulations mandating disclosure to domestic or international law enforcement bodies, which could adversely impact our business, our brand or our reputation with customers. For example, some countries are considering laws mandating that personal data regarding customers in their country be maintained solely in their country. Having to maintain local data centers and redesign product, service and business operations to limit personal data processing to within individual countries could increase our operating costs significantly. In addition, the European Commission has approved a data protection regulation, known as the General Data Protection Regulation (GDPR), which has been finalized and is due to come into force in or around May 2018. The GDPR will include additional operational and other requirements for companies that receive or process personal data of residents of the European Union that are different than those currently in place in the European Union, and that will include significant penalties for non-compliance.

The interpretation and application of privacy, data protection and data retention laws and regulations are often uncertain and in flux in the U.S. and internationally. Complying with these varying international requirements could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business and operating results. In addition, these laws may be interpreted and applied inconsistently from country to country and inconsistently with our current policies and practices, complicating long-range business planning decisions. If privacy, data protection or data retention laws are interpreted and applied in a manner that is inconsistent with our current policies and practices we may be deemed non-compliant, subject to legal or regulatory process, fined or ordered to change our business practices in a manner that could cause us to incur substantial costs, or that adversely impacts our business or operating results.

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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. Also, the collection and protection of information from children under the age of 13 is subject to the provisions of the Children's Online Privacy Protection Act (COPPA), which is particularly relevant to our learning solutions focused on children. 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.

***Changes in how network operators handle and charge for access to data that travel across their networks could adversely impact our business.***

We rely upon the ability of customers to access many of our products through the Internet. To the extent that network operators implement usage based pricing, including meaningful bandwidth caps, or otherwise try to monetize access to their networks by data providers, we could incur greater operating expenses and our customer acquisition and retention could be negatively impacted. Furthermore, to the extent network operators were to create tiers of Internet access service and either charge us for or prohibit us from being available through these tiers, our business could be negatively impacted.

***We are exposed to risks associated with credit card and payment fraud, and with our obligations under rules on credit card processing and alternative payment methods, which could cause us to lose revenue or incur costs. We depend upon our credit card processors and payment card associations.***

As an e-commerce provider that accepts debit and credit cards for payment, we are subject to the Payment Card Industry Data Security Standard ("PCI DSS"), issued by the PCI Council. PCI DSS contains compliance guidelines and standards with regard to our network security surrounding the physical and electronic storage, processing and transmission of individual cardholder data. Despite our compliance with these standards and other information security measures, we cannot guarantee that all our information technology systems are able to prevent, contain or detect any cyber attacks, cyber terrorism, or security breaches from currently known viruses or malware, or viruses or malware that may be developed in the future. To the extent any disruption results in the loss, damage or misappropriation of information, we may be adversely affected by claims from customers, financial institutions, regulatory authorities, payment card associations and others. In addition, the cost of complying with stricter privacy and information security laws and standards could be significant.

We are subject to rules, regulations and practices governing our accepted payment methods which could change or be reinterpreted to make it difficult or impossible for us to comply. A failure to comply with these rules or requirements could make us subject to fines and higher transaction fees and we could lose our ability to accept these payment methods. We depend upon our credit card processors to carry out our sales transactions and remit the proceeds to us. At any time, credit card processors have the right to withhold funds otherwise payable to us to establish or increase a reserve based on their assessment of the inherent risks of credit card processing and their assessment of the risks of processing our customers' credit cards. If our credit card processors exercise their right to establish or increase a reserve, it may adversely impact our liquidity. Our business and results of operations could be adversely affected if these changes were to occur.

***The uncertainty surrounding the terms of the United Kingdom's withdrawal from the European Union and its consequences could cause disruptions and create uncertainty to our businesses and adversely impact consumer and investor confidence in our products and services.***

In June 2016, a majority of voters in the United Kingdom elected to withdraw from the European Union in a national referendum (also referred to as "Brexit"). The referendum was advisory, and by the terms of the Treaty on European Union, any withdrawal is subject to a negotiation period that could last at least two years after the government of the United Kingdom formally initiates the withdrawal process. The ultimate effects of Brexit on us are difficult to predict, but because we currently conduct business in the United Kingdom and in Europe, the results of the referendum and any eventual withdrawal could cause disruptions and create uncertainty to our businesses, including affecting the business of and/or our relationships with our customers and suppliers, as well as altering the relationship among tariffs and currencies, including the value of the British pound and the Euro relative to the U.S. dollar. Such disruptions and uncertainties could adversely affect our financial condition, operating results, and cash flows. Additionally, Brexit could result in legal uncertainty and potentially divergent national laws and regulations as new legal relationships between the United Kingdom and the European Union are established. The ultimate

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effects of Brexit on us will also depend on the terms of any agreements the United Kingdom and the European Union make to retain access to each other's respective markets either during a transitional period or more permanently. Any of these effects, among others, could materially adversely affect our business, business opportunities, results of operations, and financial condition.

### ***Uncertainty in the global geopolitical landscape from recent events may impede the implementation of our strategy outside the United States.***

There may be uncertainty as to the position the United States will take with respect to world affairs and events following the 2016 U.S. presidential election and related change in political agenda, coupled with the transition of administrations. This uncertainty may include such issues as U.S. support for existing treaty and trade relationships with other countries. This uncertainty, together with other key global events during 2016 (such as the continuing uncertainty arising from the Brexit referendum in the United Kingdom as well as ongoing terrorist activity), may adversely impact (i) the ability or willingness of non-U.S. companies to transact business in the United States, including with the Company (ii) regulation and trade agreements affecting U.S. companies, (iii) global stock markets (including the New York Stock Exchange on which our common stock is traded), and (iv) general global economic conditions. All of these factors are outside of our control, but may nonetheless cause us to adjust our strategy in order to compete effectively in global markets.

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

We rely on our website, an in-house call center and third-party call centers, over which we have little or no control, to sell our solutions, respond to customer service and technical support requests and process orders. These activities are especially important during the holiday season and in particular the period beginning on Black Friday through the end of the calendar year. 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, or a failure of third-party call centers to handle higher volumes of use, could reduce our ability to receive and process orders and provide products and services, which could result in cancelled sales and loss of revenue and damage to our brand and reputation. These risks are more important during the holiday season, when many sales of our products and services take place.

We structure our marketing and advertising to drive potential customers to our website and call centers to purchase our solutions. If we experience technical difficulties with our website or 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 may not convert inquiries into sales at an acceptable rate.

### ***If any of our products or services 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 or services 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 could 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 marketplace acceptance of our products and services;
- diversion of our resources;
- a lower rate of license renewals or upgrades for Consumer, Literacy and Enterprise & Education Language customers;
- injury to our reputation;
- increased service expenses or payment of damages; or
- costly litigation.

### ***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

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require modification and refinement 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.

***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 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 learning solutions. 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. In the event of an interruption or system event we may be unable to meet contract service level requirements, or we could experience an unrecoverable 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. As we continue to move additional product features to online systems or place 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.

***We may incur losses associated with currency fluctuations and may not be able to effectively hedge our exposure, which could impair our financial performance.***

Our operating results are subject to fluctuations in foreign currency exchange rates. We currently do not attempt to mitigate a portion of these risks through foreign currency hedging, based on our judgment of the appropriate trade-offs among risk, opportunity and expense. In the future, we might choose to engage in foreign currency hedging transactions, which would involve different risks and uncertainties.

***Our revolving credit facility contains borrowing limitations and other restrictive covenants and the failure to maintain a sufficient borrowing base or to comply with such covenants could prevent us from borrowing funds, and could cause any outstanding debt to become immediately payable, which might adversely impact our business.***

Our revolving credit facility contains borrowing limitations based on a combination of our cash balance and eligible accounts receivable balances and financial covenants currently applicable to us, as well as a number of restrictive covenants, including restrictions on incurring additional debt, making investments and other restricted payments, selling assets, paying dividends and redeeming or repurchasing capital stock and debt, subject to certain exceptions. Collectively, these borrowing limitations and covenants could constrain our ability to grow our business through acquisition or engage in other transactions. During the term of our \$25.0 million revolving credit facility, we are also subject to certain financial covenants that require us to maintain a minimum liquidity amount and minimum financial performance requirements, as defined in the credit agreement. If we are not able to comply with all of these covenants, for any reason, we would not be able to borrow funds under the facility, and some or all of any outstanding debt could become immediately due and payable which could have a material adverse effect on our liquidity and ability to conduct our business.

***A significant deterioration in our profitability and/or cash flow caused by prolonged economic instability could reduce our liquidity and/or impair our financial ratios, and trigger a need to raise additional funds from the capital markets and/or renegotiate our banking covenants.***

To the extent economic difficulties continue, our revenue, profitability and cash flows could be significantly reduced. A liquidity shortfall may delay certain development initiatives or may expose us to a need to negotiate further funding. While we anticipate that our existing cash and cash equivalents, together with availability under our existing revolving credit facility, cash balances and cash from operations, will be sufficient to fund our operations for at least the next 12 months, we may need to raise additional capital to fund operations in the future or to finance acquisitions. If we seek to raise additional capital in order to meet various objectives, including developing future technologies and services, increasing working capital, acquiring businesses and responding to competitive pressures, capital may not be available on favorable terms or may not be available at all. A lack of sufficient capital resources could significantly limit our ability to take advantage of business and strategic opportunities. Any additional capital raised through the sale of equity securities would dilute our stock ownership. If adequate

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additional funds are not available, we may be required to delay, reduce the scope of, or eliminate material parts of our business strategy, including potential additional acquisitions or development of new products, services and technologies.

***We might require additional funds from what we internally generate to support our business which might not be available on acceptable terms or at all.***

We might need to further reduce costs or raise additional funds through public or private financings or borrowings in order to maintain our operations at their current level, develop or enhance products, fund expansion, respond to competitive pressures or to acquire complementary products, businesses or technologies. If required, additional financing might not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of debt, equity or convertible debt securities, these securities might have rights, preferences and privileges senior to those of our current stockholders.

***If our goodwill or indefinite-lived intangible assets become impaired, we may be required to record a significant non-cash charge to earnings.***

Under accounting principles generally accepted in the U.S. ("GAAP"), we review our goodwill and indefinite lived intangible assets for impairment at least annually and when there are changes in circumstances. Factors that may be considered a change in circumstances include a decline in stock price and market capitalization, expected future cash flows and slower growth rates in our industry. We may be required to record significant charges to earnings in our financial statements during the period in which any impairment of our goodwill or indefinite lived intangible assets is determined, resulting in a negative effect on our results of operations.

***We may have exposure to greater than anticipated tax liabilities.***

We are subject to income and indirect tax in the U.S. and many foreign jurisdictions. The application of indirect taxes (such as sales and use tax, value-added tax, goods and services tax, business tax and gross receipt tax) to our businesses and to our users is complex, uncertain and evolving, in part because many of the fundamental statutes and regulations that impose indirect taxes were established before the adoption and growth of the Internet and e-commerce. We are subject to audit by multiple tax authorities throughout the world. Although we believe our tax estimates are reasonable and accurate, the final determination of tax audits and any related litigation could be materially different from our historical tax provisions and accruals. The results of an audit or litigation could have a material adverse effect on our financial statements in the period or periods for which that determination is made.

In addition, the United States government and other governments are considering and may adopt tax reform measures that could impact future effective tax rates favorably or unfavorably affected by changes in tax rates, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws or their interpretation. Such changes could have a material adverse impact on our financial results. Further, any changes to the U.S. or any foreign jurisdictions' tax laws, tax rates, or the interpretation of such tax laws, including the Base Erosion Profit Shifting project being conducted by the Organization for Economic Co-operation and Development could significantly impact how U.S. multinational corporations are taxed. Although we cannot predict whether or in what form any legislation changes may pass, if enacted it could have a material adverse impact on our tax expense, deferred tax assets and cash flows.

***Our deferred tax assets may not be fully realizable.***

We record tax valuation allowances to reflect uncertainties about whether we will be able to realize some of our deferred tax assets before they expire. Our tax valuation allowance is based on our estimates of taxable income for the jurisdictions in which we operate and the period over which our deferred tax assets will be realizable. In the future, we could be required to increase the valuation allowance to take into account additional deferred tax assets that we may be unable to realize. An increase in the valuation allowance would have an adverse impact, which could be material, on our income tax provision and net income in the period in which we record the increase.

***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, patents, pending patent applications, 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 dress, trade secret laws, confidentiality procedures, contractual provisions and technical measures. However, even if we are able to secure such rights in the United States, the laws of other countries in which our products are sold may not protect our intellectual property rights to the same extent as the laws of the United States.

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In addition to issued patents, we have several patent applications on file in the U.S. 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 are not certain, they may be challenged, 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 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, and other intellectual property where available and appropriate. 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 guarantee 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, could be unenforceable under the laws of several jurisdictions.

Protection of trade secret and other intellectual property rights in the places 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 could lose significant revenue due to illegal use of our software and from counterfeit copies of our software. If piracy activities increase, it could further harm our business.

We also suspect that competitors might 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 trade secret protection for our source code if any unauthorized disclosure of such code occurs. The loss of 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 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 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 might not significantly distinguish us from our competition.***

We own several U.S. trademark registrations, including registrations of the *Rosetta Stone*, *Lexia Learning*, *Lexia*, *Fit Brains* and *Catalyst* trademarks, as well as U.S. registrations of the color yellow as a trademark. In addition, we hold common law trademark rights and have trademark applications pending in the U.S. 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 U.S. and overseas. Furthermore, notwithstanding the fact that we may have secured trademark rights for our various trademarks in the U.S. and in some countries where we do business, in other countries we may not have secured similar rights and, in those countries there may be third parties who have prior use and prior or superior rights to our own. That prior use, prior or superior right could limit use of our trademarks and we could be challenged in our efforts to use our trademarks. 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 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 related to our business. Third parties may acquire substantially similar domain names or Top Level Domains ("TLDs") that decrease the value of our domain names and trademarks and other proprietary rights which may adversely affect our business. Third parties also may acquire country-specific domain names in the form of Country Code TLDs that include our trademarks or similar terms 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 U.S. and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars, modify the requirements for holding domain names or release additional TLDs. As a result, we may have to incur additional costs to maintain control over potentially relevant domain names or may not maintain exclusive rights to all potentially relevant domain names in the U.S. 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 or as domain names within new TLDs and we will have to make efforts to enforce our rights against such registration attempts.

***Our business depends on our strong brands, and failing to maintain or enhance the Rosetta Stone brands in a cost-effective manner could harm our operating results.***

Maintaining and enhancing our brands is an important aspect of our efforts to attract new customers and expand our business. We believe that maintaining and enhancing our brands will depend largely on our ability to provide high-quality, innovative products, and services, which we might not do successfully. Our brands may be negatively impacted by a number of factors such as service outages, product malfunctions, data protection and security issues, and exploitation of our trademarks by others without permission.

Further, while we attempt to ensure that the quality of our brands is maintained by our licensees, our licensees might take actions that could impair the value of our brands, our proprietary rights, or the reputation of our products. If we are unable to maintain or enhance our brands in a cost-effective manner, or if we incur excessive expenses in these efforts, our business, operating results and financial condition could be harmed.

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

As we expand our business and develop new technologies, products and services, 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 made significant investments in competing products and technologies, and 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 advertising and sale of the affected products or impose significant penalties, limitations 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

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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, and the failure to obtain rights to use such software, other technologies and content could harm our business.***

Some of our products and services contain intellectual property owned by third parties, including software that is integrated with internally developed software and voice recognition software, which we license from third parties. 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, this could harm our business, by resulting 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. Therefore, 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 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.

***We offer Consumer language-learning packages that include perpetual software and online services that have increased our costs as a percentage of revenue, and these and future product introductions may not succeed and may harm our business, financial results and reputation.***

Our Consumer language-learning packages integrate our language-learning software solutions with online services, which provide opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. The costs associated with the online services included with these software packages decrease margins. Customers may choose to not engage with conversation coaches or be willing to pay higher prices to do so. In addition, we are required to defer recognition of all or a portion of each sale of this packaged software over the duration of our online service periods. We cannot assure you that our future software package offerings will be successful or profitable, or if they are profitable, that they will provide an adequate return on invested capital. If our software package offerings are not successful, our business, financial results and reputation may be harmed.

***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. As our business continues to move online, we expect that this risk will diminish over time.

***Our business could be impacted as a result of actions by activist shareholders or others.***

We may be subject, from time to time, to legal and business challenges in the operation of our company due to proxy contests, shareholder proposals, media campaigns and other such actions instituted by activist shareholders or others. Responding to such actions could be costly and time-consuming, disrupt our operations, may not align with our business strategies and could divert the attention of our Board of Directors and senior management from the pursuit of current business strategies. Perceived uncertainties as to our future direction as a result of shareholder activism or potential changes to the composition of the Board of Directors may lead to the perception of a change in the direction of the business or other instability that may make it more difficult to attract and retain qualified personnel and business partners, and could have a materially adverse effect on the Company's stock price.



***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.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

As of December 31, 2016, our corporate headquarters are located in Arlington, Virginia, where we occupy approximately 13,000 square feet of space on the top floor of an office building under a lease that ends January 31, 2020. For more information about our Arlington, Virginia lease and subleases, please see Note 16 of Item 8, *Financial Statements and Supplementary Data*. We currently own one facility in Harrisonburg, Virginia, that provides operations and customer support services. We lease another facility in Virginia for use as a packing and distribution center for all of our U.S. and some of our international fulfillment.

In addition, the Company leases property in various locations in the U.S. and around the world as sales offices, for research and development activities, operations, product distribution, data centers, and market research. We utilize international locations in or near cities including the following: London, United Kingdom; Vancouver, Canada; and Cologne, Germany. Our offices and facilities are used across multiple segments. We believe our offices and facilities are adequate for our current needs.

**Item 3. Legal Proceedings**

Information with respect to this item may be found in Note 16 of Item 8, *Financial Statements and Supplementary Data*, which is incorporated herein by reference.

**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." There were approximately 88 stockholders of record of our common stock as of March 8, 2017 when the last reported sales price of our common stock on the NYSE was \$7.69 per share. 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, 2016</b>		
Fourth Quarter	\$ 9.20	\$ 6.80
Third Quarter	9.22	7.44
Second Quarter	8.46	6.68
First Quarter	8.60	6.17
<b>Year ended December 31, 2015</b>		
Fourth Quarter	\$ 8.22	\$ 6.31
Third Quarter	8.50	6.40
Second Quarter	9.19	6.39
First Quarter	10.37	7.16

**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. Further, our revolving credit facility contains financial and restrictive covenants that, among other restrictions and subject to certain exceptions, limit our ability to pay dividends.

**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."

**Purchases of Equity Securities**

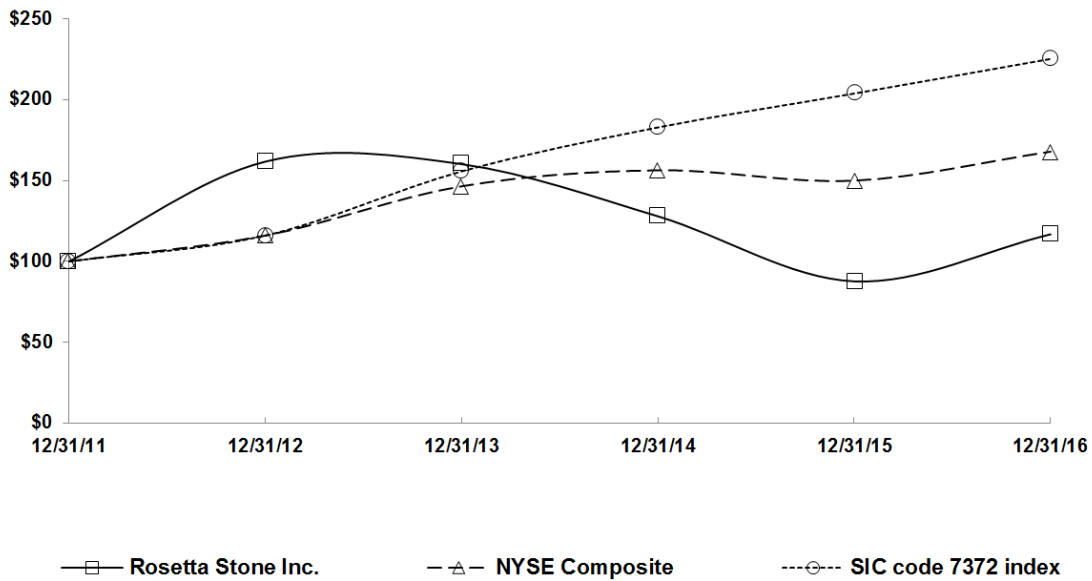
Our revolving credit facility contains financial and restrictive covenants that, among other restrictions and subject to certain limitations, limit our ability to repurchase our shares.

**Stockholder Return Performance Presentation**

The following graph compares the change in the cumulative total stockholder return on our common stock during the 5-year period from December 31, 2011 through December 31, 2016, 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 December 31, 2011 in our common stock and in each of the foregoing indices and assumes reinvestment of dividends, if any.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

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



\*\$100 invested on 12/31/11 in stock or index, including reinvestment of dividends.  
Fiscal year ending December 31.

The foregoing graph shall not be deemed to be filed as part of this Annual Report on Form 10-K and does not constitute soliciting material and should not be deemed filed or incorporated by reference into any other filing of the Company under the Securities Act, or the Exchange Act, except to the extent we specifically incorporate the graph by reference.

**Item 6. Selected Consolidated Financial Data**

The following tables set forth selected consolidated statement of operations data, balance sheet data, and other data for the periods indicated. The selected consolidated statement of operations data for the years ended December 31, 2016, 2015, 2014, 2013 and 2012, and the selected consolidated balance sheet data as of December 31, 2016, 2015, 2014, 2013 and 2012 have been derived from our audited consolidated financial statements. The selected consolidated financial data should be read in conjunction with the information under “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations,” our consolidated financial statements, the related notes and the accompanying independent registered public accounting firm’s report, which are included in “Item 8. *Financial Statements and Supplementary Data.*” Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

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	Year Ended December 31,				
	2016(1)	2015(2)	2014(3)	2013(4)	2012(5)
(in thousands, except per share data)					
<b>Selected Statements of Operations Data:</b>					
Revenue	\$ 194,089	\$ 217,670	\$ 261,853	\$ 264,645	\$ 273,241
Gross profit	159,768	179,143	208,799	218,931	224,331
Loss from operations	(26,920)	(43,813)	(78,850)	(18,442)	(5,266)
Net loss	(27,550)	(46,796)	(73,706)	(16,134)	(33,985)
<b>Loss per share attributable to common stockholders:</b>					
Basic	\$ (1.25)	\$ (2.17)	\$ (3.47)	\$ (0.75)	\$ (1.61)
Diluted	\$ (1.25)	\$ (2.17)	\$ (3.47)	\$ (0.75)	\$ (1.61)
<b>Other Selected Data:</b>					
Total stock-based compensation expense	\$ 4,906	\$ 7,195	\$ 6,762	\$ 9,241	\$ 8,009
Total intangible amortization expense	\$ 4,351	\$ 5,192	\$ 6,263	\$ 1,822	\$ 40

- (1) As discussed in Notes 1 and 13 of Item 8, *Financial Statements and Supplementary Data*, the Company announced and initiated restructuring actions in the first quarter of 2016 to exit the direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of its Enterprise & Education Language offerings. Under this initiative, the Company made headcount reductions, office lease terminations, and other cost reductions in France, China, Brazil, Canada, Spain, Mexico, U.S. and the U.K.
- (2) As discussed in Notes 1 and 13 of Item 8, *Financial Statements and Supplementary Data*, the Company undertook restructuring actions in the first quarter of 2015 to focus on the Enterprise & Education business and optimize the Consumer business for profitability. Under this initiative, the Company undertook headcount and cost reductions to areas including Consumer sales and marketing, Consumer product investment, and general and administrative functions.
- (3) The Company acquired Vivity Labs, Inc. on January 2, 2014 and Tell Me More S.A. on January 9, 2014. The results of operations from these entities have been included from the acquisition date.
- (4) The Company acquired Livemocha, Inc. on April 1, 2013 and acquired Lexia Learning Systems, Inc. on August 1, 2013. The results of operations from these entities have been included from the acquisition date.
- (5) The Company established a full valuation allowance to reduce the deferred tax assets of the Korea, Brazil, Japan and U.S. subsidiaries. The establishment of the valuation allowance resulted in a non-cash charge of \$29.7 million during the year ended December 31, 2012.

	As of December 31,				
	2016	2015	2014	2013	2012
(in thousands)					
<b>Selected Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 36,195	\$ 47,782	\$ 64,657	\$ 98,825	\$ 148,190
Total assets	194,310	228,543	288,173	290,776	279,405
Total deferred revenue	141,457	142,748	128,169	78,857	63,416
Notes payable and capital lease obligation	2,559	3,143	3,748	242	5
Total stockholders' (deficit) equity	(1,659)	22,410	63,445	131,243	148,194

**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") contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The 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

Rosetta Stone is dedicated to changing people's lives through the power of language and literacy education. Our innovative digital solutions drive positive learning outcomes for the inspired learner at home or in schools and workplaces around the world. Founded in 1992, Rosetta Stone's language division uses cloud-based solutions to help all types of learners read, write, and speak more than 30 languages. Lexia Learning, Rosetta Stone's literacy education division, was founded more than 30 years ago and is a leader in the literacy education space. Today, Lexia helps students build fundamental reading skills through its rigorously researched, independently evaluated, and widely respected instruction and assessment programs. Rosetta Stone Inc. was incorporated in Delaware in 2005.

The Enterprise & Education Language segment derives revenue from sales to educational institutions, corporations, and government agencies worldwide. The Literacy segment derives revenue from the sales of literacy solutions to educational institutions serving grades K through 12. The Consumer segment derives revenue from sales to individuals and retail partners. Our Enterprise & Education Language distribution model is focused on targeted sales activity primarily through a direct sales force in five markets: K-12 schools; colleges and universities; federal government agencies; corporations; and not-for-profit organizations. Our Literacy distribution channel utilizes a direct sales force as well as relationships with third-party resellers focused on the sale of Lexia Learning solutions to K-12 schools. Our Consumer distribution channel comprises a mix of our call centers, websites, app-stores, third party e-commerce websites, select retail resellers, such as Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Sam's Club, Staples, consignment distributors such as Wynit Distribution and Software Packaging Associates, and daily deal partners.

As our Company has evolved, we believe that our Enterprise & Education Language and Literacy segments are our largest opportunities for long-term value creation. The customers in these markets have needs that recur each year, creating a more predictable sales opportunity. This need profile also fits well with our suite of language and literacy products and the well-known Rosetta Stone brand. We also believe the demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe.

As a result, we are emphasizing the development of products and solutions for Corporate and K-12 learners who need to speak and read English. This focus extends to the Consumer segment where we continue to make product investments serving the needs of passionate language learners who are motivated, results focused and willing to pay for a quality language-learning experience.

To position the organization for success, our focus is on the following priorities:

1. Grow literacy sales and market share by providing fully aligned digital instruction and assessment tools for K-12, building a direct distribution sales force to augment our historical reseller model, and continuing to develop our implementation services business;
2. Position our Enterprise & Education Language business for profitable growth by focusing our direct sales on our best geographies and customer segments, partnering with resellers in other geographies and successfully delivering our Catalyst product to Corporate customers. Catalyst integrates our Foundations, Advantage, and Advanced English for Business products with enhanced reporting, assessment, and administrator tools that offers a simple, more modern, metrics-driven suite of tools that are results-oriented and easily integrated with leading corporate language-learning systems;
3. Maximize the profitability of our Consumer language business by providing an attractive value proposition and a streamlined, mobile-oriented product portfolio focused on customers' demand, while optimizing our marketing spend appropriately;
4. Seek opportunities to leverage our language assets including our content, tools and pedagogy, as well as our well-known Rosetta Stone brand, through partnerships with leading players in key markets around the world, and
5. Continue to identify opportunities to become more efficient.

In pursuing these priorities, we will (i) allocate capital to the areas of our business that we believe have the greatest value creation potential, including our Lexia literacy business, (ii) focus our businesses on their best customers, including K-12 learners primarily in North America, Corporate learners primarily in North America and Northern Europe in our Enterprise & Education Language segment, and passionate learners in the U.S. and select non-U.S. markets in our Consumer language business, and (iii) optimize the sales and marketing costs for these businesses and the costs of our business overall.

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In March 2016, we announced the 2016 Restructuring Plan ("2016 Restructuring Plan"), outlining our withdrawal of the direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings. These operations added sales, but at too high a cost and without the near-term ability to capture scale efficiencies. Where appropriate, we will seek to operate through partners in the geographies being exited. We have also initiated processes to close our software development operations in France and China. These actions were in addition to the 2015 Restructuring Plan to accelerate and prioritize our focus on satisfying the needs of the more passionate learners in the United States and select non-U.S. geographies in the Consumer language segment. In March 2015, we initiated a plan (the "2015 Restructuring Plan") to make reductions to Consumer sales and marketing, Consumer product investment, and general and administrative costs. See Note 2 and Note 13 of Item 8, *Financial Statements and Supplementary Data* for additional information about these strategic undertakings.

In conjunction with the 2016 and 2015 Restructuring Plans, outside financial and legal advisors have been retained to assist management and the Board of Directors with their ongoing comprehensive review to analyze potential options to improve financial performance and enhance shareholder value.

In March 2016, we announced our strategy to position the organization for success and we have prioritized the growth of literacy sales and have begun to take actions to align resources to drive this growth. As a result of this shift, we reevaluated our segment structure. Prior to the strategy shift, we were managed in two operating segments (Enterprise & Education and Consumer). Following the shift, we are managed in three operating segments (Enterprise & Education Language, Literacy, and Consumer). We discuss the profitability of each segment in terms of segment contribution. Segment contribution is the measure of profitability used by our Chief Operating Decision Maker. Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expense and bad debt expense. Prior periods have been reclassified to reflect our current segment presentation and definition of segment contribution.

For the year ended December 31, 2016, Enterprise & Education Language segment contribution increased to \$28.3 million with a segment contribution margin of 39%, compared to \$21.3 million with a segment contribution margin of 28% for the year ended December 31, 2015. The dollar and margin increases were primarily due to the cost reduction initiatives in early 2016 as compared to the prior year. Literacy segment contribution increased to \$5.6 million with segment contribution margin of 17% for the year ended December 31, 2016 as compared to a segment contribution of \$0.7 million and a segment contribution margin of 3% for the year ended December 31, 2015. The dollar and margin increases were primarily due to the larger revenue base on which segment contribution is calculated, offset by an increase in sales and marketing expense due to the transition to a direct sales team and support infrastructure. The margin improvement partially related to the effect of purchase accounting that will diminish over time. Consumer segment contribution decreased to \$21.1 million with a contribution margin of 24% for the year ended December 31, 2016, from \$30.0 million with a contribution margin of 25% for the year ended December 31, 2015. The dollar and margin decreases were primarily due to a decrease in Consumer revenue of \$31.7 million.

For the year ended December 31, 2015, Enterprise & Education Language segment contribution increased to \$21.3 million with a segment contribution margin of 28%, compared to \$16.9 million with a segment contribution margin of 23% for the year ended December 31, 2014. The dollar and margin increases were primarily due to the increase in Enterprise & Education revenue which was slightly offset by an increase in direct sales related expenses. Literacy segment contribution increased to \$0.7 million with segment contribution margin of 3% for the year ended December 31, 2015, as compared to a segment contribution loss of \$3.0 million and a segment contribution margin of negative 30% for the year ended December 31, 2014. The dollar and margin increases were primarily due to the impacts of purchase accounting. Consumer segment contribution increased to \$30.0 million with a contribution margin of 25% for the year ended December 31, 2015, from \$28.0 million with a contribution margin of 16% for the year ended December 31, 2014. The dollar and margin increases in Consumer segment contribution was primarily due to cost reduction initiatives.

Over the last few years, our Consumer strategy has been to shift more and more of our Consumer business to online subscriptions (with access across the web and apps) and away from perpetual digital download and CD packages. We believe that these online subscription formats provide customers with an overall better experience, flexibility to use our products on multiple platforms (tablets, smartphones and computers), and provide a more economical and relevant way for us to deliver our products to customers. One challenge to encouraging customers to enter into or renew a subscription arrangement is that usage of our product varies greatly, ranging from customers that purchase but do not have any usage to customers with high usage. The majority of purchasers tend towards the lower end of that spectrum, with most usage coming in the first few months after purchase and declining over time - similar to a gym membership. We expect the trend in Consumer subscription sales to accelerate through the end of 2017 as customer preferences continue to move towards cross-platform experiences. Our goal is to move almost entirely all of our Consumer business to subscription sales by the end of 2017.

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For additional information regarding our segments, see Note 17 of Item 8, *Financial Statements and Supplementary Data*. For additional information regarding fluctuations in segment revenue, see Results of Operations, below. Prior periods have been reclassified to reflect our current operating segments presentation and definition of segment contribution.

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

#### *Revenue*

We derive revenue from sales of language-learning and literacy solutions. Revenue is presented as subscription and service revenue or product revenue in our consolidated financial statements. Subscription and service revenue consists of sales from web-based software subscriptions, online services, professional services, and certain mobile applications. Our online services are typically sold in short-term service periods and include dedicated online conversational coaching services and access to online communities of language learners. Our professional services include training and implementation services. Product revenue primarily consists of revenue from our perpetual language-learning product software, our audio practice products, and certain mobile applications. Our audio practice products are often combined with our language-learning software and sold as a solution.

In the Consumer market, our perpetual product software is often bundled with our short-term online conversational coaching and online community services and sold as a package. Approximately \$39 in revenue per unit is derived from these short-term online services. As a result, we typically defer 10% to 35% of the revenue of each of these bundled sales to be recognized over the term of the service period. The content of our perpetual product software and our web-based language-learning subscription offerings are the same. We offer our customers the ability to choose which format they prefer without differentiating the learning experience.

We sell our solutions directly and indirectly to individuals, educational institutions, corporations, and governmental agencies. We sell to enterprise and education organizations primarily through our direct sales force as well as through our network of resellers and organizations who typically gain access to our solutions under a web-based subscription service. We distribute our Consumer products predominantly through our direct sales channels, primarily utilizing our websites and call centers, which we refer to as our direct-to-consumer channel. We also distribute our Consumer products through select third-party retailers and distributors. For purposes of explaining variances in our revenue, we separately discuss changes in our Enterprise & Education Language, Literacy, and our Consumer segments because the customers and revenue drivers of these channels are different.

Within our Enterprise & Education Language segment, sales in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Literacy segment sales are seasonally stronger in the third quarter of the calendar year corresponding to school district budget years. Consumer sales are affected by seasonal trends associated with the holiday shopping season. We expect these trends to continue.

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

Cost of subscription and service revenue primarily represents costs associated with supporting our web-based subscription services and online language-learning services, 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 subscription and service revenue and cost of product 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.

#### *Operating Expenses*

We classify our operating expenses into the following categories: sales and marketing, research and development, and general and administrative. When certain events occur, we also recognize operating expenses related to asset impairment and operating lease terminations.

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. Included within our operating expenses are restructuring costs that consist primarily of employee severance and related benefit costs, contract termination costs, and other related costs associated with our restructuring activities.

*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, and

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commissions earned by our sales personnel. Sales commissions are generally paid at the time the customer is invoiced. However, sales commissions are deferred and recognized as expense in proportion to when the related revenue is recognized.

*Research and Development.* Research and development expenses consist primarily of employee compensation costs, consulting fees, and overhead costs associated with development of our solutions. Our development efforts are primarily based in the U.S. and are devoted to modifying and expanding our offering portfolio through the addition of new content, as well as new paid and complementary products and services to our language-learning and literacy solutions.

*General and Administrative.* General and administrative expenses consist primarily of shared services, such as personnel costs of our executive, finance, legal, human resources and other administrative personnel, as well as accounting and legal professional services fees including professional service fees related to acquisitions and other corporate expenses.

*Impairment.* Impairment expenses consist primarily of goodwill impairment, impairment of long-lived assets, and impairment expense related to the abandonment of previously capitalized internal-use software projects.

*Lease Abandonment and Termination.* Lease abandonment and termination expenses include the recognition of costs associated with the termination or abandonment of our office operating leases, such as early termination fees and expected lease termination costs.

### *Interest and Other Income (Expense)*

Interest and other income (expense) primarily consist of interest income, interest expense, foreign exchange gains and losses, income from litigation settlements, and income or loss from equity method investments. Interest income represents interest received on our cash and cash equivalents. Interest expense is primarily related to interest on our capital leases and amortization of deferred financing fees associated with our revolving credit facility. Fluctuations in foreign currency exchange rates in our foreign subsidiaries cause foreign exchange gains and losses. Legal settlements are related to agreed upon settlement payments from various anti-piracy enforcement efforts. Income or loss from equity method investments represents our proportionate share of the net income or loss of our investment in entities accounted for under the equity method.

### *Income Tax Expense (Benefit)*

Income tax expense (benefit) consists of federal, state and foreign income taxes.

We regularly evaluate the recoverability of our deferred tax assets and establish a valuation allowance, if necessary, to reduce the deferred tax assets to an amount that is more likely than not to be realized (a likelihood of more than 50 percent). Significant judgment is required to determine whether a valuation allowance is necessary and the amount of such valuation allowance, if appropriate.

The establishment of a valuation allowance has no effect on the ability to use the deferred tax assets in the future to reduce cash tax payments. We assess the likelihood that the deferred tax assets will be realizable at each reporting period, and the valuation allowance will be adjusted accordingly, which could materially affect our financial position and results of operations.

## **Critical Accounting Policies and Estimates**

In presenting our financial statements in conformity with GAAP, 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 following critical accounting policies involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements. In addition, we believe that a discussion of these policies is necessary for readers to understand and evaluate our consolidated financial statements contained in this annual report on Form 10-K. See Note 2 of Item 8, *Financial Statements and Supplementary Data* for a complete description of our significant accounting policies.

### **Revenue Recognition**

Our primary sources of revenue are web-based software subscriptions, online services, perpetual product software, and bundles of perpetual product software and online services. We also generate revenue from the sale of audio practice products,



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mobile applications, and professional services. Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenue is recorded net of discounts and net of taxes.

We identify the units of accounting contained within our sales arrangements and in doing so, we evaluate a variety of factors including whether the undelivered element(s) have value to the customer on a stand-alone basis or if the undelivered element(s) could be sold by another vendor on a stand-alone basis.

For multiple element arrangements that contain perpetual software products and related online services, we allocate the total arrangement consideration to the deliverables based on the existence of vendor-specific objective evidence of fair value ("VSOE"). We generate a portion of Consumer revenue from the CD and digital download formats of the Rosetta Stone language-learning product which are typically multiple-element arrangements that contain two deliverables: perpetual software, delivered at the time of sale, and online service, which is considered an undelivered software-related element. The online service includes access to conversational coaching services. Because we only sell the perpetual language-learning software on a stand-alone basis in our homeschool version, we do not have a sufficient concentration of stand-alone sales to establish VSOE for the perpetual product. Where VSOE of the undelivered online services can be established, arrangement consideration is allocated using the residual method. We determine VSOE by reference to the range of comparable stand-alone renewal sales of the online service. We review these stand-alone sales on a quarterly basis. VSOE is established if at least 80% of the stand-alone sales are within a range of plus or minus 15% of a midpoint of the range of prices, consistent with generally accepted industry practice. Where VSOE of the undelivered online services cannot be established, revenue is deferred and recognized commensurate with the delivery of the online services.

For non-software multiple element arrangements we allocate revenue to all deliverables based on their relative selling prices. Our non-software multiple element arrangements primarily occur as sales to our Enterprise & Education Language and Literacy customers, and to a lesser extent to our Consumer customers. These arrangements can include web-based subscription services, audio practice products and professional services or any combination thereof. We do not have a sufficient concentration of stand-alone sales of the various deliverables noted above to our customers, and therefore cannot establish VSOE for each deliverable. Third party evidence of fair value does not exist for the web-based subscription, audio practice products and professional services due to the lack of interchangeable language-learning products and services within the market. Accordingly, we determine the relative selling price of the web-based subscription, audio practice products and professional services deliverables included in our non-software multiple element arrangements using our best estimate of selling price. We determine our best estimate of selling price based on our internally published price list which includes suggested sales prices for each deliverable based on the type of client and volume purchased. This price list is derived from past experience and from the expectation of obtaining a reasonable margin based on our cost of each deliverable.

In the U.S. and Canada, we offer consumers who purchase our packaged software and audio practice products directly from us a 30-day, unconditional, full money-back refund. We also permit some of our retailers and distributors to return unsold packaged products, subject to certain limitations. We estimate and establish revenue reserves for packaged product returns at the time of sale based on historical return rates, estimated channel inventory levels, the timing of new product introductions, and other factors.

We distribute products and services both directly to the end customer and indirectly through resellers. Our resellers earn commissions generally calculated as a fixed percentage of the gross sale to the end customer. We evaluate each of our reseller relationships to determine whether the revenue recognized from indirect sales should be the gross amount of the contract with the end customer or reduced for the reseller commission. In making this determination we evaluate a variety of factors including whether we are the primary obligor to the end customer.

Revenue for web-based subscriptions and online services is recognized ratably over the term of the subscription or service period, assuming all revenue recognition criteria have been met. Our CD and digital download formats of Rosetta Stone language-learning products are typically bundled with an online service where customers are allowed to begin their online services at any point during a registration window, which is typically up to six months from the date of purchase from us or an authorized reseller. The online services that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Revenue from non-refundable upfront fees that are not related to products already delivered or services already performed is deferred and recognized ratably over the term of the related arrangement because the period over which a customer is expected to benefit from the service that is included within our subscription arrangements does not extend beyond the contractual period. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement.

Software products are sold to end user customers and resellers. In many cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products and audio practice products is recognized as the products are shipped and title passes

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and risks of loss have been transferred. For many 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. In other cases where 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. Cash sales incentives to resellers are accounted for as a reduction of revenue, unless a specific identifiable benefit is identified and the fair value is reasonably determinable. 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 at the time of sale.

We offer our U.S. and Canada consumers 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, a successful collection history has been established and these fees are fixed and determinable, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met.

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

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

### ***Stock-Based Compensation***

All stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date. For options granted with service and/or performance conditions, the fair value of each grant is estimated on the date of grant using the Black-Scholes option pricing model. For options granted with market-based conditions, the fair value of each grant is estimated on the date of grant using the Monte-Carlo simulation model. Determining the fair value at the grant date requires the use of estimates, including expected term, future stock price volatility, forfeiture rates, and risk-free interest rate.

As we do not have sufficient historical option exercise experience that spans the full 10 year contractual term for determining the expected term of options granted, we estimate the expected term of options using a combination of historical information and the simplified method. We use our own historical stock price data to estimate a forfeiture rate and expected volatility over the most recent period commensurate with the estimated expected term of the awards. For the risk free interest rate, we use a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.

Stock-based compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. For equity awards granted with market-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions. Stock compensation expense is recognized based on the estimated portion of the awards that are expected to vest. Estimated forfeiture rates were applied in the expense calculation.

### ***Goodwill***

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisitions of Livemocha and Lexia in 2013 and the acquisitions of Vivity and Tell Me More in 2014.

As of December 31, 2016, our reporting units are: Enterprise & Education Language, Literacy, Consumer Language, and Consumer Fit Brains. Each of these businesses is considered a reporting unit for goodwill impairment testing purposes. Consumer Language and Consumer Fit Brains are components of the Consumer operating segment.

We test goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach or more frequently, if impairment indicators arise. We have the option 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, a "Step 0" analysis. If, based on a review of qualitative factors, it is more likely than not that the fair value of a reporting unit is less than its carrying value, we perform "Step 1" of the traditional two-step goodwill impairment test by comparing the fair value of a reporting unit with its

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carrying amount. If the carrying value exceeds the fair value, we measure the amount of impairment loss in "Step 2", if any, by comparing the implied fair value of the reporting unit goodwill to its carrying amount.

The factors that we consider important in a qualitative analysis, and which could trigger an interim 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. We evaluate our reporting units with remaining goodwill balances on a quarterly basis to determine if a triggering event has occurred. We will continue to review for impairment indicators.

In estimating the fair value of our reporting units in Step 1, we use a variety of techniques including the income approach (i.e., the discounted cash flow method) and the market approach (i.e., the guideline public company method). Our projections are estimates that can significantly affect the outcome of the analysis, both in terms of our ability to accurately project future results and in the allocation of fair value between reporting units.

Consistent with our election in prior annual tests, we exercised our option to bypass Step 0 for all reporting units with remaining goodwill balances in connection with the annual goodwill impairment analysis performed as of June 30, 2016. The Enterprise & Education Language and Literacy reporting unit tests both resulted in fair values that substantially exceeded the carrying values, and therefore no goodwill impairment charges were recorded in connection with the annual analysis for these reporting units.

The Consumer Fit Brains reporting unit was also evaluated, which resulted in a fair value that was significantly below the carrying value. The decrease in fair value was due to the second quarter 2016 strategy update for the Consumer Fit Brains business. The Consumer Fit Brains reporting unit was no longer considered central to our core strategy to focus on language and literacy learning. Due to the continued declines in operations since the \$5.6 million partial impairment in the fourth quarter of 2015, we revised the Consumer Fit Brains financial projections in the second quarter of 2016 assuming reduced media spend and reduced revenue in 2016 and beyond. The change in operating plans and the lack of cushion since the fourth quarter 2015 impairment resulted in an implied fair value of goodwill that was significantly below its carrying value. As a result, we recorded a second quarter impairment loss of \$1.7 million, which represented a full impairment of the remaining Consumer Fit Brains reporting unit's goodwill. The impairment charge was recorded in the "Impairment" line on the statement of operations.

We routinely review goodwill at the reporting unit level for potential impairment as part of our internal control framework. As of December 31, 2016, the Enterprise & Education Language and Literacy reporting units are the only reporting units with remaining goodwill balances. In the fourth quarter of 2016, we evaluated these reporting units to determine if a triggering event has occurred. As of December 31, 2016, the Company concluded that there were no indicators of impairment that would cause us to believe that it is more likely than not that the fair value of any such reporting units is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no goodwill impairment charges were recorded in connection with the interim impairment reviews of any such reporting units.

### ***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. Intangible assets with finite lives are reviewed routinely for potential impairment as part of our internal control framework. Annually, as of December 31, and more frequently if a triggering event occurs, we review the Rosetta Stone trade name, our only indefinite-lived intangible asset, to determine if indicators of impairment exist. We have the option to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative test. If necessary, the quantitative test is performed by comparing the fair value of indefinite-lived intangible assets to the carrying value. In the event the carrying value exceeds the fair value of the assets, the assets are written down to their fair value.

During the second quarter of 2016, we revised the business outlook and financial projections for the Consumer Fit Brains reporting unit, which prompted a long-lived intangible asset impairment analysis of the Consumer Fit Brains tradename, developed technology, and customer relationships. The carrying values of the intangible assets exceeded the estimated fair values. As a result, we recorded an impairment loss of \$1.2 million associated with the impairment of the remaining carrying value of the Consumer Fit Brains long-lived intangible assets as of June 30, 2016. The impairment charge was recorded in the "Impairment" line on the statement of operations.

During the fourth quarter of 2016, we elected to bypass the qualitative assessment and performed the quantitative assessment. In the quantitative assessment, we noted that the fair value of the Rosetta Stone trade name exceeded the carrying value. There has been no impairment of intangible assets during the years ending December 31, 2015 and 2014.

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

As part of our internal control framework we evaluate the recoverability of our long-lived assets. An impairment of long-lived assets is recognized 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. During 2016, 2015, and 2014, we recorded \$1.0 million, \$1.1 million, and \$0.2 million in impairment expense related to the abandonment of software projects that were previously capitalized.

### ***Restructuring Costs***

As part of the 2016 and 2015 Restructuring Plans, we announced and initiated actions to reduce headcount and other costs in order to support our strategic shift in business focus. In connection with these plans, we incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included within Cost of Sales and our Sales and marketing, Research and development, and General and administrative operating expense categories in our consolidated statements of operations.

Employee severance and related benefit costs primarily include cash payments, outplacement services, continuing health insurance coverage, and other benefits. Where no substantive involuntary termination plan previously exists, these severance costs are generally considered “one-time” benefits and recognized at fair value in the period in which a detailed plan has been approved by management and communicated to the terminated employees. Severance costs pursuant to ongoing benefit arrangements, including termination benefits provided for in existing employment contracts, are recognized when probable and reasonably estimable.

Contract termination costs include penalties to cancel certain service and license contracts and costs to terminate operating leases. Contract termination costs are recognized at fair value in the period in which the contract is terminated in accordance with the contract terms.

Other related costs generally include external consulting and legal costs associated with the strategic shift in business focus. Such costs are recognized at fair value in the period in which the costs are incurred.

### ***Income Taxes***

We believe that the accounting estimate for the realization 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. 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.

We use the 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.

We reduce 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 is assessed quarterly based on the more-likely-than-not realization threshold criterion. In the assessment, 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. Significant judgment is required to determine whether a valuation allowance is necessary and the amount of such valuation allowance, if appropriate. The valuation allowance is reviewed quarterly and is maintained until sufficient positive evidence exists to support a reversal.

In assessing the recoverability of our deferred tax assets, we consider all available evidence, including:

- the nature, frequency, and severity of cumulative financial reporting losses in recent years;
- the carryforward periods for the net operating loss, capital loss, and foreign tax credit carryforwards;
- predictability of future operating profitability of the character necessary to realize the asset;
- prudent and feasible tax planning strategies that would be implemented, if necessary, to protect against the loss of the deferred tax assets; and

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- the effect of reversing taxable temporary differences.

The evaluation of the recoverability of the deferred tax assets requires that we weigh all positive and negative evidence to reach a conclusion that it is more likely than not that all or some portion of the deferred tax assets will not be realized. The weight given to the evidence is commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed. Our valuation allowance analysis considers a number of factors, including our cumulative losses in recent years, our expectation of future taxable income and the time frame over which our net operating losses expire.

As of December 31, 2016, a full valuation allowance exists for the U.S., Japan, China, Hong Kong, Mexico, Spain, Brazil, Canada, and France where we have determined the deferred tax assets will not more likely than not be realized.

All of the jurisdictions mentioned above, with the exception of China, have cumulative losses and pre-tax losses for the most recent year ended December 31, 2016. The establishment of a valuation allowance has no effect on the ability to use the deferred tax assets in the future to reduce cash tax payments. We will continue to assess the likelihood that the deferred tax assets will be realizable at each reporting period and the valuation allowance will be adjusted accordingly, which could materially affect our financial position and results of operations.

As of December 31, 2016 and 2015, our net deferred tax liability was \$6.2 million and \$5.0 million, respectively.

### ***Going Concern Assessment***

The consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Management has evaluated whether relevant conditions or events, considered in the aggregate, indicate that there is substantial doubt about the Company's ability to continue as a going concern. Substantial doubt exists when conditions and events, considered in the aggregate, indicate it is probable that the Company will be unable to meet its obligations as they become due within one year after the financial statement issuance date. The assessment is based on the relevant conditions that are known or reasonable knowable as of March 14, 2017.

The assessment of our ability to meet our future obligations is inherently judgmental, subjective and susceptible to change. The inputs that we considered important in a going concern analysis, include, but are not limited to, our 2017 cash flow forecast, 2017 operating budget, and long-term plan that extends beyond 2017. These inputs consider information including, but not limited to, our financial condition, liquidity sources, obligations due within one year after the financial statement issuance date, funds necessary to maintain operations, and financial conditions, including negative financial trends or other indicators of possible financial difficulty.

We have considered both quantitative and qualitative factors as part of the assessment that are known or reasonably knowable as of March 14, 2017, and concluded that conditions and events considered in the aggregate, do not indicate that it is probable that we will be unable to meet obligations as they become due through the one year period following the financial statement issuance date.

### ***Recently Issued Accounting Standards***

For a summary of recent accounting pronouncements applicable to our consolidated financial statements see Note 2 of Item 8, *Financial Statements and Supplementary Data*, which is incorporated herein by reference.

**Results of Operations**

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

	Year Ended December 31,		
	2016	2015	2014
(in thousands, except per share data)			
<b>Statements of Operations Data:</b>			
Revenue:			
Subscription and service	\$ 154,336	\$ 151,701	\$ 125,602
Product	39,753	65,969	136,251
Total revenue	194,089	217,670	261,853
Cost of revenue:			
Cost of subscription and service revenue	23,676	21,629	18,862
Cost of product revenue	10,645	16,898	34,192
Total cost of revenue	34,321	38,527	53,054
Gross profit	159,768	179,143	208,799
Operating expenses			
Sales and marketing	114,340	136,084	173,208
Research and development	26,273	29,939	33,176
General and administrative	40,501	50,124	57,120
Impairment	3,930	6,754	20,333
Lease abandonment and termination	1,644	55	3,812
Total operating expenses	186,688	222,956	287,649
Loss from operations	(26,920)	(43,813)	(78,850)
Other income and (expense):			
Interest income	46	23	17
Interest expense	(470)	(378)	(233)
Other income and (expense)	2,297	(1,469)	(1,129)
Total other income and (expense)	1,873	(1,824)	(1,345)
Loss before income taxes	(25,047)	(45,637)	(80,195)
Income tax expense (benefit)	2,503	1,159	(6,489)
Net loss	\$ (27,550)	\$ (46,796)	\$ (73,706)
Loss per share:			
Basic	\$ (1.25)	\$ (2.17)	\$ (3.47)
Diluted	\$ (1.25)	\$ (2.17)	\$ (3.47)
Common shares and equivalents outstanding:			
Basic weighted average shares	21,969	21,571	21,253
Diluted weighted average shares	21,969	21,571	21,253
<i>Stock-based compensation included in:</i>			
Cost of revenue	48	101	108
Sales and marketing	998	1,327	1,975
Research and development	709	841	958
General and administrative	3,151	4,926	3,721
Total stock-based compensation expense	\$ 4,906	\$ 7,195	\$ 6,762

**Comparison of the Year Ended December 31, 2016 and the Year Ended December 31, 2015**

Our total revenue decreased to \$194.1 million for the year ended December 31, 2016 from \$217.7 million for the year ended December 31, 2015. The change in total revenue was primarily due to a decrease in Consumer revenue of \$31.7 million and a slight decrease in Enterprise & Education Language revenue of \$4.0 million, which were partially offset by an increase in Literacy revenue of \$12.2 million.

We reported an operating loss of \$26.9 million for the year ended December 31, 2016 compared to an operating loss of \$43.8 million for the year ended December 31, 2015. Operating expense decreased \$36.3 million, comprised of decreases of \$21.7 million in sales and marketing expenses, \$9.6 million in general and administrative expenses, \$3.7 million in research and development expenses, and \$2.8 million in impairment expenses. The decrease in general and administrative expenses and sales and marketing expenses reflects the continued savings as a result of the 2016 Restructuring Plan and other ongoing expense reduction actions. The \$36.3 million reduction in operating expenses were partially offset by a decrease in gross profit of \$19.4 million, driven by a decrease of \$4.2 million in cost of revenue, which was offset by a \$23.6 million decrease in revenue, and a slight increase of \$1.6 million in lease abandonment and termination expenses associated with the space consolidation and move to our new headquarters.

**Revenue by Operating Segment**

The following table sets forth revenue for our three operating segments for the years ended December 31, 2016 and 2015:

	Year ended December 31,				2016 versus 2015	
	2016		2015		Change	% Change
	(in thousands, except percentages)					
Enterprise & Education Language	\$ 72,083	37.1%	\$ 76,129	35.0%	\$ (4,046)	(5.3)%
Literacy	34,123	17.6%	21,928	10.0%	\$ 12,195	55.6 %
Consumer	87,883	45.3%	119,613	55.0%	\$ (31,730)	(26.5)%
Total Revenue	\$ 194,089	100.0%	\$ 217,670	100.0%	\$ (23,581)	(10.8)%

**Enterprise & Education Language Segment**

Total Enterprise & Education Language revenue decreased \$4.0 million, or 5%, from \$76.1 million for the year ended December 31, 2015 to \$72.1 million for the year ended December 31, 2016. The decrease in Enterprise & Education Language revenue reflects a decrease of \$5.3 million in the corporate channel, which was partially offset by increases of \$0.7 million and \$0.5 million in our non-profit and education sales channels, respectively. We expect revenue associated with the Enterprise & Education Language segment will slightly decline in the near term, due to the execution of our strategy to exit our direct presence in unprofitable geographies and manage this business for profitable growth. Where appropriate, we will seek to operate in the geographies we exit through partners. Our goal is to offset this decline with growth in our retained channels. We expect to continue to balance investments and adjust our cost structure to align scale without impacting growth.

**Literacy Segment**

Literacy revenue increased \$12.2 million, or 56%, from \$21.9 million for the year ended December 31, 2015 to \$34.1 million for the year ended December 31, 2016, partially reflecting the impact of purchase accounting. Adjusting for the impact of purchase accounting on Literacy revenue, revenue would have been \$38.4 million for the year ended December 31, 2016 compared to \$29.8 million for the year ended December 31, 2015, and the Literacy pro-forma growth would have been 29% year-over-year. The revenue growth was due to increased market share associated with new literacy offerings, a larger revenue capacity associated with the move from resellers to a direct sales team, and an increase in implementation services. We will continue to experience the purchase accounting impacts for the Literacy segment through 2017 due to the typical subscription length. As a result, we expect year-over-year revenues to become more comparable as we move beyond the purchase accounting impact, which we expect to result in lower growth rates than what we experienced during 2016. We anticipate additional investments in the Literacy business to grow this segment.

**Consumer Segment**

Consumer revenue decreased \$31.7 million, or 27%, from the year ended December 31, 2015 to the year ended December 31, 2016. This decrease was largely due to reductions in revenue from our direct-to-consumer, retail, and homeschool sales channels of \$18.1 million, \$11.6 million, and \$2.4 million, respectively. These declines reflect the decision to significantly curtail promotional pricing under our shift in strategy. The reduction in the retail channel was due in part to the planned reduction in the suggested retail value in the U.S. which impacted Consumer revenue by \$3.6 million. The reduction in

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homeschool revenue was primarily due to the sale of the Korea entity in the third quarter of 2015. In connection with our recent shift in strategy, we continue to manage the Consumer business for a targeted bottom-line result which has resulted in a decline in scale which we expect to continue. Our Consumer business is seasonal and typically peaks in the fourth quarter during the holiday shopping season.

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

We categorize and report our revenue in two categories—subscription and service revenue and product revenue. Subscription and service revenue includes web-based software subscriptions, online services, as well as revenues from professional services. Subscription and service revenues are typically deferred at the time of sale and then recognized ratably over the subscription or service period. Product revenue includes revenues allocated to our perpetual language-learning product software, revenues from the sale of audio practice products, and sales of certain mobile applications. We bundle our perpetual product software typically with online services. As a result, we typically defer 10% to 35% of the revenue of each of these bundled sales. We recognize the deferred revenue associated with the online services over the term of the service period.

The following table sets forth revenue for subscription and service revenue and product revenue for the years ended December 31, 2016 and 2015:

	Year ended December 31,				2016 versus 2015	
	2016		2015		Change	% Change
	(in thousands, except percentages)					
Subscription and service revenue	\$ 154,336	79.5%	\$ 151,701	69.7%	\$ 2,635	1.7 %
Product revenue	39,753	20.5%	65,969	30.3%	(26,216)	(39.7)%
Total revenue	\$ 194,089	100.0%	\$ 217,670	100.0%	\$ (23,581)	(10.8)%

**Subscription and Service Revenue**

Subscription and service revenue increased \$2.6 million, or 2%, to \$154.3 million for the year ended December 31, 2016. An increase in Literacy segment revenue, which entirely falls within the subscription and service revenue category, contributed \$12.2 million of the \$2.6 million increase, due in part to the write-down effects of purchase accounting on the pre-acquisition deferred revenue balances associated with the Lexia acquisition. Within the Enterprise & Education Language segment, the corporate sales channel decreased by \$4.3 million, which was partially offset by an increase in the education sales channel of \$0.9 million. Consumer segment subscription and service revenue declined in the direct-to-consumer, homeschool, and retail channels of \$4.3 million, \$1.6 million, and \$1.6 million, respectively, due to the Consumer decline in revenue associated with our recent shift in strategy to focus on the passionate learner. In the Consumer segment, we have begun shifting sales from our box-based and perpetual download products to similarly priced long-term subscription products. However, it is important to note that these subscribers generally only stay for the duration of the subscription period, which could negatively impact our revenue in the future. We are testing shorter duration subscriptions which if we are successful in achieving an adequate level of renewals, allow pricing that has the potential to open up new customer demographics. If, over time, more of our Consumer products are sold through shorter-term subscriptions it would have the effect of spreading the receipt of cash from those sales over the initial sale period and any subsequent renewals. Our goal is to be almost entirely subscription-based by the end of 2017.

**Product Revenue**

Product revenue decreased \$26.2 million, or 40%, to \$39.8 million during the year ended December 31, 2016 from \$66.0 million during the year ended December 31, 2015. Product revenue primarily decreased \$13.8 million and \$10.1 million in our direct-to-consumer and retail sales channels, respectively, within the Consumer segment. The decrease in retail sales is due in part to the reduction in suggested retail value in the U.S. which negatively impacted product revenue by \$3.6 million. Product revenue also decreased due to the ongoing transition of our sales model towards subscription sales rather than perpetual license and box product sales, with an objective to be nearly all subscription-based by the end of 2017.

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

The following table sets forth cost of subscription and service revenue and product revenue, as well as gross profit for the years ended December 31, 2016 and 2015:



	Year ended December 31,		2016 versus 2015	
	2016	2015	Change	% Change
(in thousands, except percentages)				
<b>Revenue:</b>				
Subscription and service	\$ 154,336	\$ 151,701	\$ 2,635	1.7 %
Product	39,753	65,969	(26,216)	(39.7)%
Total revenue	194,089	217,670	(23,581)	(10.8)%
<b>Cost of revenue:</b>				
Cost of subscription and service revenue	23,676	21,629	2,047	9.5 %
Cost of product revenue	10,645	16,898	(6,253)	(37.0)%
Total cost of revenue	34,321	38,527	(4,206)	(10.9)%
<b>Gross profit</b>	<b>\$ 159,768</b>	<b>\$ 179,143</b>	<b>\$ (19,375)</b>	<b>(10.8)%</b>
Gross profit percentages	82.3%	82.3%	—%	

Total cost of revenue decreased \$4.2 million for the year ended December 31, 2016 from \$38.5 million for the year ended December 31, 2015. The decrease in total cost of revenue was primarily due to a decline in product revenue which also reflects the ongoing shift of the Consumer segment towards subscriptions which resulted in decreases in inventory expense, freight and payment processing fees, and professional services. Inventory expense declined \$2.7 million due to the decrease in box product sales. Freight and processing fees decreased \$2.1 million due to the decrease in box product sales, which was slightly offset by an increase in amortization of capitalized internal-use software costs.

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

Cost of subscription and service revenue for the year ended December 31, 2016 was \$23.7 million, an increase of \$2.0 million, or 9% from the year ended December 31, 2015. As a percentage of subscription and service revenue, cost of subscription and service revenue increased slightly to 15% from 14% for the year ended December 31, 2016 compared to the prior year period. The dollar increase in cost of subscription and service revenue was primarily due to increases in amortization of capitalized internal-use software costs and other allocable costs due to the shift in sales mix to subscription service sales.

#### *Cost of Product Revenue*

Cost of product revenue for the year ended December 31, 2016 was \$10.6 million, a decrease of \$6.3 million or 37% compared to \$16.9 million for the year ended December 31, 2015. As a percentage of product revenue, cost of product revenue slightly increased to 27% for the year ended December 31, 2016 from 26% as compared to the prior year period. The dollar decrease in cost of product revenue is primarily due to decreases of \$1.8 million, \$1.4 million, \$0.8 million, and \$0.6 million in inventory costs, payroll and benefits, freight costs, and payment processing fees respectively, due to the shift away from hard product sales to online subscription sales.

#### *Gross Profit*

Gross profit decreased \$19.4 million to \$159.8 million for the year ended December 31, 2016 compared to \$179.1 million for the year ended December 31, 2015. Gross profit percentage remained flat at 82% for both the years ended December 31, 2016 and December 31, 2015. The dollar decrease in gross profit was primarily due to the decrease in revenue.

#### *Operating Expenses*

	Year ended December 31,		2016 versus 2015	
	2016	2015	Change	% Change
(in thousands, except percentages)				
Sales and marketing	\$ 114,340	\$ 136,084	\$ (21,744)	(16.0)%
Research and development	26,273	29,939	(3,666)	(12.2)%
General and administrative	40,501	50,124	(9,623)	(19.2)%
Impairment	3,930	6,754	(2,824)	(41.8)%
Lease abandonment and termination	1,644	55	1,589	2,889.1 %
Total operating expenses	<u>\$ 186,688</u>	<u>\$ 222,956</u>	<u>\$ (36,268)</u>	<u>(16.3)%</u>

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In the first quarter of 2016, we announced and initiated actions to exit the direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of our Enterprise & Education Language offerings and to close our software development operations in France and China. In the first quarter of 2015, we announced and initiated actions to reduce headcount and other costs in order to support our 2015 strategic shift in business focus.

Included within our operating expenses are restructuring charges related to the 2016 and 2015 Restructuring Plans which relate to employee severance and related benefits costs incurred in connection with headcount reductions, contract termination costs, and other related costs. As a result of these actions, we realized reductions in our operating expenses, primarily associated with reduced payroll and benefits costs.

The following table presents restructuring costs associated with the 2016 and 2015 Restructuring Plans included in the related line items of our results from operations:

	Year ended December 31,	
	2016	2015
	(in thousands)	
Cost of revenue	\$ 573	\$ 113
Sales and marketing	2,324	4,492
Research and development	913	602
General and administrative	1,383	3,584
Total	\$ 5,193	\$ 8,791

While there were restructuring plans initiated in each of the years ended December 31, 2016 and 2015, the severance expenses in 2015 were greater than the severance expenses in 2016, primarily due to a larger number of headcount reductions in senior management in 2015.

#### *Sales and Marketing Expenses*

Sales and marketing expenses for the year ended December 31, 2016 were \$114.3 million, a decrease of \$21.7 million, or 16%, from the year ended December 31, 2015. As a percentage of total revenue, sales and marketing expenses decreased to 59% for the year ended December 31, 2016, from 63% for the year ended December 31, 2015. The decrease in sales and marketing expense was primarily due to decreases in media and marketing spend, payroll and benefits, and professional services. Media expenses decreased \$8.0 million, comprised of a reduction of \$4.1 million in online and social media and a decrease of \$3.9 million in offline media. Marketing expenses decreased \$1.8 million due to overall decreased spend in advertising and retail visual displays due to the change in focus in the general consumer market. Payroll and benefit expense decreased \$6.4 million primarily due to the reduction in headcount which resulted in lower salary expense, severance expense, and stock compensation expense. Professional services expenses declined \$3.5 million related to a \$1.1 million contract termination fee associated with the 2015 Restructuring Plan and other reductions in the consumer market. We intend to continue to optimize our Consumer media and marketing costs and manage the Consumer business for profitability and plan to manage the sales and marketing expenses to drive these results.

#### *Research and Development Expenses*

Research and development expenses were \$26.3 million for the year ended December 31, 2016, a decrease of \$3.7 million, or 12%, from the year ended December 31, 2015. As a percentage of revenue, research and development expenses remained flat at 14% for both of the years ended December 31, 2016 and 2015. The dollar decrease was primarily due to a reduction in payroll and benefits expense of \$2.7 million driven by increased capitalized labor projects primarily associated with new Lexia product offerings and Catalyst and secondarily due to a reduction in headcount. In the near term we will focus our product investment on Lexia and key Enterprise & Education Language initiatives.

#### *General and Administrative Expenses*

General and administrative expenses for the year ended December 31, 2016 were \$40.5 million, a decrease of \$9.6 million, or 19%, from the year ended December 31, 2015. As a percentage of revenue, general and administrative expenses decreased slightly to 21% for the year ended December 31, 2016 compared to 23% for year ended December 31, 2015. The decrease in general and administrative expenses was primarily due to reductions in payroll and benefits, bad debt, and other cost reductions. Payroll and benefits decreased \$4.3 million driven by a reduction in headcount, heavier executive restructuring accruals in the prior year related to the 2015 Restructuring Plan, and reductions in stock compensation expense related to the change in CEO in the second quarter of 2015. Bad debt expense decreased by \$1.0 million due to reduced sales in the consumer

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market and improvements in accounts receivable collections. Other costs decreased due to the ongoing cost saving measures. We expect our general and administrative expenses to increase slightly in the near term.

**Impairment**

Impairment expense for the year ended December 31, 2016 was \$3.9 million, a decrease of \$2.8 million, from the year ended December 31, 2015. The decrease was due to the 2016 second quarter impairment of the Fit Brains goodwill of \$1.7 million, the second quarter impairment of Fit Brains intangible assets of \$1.2 million, and the third quarter impairment of \$1.0 million associated with a previously capitalized software project that no longer aligned to our strategic direction. These 2016 amounts were partially offset by a \$5.6 million goodwill impairment charge related to our Consumer Fit Brains reporting unit and prior year impairment charges related to the abandonment of previously capitalized internal-use software projects.

**Lease Abandonment and Termination**

Lease abandonment and termination expenses for the year ended December 31, 2016 were \$1.6 million, compared to \$0.1 million for the year ended December 31, 2015. The increase was attributable to the fourth quarter 2016 lease abandonment charge associated with the planned space consolidation of our former headquarters location in Arlington, VA.

**Other Income and (Expense)**

	Year ended December 31,		2016 versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Interest income	\$ 46	\$ 23	\$ 23	100.0 %
Interest expense	(470)	(378)	(92)	24.3 %
Other income and (expense)	2,297	(1,469)	3,766	(256.4)%
Total other income and (expense)	\$ 1,873	\$ (1,824)	\$ 3,697	(202.7)%

Interest income for the year ended December 31, 2016 was \$46 thousand, a slight increase from the year ended December 31, 2015. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the year ended December 31, 2016 was \$0.5 million, an increase of \$0.1 million, from the year ended December 31, 2015. This increase was primarily attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn credit facility.

Other income and (expense) for the year ended December 31, 2016 was income of \$2.3 million, an increase of \$3.8 million, as compared to expense of \$1.5 million for the year ended December 31, 2015. The change was primarily attributable to foreign exchange fluctuations.

**Income Tax Expense (Benefit)**

	Year ended December 31,		2016 versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Income tax expense	\$ 2,503	\$ 1,159	\$ 1,344	116.0%

Our Income tax expense for the year ended December 31, 2016 was \$2.5 million, compared to \$1.2 million for the year ended December 31, 2015. The increase primarily due to the inability to benefit from Canada losses, higher earnings in U.K. and Germany in 2016, and tax benefit related to Korea withholdings in 2015.

**Comparison of the Year Ended December 31, 2015 and the Year Ended December 31, 2014**

Our total revenue decreased to \$217.7 million for the year ended December 31, 2015 from \$261.9 million for the year ended December 31, 2014. The change in total revenue was due to a decrease in Consumer revenues of \$57.5 million, which was offset by increases in Literacy and Enterprise & Education Language revenue of \$12.0 million and \$1.3 million.

We reported an operating loss of \$43.8 million for the year ended December 31, 2015 compared to an operating loss of \$78.9 million for the year ended December 31, 2014. The decrease in operating loss was due to a decrease in operating expenses of \$64.7 million, a decrease of \$14.5 million in cost of revenue, which was offset by a \$44.2 million decrease in revenue.

**Revenue by Operating Segment**

During 2016, our operating segment structure changed to three operating segments: Enterprise & Education Language, Literacy, and Consumer. Our 2015 and 2014 operating segments were recast under our current operating segment structure and the following table sets forth revenue for our operating segments for the years ended December 31, 2015 and 2014:

	Year ended December 31,				2015 versus 2014	
	2015		2014		Change	% Change
	(in thousands, except percentages)					
Enterprise & Education Language	\$ 76,129	35.0%	\$ 74,788	28.6%	\$ 1,341	1.8 %
Literacy	21,928	10.0%	9,912	3.8%	\$ 12,016	121.2 %
Consumer	119,613	55.0%	177,153	67.6%	\$ (57,540)	(32.5)%
Total Revenue	<u>\$ 217,670</u>	<u>100.0%</u>	<u>\$ 261,853</u>	<u>100.0%</u>	<u>\$ (44,183)</u>	<u>(16.9)%</u>

***Enterprise & Education Language Segment***

Total Enterprise & Education revenue increased \$1.3 million, or 2%, from \$74.8 million for the year ended December 31, 2014 to \$76.1 million for the year ended December 31, 2015. The increase in Enterprise & Education Language revenue was comprised primarily of increases of \$3.7 million and \$0.8 million in our education and non-profit sales channels, respectively, which were partially offset by a decrease of \$2.9 million in the corporate sales channel.

***Literacy Segment***

Literacy revenue increased \$12.0 million, or 121%, from \$9.9 million for the year ended December 31, 2014 to \$21.9 million for the year ended December 31, 2015. Literacy revenue increased, in part, due to the revenue recognition of subscription service contracts recorded as deferred revenue in prior periods. Due to purchase accounting, deferred revenue associated with Lexia was recorded at fair value, which is lower than the book value, and resulted in lower 2014 revenue. As a result, we expect year-over-year revenues to become more comparable as we move beyond the purchase accounting impact, which will result in lower revenue growth rates than what we experienced during 2015.

***Consumer Segment***

Consumer revenue decreased \$57.5 million, or 32%, from the year ended December 31, 2014 to the year ended December 31, 2015. This decrease was largely due to reductions in revenue from our direct-to-consumer, retail, and homeschool sales channels of \$48.2 million, \$10.4 million, and \$1.0 million, respectively, slightly offset by an increase of \$1.6 million in revenue related to our Fit Brains offerings. These declines reflect the decision to significantly curtail promotional pricing under our 2015 strategic transformation. In 2014, we focused on driving customers to purchase our direct-to-consumer channel, particularly through our website, by implementing more aggressive discounting and promotional activity to combat the introduction of lower priced competitor products. During 2015, we were more disciplined with discounting and focused on stabilizing prices.

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

The following table sets forth revenue for subscription and service revenue and product revenue for the years ended December 31, 2015 and 2014:

	Year ended December 31,				2015 versus 2014	
	2015		2014		Change	% Change
(in thousands, except percentages)						
Subscription and service revenue	\$ 151,701	69.7%	\$ 125,602	48.0%	\$ 26,099	20.8 %
Product revenue	65,969	30.3%	136,251	52.0%	(70,282)	(51.6)%
Total revenue	\$ 217,670	100.0%	\$ 261,853	100.0%	\$ (44,183)	(16.9)%

### Subscription and Service Revenue

Subscription and service revenue increased \$26.1 million, or 21%, to \$151.7 million for the year ended December 31, 2015. Within the Enterprise & Education segment, the increase in subscription and service revenue was primarily due to the \$12.0 million increase in Enterprise & Education literacy revenue combined with revenue increases within Enterprise & Education language of \$3.2 million and \$0.9 million in the education and non-profit service sales channels, respectively. These increases were slightly offset by a decrease of \$2.1 million in the corporate sales channel within Enterprise & Education language. The Consumer segment realized increases of \$10.5 million, \$1.6 million, and \$0.4 million in direct-to-consumer, Fit Brains, and global retail service sales channels, respectively. Our 2014 subscription and service revenue was lower due to the write-down effects of purchase accounting on the pre-acquisition deferred revenue balances associated with Lexia and Tell Me More. We continue to experience these purchase accounting impacts for Lexia due to the typical subscription length. As a result, we expect the growth rates from our Enterprise & Education segment to mitigate over time. Subscription and services sales volume increased as we continue to carry out our strategy to migrate our Consumer business to subscription-based products. However, it is important to note that these subscribers generally only stay for the duration of the subscription period, which could negatively impact our revenue in the future.

### Product Revenue

Product revenue decreased \$70.3 million, or 52%, to \$66.0 million during the year ended December 31, 2015 from \$136.3 million during the year ended December 31, 2014. Product revenue primarily decreased \$58.6 million, \$9.8 million, and \$1.2 million in our direct-to-consumer, global retail, and homeschool sales channels, respectively. Product sales volume decreased as we continue to carry out our strategy to migrate our Consumer business to subscription-based products. Product revenue also decreased due to the year-over-year decline in product unit sales volume as a result of the strategic decision to be more disciplined marketing and advertising expenses and curtail promotional pricing to focus on stabilizing prices.

### Cost of Subscription and Service Revenue, Product Revenue Gross Profit

The following table sets forth cost of subscription and service revenue and cost of product revenue, as well as gross profit for the years ended December 31, 2015 and 2014:

	Year ended December 31,				2015 versus 2014	
	2015		2014		Change	% Change
(in thousands, except percentages)						
<b>Revenue:</b>						
Subscription and service	\$ 151,701		\$ 125,602		\$ 26,099	20.8 %
Product	65,969		136,251		(70,282)	(51.6)%
Total revenue	217,670		261,853		(44,183)	(16.9)%
<b>Cost of revenue:</b>						
Cost of subscription and service revenue	21,629		18,862		2,767	14.7 %
Cost of product revenue	16,898		34,192		(17,294)	(50.6)%
Total cost of revenue	38,527		53,054		(14,527)	(27.4)%
<b>Gross profit</b>	\$ 179,143		\$ 208,799		\$ (29,656)	(14.2)%
Gross profit percentages	82.3%		79.7%		2.6%	

Total cost of revenue decreased \$14.5 million for the year ended December 31, 2015 from \$53.1 million for the year ended December 31, 2014. The change in total cost of revenue was primarily due to decreases in inventory expense, payroll and benefits expense, and freight and payment processing fees. Inventory expense declined \$6.3 million primarily due to the decrease in product sales combined with higher first quarter 2014 charges to inventory obsolescence in our Asian operations that did not recur in 2015. Payroll and benefit expenses declined \$3.7 million driven by reduced headcount as a result of the

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2015 Restructuring Plan, the absence of higher severance payments in 2014 related to operations in France and Korea, and lower variable incentive compensation expenses based on reduced funding expectations. Freight and processing fees decreased \$3.5 million due to the decrease in sales.

**Cost of Subscription and Service Revenue**

Cost of subscription and service revenue for the year ended December 31, 2015 was \$21.6 million, an increase of \$2.8 million, or 15% from the year ended December 31, 2014. As a percentage of subscription and service revenue, cost of subscription and service revenue decreased to 14% from 15% for the year ended December 31, 2015 compared to the prior year period. The dollar increase in cost of subscription and service revenue was primarily due to increases in hosting, amortization of capitalized internal-use software costs, and other allocable costs due to the shift in sales mix to subscription service sales.

**Cost of Product Revenue**

Cost of product revenue for the year ended December 31, 2015 was \$16.9 million, a decrease of \$17.3 million or 51% compared to \$34.2 million for the year ended December 31, 2014. As a percentage of product revenue, cost of product revenue slightly increased to 26% for the year ended December 31, 2015 from 25% as compared to the prior year period. The dollar decrease in cost of product revenue is primarily due to decreases of \$5.5 million, \$4.7 million, \$2.2 million, \$1.6 million, and \$1.2 million in inventory costs, payroll and benefits, freight costs, commission fees, and payment processing fees respectively, due to the shift away from hard product sales to online subscription sales.

**Gross Profit**

Gross profit decreased \$29.7 million to \$179.1 million for the year ended December 31, 2015 compared to \$208.8 million for the year ended December 31, 2014. Gross profit percentage increased to 82% from 80% for the year ended December 31, 2015 compared to the year ended December 31, 2014. The dollar decrease in gross profit was primarily due to the decrease in revenue. The percentage increase in gross profit percentage was primarily due to the decrease in inventory and freight costs associated with hard product sales as we continue to shift to a SaaS delivery model which attracts higher margins.

**Operating Expenses**

	Year ended December 31,		2015 versus 2014	
	2015	2014	Change	% Change
(in thousands, except percentages)				
Sales and marketing	\$ 136,084	\$ 173,208	\$ (37,124)	(21.4)%
Research and development	29,939	33,176	(3,237)	(9.8)%
General and administrative	50,124	57,120	(6,996)	(12.2)%
Impairment	6,754	20,333	(13,579)	(66.8)%
Lease abandonment and termination	55	3,812	(3,757)	(98.6)%
Total operating expenses	\$ 222,956	\$ 287,649	\$ (64,693)	(22.5)%

In the first quarter of 2015, we announced and initiated actions to reduce headcount and other costs in order to support our 2015 strategic shift in business focus. Included within our operating expenses are restructuring charges related to the 2015 Restructuring Plan which relate to employee severance and related benefits costs incurred in connection with headcount reductions, contract termination costs, and other related costs. As a result of these actions, we realized reductions in our operating expenses, primarily associated with reduced payroll and benefits costs.

The following table presents restructuring costs associated with the 2015 Restructuring Plan included in the related line items of our results from operations:

	Year ended December 31,	
	2015	2014
(in thousands)		
Cost of revenue	\$ 113	\$ —
Sales and marketing	4,492	—
Research and development	602	—
General and administrative	3,584	—
Total	\$ 8,791	\$ —

### ***Sales and Marketing Expenses***

Sales and marketing expenses for the year ended December 31, 2015 were \$136.1 million, a decrease of \$37.1 million, or 21%, from the year ended December 31, 2014. As a percentage of total revenue, sales and marketing expenses decreased to 63% for the year ended December 31, 2015, from 66% for the year ended December 31, 2014. The dollar and percentage decreases in sales and marketing expenses were primarily due to decreases in media and marketing expenses, payroll and benefit expenses, professional services, and amortization expense, which were partially offset by an increase in commission expense. Media spend decreased \$27.1 million due to a decrease of \$17.2 million in spend from offline media like TV, radio, and print and a \$9.9 million decrease in spend in online and social media expenses. Marketing expenses also decreased by \$5.7 million due to decreased spend in creative development and advertising expenses as a result of the strategic shift in focus and the positioning of the Consumer business for profitability. Payroll and benefit expense decreased \$4.1 million due to salary savings from the reduced headcount as a result of the 2015 Restructuring Plan, lower variable incentive compensation expenses based on reduced funding expectations, and the absence of Long Term Incentive Plan ("LTIP") expense as the plan ended in 2014. Professional services decreased \$2.9 million due to reduced outsourced staffing in the call centers as a result of the strategic shift in the Consumer segment. Amortization expense decreased \$1.2 million due to the fully depreciated Tell Me More trade name at the end of 2014. Commission expense increased \$4.5 million primarily driven by an increase in Enterprise & Education literacy revenue.

### ***Research and Development Expenses***

Research and development expenses were \$29.9 million for the year ended December 31, 2015, a decrease of \$3.2 million, or 10%, from the year ended December 31, 2014. As a percentage of revenue, research and development expenses increased slightly to 14% from 13% for the years ended December 31, 2015 and 2014, respectively. The dollar decrease was primarily due to a reduction in payroll and benefits expense of \$2.3 million due to the headcount reductions from the 2015 Restructuring Plan, coupled with a \$1.2 million reduction in costs associated with the Kids Reading and Kids Storytime projects that were released in the second half of 2014 or put on hold in the first half of 2015, respectively.

### ***General and Administrative Expenses***

General and administrative expenses for the year ended December 31, 2015 were \$50.1 million, a decrease of \$7.0 million, or 12%, from the year ended December 31, 2014. As a percentage of revenue, general and administrative expenses increased slightly to 23% for the year ended December 31, 2015 compared to 22% for year ended December 31, 2014. The dollar decrease was primarily due to reductions in payroll and benefits, third party services, bad debt, communications, travel, and other expenses. Payroll and benefits decreased \$2.5 million driven by the reduction in headcount related to the 2015 Restructuring Plan, lower variable incentive compensation expense due to the reduction in employees, and the absence of LTIP expense as the plan ended in 2014, partially offset by increases in severance and stock compensation expenses related to the change in CEO effective April 1, 2015. Third party services expense decreased \$1.9 million mainly driven by decreased software and hardware maintenance expenses in 2015. Bad debt expense decreased by \$0.8 million due to improvements in accounts receivable aging as compared to 2014. Communications expense decreased \$0.5 million due to cost savings identified related to hosting, network, and telephone charges. Travel expenses decreased \$0.5 million as a result of the international trips in support of acquisition related activities in the first quarter of 2014.

### ***Impairment***

Impairment expense for the year ended December 31, 2015 was \$6.8 million, a decrease of \$13.6 million, from the year ended December 31, 2014. The decrease was primarily attributable to a \$20.2 million goodwill impairment charge related to our Consumer business during 2014, partially offset by a \$5.6 million goodwill impairment charge related to our Consumer Fit Brains reporting unit and 2015 impairment charges of \$1.1 million, primarily related to the abandonment of certain previously capitalized internal-use software projects.

### ***Lease Abandonment and Termination***

Lease abandonment and termination expenses for the year ended December 31, 2015 were \$0.1 million, compared to \$3.8 million for the year ended December 31, 2014. The decrease was attributable to the 2014 lease abandonment of the sixth floor space in the Arlington, VA office of \$3.2 million, as well as the closure of the Japan office resulting in lease abandonment costs of \$0.4 million.

**Other Income and (Expense)**

	Year ended December 31,		2015 versus 2014	
	2015	2014	Change	% Change
(in thousands, except percentages)				
Interest income	\$ 23	\$ 17	\$ 6	35.3%
Interest expense	(378)	(233)	(145)	62.2%
Other expense	(1,469)	(1,129)	(340)	30.1%
Total other income and (expense)	\$ (1,824)	\$ (1,345)	\$ (479)	35.6%

Interest income for the year ended December 31, 2015 was \$23 thousand, a slight increase from the year ended December 31, 2014. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the year ended December 31, 2015 was \$0.4 million, an increase of \$0.1 million, from the year ended December 31, 2014. This increase was primarily attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn credit facility.

Other expense for the year ended December 31, 2015 was \$1.5 million, an increase of \$0.3 million, as compared to \$1.1 million for the year ended December 31, 2014. The fluctuation was primarily attributable to foreign exchange losses, partially offset by the divestiture of our Korea entity of \$0.7 million.

**Income Tax Expense (Benefit)**

	Year ended December 31,		2015 versus 2014	
	2015	2014	Change	% Change
(in thousands, except percentages)				
Income tax expense (benefit)	\$ 1,159	\$ (6,489)	\$ 7,648	(117.9)%

Our income tax expense for the year ended December 31, 2015 was \$1.2 million, compared to income tax benefit of \$6.5 million for the year ended December 31, 2014. The tax expense was due to current year taxable income from our operations in Germany and the UK, the tax impact of the amortization of indefinite lived intangibles, and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities. These tax expenses were partially offset by tax benefits related to current year losses (excluding the Consumer Fit Brains goodwill impairment) in Canada. The goodwill that was impaired in 2015 was not deductible for tax. Additionally, tax benefits were recorded related to the reversal of accrued withholding taxes as a result of an intercompany transaction. For the year ended December 31, 2015, we incurred an income tax expense of \$1.2 million based on losses before taxes of \$45.6 million resulting in a worldwide effective tax rate of approximately (2.5)%.

**Liquidity and Capital Resources**

**Liquidity**

Our principal source of liquidity at December 31, 2016 consisted of \$36.2 million in cash and cash equivalents and short-term investments, a decrease of \$11.6 million, from \$47.8 million as of December 31, 2015. Our primary operating cash requirements include the payment of salaries, employee benefits and other personnel related costs, as well as direct advertising expenses, costs of office facilities, and costs of information technology systems. Historically, we have primarily funded these requirements through cash flow from our operations. For the year ended December 31, 2016, we generated \$1.2 million cash flows from operations as reflected in our consolidated statements of cash flows.

As part of our strategic shift, we have begun and continue to reorganize our business around our Enterprise & Education Language and Literacy segments while we optimize our Consumer segment for profitability and cash generation. Our operating segments are affected by different sales-to-cash patterns. Within our Enterprise & Education Language and Literacy segments, revenue in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Our Consumer revenue is affected by seasonal trends associated with the holiday shopping season. Consumer sales typically turn to cash more quickly than Enterprise & Education Language and Literacy sales, which tend to have longer collection cycles. Historically, in the first half of the year we have been a net user of cash and in the second half of the year we have been a net generator of cash. We expect this trend to continue.



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On October 28, 2014, we entered into a \$25.0 million revolving credit Loan and Security Agreement with Silicon Valley Bank, which was amended effective March 31, 2015, May 1, 2015, June 29, 2015, December 29, 2015 and further amended effective March 14, 2016. Under the amended agreement, we may borrow up to \$25.0 million including a sub-facility, which reduces available borrowings, for letters of credit in the aggregate availability amount of \$4.0 million (the "credit facility"). Borrowings by RSL under the credit facility are guaranteed by us as the ultimate parent. The credit facility has a term that expires on January 1, 2018, during which time RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

The total obligations under the credit facility cannot exceed the lesser of (i) the total revolving commitment of \$25.0 million or (ii) the borrowing base, which is calculated as 80% of eligible accounts receivable. As a result, the borrowing base will fluctuate and we expect it will follow the general seasonality of cash and accounts receivable (lower in the first half of the year and higher in the second half of the year). If the borrowing base less any outstanding amounts, plus the cash held at SVB ("Availability") is greater than \$25.0 million, then we may borrow up to an additional \$5.0 million, but in no case can borrowings exceed \$25.0 million. Interest on borrowings accrue at the Prime Rate provided that we maintain a minimum cash and Availability balance of \$17.5 million. If cash and Availability is below \$17.5 million, interest will accrue at the Prime Rate plus 1%.

As of the date of this filing, no borrowings have been made under the revolving credit agreement and we were eligible to borrow \$20.8 million of available credit less \$4.0 million in letters of credit that have been issued by Silicon Valley Bank on our behalf, resulting in a net borrowing availability of \$16.8 million. We are subject to certain financial and restrictive covenants under the credit facility, which have been amended to reflect the revised outlook in connection with our 2016 Restructuring Plan. We are required to maintain compliance with a minimum liquidity ratio and maintain a minimum Adjusted EBITDA. As of December 31, 2016, we were in compliance with all of the covenants under the revolving credit agreement. On March 10, 2017, we entered into the sixth amendment to the credit facility, which primarily extended the term to April 1, 2020.

The total amount of cash that was held by foreign subsidiaries as of December 31, 2016 was \$6.5 million. As of December 31, 2016, we do not intend to repatriate the cash from our foreign subsidiaries, however, if we were to repatriate this foreign cash, no tax liability would result due to the current period and carryforward net operating losses.

During the last three years, inflation has 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.

### **Capital Resources**

We believe our current cash and cash equivalents, short-term investments, and funds generated from our sales will be sufficient to meet our cash needs for at least the next twelve months from the date of issuance of this report. We have generated significant operating losses as reflected in our accumulated deficit and stockholders' deficit and we may continue to incur operating losses in the future that may continue to require additional working capital to execute strategic initiatives. 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 optimization of office space in the U.S. and worldwide, building the infrastructure necessary to support our growth, the response of competitors to our products and services, and our relationships with suppliers. We extend payments to certain vendors in order to minimize the amount of working capital deployed in the business. In order to maximize our cash position, we will continue to manage our existing inventory, accounts receivable, and accounts payable balances. Borrowings under our credit facility can be utilized to meet working capital requirements, anticipated capital expenditures, and other obligations.

### **Cash Flow Analysis for the Year ended December 31, 2016 as compared to the year ended December 31, 2015**

	Year ended December 31,		2016 versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Net cash provided by (used in) operating activities	\$ 1,240	\$ (5,645)	\$ 6,885	(122.0)%
Net cash used in investing activities	\$ (12,476)	\$ (9,374)	\$ (3,102)	33.1 %
Net cash used in financing activities	\$ (658)	\$ (727)	\$ 69	(9.5)%

[Table of Contents](#)*Net Cash Provided By Operating Activities*

Net cash provided by operating activities was \$1.2 million for the year ended December 31, 2016 compared to net cash used in operating activities of \$5.6 million for the year ended December 31, 2015, a favorable change of \$6.9 million. The primary factor contributing to the increase in cash provided by operating activities is the improvement in net loss, which reflects our cost reduction initiatives to drive profitable results. For a summary of the factors that led to the net loss for the year ended December 31, 2016 see "Results of Operations" section above. Non-cash items primarily consisted of \$13.3 million in depreciation and amortization expense, \$4.9 million in stock-based compensation expense, and \$3.9 million in impairment loss, which was partially offset by \$2.4 million in a gain on foreign currency transactions. The primary drivers of the change in operating assets and liabilities were a decrease in accounts receivable of \$14.7 million and an increase in accrued compensation of \$2.7 million, partially offset by a decrease in other current liabilities of \$13.3 million. The decrease in accounts receivable was primarily related to the lower sales during 2016 as compared to 2015 and faster collections which slightly improved days sales outstanding. The increase in accrued compensation was primarily attributable to an increase in variable compensation related to a higher funding rate in 2016 when compared to 2015. The decrease in other current liabilities reflected our shift in strategy, which resulted in lower operating expenses and fewer obligations due for marketing, advertising, and rebates which included the \$4.6 million cash outflow associated with the reduction in suggested retail value initiated in mid-2016

*Net Cash Used in Investing Activities*

Net cash used in investing activities was \$12.5 million for the year ended December 31, 2016, compared to \$9.4 million for the year ended December 31, 2015. Net cash used in investing activities increased primarily due to a larger amount of capitalized software costs in 2016 as compared to 2015.

*Net Cash Used in Financing Activities*

Net cash used in financing activities was flat at \$0.7 million for the years ended December 31, 2016 and 2015.

*Cash Flow Analysis for the Year ended December 31, 2015 as compared to the year ended December 31, 2014*

	Year ended December 31,		2015 versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Net cash (used in) provided by operating activities	\$ (5,645)	\$ 6,673	\$ (12,318)	(184.6)%
Net cash used in investing activities	\$ (9,374)	\$ (39,109)	\$ 29,735	(76.0)%
Net cash used in financing activities	\$ (727)	\$ (305)	\$ (422)	138.4 %

*Net Cash Used In Operating Activities*

Net cash used in operating activities was \$5.6 million for the year ended December 31, 2015 compared to net cash provided by operating activities of \$6.7 million for the year ended December 31, 2014. The primary factor affecting our net use of cash from operating activities during the year ended December 31, 2015 was our net loss of \$46.8 million, which was too large to be offset by the non-cash adjustments totaling \$31.1 million and the favorable overall change in operating assets and liabilities of \$10.1 million. For a summary of the factors that led to the net loss for the year ended December 31, 2015 see "Results of Operations" section above. Non-cash items primarily consisted of \$13.7 million in depreciation and amortization expense, \$7.2 million in stock-based compensation expense, \$6.8 million in impairment loss, \$1.7 million in bad debt expense, and \$1.5 million of loss on foreign currency transactions. The primary drivers of the change in operating assets and liabilities were a decrease in other current liabilities of \$14.2 million, a decrease of \$8.6 million in accounts payable, a decrease in accrued compensation of \$5.5 million, an increase in deferred sales commissions of \$4.1 million, and an increase of \$1.3 million in inventory, partially offset by a decrease in accounts receivable of \$26.4 million and an increase of \$16.9 million in deferred revenue. The decrease in other current liabilities and accounts payable reflected our shift in strategy, which resulted in fewer obligations due for marketing, advertising, and rebates. The decrease in accrued compensation was primarily attributable to the 2015 Restructuring Plan, which reduced global non-Enterprise & Education headcount approximately 15% and led to a reduction in payroll, benefits, and variable compensation. The increase in deferred sales commission was primarily attributable to the 2014 acquisitions and an increase in Lexia deferred commissions. Inventory increased due to missed forecasts on holiday season sales orders resulting in additional inventory on hand. The decrease in accounts receivable was primarily related to the higher sales during the fourth quarter 2014 holiday season as compared to 2015. The increase in deferred revenue was primarily to a higher mix of Consumer revenue associated with web-based software subscription services and to a lesser extent the purchase accounting impacts related to the 2014 acquisitions.

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Net cash provided by operating activities for the year ended December 31, 2014 was \$6.7 million. The primary factors affecting our operating cash flows during the year were our net loss of \$73.7 million, which were offset by non-cash charges totaling \$37.1 million, and a favorable overall change in operating assets and liabilities of \$43.3 million. Non-cash items primarily consisted of \$20.3 million in impairment loss, \$13.9 million in depreciation and amortization expense, \$6.8 million in stock-based compensation expense, and \$2.4 million in bad debt expense, only slightly offset by a deferred income tax benefit of \$7.7 million. The primary drivers of the change in operating assets and liabilities were an increase of \$48.9 million in deferred revenue, an increase in other current liabilities of \$11.3 million, and an increase of \$8.4 million in accounts payable, partially offset by an increase in accounts receivable of \$16.5 million, an increase in deferred sales commissions of \$7.3 million, and a decrease in accrued compensation of \$4.5 million. The increase in deferred revenue was primarily due to the purchase accounting impacts related to the 2014 acquisitions that did not exist in 2013. The increases in other current liabilities and accounts payable were primarily attributable to the timing of our cash payments. The increase in accounts receivable was primarily related to the higher sales during the fourth quarter 2014 holiday season as compared to 2013. The increase in deferred sales commission was primarily attributable to the 2014 acquisitions that did not exist in 2013. The decrease in accrued compensation was primarily due to the reduction of payroll, benefits, and the timing of cash payments.

*Net Cash Used in Investing Activities*

Net cash used in investing activities was \$9.4 million for the year ended December 31, 2015, compared to net cash used of \$39.1 million for the year ended December 31, 2014. Net cash used in investing activities decreased primarily due to the 2014 acquisition related cash outflows of \$29.4 million pertaining to the acquisitions of Tell Me More and Vivity during the first quarter of 2014. In the first quarter of 2015, we paid the remaining holdback of \$1.7 million related to the 2013 acquisition of Lexia. Purchases of property and equipment decreased from \$9.7 million for the year ended December 31, 2014 to \$8.9 million for the year ended December 31, 2015 primarily due to the reduction of internal-use software capitalization due to the completion and go-live of a major software project in late 2015. Proceeds from the sale of fixed assets totaled \$1.6 million during the year ended December 31, 2015 associated with the fourth quarter 2015 sale of an owned office building in Harrisonburg, Virginia, with no comparable activity in 2014.

*Net Cash Used in Financing Activities*

Net cash used in financing activities was \$0.7 million for the year ended December 31, 2015 compared to \$0.3 million for the year ended December 31, 2014. The decrease in net cash related to financing activities was primarily due to the decrease in proceeds from the exercise of stock options of \$0.6 million due to the decrease in our stock price. Capital lease payments totaled \$0.7 million and \$0.6 million during the years ended December 31, 2015 and 2014, respectively. Deferred financing costs were larger in 2014 due to the original execution of the revolving credit facility in the fourth quarter of 2014. Deferred financing fees continued to be incurred during 2015 due to the execution of the four amendments discussed above. As mentioned earlier, no borrowings have been made under the revolving credit facility.

**Off-Balance Sheet Arrangements**

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

**Contractual Obligations**

As discussed in Notes 9 and 16 of Item 8, *Financial Statements and Supplementary Data*, we lease buildings, parking spaces, equipment, and office space under operating lease agreements. We also lease a building in France, certain equipment, and certain software under capital lease agreements. The following table summarizes our future minimum rent payments under non-cancellable operating and capital lease agreements as of December 31, 2016 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
	(in thousands)				
Capitalized leases and other financing arrangements	\$ 2,901	\$ 635	\$ 963	\$ 949	\$ 354
Operating leases	12,250	4,552	6,104	1,594	—
Total	<u>\$ 15,151</u>	<u>\$ 5,187</u>	<u>\$ 7,067</u>	<u>\$ 2,543</u>	<u>\$ 354</u>

## **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 in 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.

### ***Credit Risk***

Accounts receivable and cash and cash equivalents present the highest potential concentrations of credit risk. We reserve for credit losses and do not require collateral on our trade accounts receivable. In addition, we maintain cash and investment balances in accounts at various banks and brokerage firms. We have not experienced any losses on cash and cash equivalent accounts to date. We sell products to retailers, resellers, government agencies, and individual consumers and extend credit based on an evaluation of the customer's financial condition, without requiring collateral. Exposure to losses on accounts receivable is principally dependent on each customer's financial condition. We monitor exposure for credit losses and maintain allowances for anticipated losses. We maintain trade credit insurance for certain customers to provide coverage, up to a certain limit, in the event of insolvency of some customers.

## **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***

Management, with the participation of our Interim Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2016. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2016, our Interim 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***

Management is responsible for establishing and maintaining adequate internal control over our financial reporting. Management has assessed the effectiveness of internal control over financial reporting as of December 31, 2016. Management's assessment was based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, in Internal Control—Integrated Framework (2013).

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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 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, management believes our internal control over financial reporting as of December 31, 2016 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) or 15d-15(d) of the Exchange Act that occurred during the quarter ended December 31, 2016 that had 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 2017 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," "Corporate Governance—Compensation Committee," and "Corporate Governance—Corporate Governance and Nominating Committee" in our definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the SEC no later than 120 days after the fiscal year ended December 31, 2016 (the "2017 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 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," "Compensation Committee" and "Corporate Governance—Interlocks and Insider Participation" in the 2017 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 2017 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 2017 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 2017 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.





**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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<a href="#">Reports of Independent Registered Public Accounting Firm</a>	<a href="#">F-2</a>
<a href="#">Consolidated Balance Sheets</a>	<a href="#">F-4</a>
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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

We have audited the accompanying consolidated balance sheets of Rosetta Stone Inc. and subsidiaries (the "Company") as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive loss, changes in stockholders' (deficit) equity, and cash flows for each of the three years in the period ended December 31, 2016. 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 Rosetta Stone Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, 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, 2016, based on the criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2017 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP  
McLean, Virginia  
March 14, 2017

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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

We have audited the internal control over financial reporting of Rosetta Stone Inc. and subsidiaries (the “Company”) as of December 31, 2016, based on criteria established in *Internal Control-Integrated Framework (2013)* 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, 2016, based on the criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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, 2016 of the Company and our report dated March 14, 2017 expressed an unqualified opinion on those consolidated financial statements.

/s/ DELOITTE & TOUCHE LLP  
McLean, Virginia  
March 14, 2017

**ROSETTA STONE INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except per share amounts)

	As of December 31,	
	2016	2015
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 36,195	\$ 47,782
Restricted cash	402	80
Accounts receivable (net of allowance for doubtful accounts of \$1,072 and \$1,196, at December 31, 2016 and December 31, 2015, respectively)	31,788	47,327
Inventory	6,767	7,333
Deferred sales commissions	14,085	13,526
Prepaid expenses and other current assets	3,813	3,612
Total current assets	93,050	119,660
Deferred sales commissions	4,143	5,614
Property and equipment, net	24,795	22,532
Goodwill	48,251	50,280
Intangible assets, net	22,753	28,244
Other assets	1,318	2,213
<b>Total assets</b>	\$ 194,310	\$ 228,543
<b>Liabilities and stockholders' (deficit) equity</b>		
Current liabilities:		
Accounts payable	\$ 10,684	\$ 10,778
Accrued compensation	10,777	8,201
Income tax payable	785	121
Obligations under capital lease	532	521
Other current liabilities	22,150	35,318
Deferred revenue	113,821	106,868
Total current liabilities	158,749	161,807
Deferred revenue	27,636	35,880
Deferred income taxes	6,173	4,998
Obligations under capital lease	2,027	2,622
Other long-term liabilities	1,384	826
<b>Total liabilities</b>	195,969	206,133
Commitments and contingencies (Note 16)		
<b>Stockholders' (deficit) 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, 2016 and December 31, 2015, respectively	—	—
Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 23,451 and 23,150 shares issued and 22,451 and 22,150 shares outstanding at December 31, 2016 and December 31, 2015, respectively	2	2
Additional paid-in capital	190,827	185,863
Treasury stock, at cost; 1,000 and 1,000 shares at December 31, 2016 and December 31, 2015, respectively	(11,435)	(11,435)
Accumulated loss	(177,344)	(149,794)
Accumulated other comprehensive loss	(3,709)	(2,226)
<b>Total stockholders' (deficit) equity</b>	(1,659)	22,410
<b>Total liabilities and stockholders' (deficit) equity</b>	\$ 194,310	\$ 228,543

See accompanying notes to consolidated financial statements

**ROSETTA STONE INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(in thousands, except per share amounts)**

	Years Ended December 31,		
	2016	2015	2014
<b>Revenue:</b>			
Subscription and service	\$ 154,336	\$ 151,701	\$ 125,602
Product	39,753	65,969	136,251
Total revenue	194,089	217,670	261,853
<b>Cost of revenue:</b>			
Cost of subscription and service revenue	23,676	21,629	18,862
Cost of product revenue	10,645	16,898	34,192
Total cost of revenue	34,321	38,527	53,054
Gross profit	159,768	179,143	208,799
<b>Operating expenses</b>			
Sales and marketing	114,340	136,084	173,208
Research and development	26,273	29,939	33,176
General and administrative	40,501	50,124	57,120
Impairment	3,930	6,754	20,333
Lease abandonment and termination	1,644	55	3,812
Total operating expenses	186,688	222,956	287,649
Loss from operations	(26,920)	(43,813)	(78,850)
<b>Other income and (expense):</b>			
Interest income	46	23	17
Interest expense	(470)	(378)	(233)
Other income and (expense)	2,297	(1,469)	(1,129)
Total other income and (expense)	1,873	(1,824)	(1,345)
Loss before income taxes	(25,047)	(45,637)	(80,195)
Income tax expense (benefit)	2,503	1,159	(6,489)
Net loss	\$ (27,550)	\$ (46,796)	\$ (73,706)
<b>Loss per share:</b>			
Basic	\$ (1.25)	\$ (2.17)	\$ (3.47)
Diluted	\$ (1.25)	\$ (2.17)	\$ (3.47)
<b>Common shares and equivalents outstanding:</b>			
Basic weighted average shares	21,969	21,571	21,253
Diluted weighted average shares	21,969	21,571	21,253

See accompanying notes to consolidated financial statements

**ROSETTA STONE INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**  
**(in thousands)**

	Years Ended December 31,		
	2016	2015	2014
Net loss	\$ (27,550)	\$ (46,796)	\$ (73,706)
Other comprehensive loss, net of tax:			
Foreign currency translation loss	(1,483)	(1,548)	(1,523)
Other comprehensive loss	(1,483)	(1,548)	(1,523)
Comprehensive loss	<u>\$ (29,033)</u>	<u>\$ (48,344)</u>	<u>\$ (75,229)</u>

See accompanying notes to consolidated financial statements

**ROSETTA STONE INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' (DEFICIT) EQUITY**  
(in thousands)

	Non-Designated Common Stock		Additional Paid-in Capital	Treasury Stock	Accumulated Loss	Accumulated Other Comprehensive Income / (Loss)	Total Stockholders' (Deficit) / Equity
	Shares	Amount					
Balance—January 1, 2014	20,926	\$ 2	\$ 171,123	\$ (11,435)	\$ (29,292)	\$ 845	\$ 131,243
Stock Issued Upon the Exercise of Stock Options	116	—	669	—	—	—	669
Restricted Stock Award Vesting	287	—	—	—	—	—	—
Stock-based Compensation Expense	—	—	6,762	—	—	—	6,762
Net loss	—	—	—	—	(73,706)	—	(73,706)
Other comprehensive loss	—	—	—	—	—	(1,523)	(1,523)
Balance—December 31, 2014	21,329	\$ 2	\$ 178,554	\$ (11,435)	\$ (102,998)	\$ (678)	\$ 63,445
Stock Issued Upon the Exercise of Stock Options	25	—	114	—	—	—	114
Restricted Stock Award Vesting	452	—	—	—	—	—	—
Stock-based Compensation Expense	—	—	7,195	—	—	—	7,195
Net loss	—	—	—	—	(46,796)	—	(46,796)
Other comprehensive loss	—	—	—	—	—	(1,548)	(1,548)
Balance—December 31, 2015	21,806	\$ 2	\$ 185,863	\$ (11,435)	\$ (149,794)	\$ (2,226)	\$ 22,410
Stock Issued Upon the Exercise of Stock Options	13	—	58	—	—	—	58
Restricted Stock Award Vesting	255	—	—	—	—	—	—
Stock-based Compensation Expense	—	—	4,906	—	—	—	4,906
Net loss	—	—	—	—	(27,550)	—	(27,550)
Other comprehensive loss	—	—	—	—	—	(1,483)	(1,483)
Balance—December 31, 2016	22,074	\$ 2	\$ 190,827	\$ (11,435)	\$ (177,344)	\$ (3,709)	\$ (1,659)

See accompanying notes to consolidated financial statements

**ROSETTA STONE INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Years Ended December 31,		
	2016	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (27,550)	\$ (46,796)	\$ (73,706)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:			
Stock-based compensation expense	4,906	7,195	6,762
(Gain) loss on foreign currency transactions	(2,449)	1,471	1,171
Bad debt expense	709	1,657	2,405
Depreciation and amortization	13,322	13,660	13,904
Deferred income tax expense (benefit)	1,162	849	(7,667)
Loss (gain) on disposal of equipment	179	(15)	184
Amortization of deferred financing costs	274	160	21
Loss on impairment	3,930	6,754	20,333
Loss from equity method investments	45	23	—
Gain on divestiture of subsidiary	—	(660)	—
Net change in:			
Restricted cash	(378)	43	(13)
Accounts receivable	14,681	26,376	(16,478)
Inventory	538	(1,253)	341
Deferred sales commissions	919	(4,121)	(7,268)
Prepaid expenses and other current assets	(167)	1,080	1,844
Income tax receivable or payable	719	568	(147)
Other assets	668	(684)	446
Accounts payable	(74)	(8,636)	8,394
Accrued compensation	2,701	(5,485)	(4,494)
Other current liabilities	(13,261)	(14,223)	11,318
Other long-term liabilities	558	(486)	459
Deferred revenue	(192)	16,878	48,864
Net cash provided by (used in) operating activities	1,240	(5,645)	6,673
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(12,514)	(8,856)	(9,736)
Proceeds from sale of fixed assets	38	1,642	—
Decrease in restricted cash for Vivity acquisition	—	—	12,314
Acquisitions, net of cash acquired	—	(1,688)	(41,687)
Net cash outflow from divestiture of subsidiary	—	(186)	—
Other investing activities	—	(286)	—
Net cash used in investing activities	(12,476)	(9,374)	(39,109)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from the exercise of stock options	58	114	669
Payment of deferred financing costs	(183)	(130)	(381)
Payments under capital lease obligations	(533)	(711)	(593)
Net cash used in financing activities	(658)	(727)	(305)
Decrease in cash and cash equivalents	(11,894)	(15,746)	(32,741)
Effect of exchange rate changes in cash and cash equivalents	307	(1,129)	(1,427)
Net decrease in cash and cash equivalents	(11,587)	(16,875)	(34,168)
Cash and cash equivalents—beginning of year	47,782	64,657	98,825
Cash and cash equivalents—end of year	\$ 36,195	\$ 47,782	\$ 64,657
<b>SUPPLEMENTAL CASH FLOW DISCLOSURE:</b>			
Cash paid during the periods for:			
Interest	\$ 197	\$ 218	\$ 211
Income taxes, net of refund	\$ 604	\$ 601	\$ 1,722
Noncash financing and investing activities:			
Accrued liability for purchase of property and equipment	\$ 270	\$ 258	\$ 561
Equipment acquired under capital lease	\$ 27	\$ 462	\$ —



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," or the "Company") develop, market and support a suite of language-learning and literacy solutions consisting of perpetual software products, web-based software subscriptions, online and professional services, audio practice products and mobile applications. The Company's offerings are sold on a direct basis and through select third party retailers and distributors. The Company provides its solutions to customers through the sale of packaged software and web-based software subscriptions, domestically and in certain international markets.

In March 2016, the Company announced the withdrawal of direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings (the "2016 Restructuring Plan"). Where appropriate, the Company seeks to operate through partners in the geographies being exited. The Company has also initiated processes to close the software development operations in France and China. These actions are in addition to the plan announced in early 2015 (the "2015 Restructuring Plan") to accelerate and prioritize its focus on satisfying the needs of the passionate learners in the U.S. and select non-U.S. geographies in the Consumer language business. See Note 2 "Summary of Significant Accounting Policies," Note 13 "Restructuring," Note 17 "Segment Information" and Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" within Part II for additional information about these strategic undertakings and the associated impact to the Company's financial statements and financial results.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

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

The equity method is used to account for investments in entities if the investment provides the Company with the ability to exercise significant influence over operating and financial policies of the investee. The Company determines its level of influence over an equity method investment by considering key factors such as ownership interest, representation on the investee's governance body, participation in policy-making decisions, and technological dependencies. The Company's proportionate share of the net income or loss of any equity method investments is reported in "Other income and (expense)" and included in the net loss on the consolidated statements of operations. The carrying value of any equity method investment is reported in "Other assets" on the consolidated balance sheets.

**Use of Estimates**

The preparation of financial statements, in accordance with GAAP requires management to make certain estimates and assumptions. The amounts reported in the consolidated financial statements include significant estimates and assumptions that have been made, including, but not limited to, those related to revenue recognition, allowance for doubtful accounts, estimated sales returns and reserves, stock-based compensation, restructuring costs, fair value of intangibles and goodwill, disclosure of contingent assets and liabilities, disclosure of contingent litigation, allowance for valuation of deferred tax assets, and the Company's quarterly going concern assessment. The Company bases its estimates and assumptions on historical experience and on various other judgments that are believed to be reasonable under the circumstances. The Company continuously evaluates its estimates and assumptions. Actual results may differ from these estimates and assumptions.

**Revenue Recognition**

The Company's primary sources of revenue are web-based software subscriptions, online services, perpetual product software, and bundles of perpetual product software and online services. The Company also generates revenue from the sale of audio practice products, mobile applications, and professional services. Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenue is recorded net of discounts and net of taxes.

The Company identifies the units of accounting contained within sales arrangements in accordance with Accounting Standards Codification ("ASC") subtopic 605-25 *Revenue Recognition - Multiple Element Arrangements* ("ASC 605-25"). In doing so, the Company evaluates a variety of factors including whether the undelivered element(s) have value to the customer on a stand-alone basis or if the undelivered element(s) could be sold by another vendor on a stand-alone basis.

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

For multiple element arrangements that contain perpetual software products and related online services, the Company allocates the total arrangement consideration to its deliverables based on the existence of vendor-specific objective evidence of fair value, or vendor-specific objective evidence ("VSOE"), in accordance with ASC subtopic 985-605-25 *Software: Revenue Recognition-Multiple-Element Arrangements* ("ASC 985-605-25"). The Company generates a portion of its Consumer revenue from the CD and digital download formats of the Rosetta Stone language-learning product which are typically multiple-element arrangements that contain two deliverables: perpetual software, delivered at the time of sale, and online service, which is considered an undelivered software-related element. The online service includes access to conversational coaching services. Because the Company only sells the perpetual language-learning software on a stand-alone basis in its homeschool version, the Company does not have a sufficient concentration of stand-alone sales to establish VSOE for the perpetual product. Where VSOE of the undelivered online services can be established, arrangement consideration is allocated using the residual method. The Company determines VSOE by reference to the range of comparable stand-alone renewal sales of the online service. The Company reviews these stand-alone sales on a quarterly basis. VSOE is established if at least 80% of the stand-alone sales are within a range of plus or minus 15% of a midpoint of the range of prices, consistent with generally accepted industry practice. Where VSOE of the undelivered online services cannot be established, revenue is deferred and recognized commensurate with the delivery of the online services.

For non-software multiple element arrangements, the Company allocates revenue to all deliverables based on their relative selling prices. The Company's non-software multiple element arrangements primarily occur as sales to its Enterprise & Education Language and Literacy customers, and to a lesser extent its Consumer customers. These arrangements can include web-based subscription services, audio practice products and professional services or any combination thereof. The Company does not have a sufficient concentration of stand-alone sales of the various deliverables noted above to its customers, and therefore cannot establish VSOE for each deliverable. Third party evidence of fair value does not exist for the web-based subscription, audio practice products and professional services due to the lack of interchangeable language-learning products and services within the market. Accordingly, the Company determines the relative selling price of the web-based subscription, audio practice products and professional services deliverables included in its non-software multiple element arrangements using the best estimated selling price. The Company determines the best estimated selling price based on its internally published price list which includes suggested sales prices for each deliverable based on the type of client and volume purchased. This price list is derived from past experience and from the expectation of obtaining a reasonable margin based on what each deliverable costs the Company.

In the U.S. and Canada, the Company offers consumers who purchase packaged software and audio practice products directly from the Company a 30-day, unconditional, full money-back refund. The Company also permits some of our retailers and distributors to return unsold packaged products, subject to certain limitations. In accordance with ASC subtopic 985-605, *Software: Revenue Recognition* ("ASC 985-605"), the Company estimates and establishes revenue reserves for packaged product returns at the time of sale based on historical return rates, estimated channel inventory levels, the timing of new product introductions and other factors.

The Company distributes its products and services both directly to the end customer and indirectly through resellers. Resellers earn commissions generally calculated as a fixed percentage of the gross sale to the end customer. The Company evaluates each of its reseller relationships in accordance with ASC subtopic 605-45, *Revenue Recognition - Principal Agent Considerations* ("ASC 605-45") to determine whether the revenue recognized from indirect sales should be the gross amount of the contract with the end customer or reduced for the reseller commission. In making this determination the Company evaluates a variety of factors including whether it is the primary obligor to the end customer.

Revenue for web-based subscriptions and online services is recognized ratably over the term of the subscription or service period, assuming all revenue recognition criteria have been met. The CD and digital download formats of Rosetta Stone language-learning products are bundled with an online service where customers are allowed to begin their online services at any point during a registration window, which is typically up to six months from the date of purchase from us or an authorized reseller. The online services that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Revenue from non-refundable upfront fees that are not related to products already delivered or services already performed is deferred and recognized ratably over the term of the related arrangement because the period over which a customer is expected to benefit from the service that is included within our subscription arrangements does not extend beyond the contractual period. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement.

Software products are sold to end user customers and resellers. In many 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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

from sales of packaged software products and audio practice products is recognized as the products are shipped and title passes and risks of loss have been transferred. For many 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. In other cases where packaged software products are sold to resellers on a consignment basis, revenue is recognized for these consignment transactions once the end user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with ASC subtopic 605-50, *Revenue Recognition: Customer Payments and Incentives* ("ASC 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. 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 at the time of sale.

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, a successful collection history has been established and these fees are fixed and determinable, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met.

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

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

**Divestitures**

The Company deconsolidates divested subsidiaries when there is a loss of control or when appropriate when evaluated under the variable interest entity model. The Company recognizes a gain or loss at divestiture equal to the difference between the fair value of any consideration received and the carrying amount of the former subsidiary's assets and liabilities. Any resulting gain or loss is reported in "Other income and (expense)" on the consolidated statement of operations. See Note 5 "Divestitures" for disclosures on the Company's recent divestiture.

**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 generally used to reimburse funds to employees under the Company's flexible benefit plan and deposits received on subleased properties.

**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 establish a new cost basis for obsolete and potential obsolete inventory. See Note 3 "Inventory" for disclosures on the Company's inventory balances.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

**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 on its trade accounts receivable. In addition, the Company maintains cash and investment balances in accounts at various banks and brokerage firms. The Company has not experienced any losses on cash and cash equivalent accounts to date.

The Company sells its offerings to retailers, resellers, government agencies, and individual consumers and extends credit based on an evaluation of the customer's financial condition, and may require collateral, such as letters of credit, in certain circumstances. 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, 2016, 2015 or 2014. The four largest distributor and reseller receivable balances collectively represented 23% and 30% of accounts receivable as of December 31, 2016 and 2015, respectively, with one customer that accounted for 13% and 17% of accounts receivable as of December 31, 2016 and 2015, respectively. The Company maintains trade credit insurance for certain customers to provide coverage, up to a certain limit, in the event of insolvency of some customers.

**Fair Value of Financial Instruments**

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

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

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

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

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

**Property and Equipment**

Property and equipment are stated at cost, less accumulated depreciation. Depreciation on property, building and leasehold improvements, furniture, 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. See Note 4 "Property Plant and Equipment" for the Company's additional disclosures.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

**Valuation of Long-Lived Assets**

In accordance with ASC topic 360, *Property, Plant and Equipment* ("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.

**Software Developed for Internal Use**

The Company capitalizes software development costs related to certain of its software platforms developed exclusively to provide its web-based subscription services and other general and administrative use software in accordance with ASC subtopic 350-40: *Internal-Use Software*. Development costs for internal-use software are expensed as incurred until the project reaches the application development stage. Internal-use software is defined to have the following characteristics: (a) the software is internally developed, or modified solely to meet the Company'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.

	Years Ended December 31,		
	2016	2015	2014
Amounts capitalized as internal-use software	\$ 11,375	\$ 7,132	\$ 8,811
Amortization expense of internal-use software	\$ (6,369)	\$ (4,786)	\$ (3,379)
Impairment expense of internal-use software	\$ (1,029)	\$ (1,142)	\$ (163)

**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 ASC topic 350, *Intangibles—Goodwill and Other* ("ASC 350").

Annually, as of December 31, and more frequently if a triggering event occurs, the Company reviews its indefinite-lived intangible asset for impairment in accordance with ASC 350. This guidance provides the option to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative test. If necessary, the quantitative test is performed by comparing the fair value of indefinite lived intangible assets to the carrying value. In the event the carrying value exceeds the fair value of the assets, the assets are written down to their fair value. The Rosetta Stone trade name is the Company's only indefinite-lived intangible asset.

See Note 7 "Intangible Assets" for a discussion and results associated with the Company's recent intangible asset impairment tests.

**Goodwill**

Goodwill represents purchase consideration paid in a business combination that exceeds the values assigned to the net assets of acquired businesses. The Company tests goodwill for impairment annually on June 30 of each year or more frequently if impairment indicators arise. Goodwill is tested for impairment at the reporting unit level using a fair value approach, in accordance with the provisions of ASC 350. This guidance provides the option 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, a "Step 0" analysis. If, based on a review of qualitative factors, it is more likely than not that the fair value of a reporting unit is less than its carrying value the Company performs "Step 1" of the traditional two-step goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. If the carrying value exceeds the fair value, the Company measures the amount of impairment loss, if any, by comparing the implied fair value of the reporting unit goodwill with its carrying amount, the "Step 2" analysis.

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

See Note 6 "Goodwill" for a discussion and results associated with the Company's recent goodwill impairment tests. For income tax purposes, the goodwill balances with tax basis are amortized over a period of 15 years.

**Guarantees**

Indemnifications are provided of varying scope and size to certain Enterprise & Education Language and Literacy 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 Subscription and Service Revenue and Cost of Product Revenue**

The cost of subscription and service revenue primarily represents costs associated with supporting the web-based subscription services and online language-learning services, which includes online language conversation coaching, hosting costs and depreciation. Also included are the costs of credit card processing and customer technical support in both cost of product revenue and cost of subscription and service revenue. Cost of product revenue consists of the direct and indirect materials and labor costs to produce and distribute the Company's 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.

**Research and Development**

Research and development expenses include employee compensation costs, consulting fees and overhead costs associated with the development of our solutions. The Company develops a portion of its language-learning software products for perpetual 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 such 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.

**Income Taxes**

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

Significant judgment is required to determine whether a valuation allowance is necessary and the amount of such valuation allowance, if appropriate. The valuation allowance is reviewed at each reporting period and is maintained until sufficient positive evidence exists to support a reversal.

When assessing the realization of the Company's deferred tax assets, the Company considers all available evidence, including:

- the nature, frequency, and severity of cumulative financial reporting losses in recent years;
- the carryforward periods for the net operating loss, capital loss, and foreign tax credit carryforwards;
- predictability of future operating profitability of the character necessary to realize the asset;
- prudent and feasible tax planning strategies that would be implemented, if necessary, to protect against the loss of the deferred tax assets; and
- the effect of reversing taxable temporary differences.

The evaluation of the recoverability of the deferred tax assets requires that the Company weigh all positive and negative evidence to reach a conclusion that it is more likely than not that all or some portion of the deferred tax assets will not be realized. The weight given to the evidence is commensurate with the extent to which it can be objectively verified. The more

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed.

The establishment of a valuation allowance has no effect on the ability to use the deferred tax assets in the future to reduce cash tax payments. The Company will continue to assess the likelihood that the deferred tax assets will be realizable at each reporting period and the valuation allowance will be adjusted accordingly, which could materially affect the Company's financial position and results of operations. See Note 15 "Income Taxes" for additional disclosures.

**Stock-Based Compensation**

The Company accounts for its stock-based compensation in accordance ASC topic 718, *Compensation—Stock Compensation* ("ASC 718"). Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date. For options granted with service and/or performance conditions, the fair value of each grant is estimated on the date of grant using the Black-Scholes option pricing model. For options granted with market-based conditions, the fair value of each grant is estimated on the grant date using the Monte-Carlo simulation model. These methods require the use of estimates, including future stock price volatility, expected term and forfeitures.

As the Company does not have sufficient historical option exercise experience that spans the full 10 year contractual term for determining the expected term of options granted, the Company estimates the expected term of options using a combination of historical information and the simplified method for estimating the expected term. The Company uses its own historical stock price data to estimate its forfeiture rate and expected volatility over the most recent period commensurate with the estimated expected term of the awards. For the risk-free interest rate, the Company uses a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.

The Company's restricted stock and restricted stock unit grants are accounted for as equity awards. Stock compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. For equity awards granted with market-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions. See Note 10 "Stock-Based Compensation" for additional disclosures.

**Restructuring Costs**

As part of the 2016 Restructuring Plan and the 2015 Restructuring Plan, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. In connection with these plans, the Company incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included within Cost of Sales and the Sales and marketing, Research and development, and General and administrative operating expense categories in the Company's consolidated statements of operations.

Employee severance and related benefit costs primarily include cash payments, outplacement services, continuing health insurance coverage, and other benefits. Where no substantive involuntary termination plan previously existed, these severance costs are generally considered "one-time" benefits and recognized at fair value in the period in which a detailed plan has been approved by management and communicated to the terminated employees. Severance costs pursuant to ongoing benefit arrangements, including termination benefits provided for in existing employment contracts, are recognized when probable and reasonably estimable.

Contract termination costs include penalties to cancel certain service and license contracts and costs to terminate operating leases. Contract termination costs are recognized at fair value in the period in which the contract is terminated in accordance with the contract terms.

Other related costs generally include external consulting and legal costs associated with the strategic shift in business focus. Such costs are recognized at fair value in the period in which the costs are incurred. See Note 13 "Restructuring" for additional disclosures.



ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Net Loss Per Share

Net loss per share is computed under the provisions of ASC topic 260, *Earnings Per Share*. Basic loss per share is computed using net loss and the weighted average number of shares of common stock outstanding. Diluted loss 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. When there is a net loss, there is a presumption that there are no dilutive shares as these would be anti-dilutive.

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

	Years Ended December 31,		
	2016	2015	2014
	(dollars in thousands, except per share amounts)		
<i>Numerator:</i>			
Net loss	\$ (27,550)	\$ (46,796)	\$ (73,706)
<i>Denominator:</i>			
Common shares and equivalents outstanding:			
Basic weighted average shares	21,969	21,571	21,253
Diluted weighted average shares	21,969	21,571	21,253
Loss per share:			
Basic	\$ (1.25)	\$ (2.17)	\$ (3.47)
Diluted	\$ (1.25)	\$ (2.17)	\$ (3.47)

For the years ended December 31, 2016, 2015 and 2014, no common stock equivalent shares were included in the calculation of the Company's diluted net loss per share. The following is a summary of common stock equivalents for the securities outstanding during the respective periods that have been excluded from the earnings per share calculations as their impact was anti-dilutive.

	Years Ended December 31,		
	2016	2015	2014
	(in thousands)		
Stock options	16	35	67
Restricted stock units	174	39	103
Restricted stocks	129	82	89
Total common stock equivalent shares	319	156	259

Comprehensive Loss

Comprehensive loss consists of net loss and other comprehensive loss. Other comprehensive loss refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' (deficit) equity. For the years ended December 31, 2016, 2015 and 2014, the Company's comprehensive loss consisted of net loss and foreign currency translation losses. The other comprehensive loss presented in the consolidated financial statements and the notes are presented net of tax. There have been no tax expense or benefit associated with the components other comprehensive loss due to the presence of a full valuation allowance for each of the years ended December 31, 2016, 2015 and 2014.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Components of accumulated other comprehensive loss as of December 31, 2016 are as follows (in thousands):

	Foreign Currency	Total
Balance at beginning of period	\$ (2,226)	\$ (2,226)
Other comprehensive loss before reclassifications	(1,483)	(1,483)
Amounts reclassified from accumulated other comprehensive loss	—	—
Net current period other comprehensive loss	(1,483)	(1,483)
Accumulated other comprehensive loss	\$ (3,709)	\$ (3,709)

Upon divestiture of an investment in a foreign entity, the amount attributable to the accumulated translation adjustment component of that foreign entity is removed as a component of other comprehensive loss and reported as part of the gain or loss on sale or liquidation of the investment. During the year ended December 31, 2016, there were no reclassifications out of accumulated other comprehensive loss.

**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 loss in stockholders' (deficit) 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.

**Advertising Costs**

Costs for advertising are expensed as incurred. Advertising expense for the years ended December 31, 2016, 2015, and 2014 were \$37.0 million, \$46.9 million and \$79.6 million, respectively.

**Going Concern Assessment**

The consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Management has evaluated whether relevant conditions or events, considered in the aggregate, indicate that there is substantial doubt about the Company's ability to continue as a going concern. Substantial doubt exists when conditions and events, considered in the aggregate, indicate it is probable that the Company will be unable to meet its obligations as they become due within one year after the financial statement issuance date. The assessment is based on the relevant conditions that are known or reasonable knowable as of March 14, 2017.

The assessment of the Company's ability to meet its future obligations is inherently judgmental, subjective and susceptible to change. The inputs that are considered important in the Company's going concern analysis, include, but are not limited to, the Company's 2017 cash flow forecast, 2017 operating budget, and long-term plan that extends beyond 2017. These inputs consider information including, but not limited to, the Company's financial condition, liquidity sources, obligations due within one year after the financial statement issuance date, funds necessary to maintain operations, and financial conditions, including negative financial trends or other indicators of possible financial difficulty.

The Company has considered both quantitative and qualitative factors as part of the assessment that are known or reasonably knowable as of March 14, 2017, and concluded that conditions and events considered in the aggregate, do not indicate that it is probable that the Company will be unable to meet obligations as they become due through the one year period following the financial statement issuance date.

**Recently Issued Accounting Standards**

During 2016, the Company adopted the following recently issued Accounting Standard Updates ("ASU"):

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-15, *Presentation of Financial Statements - Going Concern (Subtopic 205-40)* ("ASU 2014-15"). ASU 2014-15 addresses

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and interim periods thereafter. Early adoption is permitted. The Company has adopted this guidance and as discussed above. No additional disclosures are required.

The following ASUs were recently issued but have not yet been adopted by the Company:

In February 2017, the FASB issued ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets* ("ASU 2017-05"). ASU 2017-05 clarifies the scope and accounting of a financial asset that meets the definition of an "in-substance nonfinancial asset" and defines the term, "in-substance nonfinancial asset." ASU 2017-05 also adds guidance for partial sales of nonfinancial assets. ASU 2017-05 is effective at the same time Topic 606, Revenue from Contracts with Customers is effective. ASU 2017-05 may be applied retrospectively for all periods presented or retrospectively with a cumulative-effect adjustment at the date of adoption. The Company is in the process of evaluating the impact of the new guidance on the Company's financial statements and disclosures and the adoption method.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment* ("ASU 2017-04"). ASU 2017-04 simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test. ASU 2017-04 is effective for annual and interim goodwill tests beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates on or after January 1, 2017. The Company is in the process of evaluating the guidance. Given the prospective adoption application, there is no impact on the Company's historical consolidated financial statements and disclosures.

In January 2017, the FASB issued ASU No. 2017-01, *Business Combination (Topic 805) Clarifying the Definition of a Business* ("ASU 2017-01"). The amendments under ASU 2017-01 clarify the definition of a business and requires that an entity apply certain criteria in order to determine when a set of assets and activities qualifies as a business. ASU 2017-01 is effective for public entities for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years, and should be applied on a prospective basis. Early adoption is permitted. The Company is currently evaluating the timing of adoption of this guidance.

In November 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230) Restricted Cash a consensus of the FASB Emerging Issues Task Force* ("ASU 2016-18"). Under ASU 2016-18, amounts generally described as restricted cash should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. ASU 2016-18 is effective for public entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the timing of adoption of this guidance. The new guidance only impacts presentation of the Company's consolidated statement of cash flows.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* ("ASU 2016-13"). ASU 2016-13 changes the methodology for measuring credit losses of financial instruments and the timing of when such losses are recorded. ASU 2016-13 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those years, beginning after December 15, 2018. The Company is in the process of evaluating the impact of the new guidance on the Company's consolidated financial statements and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* ("ASU 2016-09"). Under ASU 2016-09, accounting for share-based payment award transactions was simplified related to the accounting for (a) income tax effects; (b) minimum statutory tax withholding requirements; (c) and forfeitures. ASU 2016-09 is effective for public entities in annual periods beginning after December 15, 2016, including interim periods within those annual periods. Early adoption is permitted. The Company expects to adopt this new guidance for its 2017 interim and annual reporting periods. Due to the historical cumulative shortfall position, the adoption of ASU 2016-09 will not result in a cumulative-effect adjustment to retained earnings. ASU 2016-09 allows for an entity-wide accounting policy election, which would be applied prospectively, to either account for forfeitures when they occur or continue to estimate the number of awards that are expected to vest. The Company is in the process of evaluating the potential forfeiture policy election and the impact this election may have on the Company's consolidated financial statements and disclosures. Other aspects of adoption ASU 2016-09 are not anticipated to have a material impact to the Company's consolidated financial statements.

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). Under ASU 2016-02, entities will be required to recognize a lease liability and a right-of-use asset for all leases. Lessor accounting is largely unchanged. ASU 2016-02 is effective for public entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is in the process of evaluating the impact of the new guidance on the Company's consolidated financial statements and disclosures.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ("ASU 2016-01"). ASU 2016-01 changes how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option that are attributable to their own credit. Under the new guidance, entities will be required to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. The accounting for other financial instruments, such as loans and investments in debt securities is largely unchanged. ASU 2016-01 is effective for public entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not believe that the adoption of this guidance will have a material impact on the Company's consolidated financial statements and disclosures.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which replaces the current revenue accounting guidance. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date* which defers the effective date of the updated guidance on revenue recognition by one year. In March 2016, the FASB issued ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, which clarifies and improves the operability and understandability of the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, which clarifies and improves the operability and understanding of the implementation guidance on identifying performance obligations and licensing. Collectively these ASUs comprise the new revenue standard ("New Revenue Standard"). The core principle of the New Revenue Standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply a five step model to 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract and 5) recognize revenue when (or as) the entity satisfies a performance obligation. The New Revenue Standard is effective for annual periods beginning after December 15, 2017.

The Company expects that it will adopt the New Revenue Standard beginning in the first quarter of 2018. The New Revenue Standard provides the option between two different methods of adoption. The full retrospective method calls for the Company to present each prior reported period shown in the financial statements under the new guidance. The modified retrospective method requires the Company to calculate the cumulative effect of applying the new guidance as of the date of adoption via adjustment to retained earnings. The Company is currently considering adopting the New Revenue Standard using the full retrospective method. The Company's ability to adopt using the full retrospective method is dependent on several factors, including the significance of the impact of the New Revenue Standard to the Company's financial results, system readiness and ability to accumulate and analyze the information necessary to assess the impact on prior period financial statements, as necessary.

The Company is currently evaluating the impact the New Revenue Standard will have on its accounting policies, processes, and system requirements. Internal resources have been assigned to assist in the evaluation and the Company will continue to make investments in systems to enable timely and accurate reporting under the New Revenue Standard. As part of its initial evaluations, the Company believes the impact of the change in the New Revenue Standard on the Enterprise & Education and Literacy segments will be minimal as the accounting outcome of the vast majority of transactions remains unchanged. Due to the elimination of software specific accounting guidance, the Company anticipates more significant changes to the accounting for the packaged perpetual software product line within the Consumer segment. This change is expected to be greater in the historical periods presented for comparison in the 2018 financial statements due to the Company pursuing its strategy to transition the Consumer segment to a fully SaaS delivery model by the end of 2017. While the Company continues to assess all potential impacts under the New Revenue Standard, including the areas described above, we do not know or cannot reasonably estimate quantitative information related to the impact of the New Revenue Standard on the Company's consolidated financial statements and disclosures at this time.

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

**3. INVENTORY**

Inventory consisted of the following (in thousands):

	As of December 31,	
	2016	2015
Raw materials	\$ 4,384	\$ 3,375
Finished goods	2,383	3,958
Total inventory	<u>\$ 6,767</u>	<u>\$ 7,333</u>

**4. PROPERTY AND EQUIPMENT**

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

	As of December 31,	
	2016	2015
Land	\$ 876	\$ 893
Buildings and improvements	9,503	9,573
Leasehold improvements	1,645	1,477
Computer equipment	15,866	16,508
Software	43,688	34,478
Furniture and equipment	2,393	3,115
	<u>73,971</u>	<u>66,044</u>
Less: accumulated depreciation	(49,176)	(43,512)
Property and equipment, net	<u>\$ 24,795</u>	<u>\$ 22,532</u>

The Company leases certain computer equipment, software, buildings, and machinery under capital lease agreements. As of December 31, 2016 and 2015, assets under capital lease included in property and equipment above were \$5.4 million and \$5.5 million, respectively. As of December 31, 2016 and 2015, accumulated depreciation and amortization relating to property and equipment under capital lease arrangements totaled \$2.1 million and \$1.5 million, respectively.

The Company recorded total depreciation and amortization expense for its property and equipment for the years ended December 31, 2016, 2015 and 2014 in the amount of \$9.0 million, \$8.5 million and \$7.6 million, respectively. Depreciation and amortization expense related to property and equipment includes depreciation related to its physical assets and amortization expense related to amounts capitalized in the development of internal-use software.

During the years ending December 31, 2016, 2015, and 2014 the Company recorded \$1.0 million, \$1.1 million, and \$0.2 million respectively, in impairment expense related to the abandonment of previously capitalized internal-use software projects.

**5. DIVESTITURES**

As part of the shift in strategy initiated in early 2015, the Company determined that its ownership of the consumer-oriented Rosetta Stone Korea Ltd. ("RSK") entity no longer agreed with the Company's overall strategy to focus on the Enterprise & Education business. In September 2015, the Company completed the divestiture of 100% of the Company's capital stock of RSK to the current President of RSK for consideration equal to the assumption of RSK's net liabilities at the date of sale. This divestiture resulted in a pre-tax gain of \$0.7 million reported in "Other income and (expense)" line of the consolidated statements of operations. This gain was comprised of a gain of \$0.2 million equal to the value of the net liabilities transferred and a \$0.5 million gain on the transfer of the foreign subsidiary's cumulative translation adjustment on the date of sale.

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**5. DIVESTITURES (Continued)**

As part of the transaction, the Company has agreed to continue to provide to RSK certain of its online product offerings for resale and distribution and RSK is committed to purchase those products, for an initial term ending December 31, 2025. In addition, the Company has loaned RSK \$0.5 million as of October 2, 2015, which will be repaid in five equal installments due every six months beginning December 31, 2016. The first installment was paid in full according to schedule and no allowance was deemed necessary. As a result of this loan receivable and the level of financial support it represents, the Company concluded that it holds a variable interest in RSK whereby the Company is not the primary beneficiary. The maximum exposure to loss as a result of this involvement in the variable interest entity is limited to the \$0.5 million amount of the loan.

**6. GOODWILL**

The value of gross goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisitions of Livemocha, Inc. ("Livemocha") in April 2013, the acquisition of Lexia Learning Systems, Inc. ("Lexia") in August 2013, and the acquisitions of Vivity Labs, Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") in January 2014.

The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC topic 350, *Intangibles - Goodwill and other* ("ASC 350"), or more frequently, if impairment indicators arise. The Company also routinely reviews goodwill at the reporting unit level for potential impairment.

The Company's reporting units were Enterprise & Education Language, Enterprise & Education Literacy, Consumer Language, and Consumer Fit Brains. The combined Consumer Language and Consumer Fit Brains reporting units make up the Consumer operating and reportable segment.

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

**6. GOODWILL (Continued)**

The following table shows the balance and changes in goodwill for the Company's operating segments and reporting units for the years ended December 31, 2016 and 2015 (in thousands):

	Enterprise & Education Language		Consumer		Total
			Literacy	Consumer Language	
Balance as of January 1, 2015					
Gross Goodwill	\$ 40,084	\$ 9,962	\$ 20,170	\$ 8,538	\$ 78,754
Accumulated Impairment	—	—	(20,170)	—	(20,170)
Goodwill as of January 1, 2015	<u>\$ 40,084</u>	<u>\$ 9,962</u>	<u>\$ —</u>	<u>\$ 8,538</u>	<u>\$ 58,584</u>
Partial Impairment of Consumer Fit Brains	—	—	—	(5,604)	(5,604)
Effect of change in foreign currency rate	(1,384)	—	—	(1,316)	(2,700)
Balance as of December 31, 2015					
Gross Goodwill	\$ 38,700	\$ 9,962	\$ 20,170	\$ 7,222	\$ 76,054
Accumulated Impairment	—	—	(20,170)	(5,604)	(25,774)
Goodwill as of December 31, 2015	<u>\$ 38,700</u>	<u>\$ 9,962</u>	<u>\$ —</u>	<u>\$ 1,618</u>	<u>\$ 50,280</u>
Remaining Full Impairment of Consumer Fit Brains	—	—	—	(1,740)	(1,740)
Effect of change in foreign currency rate	(411)	—	—	122	(289)
Balance as of December 31, 2016					
Gross Goodwill	\$ 38,289	\$ 9,962	\$ 20,170	\$ 7,344	\$ 75,765
Accumulated Impairment	—	—	(20,170)	(7,344)	(27,514)
Goodwill as of December 31, 2016	<u>\$ 38,289</u>	<u>\$ 9,962</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 48,251</u>

**2016 Activity**
*Annual Impairment Testing of Goodwill and Consumer Fit Brains Impairment*

Consistent with elections in prior annual tests, the Company exercised its option to bypass Step 0 for all reporting units with remaining goodwill balances in connection with the annual goodwill impairment analysis performed as of June 30, 2016. The Enterprise & Education Language and Literacy reporting units both resulted in fair values that substantially exceeded the carrying values, and therefore no goodwill impairment charges were recorded in connection with the annual analysis for these reporting units.

The Consumer Fit Brains reporting unit was also evaluated, which resulted in a fair value that was significantly below the carrying value. The decrease in fair value was due to the second quarter 2016 strategy update for the Consumer Fit Brains business. The Consumer Fit Brains reporting unit was no longer considered central to the core strategy for the Company's focus on language and literacy learning. Due to the continued declines in operations since the \$5.6 million partial impairment in the fourth quarter of 2015 which is further discussed below, management revised the Consumer Fit Brains financial projections in the second quarter of 2016 assuming reduced media spend and reduced revenue in 2016 and beyond. The change in operating plans and the lack of cushion since the fourth quarter 2015 impairment resulted in an implied fair value of goodwill that was significantly below its carrying value. As a result, the Company recorded a second quarter impairment loss of \$1.7 million, which represented a full impairment of the remaining Consumer Fit Brains reporting unit's goodwill. The impairment charge was recorded in the "Impairment" line on the statement of operations.

*Interim Impairment Review*

The Company also routinely reviews goodwill at the reporting unit level for potential impairment as part of the Company's internal control framework. In the fourth quarter of 2016, the Enterprise & Education Language and Literacy

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 6. GOODWILL (Continued)

reporting units (the only reporting units with remaining goodwill balances) were evaluated to determine if a triggering event has occurred. As of December 31, 2016, the Company concluded that there were no indicators of impairment that would cause it to believe that it is more likely than not that the fair value of these reporting units is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no impairment charges were recorded for these reporting units in connection with the interim impairment review.

## 2015 Activity

## Consumer Fit Brains Impairment

During the fourth quarter of 2015, the Company determined that sufficient indication existed to require performance of an interim goodwill impairment analysis for the Consumer Fit Brains reporting unit. This indicator was due to a decline in the operations of the Consumer Fit Brains reporting unit, with decreases in revenue and bookings within this reporting unit driving lower than expected operating results for the quarter and impacting the forecast going forward. In this interim goodwill impairment test, the Consumer Fit Brains reporting unit failed Step 1. The combination of lower reporting unit fair value calculated in Step 1 and the identification of unrecognized fair value adjustments to the carrying values of other assets and liabilities (primarily developed technology and deferred revenue) in Step 2 of the interim goodwill impairment test, resulted in an implied fair value of goodwill below its carrying value. As a result, the Company recorded an impairment loss of \$5.6 million associated with the interim impairment assessment of the Consumer Fit Brains reporting unit as of December 31, 2015.

## 7. INTANGIBLE ASSETS

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

	Trade name / trademark *	Core technology	Customer relationships	Patents and Other	Total
Gross Carrying Amount	\$ 12,442	\$ 15,149	\$ 26,245	\$ 312	\$ 54,148
Accumulated Amortization	(1,271)	(7,817)	(16,603)	(213)	(25,904)
Balance as of December 31, 2015	\$ 11,171	\$ 7,332	\$ 9,642	\$ 99	\$ 28,244
Gross Carrying Amount	12,431	15,092	26,149	312	53,984
Accumulated Amortization	(1,481)	(9,859)	(18,485)	(251)	(30,076)
Accumulated Impairment	(26)	(1,001)	(128)	—	(1,155)
Balance as of December 31, 2016	\$ 10,924	\$ 4,232	\$ 7,536	\$ 61	\$ 22,753

\* Included within the Trade name/ trademark intangible asset category is the Rosetta Stone trade name with a carrying amount of \$10.6 million. This intangible asset is considered to have an indefinite useful life and is therefore not amortized, but rather tested for impairment on at least an annual basis.

The Company computes amortization of intangible assets on a straight-line basis over the estimated useful life. Below are the weighted average remaining useful lives of the Company's amortizing intangible assets:

	Weighted Average Life
Trade name / trademark	19 months
Core technology	32 months
Customer relationships	69 months
Patents	27 months



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

**7. INTANGIBLE ASSETS (Continued)**

Amortization expense consisted of the following (in thousands):

	Years Ended December 31,		
	2016	2015	2014
Included in cost of revenue:			
Cost of subscription and service revenue	\$ 404	\$ 322	\$ 209
Cost of product revenue	182	264	377
Total included in cost of revenue	586	586	586
Included in operating expenses:			
Sales and marketing	2,178	2,804	3,677
Research and development	1,587	1,802	2,000
General and administrative	—	—	—
Total included in operating expenses	3,765	4,606	5,677
Total	\$ 4,351	\$ 5,192	\$ 6,263

The following table summarizes the estimated future amortization expense related to intangible assets as of December 31, 2016 (in thousands):

	As of December 31, 2016
2017	\$ 3,749
2018	3,155
2019	1,532
2020	1,282
2021	940
Thereafter	1,488
Total	\$ 12,146

**2016 Activity***Impairment Reviews of Intangible Assets*

The Company also routinely reviews indefinite-lived intangible assets and long-lived intangible assets for potential impairment as part of the Company's internal control framework.

During the second quarter of 2016, the Company revised the business outlook and financial projections for the Consumer Fit Brains reporting unit, which prompted a long-lived intangible asset impairment analysis of the tradename, developed technology, and customer relationships associated with the Consumer Fit Brains reporting unit ("Consumer Fit Brains Intangible Assets"). The carrying values of the Consumer Fit Brains Intangible Assets exceeded the estimated fair values. As a result, the Company recorded an impairment loss of \$1.2 million associated with the impairment of the remaining carrying value of the Consumer Fit Brains Intangible Assets as of June 30, 2016. The impairment charge was recorded in the "Impairment" line on the statement of operations.

As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of December 31, 2016 to determine if indicators of impairment exist. The Company elected to bypass the option to first assess qualitative factors to determine whether it is more likely than not that the Rosetta Stone trade name was impaired and performed the quantitative assessment. In the quantitative assessment, the Company noted that the fair value of the Rosetta Stone trade name exceeded the carrying value. There were no impairment charges related to the Rosetta Stone trade name for the year ended December 31, 2016.

Additionally, all other long-lived intangible assets were evaluated at December 31, 2016 to determine if indicators of impairment exist and the Company concluded that there are no additional potential indicators of impairment and no further

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

**7. INTANGIBLE ASSETS (Continued)**

impairment chargers were recorded during the year ended December 31, 2016. There were no impairment charges related to intangible assets for the years ended December 31, 2015 and 2014.

**8. OTHER CURRENT LIABILITIES**

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

	As of December 31,	
	2016	2015
Accrued marketing expenses	\$ 8,460	\$ 20,022
Accrued professional and consulting fees	2,050	1,746
Sales return reserve	1,338	3,728
Sales, withholding, and property taxes payable	3,772	3,879
Other	6,530	5,943
Total Other current liabilities	<u>\$ 22,150</u>	<u>\$ 35,318</u>

**9. FINANCING ARRANGEMENTS*****Revolving Line of Credit***

See Note 21 "Subsequent Events" regarding the March 2017 amendment of the Company's credit facility. The following discussion pertains to the credit facility as in effect as of December 31, 2016.

On October 28, 2014, Rosetta Stone Ltd ("RSL"), a wholly owned subsidiary of parent company Rosetta Stone Inc., executed a Loan and Security Agreement with Silicon Valley Bank ("Bank") to obtain a \$25.0 million revolving credit facility (the "credit facility"). The Company executed the First Amendment to the credit facility with the Bank effective March 31, 2015, the Second Amendment effective May 1, 2015, the Third Amendment effective June 29, 2015, and the Fourth Amendment effective December 29, 2015. The Company is subject to certain covenants under the Loan and Security Agreement including financial covenants and limitations on indebtedness, encumbrances, investments and distributions and dispositions of assets, certain of which covenants were amended in the First, Second, Third, and Fourth Amendments, which were primarily amended to reflect updates to the Company's financial outlook. The Third Amendment also changed the definition of "change of control" to eliminate the clause referring to a change in a portion of the Board of Directors within a twelve-month period.

On March 14, 2016, the Company executed the Fifth Amendment to the credit facility. Under the amended agreement, the Company may borrow up to \$25.0 million including a sub-facility, which reduces available borrowings, for letters of credit in the aggregate availability amount of \$4.0 million (the "credit facility"). Borrowings by RSL under the credit facility are guaranteed by the Company as the ultimate parent. The credit facility has a term that expires on January 1, 2018, during which time RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

The total obligations under the credit facility cannot exceed the lesser of (i) the total revolving commitment of \$25.0 million or (ii) the borrowing base, which is calculated as 80% of eligible accounts receivable. As a result, the borrowing base will fluctuate and the Company expects it will follow the general seasonality of cash and accounts receivable (lower in the first half of the year and higher in the second half of the year). If the borrowing base less any outstanding amounts, plus the cash held at SVB ("Availability") is greater than \$25.0 million, then the Company may borrow up to an additional \$5.0 million, but in no case can borrowings exceed \$25.0 million. Interest on borrowings accrue at the Prime Rate provided that the Company maintains a minimum cash and Availability balance of \$17.5 million. If cash and Availability is below \$17.5 million, interest will accrue at the Prime Rate plus 1%.

Proceeds of loans made under the credit facility may be used as working capital or to fund general business requirements. All obligations under the credit facility, including letters of credit, are secured by a security interest on substantially all of the Company's assets including intellectual property rights and by a stock pledge by the Company of 100% of its ownership interests in U.S. subsidiaries and 66% of its ownership interests in certain foreign subsidiaries.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**9. FINANCING ARRANGEMENTS (Continued)**

The credit facility contains customary affirmative and negative covenants, including covenants that limit or restrict our ability to, among other things, incur additional indebtedness, dispose of assets, execute a material change in business, acquire or dispose of an entity, grant liens, make share repurchases, and make distributions, including payment of dividends. The Company is required to maintain compliance with a minimum liquidity amount and minimum financial performance requirements, as defined in the credit facility. As of December 31, 2016, the Company was in compliance with all covenants.

The credit facility contains customary events of default, including among others, non-payment defaults, covenant defaults, bankruptcy and insolvency defaults, and a change of control default, in each case, subject to customary exceptions. The occurrence of a default event could result in the Bank's acceleration of repayment obligations of any loan amounts then outstanding.

As of December 31, 2016, there were no borrowings outstanding and the Company was eligible to borrow the entire \$20.8 million of available credit, less \$4.0 million in letters of credit have been issued by the Bank on the Company's behalf, resulting in a net borrowing availability of \$16.8 million. A quarterly commitment fee accrues on any unused portion of the credit facility at a nominal annual rate.

**Capital Leases**

The Company enters into capital leases under non-committed arrangements for equipment and software. In addition, as a result of the Tell Me More Merger, the Company assumed a capital lease for a building near Versailles, France, where Tell Me More's headquarters are located. The fair value of the lease liability at the date of acquisition was \$4.0 million.

During the years ended December 31, 2016 and 2015, the Company acquired equipment or software through the issuance of capital leases totaling \$27,000 and \$0.5 million, respectively. This non-cash investing activity has been excluded from the consolidated statement of cash flows. There were no equipment or software acquired through the issuance of capital leases during the year ended December 31, 2014.

As of December 31, 2016, the future minimum payments under capital leases with initial terms of one year or more are as follows (in thousands):

Periods Ending December 31,		
2017	\$	635
2018		483
2019		480
2020		476
2021		473
Thereafter		354
Total minimum lease payments	\$	2,901
Less amount representing interest		342
Present value of net minimum lease payments	\$	2,559
Less current portion		532
Obligations under capital lease, long-term	\$	2,027

**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

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

available stock. All unissued stock associated with the 2006 Stock Incentive Plan expired in 2016 at the end of the ten year contractual term.

*2009 Omnibus Incentive Plan*

On February 27, 2009, the Company's Board of Directors approved the 2009 Omnibus Incentive Plan (the "2009 Plan") that provides for the ability of the Company to grant up to 2,437,744 of new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. The stock incentive awards and options granted under the 2009 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants.

On May 26, 2011 the Board of Directors authorized and the Company's shareholders' approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan. On May 23, 2012, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,122,930 additional shares of common stock to the 2009 Plan. On May 23, 2013, the Board of Directors authorized and the Company's shareholders approved the allocation of 2,317,000 additional shares of common stock to the 2009 Plan. On May 20, 2014, the Board of Directors authorized and the Company's shareholders approved the allocation of 500,000 additional shares of common stock to the 2009 Plan. On June 12, 2015, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,200,000 additional shares of common stock to the 2009 Plan. At December 31, 2016 there were 1,403,424 shares available for future grant under the 2009 Plan.

*Valuation Assumptions*

The determination of fair value of our stock-based awards is affected by assumptions regarding subjective and complex variables. Generally, our assumptions are based on historical information and judgment is required to determine if historical trends may be indicators of future outcomes. In accordance with ASC 718, the fair value of stock-based awards to employees is calculated as of the date of grant. Compensation expense is then recognized over the requisite service period of the award. Stock-based compensation expense recognized is based on the estimated portion of the awards that are expected to vest. Estimated forfeiture rates are applied in the expense calculation. The Company calculates the pool of additional paid-in capital associated with excess tax benefits in accordance with ASC 718. The Company determines the fair values of stock-based awards as follows:

- Service-Based Restricted Stock Awards, Restricted Stock Units, and Performance-Based Restricted Stock Awards: Fair value is determined based on the quoted market price of our common stock on the date of grant.
- Service-Based Stock Options and Performance-Based Stock Options: Fair value is determined using the Black-Scholes pricing model, which requires the use of estimates, including the risk-free interest rate, expected volatility, expected dividends, and expected term.
- Market-Based Restricted Stock Awards and Market-Based Stock Options: The fair value of the market-based awards is determined using a Monte-Carlo simulation model. The Monte Carlo valuation also estimates the number of market-based awards that would be awarded which is reflected in the fair value on the grant date.

For the years ended December 31, 2016, 2015, and 2014 the fair value of service-based stock options and performance-based stock options granted was calculated using the following assumptions in the Black-Scholes model:

	Years Ended December 31,		
	2016	2015	2014
Expected stock price volatility	46%-47%	49%-63%	63%-65%
Expected term of options	5.5-6.5 years	6 years	6 years
Expected dividend yield	—	—	—
Risk-free interest rate	1.24%-1.50%	1.19%-1.75%	1.46%-1.80%

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

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

For the years ended December 31, 2016, 2015, and 2014 the fair value of market-based stock options and market-based restricted stock awards granted was calculated using the following assumptions in the Monte-Carlo simulation model:

	Years Ended December 31,		
	2016	2015	2014
Expected stock price volatility	45%-49%	none	none
Expected term of options	1.7 years-7 years	none	none
Expected dividend yield	—	none	none
Risk-free interest rate	.71%-1.53%	none	none

***Stock-Based Compensation Expense***

Stock compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. For equity awards granted with market-based conditions, stock compensation is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.

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

	Years Ended December 31,		
	2016	2015	2014
<b>Included in cost of revenue:</b>			
Cost of subscription and service revenue	\$ (4)	\$ 44	\$ 13
Cost of product revenue	52	57	95
Total included in cost of revenue	48	101	108
<b>Included in operating expenses:</b>			
Sales and marketing	998	1,327	1,975
Research & development	709	841	958
General and administrative	3,151	4,926	3,721
Total included in operating expenses	4,858	7,094	6,654
Total	\$ 4,906	\$ 7,195	\$ 6,762

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

**10. STOCK-BASED COMPENSATION (Continued)***Service-Based Stock Options*

The following table summarizes the Company's service-based stock option activity from January 1, 2016 to December 31, 2016:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2016	1,837,165	\$ 10.58	7.70	\$ 130,262
Options granted	464,194	7.50		
Options exercised	(12,971)	4.42		
Options cancelled	(494,458)	10.65		
Options Outstanding, December 31, 2016	<u>1,793,930</u>	9.81	7.58	1,154,498
Vested and expected to vest at December 31, 2016	<u>1,687,078</u>	9.93	7.50	1,032,107
Exercisable at December 31, 2016	1,125,493	\$ 10.34	7.02	\$ 576,390

As of December 31, 2016 and 2015, there was approximately \$3.1 million and \$5.2 million of unrecognized compensation expense related to non-vested service-based stock options that is expected to be recognized over a weighted average period of 2.36 and 1.84 years, respectively.

Service-based 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. Service-based stock options generally vest over a four-year period based upon required service conditions and do not have performance or market conditions.

The weighted average remaining contractual term and the aggregate intrinsic value for service-based stock options outstanding at December 31, 2016 was 7.58 years and \$1.2 million, respectively. The weighted average remaining contractual term and the aggregate intrinsic value for service-based stock options exercisable at December 31, 2015 was 7.70 years and \$0.1 million, respectively. As of December 31, 2016, service-based stock options that were vested and exercisable totaled 1,125,493 shares of common stock with a weighted average exercise price per share of \$10.34.

The weighted average grant-date fair value per share of service-based stock options granted was \$3.41 and \$4.77 for the years ended December 31, 2016 and 2015, 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, 2016, and the exercise price, multiplied by the number of in-the-money service-based stock options) that would have been received by the option holders had all option holders exercised their options on December 31, 2016. 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)

*Service-Based Restricted Stock Awards*

The following table summarizes the Company's service-based restricted stock activity for the years ended December 31, 2016 and 2015, respectively:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2015	482,645	\$ 12.59	\$ 6,074,136
Awards granted	481,992	9.05	
Awards vested	(452,341)	10.56	
Awards canceled	(170,717)	11.88	
Nonvested Awards, December 31, 2015	341,579	10.61	3,624,153
Awards granted	300,650	7.59	
Awards vested	(196,001)	9.54	
Awards canceled	(71,848)	9.65	
Nonvested Awards, December 31, 2016	374,380	8.94	3,348,080

During 2016 and 2015, 300,650 and 481,992 shares of service-based restricted stock were granted, respectively. The aggregate grant date fair value of the service-based restricted stock awards in 2016 and 2015 was \$2.3 million and \$4.4 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 service-based restricted stock awards 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 2016, 71,848 shares of restricted stock were forfeited. As of December 31, 2016, future compensation cost related to the nonvested portion of the service-based restricted stock awards not yet recognized in the statement of operations was \$2.6 million and is expected to be recognized over a period of 2.06 years.

Service-based restricted stock awards are considered outstanding at the time of grant as the stockholders 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 service-based restricted stock awards are not considered outstanding in the computation of basic earnings per share.

*Restricted Stock Units*

The following table summarizes the Company's restricted stock unit activity from January 1, 2016 to December 31, 2016:

	Units Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Units Outstanding, January 1, 2016	187,942	\$ 11.16	\$ 1,257,332
Units granted	67,663	7.70	
Units released	(58,719)	11.51	
Units cancelled	(8,829)	8.50	
Units Outstanding, December 31, 2016	188,057	9.93	1,675,588
Vested and expected to vest at December 31, 2016	115,263	7.70	1,026,990
Vested and deferred at December 31, 2016	82,157	\$ 12.44	\$ 732,019

During 2016 and 2015, 67,663 and 63,436 restricted stock units were granted, respectively, to members of the Board of Directors as part of their compensation package. Restricted stock units convert to common stock following the separation of service with the Company. The aggregate grant date fair value of the awards in 2016 and 2015 was \$0.5 million and \$0.5 million, respectively. Beginning June 2015, all restricted stock unit awards vest quarterly over a one year period from the date

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

of grant, with expense recognized straight-line over the vesting period. Prior to June 2015, all restricted stock unit awards were immediately vested with expense recognized in full on the grant date. 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.

*Performance and Market Conditioned Restricted Stock Awards and Stock Options*

On April 4, 2016, the Company named Mr. John Hass as President, CEO and Chairman of the Board. In conjunction with his appointment, the Compensation Committee approved a stock-based compensation package for Mr. Hass aimed to provide significant reward potential for achieving outstanding Company operating performance results and building shareholder value. The package was comprised of performance-based restricted stock awards (PRSAs), performance-based stock options (PSOs), market-based restricted stock awards (MRSAs), and market-based stock options (MSOs). Awards also vest if a majority change in control of the Company occurs during the performance or vesting period.

*Performance Conditioned:*

In addition to the performance condition, the PRSAs and PSOs also have a service condition. Vesting of PRSAs and PSOs are dependent upon whether the Company achieves certain operating performance targets which are based on the Company's defined measures of revenue, bookings, adjusted free cash flow, and adjusted EBITDA, measured against the full-year 2016 operating results. Following the end of the performance measurement period on December 31, 2016, PRSAs and PSOs issued based on the operating performance metrics will vest 50%, 25%, and 25% on April 4, 2017, 2018 and 2019, respectively.

The Company records compensation expense ratably for each vesting tranche of the PRSAs and PSOs based on the probability that operating performance conditions will be met and to what extent. Changes in the probability estimates will be accounted for in the period of change using a cumulative catch-up adjustment to retroactively apply the new probability estimates. In any period in which the Company determines that achievement of the performance metrics is not probable, the Company ceases recording compensation expense and all previously recognized compensation expense for the award is reversed.

The PRSAs were granted at "target" (at 100% of target). Based upon actual attainment of the operating performance results through December 31, 2016 relative to target, actual issuance of RSAs can fall anywhere between a maximum of 200% and 0% of the target number of PRSAs originally granted. As of December 31, 2016, future compensation cost related to the nonvested portion of the PRSAs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 1.69 years.

The following table summarizes the Company's PRSA activity from January 1, 2016 to December 31, 2016:

	Nonvested PRSAs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested PRSAs, January 1, 2016	—	\$ —	\$ —
PRSAs granted	70,423	7.10	500,003
PRSAs vested	—	—	—
PRSAs canceled	—	—	—
Performance adjustments	(8,360)	—	—
Nonvested PRSAs, December 31, 2016	62,063	\$ 7.10	\$ 440,647

The PSOs were granted at "maximum" (at 200% of target). Based on actual attainment of the operating performance results through December 31, 2016 relative to maximum, actual issuance of stock options can fall anywhere between 100% and 0% of the maximum number of PSOs originally granted. As of December 31, 2016, future compensation cost related to the nonvested portion of the PSOs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 1.69 years.



ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's PSO activity from January 1, 2016 to December 31, 2016:

	PSOs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
PSOs Outstanding, January 1, 2016	—	\$ —	\$ —
PSOs granted	314,465	3.24	1,000,242
PSOs released	—	—	—
PSOs cancelled	—	—	—
Performance adjustments	(175,898)		
PSOs Outstanding, December 31, 2016	138,567	3.24	440,750
Vested and expected to vest at December 31, 2016	—	—	—
Exercisable at December 31, 2016	—	\$ —	\$ —

*Market Conditioned:*

In addition to the market condition, the MRSAs and MSOs also have a service condition. Vesting of these MRSAs and MSOs are dependent upon whether the Company achieves predetermined growth rates of total shareholder return for the two-year measurement period beginning on January 4, 2016 and ending on December 29, 2017. Following the end of the market performance measurement period on December 29, 2017, MRSAs and MSOs issued based on total shareholder return will vest annually on a pro-rata basis over three years beginning April 4, 2018. The Company records compensation expense ratably for each vesting tranche of the MRSAs and MSOs based on the Monte Carlo fair value estimated on the grant date, regardless of meeting or not meeting the market conditions.

The MRSAs were granted at "target" (at 100% of target). Based upon actual attainment of total shareholder return growth rate results through December 29, 2017 relative to target, actual issuance of RSAs can fall anywhere between a maximum of 200% and 0% of the target number of MRSAs originally granted. As of December 31, 2016, future compensation cost related to the nonvested portion of the MRSAs not yet recognized in the consolidated statement of operations was \$0.3 million and is expected to be recognized over a weighted average period of 2.56 years.

The following table summarizes the Company's MRSA activity from January 1, 2016 to December 31, 2016:

	Nonvested MRSAs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested MRSAs, January 1, 2016	—	\$ —	\$ —
MRSAs granted	70,423	6.17	434,510
MRSAs vested	—	—	—
MRSAs canceled	—	—	—
Nonvested MRSAs, December 31, 2016	70,423	\$ 6.17	\$ 434,510

The MSOs were granted at "maximum" (at 200% of target). Based on actual attainment of total shareholder return growth rate results through December 29, 2017 relative to maximum, actual issuance of stock options can fall anywhere between 100% and 0% of the maximum number of MSOs originally granted. As of December 31, 2016, future compensation cost related to the nonvested portion of the MSOs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 2.56 years.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's MSO activity from January 1, 2016 to December 31, 2016:

	MSOs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
MSOs Outstanding, January 1, 2016	—	\$ —	\$ —
MSOs granted	314,465	0.94	294,550
MSOs released	—	—	—
MSOs cancelled	—	—	—
MSO Outstanding, December 31, 2016	<u>314,465</u>	—	—
Vested and expected to vest at December 31, 2016	<u>—</u>	—	—
Exercisable at December 31, 2016	—	\$ —	\$ —

## 11. STOCKHOLDERS' (DEFICIT) EQUITY

At December 31, 2016, 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, 2016 and 2015, the Company had shares of Common Stock issued of 23,450,864 and 23,149,634, respectively, and shares of Common Stock outstanding of 22,450,864 and 22,149,634, respectively.

On August 22, 2013, the Company's Board of Directors approved a share repurchase program under which the Company is authorized to repurchase up to \$25.0 million of its outstanding common stock from time to time in the open market or in privately negotiated transactions depending on market conditions, other corporate considerations, debt facility covenants and other contractual limitations, and applicable legal requirements. For the year ended December 31, 2013, the Company paid \$11.4 million to repurchase 1,000,000 shares at a weighted average price of \$11.44 per share as part of this program. No shares were repurchased during the years ended December 31, 2014, 2015, or 2016. Shares repurchased under the program were recorded as treasury stock on the Company's consolidated balance sheet. The shares repurchased under this program during the year ended December 31, 2013 were not the result of an accelerated share repurchase agreement. Management has not made a decision on whether shares purchased under this program will be retired or reissued.

Holders of the Company's common stock are entitled to receive dividends when and if declared by the Board of Directors out of assets or funds legally available for that purpose. Future dividends are dependent on the Company's financial condition and results of operations, the capital requirements of its business, covenants associated with financing arrangements, other contractual restrictions, legal requirements, regulatory constraints, industry practice and other factors deemed relevant by its Board of Directors. The Company has not paid any cash dividends on its common stock and does not intend to do so in the foreseeable future.

## 12. 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. The Company recorded Company contribution matching expenses for the Plan totaling \$2.0 million, \$2.0 million, and \$2.2 million for the years ended December 31, 2016, 2015 and 2014, respectively.

## 13. RESTRUCTURING AND OTHER EMPLOYEE SEVERANCE

*2016 Restructuring Actions*

In the first quarter of 2016, the Company announced and initiated actions to withdraw the direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of Enterprise & Education Language offerings. The Company has also initiated processes to close its software development operations in France and China.

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

**13. RESTRUCTURING AND OTHER EMPLOYEE SEVERANCE (Continued)**

Restructuring charges included in the Company's consolidated statement of operations related to the 2016 Restructuring Plan include the following:

- Employee severance and related benefits costs incurred in connection with headcount reductions involving employees primarily in France, China, Brazil, Canada, Spain, Mexico, U.S. and the U.K.;
- Contract termination costs associated with operating lease terminations from office closures; and
- Other related costs.

The following table summarizes activity with respect to the restructuring charges for the 2016 Restructuring Plan during the year ended December 31, 2016 (in thousands):

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at December 31, 2016
Severance costs	\$ —	\$ 4,367	\$ (3,867)	\$ —	\$ 500
Contract termination costs	—	165	(74)	(69)	22
Other costs	—	590	(399)	(121)	70
<b>Total</b>	<b>\$ —</b>	<b>\$ 5,122</b>	<b>\$ (4,340)</b>	<b>\$ (190)</b>	<b>\$ 592</b>

(1) Other Adjustments includes non-cash period changes in the liability balance, which may include non-cash lease closure expense and foreign currency translation adjustments.

**2015 Restructuring Actions**

In the first quarter of 2015, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. During 2016, the final payments were made against the 2015 Restructuring Plan accruals and the Company does not expect to incur any additional restructuring costs in connection with the 2015 Plan.

Restructuring charges included in the Company's consolidated statement of operations related to the 2015 Restructuring Plan include the following:

- Employee severance and related benefits costs incurred in connection with headcount reductions involving employees primarily in the U.S. and the U.K.;
- Contract termination costs; and
- Other related costs.

The following table summarizes activity with respect to the restructuring charges for the 2015 Restructuring Plan during the years ended December 31, 2015 and December 31, 2016 (in thousands):

	Balance at January 1, 2015	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at December 31, 2015
Severance costs	\$ —	\$ 7,240	\$ (5,940)	\$ (1,048)	\$ 252
Contract termination costs	—	1,134	(1,134)	—	—
Other costs	—	417	(417)	—	—
<b>Total</b>	<b>\$ —</b>	<b>\$ 8,791</b>	<b>\$ (7,491)</b>	<b>\$ (1,048)</b>	<b>\$ 252</b>

(1) Other Adjustments includes non-cash period changes in the liability balance, which may include non-cash stock compensation expense and foreign currency translation adjustments.

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

**13. RESTRUCTURING AND OTHER EMPLOYEE SEVERANCE (Continued)**

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Balance at December 31, 2016
Severance costs	\$ 252	\$ 71	\$ (323)	\$ —
Contract termination costs	—	—	—	—
Other costs	—	—	—	—
<b>Total</b>	<b>\$ 252</b>	<b>\$ 71</b>	<b>\$ (323)</b>	<b>\$ —</b>

**Restructuring Cost**

The following table summarizes the major types of costs associated with the 2016 and 2015 Restructuring Plans for the years ended December 31, 2016 and 2015, and total costs incurred through December 31, 2016 (in thousands):

	Years ended December 31,		Incurred through December 31, 2016
	2016	2015	
Severance costs	\$ 4,438	\$ 7,240	\$ 11,678
Contract termination costs	165	1,134	1,299
Other costs	590	417	1,007
<b>Total</b>	<b>\$ 5,193</b>	<b>\$ 8,791</b>	<b>\$ 13,984</b>

As of December 31, 2016, the entire restructuring liability of \$0.6 million was classified as a current liability within accrued compensation and other current liabilities on the consolidated balance sheets.

The following table presents restructuring costs associated with the 2016 and 2015 Restructuring Plans included in the related line items of our Statement of Operations (in thousands):

	Years ended December 31,	
	2016	2015
Cost of revenue	\$ 573	\$ 113
Sales and marketing	2,324	4,492
Research and development	913	602
General and administrative	1,383	3,584
<b>Total</b>	<b>\$ 5,193</b>	<b>\$ 8,791</b>

These restructuring expenses are not allocated to any reportable segment under our definition of segment contribution as defined in Note 17 "Segment Information."

At each reporting date, the Company will evaluate its accrued restructuring costs to ensure the liabilities reported are still appropriate. Any changes to the estimated costs of executing approved restructuring plans will be reflected in the Company's consolidated statements of operations.

**2014 Employee Severance Actions**

On January 9, 2014, the Company completed its acquisition of Tell Me More, a company organized under the laws of France. At acquisition, the plan was to fully integrate Tell Me More into the operations of the Company. Following the acquisition, the Company undertook financial performance review of the French entity and of the Company as a whole. As a result, the Company identified the need to reduce expenses. In the second quarter of 2014, the Company began to create a plan to address the economic issues of the business through the reduction of expense. The result of this economic planning was to reduce headcount within certain business units of the French entity.

Under the requirements of French Labour Law, there is an expectation on the part of both the employer and employee that if an employee is terminated, the employer is required to pay a minimum amount of severance. Accordingly, the Company concluded that the termination benefits for certain employees as the result of the reduction in force in France were payable based upon an ongoing benefit arrangement. A severance liability became probable and estimable when the Company received

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**13. RESTRUCTURING AND OTHER EMPLOYEE SEVERANCE (Continued)**

approval from the French Labour Administration and when the specific employees impacted were determined. These criteria were met in the third quarter of 2014 and the Company recorded an accrual and related expense of \$1.0 million. Severance payments totaling \$0.5 million related to this reduction in force were paid during the fourth quarter of 2014 and \$0.4 million was paid in 2015.

During 2014, the Company initiated other actions across its business to reduce headcount in order to align resources to support business needs. The Company recorded \$3.2 million in severance costs associated with these actions. As a result, \$2.3 million was paid during 2014, \$0.8 million was paid during 2015, and the remaining \$0.1 million liability was paid in 2016.

As of December 31, 2016, the Company does not expect any further activity associated with the 2014 Employee Severance Actions and were considered closed and remaining accruals were reversed.

**14. LEASE ABANDONMENT AND TERMINATION**

As part of the Company's effort to reduce general and administrative expenses through a planned space consolidation at its Arlington, Virginia headquarters location, the Company incurred a lease abandonment charge of \$3.2 million for the year ended December 31, 2014. Prior to January 31, 2014, the Company occupied the 6th and 7th floors at its Arlington, Virginia headquarters. The Company estimated the liability under the operating lease agreements and accrued lease abandonment costs in accordance with ASC 420, *Exit or Disposal Cost Obligations* ("ASC 420"), as the Company has no future economic benefit from the abandoned space and the lease does not terminate until December 31, 2018. All leased space related to the 6th floor was abandoned and ceased to be used by the Company on January 31, 2014.

In a further effort to reduce general and administrative expenses through a planned space consolidation, effective October 10, 2016, the Company relocated its headquarters location to 1621 North Kent Street, Suite 1200, Arlington, Virginia 22209. The previously leased space at the 7th floor of 1919 North Lynn Street was abandoned and ceased to be used by the Company on October 10, 2016 and resulted in \$1.6 million in lease abandonment expense in the fourth quarter of 2016.

A summary of the Company's lease abandonment activity for the years ended December 31, 2016 and 2015 is as follows (in thousands):

	As of December 31,	
	2016	2015
Accrued lease abandonment costs, beginning of period	\$ 1,282	\$ 1,679
Costs incurred and charged to expense	1,644	55
Principal reductions	(803)	(452)
Accrued lease abandonment costs, end of period	\$ 2,123	\$ 1,282
Accrued lease abandonment costs liability:		
Short-term	\$ 1,047	\$ 455
Long-term	1,076	827
Total	\$ 2,123	\$ 1,282

**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, 2016 and 2015 (in thousands):

	As of December 31,	
	2016	2015
Deferred tax assets:		
Inventory	\$ 735	\$ 564
Net operating and capital loss carryforwards	61,174	48,334
Deferred revenue	10,862	13,908
Accrued liabilities	6,975	9,780
Stock-based compensation	4,440	4,656
Amortization and depreciation	1,056	31
Bad debt reserve	389	398
Foreign and other tax credits	1,881	1,517
Gross deferred tax assets	87,512	79,188
Valuation allowance	(78,363)	(70,464)
Net deferred tax assets	9,149	8,724
Deferred tax liabilities:		
Goodwill and indefinite lived intangibles	(6,098)	(4,782)
Deferred sales commissions	(7,060)	(7,337)
Prepaid expenses	(656)	(625)
Foreign currency translation	(1,508)	(973)
Other	—	(5)
Gross deferred tax liabilities	(15,322)	(13,722)
Net deferred tax liabilities	\$ (6,173)	\$ (4,998)

For the year ended December 31, 2016, the Company recorded income tax expense of \$2.5 million. The tax expense was primarily related to current year profits of operations in Germany and the U.K. Additionally, the tax expense relates to the tax impact of the amortization of U.S. indefinite-lived intangible assets and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities.

For the year ending December 31, 2015, the Company recorded income tax expense of \$1.2 million primarily related to current year operations in Germany and the UK and the tax impact of the amortization of indefinite lived intangibles, and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities. These tax expenses were partially offset by tax benefits related to current year losses (excluding the Consumer Fit Brains goodwill impairment) in Canada. The goodwill that was impaired is not deductible for tax. Additionally, tax benefits were recorded related to the reversal of accrued withholding taxes as a result of an intercompany transaction.

During the third quarter of 2012, the Company established a full valuation allowance to reduce the deferred tax assets of its operations in Brazil, Japan, and the U.S., resulting in a non-cash charge of \$0.4 million, \$2.1 million, and \$23.1 million, respectively. Additionally, no tax benefits were provided on 2012 losses incurred in foreign jurisdictions where the Company has determined a valuation allowance is required. As of December 31, 2016, a full valuation allowance was provided for domestic and certain foreign deferred tax assets in those jurisdictions where the Company has determined the deferred tax assets will more likely than not be realized.

If future events change the outcome of the Company's projected return to profitability, a valuation allowance may not be required to reduce the deferred tax assets. The Company will continue to assess the need for a valuation allowance.

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

**15. INCOME TAXES (Continued)**

As of December 31, 2016, the Company had federal, state and foreign tax NOL carryforward amounts and expiration periods as follows (in thousands):

<b>Year of Expiration</b>	<b>U.S. Federal</b>	<b>State</b>	<b>Brazil</b>	<b>France</b>	<b>Japan</b>	<b>Other Foreign</b>	<b>Total</b>
2017-2021	\$ —	\$ 679	\$ —	\$ —	\$ —	\$ —	\$ 679
2022-2026	—	2,308	—	—	11,824	—	14,132
2027-2031	—	11,526	—	—	—	377	11,903
2032-2036	86,621	76,568	—	—	—	3	163,192
2037-2041	39,304	33,777	—	—	—	909	73,990
Indefinite	—	—	4,309	8,193	—	665	13,167
<b>Totals</b>	<b>\$ 125,925</b>	<b>\$ 124,858</b>	<b>\$ 4,309</b>	<b>\$ 8,193</b>	<b>\$ 11,824</b>	<b>\$ 1,954</b>	<b>\$ 277,063</b>

As of December 31, 2016, the Company had federal and state capital loss carryforward amounts and expiration periods as follows (in thousands):

<b>Year of Tax Capital Loss Expiration</b>	<b>U.S. Federal</b>	<b>State</b>
2017-2021	\$ 6,837	\$ 4,947
2022-2026	—	—
2027-2031	—	128
2032-2036	—	—
2037-2041	—	—
Indefinite	—	—
<b>Totals</b>	<b>\$ 6,837</b>	<b>\$ 5,075</b>

As of December 31, 2016, the Company had federal tax credit carryforward amounts and expiration periods as follows (in thousands):

<b>Year of Tax Credit Expiration</b>	<b>U.S. Federal</b>
2017-2021	\$ —
2022-2026	1,517
2027-2031	121
2032-2036	218
2037-2041	—
Indefinite	25
<b>Totals</b>	<b>\$ 1,881</b>

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

**15. INCOME TAXES (Continued)**

The components of loss before income taxes and the provision for taxes on income consist of the following (in thousands):

	Years Ended December 31,		
	2016	2015	2014
United States	\$ (24,963)	\$ (41,458)	\$ (60,434)
Foreign	(84)	(4,179)	(19,761)
Loss before income taxes	<u>\$ (25,047)</u>	<u>\$ (45,637)</u>	<u>\$ (80,195)</u>
The provision for taxes on income consists of the following (in thousands):			
Federal	\$ —	\$ (157)	\$ 29
State	78	96	23
Foreign	1,250	444	1,258
Total current	<u>\$ 1,328</u>	<u>\$ 383</u>	<u>\$ 1,310</u>
Deferred:			
Federal	\$ 1,147	\$ 1,148	\$ (5,425)
State	169	169	(797)
Foreign	(141)	(541)	(1,577)
Total deferred	<u>1,175</u>	<u>776</u>	<u>(7,799)</u>
Provision (benefit) for income taxes	<u>\$ 2,503</u>	<u>\$ 1,159</u>	<u>\$ (6,489)</u>

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

	Years Ended December 31,		
	2016	2015	2014
Income tax benefit at statutory federal rate	\$ (8,766)	\$ (15,973)	\$ (28,068)
State income tax expense, net of federal income tax effect	219	231	(782)
Acquired intangibles	—	—	—
Nondeductible goodwill impairment	604	1,961	—
Other nondeductible expenses	384	88	482
Tax rate differential on foreign operations	(474)	(1,019)	276
Increase in valuation allowance	10,404	15,713	21,772
Tax audit settlements	—	(96)	—
Change in prior year estimates	—	225	(69)
Other tax credits	129	29	(102)
Other	3	—	2
Income tax expense (benefit)	<u>\$ 2,503</u>	<u>\$ 1,159</u>	<u>\$ (6,489)</u>

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

The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income tax expense (benefit). As of December 31, 2016 and 2015, the Company had no unrecognized tax benefits or interest and penalties.



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

**15. INCOME TAXES (Continued)**

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

	Years Ended December 31,	
	2016	2015
Balance at January 1,	\$ —	\$ 446
Increases for tax positions taken during prior years	—	—
Settlements with tax authorities	—	(446)
Reductions for tax positions taken during prior years	—	—
Lapse of statute of limitations	—	—
Balance at December 31,	<u>\$ —</u>	<u>\$ —</u>

The Company is subject to taxation in the U.S. and various states and foreign jurisdictions. The Company's tax years 2010 and forward are subject to examination by the tax authorities. The Company was under audit by the Internal Revenue Service for tax years 2009 to 2012. During 2015, the U.S. audit for tax years 2009 through 2012 concluded and resulted in the Company recording a \$0.1 million tax benefit. The previously recorded \$0.4 million of unrecognized tax benefits were settled as a result of the concluded IRS audit. The Company does not expect that the amounts of unrecognized tax benefits will change significantly within the next twelve months.

The Company had an accumulated consolidated deficit related to its foreign subsidiaries of \$21.6 million at December 31, 2016 and aggregate 2016 losses before income tax related to its foreign subsidiaries of approximately \$0.1 million. The Company has certain foreign subsidiaries with aggregate undistributed earnings of \$12.0 million at December 31, 2016. The foreign subsidiaries with aggregate undistributed earnings are considered indefinitely reinvested as of December 31, 2016. As a result of the multitude of scenarios in which the earnings could be repatriated, if desired, and the complexity of associated calculations, it is not practicable to estimate the amount of additional tax that might be payable on the undistributed foreign earnings.

The Company made income tax payments of \$0.8 million, \$1.4 million, and \$1.7 million, in 2016, 2015 and 2014, respectively.

**16. COMMITMENTS AND CONTINGENCIES*****Operating Leases***

The Company leases copiers, parking spaces, buildings, a warehouse, and office space under operating lease and site license arrangements, some of which contain renewal options.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. COMMITMENTS AND CONTINGENCIES (Continued)

The following table summarizes future minimum operating lease payments as of December 31, 2016 and the years thereafter (in thousands):

	As of December 31, 2016
Periods Ending December 31,	
2017	\$ 4,552
2018	4,363
2019	1,741
2020	1,004
2021	590
Thereafter	—
Total future minimum operating lease payments	\$ 12,250

Total expenses under operating leases were \$4.0 million, \$5.1 million and \$5.6 million during the years ended December 31, 2016, 2015 and 2014, respectively.

The Company accounts for its leases under the provisions of ASC topic 840, *Accounting for Leases* ("ASC 840"), 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.

***Royalty Agreements***

The Company has entered into agreements to license software from vendors for incorporation in the Company's offerings. Pursuant to some of these agreements, the Company is required to pay minimum royalties or license fees over the term of the agreement regardless of actual license sales. In addition, such agreements typically specify that, in the event the software is incorporated into specified Company products, royalties will be due at a contractual rate based on actual sales volumes. These agreements are subject to various royalty rates typically calculated based on the level of sales for those products. The Company expenses these amounts to cost of sales or research and development expense, as appropriate. Royalty expense was \$0.3 million, \$0.2 million, and \$31,000 for the years ended December 31 2016, 2015 and 2014, respectively.

***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.

***Litigation***

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.

## 17. SEGMENT INFORMATION

In March 2016, the Company announced its strategy to position the organization for success. The Company has prioritized the growth of literacy sales and is taking actions to align resources to drive this growth. As a result of this shift, the Company reevaluated its segment structure. Prior to the strategy shift, the Company was managed in two operating segments - "Enterprise & Education" and "Consumer". Following the shift, the Company is managed in three operating segments - "Enterprise & Education Language", "Literacy", and "Consumer". The current Literacy segment was previously a component of the "Enterprise & Education" segment and is comprised solely of the Lexia business. The Literacy segment focuses on delivering subscription-based English literacy-learning and assessment solutions to grades K through 12. The Company's

**ROSETTA STONE INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**
**17. SEGMENT INFORMATION (Continued)**

current operating segments also represent the Company's reportable segments. The Company will continue to evaluate its management reporting and will update its operating and reportable segments as appropriate.

The Company assesses profitability of each segment in terms of segment contribution. Segment contribution is the measure of profitability used by our Chief Operating Decision Maker ("CODM"). The CODM assesses profitability and performance of the Company on its current operating segments. Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. Segment contribution excludes depreciation, amortization, stock compensation, research and development, restructuring related expenses, and other non-recurring expenses. The Company does not allocate expenses beneficial to all segments, which include certain general and administrative expenses such as legal fees, payroll processing fees, and accounting related expenses. These expenses are included in the unallocated expenses section in the following table. Revenue from transactions between the Company's operating segments is not material. Prior periods have been reclassified to reflect our current segment presentation and definition of segment contribution.

With the exception of goodwill, the Company does not identify or allocate its assets by operating segment. Consequently, the Company does not present assets or liabilities by operating segment.

Operating results by segment for the years ended December 31, 2016, 2015, and 2014 were as follows (in thousands, except percentages):

	Years Ended December 31,		
	2016	2015	2014
<b>Revenue:</b>			
Enterprise & Education Language	\$ 72,083	\$ 76,129	\$ 74,788
Literacy	34,123	21,928	9,912
Consumer	87,883	119,613	177,153
Total revenue	<u>\$ 194,089</u>	<u>\$ 217,670</u>	<u>\$ 261,853</u>
<b>Segment contribution:</b>			
Enterprise & Education Language	\$ 28,304	\$ 21,321	\$ 16,945
Literacy	5,634	729	(2,984)
Consumer	21,120	30,047	28,012
Total segment contribution	<u>\$ 55,058</u>	<u>\$ 52,097</u>	<u>\$ 41,973</u>
<b>Unallocated expenses, net:</b>			
Unallocated cost of sales	5,624	3,023	2,775
Unallocated sales and marketing	6,574	9,303	7,632
Unallocated research and development	26,273	29,939	33,176
Unallocated general and administrative	37,933	46,836	53,095
Unallocated impairment	3,930	6,754	20,333
Unallocated lease abandonment and termination	1,644	55	3,812
Unallocated non-operating (income)/expense	(1,873)	1,824	1,345
Total unallocated expenses, net	<u>\$ 80,105</u>	<u>\$ 97,734</u>	<u>\$ 122,168</u>
<b>Loss before income taxes</b>	<u><b>\$ (25,047)</b></u>	<u><b>\$ (45,637)</b></u>	<u><b>\$ (80,195)</b></u>
<b>Segment contribution margin:</b>			
Enterprise & Education Language	39.3%	28.0%	22.7%
Literacy	16.5%	3.3%	(30.1)%
Consumer	24.0%	25.1%	15.8%

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 17. SEGMENT INFORMATION (Continued)

*Geographic Information*

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

The information below summarizes revenue from customers by geographic area as of December 31, 2016, 2015 and 2014, respectively (in thousands):

	Years Ended December 31,		
	2016	2015	2014
United States	\$ 162,815	\$ 177,966	\$ 212,070
International	31,274	39,704	49,783
Total revenue	\$ 194,089	\$ 217,670	\$ 261,853

The information below summarizes long-lived assets by geographic area classified as held and used for the years ended December 31, 2016 and 2015, respectively (in thousands):

	As of December 31,	
	2016	2015
United States	\$ 21,652	\$ 18,704
International	3,143	3,828
Total property and equipment, net	\$ 24,795	\$ 22,532

*Revenue by Product and Service*

The Company earns revenue from the sale of language-learning, literacy and brain fitness products and services. The information below summarizes revenue by type for the years ended December 31, 2016, 2015 and 2014, respectively (in thousands):

	As of December 31,		
	2016	2015	2014
Language learning	\$ 155,532	\$ 191,568	\$ 249,340
Literacy	34,123	21,928	9,912
Brain Fitness	4,434	4,174	2,601
Total revenue	\$ 194,089	\$ 217,670	\$ 261,853

## 18. RELATED PARTIES

As of December 31, 2016 and 2015, the Company had outstanding receivables from employees in the amount of \$22,000 and \$18,000, respectively.

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

**19. VALUATION AND QUALIFYING ACCOUNTS**

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

	Years Ended December 31,		
	2016	2015	2014
<b>Allowance for doubtful accounts:</b>			
Beginning balance	\$ 1,196	\$ 1,434	\$ 1,000
Charged to costs and expenses	709	1,657	2,405
Deductions—accounts written off	(833)	(1,895)	(1,971)
Ending balance	<u>\$ 1,072</u>	<u>\$ 1,196</u>	<u>\$ 1,434</u>
<b>Promotional rebate and coop advertising reserves:</b>			
Beginning balance	\$ 16,910	\$ 23,437	\$ 13,025
Charged to costs and expenses	18,337	40,563	39,249
Deductions - reserves utilized	(29,279)	(47,090)	(28,837)
Ending balance	<u>\$ 5,968</u>	<u>\$ 16,910</u>	<u>\$ 23,437</u>
<b>Sales return reserve:</b>			
Beginning balance	\$ 3,728	\$ 3,570	\$ 4,834
Charged against revenue	5,034	11,474	12,011
Deductions—reserves utilized	(7,424)	(11,316)	(13,275)
Ending balance	<u>\$ 1,338</u>	<u>\$ 3,728</u>	<u>\$ 3,570</u>
<b>Deferred income tax asset valuation allowance:</b>			
Beginning balance	\$ 70,464	53,809	33,866
Charged to costs and expenses	7,899	16,655	19,943
Deductions	—	—	—
Ending balance	<u>\$ 78,363</u>	<u>\$ 70,464</u>	<u>\$ 53,809</u>

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

**20. SUPPLEMENTAL QUARTERLY FINANCIAL INFORMATION (Unaudited)**

Summarized quarterly supplemental consolidated financial information for 2016 and 2015 are as follows (in thousands, except per share amounts):

	Three Months Ended			
	March 31,	June 30,	September 30,	December 31,
<b>2016</b>				
Revenue	\$ 48,002	\$ 45,716	\$ 48,693	\$ 51,678
Gross profit	\$ 39,954	\$ 37,752	\$ 40,322	\$ 41,740
Net loss	\$ (7,507)	\$ (8,978)	\$ (5,452)	\$ (5,613)
Basic loss per share	\$ (0.34)	\$ (0.41)	\$ (0.25)	\$ (0.25)
Shares used in basic per share computation	21,867	21,948	21,993	22,065
Diluted loss per share	\$ (0.34)	\$ (0.41)	\$ (0.25)	\$ (0.25)
Shares used in diluted per share computation	21,867	21,948	21,993	22,065
<b>2015</b>				
Revenue	\$ 58,442	\$ 51,411	\$ 49,802	\$ 58,015
Gross profit	\$ 47,140	\$ 42,391	\$ 41,136	\$ 48,476
Net loss	\$ (19,884)	\$ (8,175)	\$ (7,301)	\$ (11,436)
Basic loss per share	\$ (0.95)	\$ (0.38)	\$ (0.34)	\$ (0.52)
Shares used in basic per share computation	21,018	21,689	21,771	21,801
Diluted loss per share	\$ (0.95)	\$ (0.38)	\$ (0.34)	\$ (0.52)
Shares used in diluted per share computation	21,018	21,689	21,771	21,801

**21. SUBSEQUENT EVENTS**

**Extension of Credit Facility**

On March 10, 2017, the Company entered into the sixth amendment to its credit facility, which primarily extended the term to April 1, 2020.

**Definitive Agreement with SOURCENEXT**

On March 13, 2017, the Company entered into a series of agreements (the "Agreement") with SOURCENEXT Corporation, ("SOURCENEXT"), a leading software distributor and developer in Japan. Under the Agreement, the Company will provide a perpetual, exclusive license of certain brands and trademarks, including the primary Rosetta Stone brand, and product code for exclusive development and sale of language and education-related products in Japan.

In conjunction with the Agreement, the Company will receive approximately \$9 million and if certain additional brand licensing and technology transfers are successfully completed, SOURCENEXT will pay the Company an additional \$4 million, net of adjustments. In addition, the Company is guaranteed to receive minimum payments totaling an additional \$6 million over the next ten years. Finally, as part of the Agreement, the Company will have the first right to license and sell any products developed by SOURCENEXT under the Rosetta Stone trademark in territories outside of Japan.

**EXHIBIT INDEX**

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3.1	Second Amended and Restated Certificate of Incorporation (incorporated herein by reference to Exhibit 3.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
3.2	Third Amended and Restated Bylaws (incorporated herein by reference to Exhibit 3.1 filed with the Company's Current Report on Form 8-K filed on November 22, 2016).
4.1	Specimen certificate evidencing shares of common stock (incorporated herein by reference to Exhibit 4.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
4.2	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 (incorporated herein by reference to Exhibit 4.3 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on November 5, 2008).
10.1 +	2006 Incentive Option Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on September 23, 2008).
10.2 +	2009 Omnibus Incentive Plan, as amended and restated and effective June 12, 2015 (incorporated herein by reference to Exhibit 99.1 filed with the Company's Registration Statement on Form S-8 (No. 333-204904) filed on June 12, 2015).
10.3 +	Director Form of Option Award Agreement under the 2006 Plan (incorporated herein by reference to Exhibit 10.3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on September 23, 2008).
10.4 +	Director Form of Option Award Agreement under the 2009 Plan (incorporated herein by reference to Exhibit 10.6 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.5 +	Executive Form of Option Award Agreement under the 2006 Plan (incorporated herein by reference to Exhibit 10.4 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on September 23, 2008).
10.6 +	Executive Form of Option Award Agreement under the 2009 Plan (incorporated herein by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.7 +	Amended Executive Form of Option Award Agreement under 2009 Plan effective for awards after October 1, 2011 (incorporated herein by reference to Exhibit 10.25 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011).
10.8 +	Amended Executive Form of Option Award Agreement under 2009 Plan effective for awards after February 1, 2016 (incorporated herein by reference to Exhibit 10.11 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015).
10.9 +	Amended Executive Form of Option Award Agreement under 2009 Plan effective for awards granted May 9, 2016 (incorporated herein by reference to Exhibit 10.3 in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016.)
10.10 +	Form of Restricted Stock Award Agreement under the 2009 Plan (incorporated herein by reference to Exhibit 10.13 to Amendment No. 4 to the Company's Registration Statement on Form S-1 (No. 333-153632), filed on March 17, 2009).
10.11 +	Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards after October 1, 2011 (incorporated herein by reference to Exhibit 10.26 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011).
10.12 +	Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards after February 1, 2016 (incorporated herein by reference to Exhibit 10.11 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015).
10.13 +	Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards granted May 9, 2016 (incorporated herein by reference to Exhibit 10.3 in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016.)
10.14 +	Director Form of Restricted Stock Unit Award Agreement under the 2009 Plan (incorporated herein by reference to Exhibit 10.12 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.15 +	Director Form of Restricted Stock Unit Award Agreement under the 2009 Plan (for awards beginning June 2015) (incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2015)
10.16 +	2013 Rosetta Stone Inc. Long Term Incentive Program (pursuant to the Rosetta Stone Inc. 2009 Omnibus Incentive Plan) (incorporated herein by reference to Exhibit 10.24 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).

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10.17	+	Form of Award Agreement under the 2013 Long Term Incentive Program (incorporated herein by reference to Exhibit 10.25 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.18	+	2014 Executive Bonus Plan (incorporated herein by reference to Exhibit 10.23 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.19	+	Policy on Recoupment of Performance Based Compensation (Clawback Policy) (incorporated herein by reference to Exhibit 10.26 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.20	+	Rosetta Stone Inc. Change in Control Severance Plan (incorporated herein by reference to Exhibit 10.18 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.)
10.21		Form of Indemnification Agreement entered into with each director and executive officer (incorporated herein by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on September 23, 2008).
10.22		Form of Indemnification Agreement to be entered into with each director and executive officer, revised as of August 2015 (incorporated herein by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2015).
10.23	+	Executive Employment Agreement between Rosetta Stone Ltd. and Stephen Swad effective as of November 9, 2010 (incorporated herein by reference to Exhibit 10.1 filed with the Company's Current Report on Form 8-K filed on October 13, 2010).
10.24	+	Amendment to Executive Employment Agreement between Rosetta Stone Ltd. and Stephen Swad effective as of December 22, 2011 (incorporated herein by reference to Exhibit 10.22 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011).
10.25	+	Second Amendment to Executive Employment Agreement between Rosetta Stone Ltd. and Stephen Swad effective as of February 22, 2012 (incorporated herein by reference to Exhibit 10.23 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011).
10.26	+	Executive Employment Agreement between Rosetta Stone Ltd. and Judy Verses effective as of October 5, 2011 (incorporated herein by reference to Exhibit 10.18 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011).
10.27	+	Executive Employment Agreement between Rosetta Stone Ltd. and Thomas Piemo effective as of May 2, 2012 (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 1, 2012).
10.28	+	Executive Employment Agreement between Rosetta Stone Ltd. and Eric Ludwig effective as of January 1, 2015 (incorporated herein by reference to Exhibit 10.30 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.29	+	Director Agreement between Rosetta Stone Inc. and A. John Hass III effective as of November 18, 2014 (incorporated herein by reference to Exhibit 10.31 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.30	+	Executive Employment Agreement between Rosetta Stone Ltd. and A. John Hass III effective as of April 1, 2015 (incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2015).
10.31	+	Executive Employment Agreement between Rosetta Stone Ltd. and A. John Hass III effective as of April 1, 2016 (incorporated herein by reference to Exhibit 10.1 in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016.)
10.32	+	Executive Employment Agreement between the Company and Sonia Cudd, effective as of January 2, 2015 (incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2015).
10.33		Lease Agreement dated as of February 20, 2006, by and between Premier Flex Condos, LLC and Fairfield Language Technologies, Inc., as amended (incorporated herein by reference to Exhibit 10.10 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (No. 333-153632), filed on November 5, 2008).
10.34		Sublease Agreement dated as of October 6, 2008, by and between The Corporate Executive Board Company and Rosetta Stone Ltd. (incorporated herein by reference to Exhibit 10.11 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (No. 333-153632), filed on November 5, 2008).
10.35		First Amendment to Sublease Agreement with The Corporate Executive Board, dated as of November 1, 2012 (incorporated herein by reference to Exhibit 10.23 filed with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012).
10.36		Sub-Sublease Agreement dated as of April 3, 2014, by and between Rosetta Stone Ltd. and The Corporate Executive Board Company (incorporated herein by reference to Exhibit 10.27 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014).
10.37	*	Sub-Sublease Agreement dated as of July 14, 2016, by and between Rosetta Stone Ltd. and Snagajob.com, Inc.

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10.38	+	Software License Agreement by and between The Regents of the University of Colorado and Fairfield & Sons Ltd. dated as of December 22, 2006 (incorporated herein by reference to Exhibit 10.12 to Amendment No. 2 to the Company's Registration Statement on Form S-1 (No. 333-153632), filed on January 21, 2009).
10.39		Loan and Security Agreement between Rosetta Stone Ltd. and Silicon Valley Bank, executed on October 28, 2014 (incorporated herein by reference to Exhibit 99.3 filed to the Company's Current Report on Form 8-K filed on October 29, 2014).
10.40		First Amendment to Loan and Security Agreement between Rosetta Stone Ltd. and Silicon Valley Bank, effective as of March 31, 2015 (incorporated herein by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2015).
10.41		Second Amendment to Loan and Security Agreement between Rosetta Stone Ltd. and Silicon Valley Bank, effective as of May 1, 2015 (incorporated herein by reference to Exhibit 10.3 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2015).
10.42		Third Amendment to Loan and Security Agreement dated as of June 29, 2015 between Silicon Valley Bank and Rosetta Stone Ltd. (incorporated herein by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2015).
10.43		Fourth Amendment to Loan and Security Agreement dated as of December 29, 2015 between Silicon Valley Bank and Rosetta Stone Ltd (incorporated herein by reference to Exhibit 10.42 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.).
10.44		Fifth Amendment to Loan and Security Agreement dated as of March 14, 2016 between Silicon Valley Bank and Rosetta Stone Ltd. (incorporated herein by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2016).
10.45	*	Sixth Amendment to Loan and Security Agreement dated as of March 10, 2017 between Silicon Valley Bank and Rosetta Stone Ltd.
21.1		Rosetta Stone Inc. Subsidiaries.
23.1		Consent of Deloitte & Touche LLP, independent registered public accounting firm.
24.1		Power of Attorney.
31.1		Certifications of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2		Certifications of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1		Certifications of Principal Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2		Certifications of Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101		Interactive Data Files.

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\* Filed herewith.

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

+ Identifies management contracts and compensatory plans or arrangements.

## SUB-SUBLEASE AGREEMENT

**THIS SUB-SUBLEASE AGREEMENT** (this “**Sub-Sublease**”) is made and entered into as of the 14th day of July, 2016, by and between (i) **ROSETTA STONE LTD.**, a Virginia corporation (“**Sub-Sublandlord**”) and (ii) **Snagajob.com, Inc.**, a Delaware corporation, (“**Sub-Subtenant**”).

### Recitals:

A. Paramount Group, Inc. (as successor in interest to Waterview, L.P.) (“**Landlord**”) and the Corporate Executive Board Company (“**Tenant**”) are parties to that certain Deed of Lease dated as of August 16, 2004 (“**Prime Lease**”), pursuant to which Tenant leases floors 4 - 24 (the “**Prime Lease Premises**”) in the building located at 1919 North Lynn Street, Arlington, Virginia, (the “**Building**”), at the rent and subject to the terms and conditions set forth in the Prime Lease; and

B. Tenant (as “**Sublandlord**”) and Rosetta Stone Ltd. (as “**Subtenant**”) are parties to that certain Sublease Agreement dated as of October 6, 2008 (the “**Original Sublease**”), as amended by First Amendment to Sublease Agreement dated November 1, 2012 (the “**First Amendment to Sublease**,” and, together with the Original Sublease, the “**Sublease**”), pursuant to which Subtenant subleases a portion of the Prime Lease Premises consisting of the entire rentable area of the 6<sup>th</sup> and 7<sup>th</sup> floors of the Building (the “**Subleased Premises**”) from Sublandlord; and

C. Subtenant (as “**Sub-Sublandlord**”) desires to sub-sublease to Sub-Subtenant, and Sub-Subtenant desires to sub-sublease from Sub-Sublandlord a portion of the Subleased Premises consisting of the entire rentable area of the seventh (7th) floor of the Building (the “**Sub-Subleased Premises**”), containing approximately 31,281 rentable square feet as more particularly described in **Exhibit D**, upon the terms and conditions set forth herein.

**NOW THEREFORE**, in consideration of the mutual covenants set forth herein, the parties hereto agree as follows:

**1. Recitals: Incorporation of Terms.** The foregoing recitals, and, subject to Section 6 hereof, the terms and provisions of the Sublease, are incorporated herein by reference and are made a substantive part of this Sub-Sublease. Capitalized terms not defined herein shall have the meanings ascribed to such terms in the Sublease (and if not defined therein, then in the Prime Lease). This Sub-Sublease is subject and subordinate to the Sublease and the Prime Lease in all respects, unless otherwise stated herein. For all purposes under this Sub-Sublease, the rentable area of the Sub-Subleased Premises is hereby stipulated and agreed to be 31,281 rentable square feet, the rentable area of the Sublease Premises is stipulated and agreed to be 62,562 rentable square feet and the rentable area of the Building is hereby stipulated and agreed to be 625,062 rentable square feet,

which rentable areas shall not be subject to further calculation, except in the event of a change in the physical size of any such space.

## 2. Sub-Subleased Premises.

(a) **Sub-Sublease; Condition of Sub-Subleased Premises.** As of the Sub-Sublease Commencement Date (defined in Section 3 below), Sub-Sublandlord shall sub-sublease to Sub-Subtenant and Sub-Subtenant shall sub-sublease from Sub-Sublandlord, the Sub-Subleased Premises upon the terms and conditions set forth herein. Sub-Sublandlord shall tender possession of the Sub-Subleased Premises to Sub-Subtenant on the Sub-Sublease Commencement Date, vacant of occupants on the Sub-Sublease Commencement Date, with the removal, reconfiguration, and other work described in subsections (b), (c) and (e) below completed, and otherwise in broom-clean condition. Sub-Subtenant has fully inspected the Sub-Subleased Premises and, subject to Sub-Sublandlord's removal and reconfiguration obligations set forth in subsections (b) and (c) below, Sub-Subtenant shall accept the Sub-Subleased Premises in its "*as is,*" "*where-is*" condition as of the date hereof, including without limitation all mechanical, electrical and plumbing systems servicing the Sub-Subleased Premises. Sub-Subtenant acknowledges that, except as specifically set forth in this Sub-Sublease, no representations, statements or warranties, express or implied, have been made by or on behalf of Sub-Sublandlord with respect to the condition of the Sub-Subleased Premises or the Building, and that Sub-Sublandlord has made no representation, statement or warranty as to the leasing of any personal property, fixtures, or equipment in the Sub-Subleased Premises other than the Walls/Partitions, Systems Furniture, Personal Property and Supplemental HVAC (as each such term is defined below).

(b) **Systems Furniture and Modular Walls/Partitions.** The configuration of the Sub-Subleased Premises shall include modular walls and partitions, approximately as shown on Exhibit B-1, attached hereto, ("**Walls/Partitions**") and office systems furniture also shown on Exhibit B-1, attached hereto ("**Systems Furniture**"). Sub-Subtenant shall have the right to use the Walls/Partitions and Systems Furniture as part of the Sub-Subleased Premises at no additional charge, subject to the conditions hereof; provided, however, Sub-Sublandlord agrees to remove any Systems Furniture or Walls/Partitions or Personal Property (hereinafter defined) designated by Sub-Subtenant, all at Sub-Sublandlord's sole cost and expense. Sub-Subtenant shall be present to designate such items for removal on the day that Sub-Sublandlord moves out of the Subleased Premises. If not insured by the Sublandlord, Sub-Subtenant shall insure the Walls/Partitions and Systems Furniture under the special cause of loss business property insurance required by Section 17.A.(1) of the Prime Lease, naming Tenant as loss payee under such policy for the Walls/Partitions and Systems Furniture. Provided that Sub-Subtenant receives the prior written consent of Sublandlord and Sub-Sublandlord, Sub-Sublandlord's consent not to be unreasonably withheld, conditioned or delayed, Sub-Subtenant shall have the right to perform modifications to the Wall/Partitions and/or Systems Furniture in accordance with Section 2(b) of the Sublease.

(c) **Office Furniture.** In consideration for the rents and other promises contained in this Sub-Sublease, Sub-Sublandlord shall sub-lease to Sub-Subtenant (and Sub-Subtenant shall sub-lease from Sub-Sublandlord) the furniture and equipment listed on **Exhibit B-2** attached hereto (the “**Personal Property**”) at no extra cost or expense to Sub-Subtenant. Sub-Sublandlord shall remove any furniture and equipment located in the Sub-Sub-Subleased Premises in excess of that set forth on **Exhibit B-2** prior to the Sub-Sublease Commencement Date and any items designated by Sub-Subtenant for removal on the day that Sub-Sublandlord moves out of the Sub-Subleased Premises shall be removed within three (3) business days thereafter. The parties hereby agree to amend and replace **Exhibit B-2** promptly following such date that Sub-Sublandlord surrenders the Sub-Subleased Premises to Sub-Subtenant. Sub-Sublandlord represents and warrants that Sublandlord is the owner of the Personal Property, except as indicated in Exhibit B-2; however Sub-Sublandlord has full authority to sub-lease such Personal Property to Sub-Subtenant. Sub-Subtenant shall not have the right to remove all or any Personal Property from the Sub-Subleased Premises and hereby agrees to return the Personal Property to Sub-Sublandlord at the end of the Sub-Sublease Term in substantially the same condition as of the date hereof, normal wear and tear and damage from casualty excepted, and Sub-Subtenant shall make any necessary repairs or restoration to such Personal Property in the event such damage or restoration is required as a result of the negligent or willful misuse thereof by Sub-Subtenant. Unless insured by Sublandlord, Sub-Subtenant shall be responsible to insure the Personal Property under the special cause of loss business property insurance required by Section 17.A.(1) of the Prime Lease, naming Tenant as loss payee under such policy for the Personal Property.

(d) **Supplemental HVAC.** As of the date hereof, the Sub-Subleased Premises contains and/or is served by supplemental HVAC equipment as set forth on **Exhibit B-3** (“**Supplemental HVAC**”). Sub-Subtenant shall have the right to use the Supplemental HVAC under the terms and conditions hereinafter set forth. Sub-Sublandlord makes no representation or warranty as to the capacity or output of the Supplemental HVAC or to its sufficiency to service Sub-Subtenant’s particular requirements in the Sub-Subleased Premises, and Sub-Subtenant acknowledges that the Supplemental HVAC equipment is in its “*as is, where is*” condition. Sub-Subtenant shall reimburse Sub-Sublandlord from time to time, within thirty (30) days after invoice therefor, all costs for use of the Supplemental HVAC actually incurred by Sub-Sublandlord pursuant to invoice from Sublandlord, including, without limitation, costs for electricity and chilled water or condenser water (including any costs for depreciation charged by Landlord as set forth below) serving the Supplemental HVAC for use in the Sub-Sublease Premises. Sub-Sublandlord shall not be required, under any circumstance, to replace the Supplemental HVAC servicing the Sub-Subleased Premises or to perform repairs or maintenance thereto, but shall use commercially reasonable efforts to cause Sublandlord to require the services covered under Supplement HVAC service contract to be performed. Sub-Subtenant shall have no responsibility to replace the Supplemental HVAC or to perform repairs or maintenance thereto.

### 3. Term.

(a) **Sub-Sublease Term.** The term of this Sub-Sublease (the “**Sub-Sublease Term**”) shall commence on October 15, 2016 (the “**Sub-Sublease Commencement Date**”) and shall expire at midnight on December 15, 2018 (the “**Sub-Sublease Expiration Date**”), unless sooner terminated or cancelled in accordance with the terms of this Sub-sublease. If Sub-Sublandlord has not tendered possession of the Sub-Subleased Premises to Sub-Subtenant on or before October 15, 2016, then Sub-Subtenant, at its sole discretion, shall have the right to terminate this Sub-Sublease by delivering written notice of such termination to Sub-Sublandlord any time before October 31, 2016. There shall be no fee, payment, penalty or other sum due from Sub-Subtenant in connection with Sub-Subtenant’s exercise of its termination right in this Section 3(a). Notwithstanding anything contained herein to the contrary, the October 15, 2016 date set forth above shall be extended one day for each day that Sub-Sublandlord is delayed in delivering the Sub-Subleased Premises to Sub-Subtenant due to actions of Sublandlord, its employees, agents, or contractors or Sub-Subtenant or due to casualty or Unavoidable Delay.

(b) **Early Entry.** Provided no Default by Sub-Subtenant then exists, from and after the date that is fifteen (15) days immediately prior to the Sub-Sublease Commencement Date (such period, the “**Early Access Period**”), Sub-Subtenant shall be permitted to access the Sub-Subleased Premises (subject to the provisions of this subsection (b)) for purposes of inspecting same, surveying requirements, moving and performing any move-related tasks, including installing furniture, fixtures, equipment, voice and data systems, telecommunications cabling and wiring in the Sub-Subleased Premises (subject to the provisions of this Sub-Sublease, including, without limitation, Section 7 of this Sub-Sublease). Such access to the Sub-Subleased Premises shall be subject to commercially reasonable prior notice to and prompt approval by Sub-Sublandlord (each of which notice and approval may be telephonic or by email correspondence), and shall be at no charge to Sub-Subtenant, but in no event shall Sub-Subtenant be permitted to commence business operations in the Sub-Subleased Premises prior to the Sub-Sublease Commencement Date without the approval of Sub-Sublandlord. Sub-Sublandlord shall use reasonable efforts to assist with the coordination of Sub-Subtenant’s access to the Building and the Sub-Subleased Premises, such assistance shall specifically include coordination with the Building’s property manager. Notwithstanding the foregoing, neither Sub-Subtenant nor any agent, contractor, representative, employee or invitee of Sub-Subtenant (collectively, “**Invitee**”) shall enter the Sub-Subleased Premises during the Early Access Period during those times that Sub-Sublandlord determines, in its reasonable discretion, that such entry will substantially interfere with activities of Sub-Sublandlord or Sub-Sublandlord’s agents or employees in the Sub-Subleased Premises. Prior to each such event, Sub-Sublandlord shall notify Sub-Subtenant of specific times during which Sub-Subtenant may make such entry. During the Early Access Period, Sub-Subtenant and any of its Invitees shall use commercially reasonable efforts to neither delay nor otherwise inhibit the work being performed in the Sub-Subleased Premises by Sub-Sublandlord or Sub-Sublandlord’s agents

or employees. Sub-Sublandlord shall have no responsibility with respect to any items placed in the Sub-Subleased Premises by Sub-Subtenant or any Invitee prior to the Sub-Sublease Commencement Date, except to the extent any damage is caused to such property due to Sub-Sublandlord's gross negligence or willful misconduct. Sub-Subtenant shall reimburse Sub-Sublandlord, within thirty (30) days after invoice, all costs actually incurred by Sub-Sublandlord associated with Sub-Subtenant's access during the Early Access Period, including (i) costs which are billed to Sub-Sublandlord by Sublandlord, including, without limitation, engineering charges or overtime/extra hours service charges associated with non-business hour access to the Building, if any, and (ii) reasonable costs incurred by Sub-Sublandlord in repairing or replacing any damage to the Sub-Subleased Premises required to be repaired by Sublandlord under the Sublease or (iii) reasonable costs incurred by Sub-Sublandlord in repairing or replacing damage to any property or equipment located therein and required to be repaired by Sublandlord under the Sublease, which damage, in the case of (ii) and (iii) above, was caused by Sub-Subtenant or its Invitees. Notwithstanding anything in this Sub-Sublease to the contrary, all of the provisions of this Sub-Sublease (including, without limitation, all insurance, indemnity and utility provisions) shall apply during the Early Access Period, except that during such period Sub-Subtenant shall not be obligated to pay Rent.

(c) **Extension Option.** Provided that Sub-Subtenant elects to enter into a direct lease with Landlord, then, at Sub-Subtenant's election, the Sub-Sublease Extension Date shall be extended to December 31, 2018 upon the same terms and conditions set forth herein.

#### 4. **Rent.**

(a) **Base Sub-Subrent.** Beginning on the Sub-Sublease Commencement Date, and throughout the Sub-Sublease Term, Sub-Subtenant shall pay to Sub-Sublandlord, as base sub-subrent hereunder, an annual rental ("**Annual Base Sub-Subrent**") for each Sub-Sublease Year in an amount set forth below, which Annual Base Sub-Subrent shall increase as set forth below. For all purposes of this Sub-Sublease, the term "**Sub-Sublease Year**" shall mean, with respect to the first Sub-Sublease Year, the period commencing on the Sub-Sublease Commencement Date and ending at midnight on the day immediately before the first anniversary of the Sub-Sublease Commencement Date, and, with respect to future Sub-Sublease Years, the one year periods ending on the anniversary of such date thereafter. Annual Base Sub-Subrent through the Sub-Sublease Term shall be as follows:

<b>Sub-Sublease Year</b>	<b>Annual Base Sub-Subrent per Rentable Square Foot</b>	<b>Annual Base Sub-Subrent</b>	<b>Monthly Installment of Annual Base Sub-Subrent</b>
1 (Anticipated to be October 15, 2016 - October 14, 2017)*	\$39.00	\$1,219,959.00	\$101,663.25
2 (Anticipated to be October 15, 2017 - October 14, 2018)	\$40.17	\$1,256,557.77	\$104,713.15
3 (Anticipated to be October 15, 2018 to December 15, 2018**)	\$41.38	\$1,294,254.50	\$107,854.54

\* Subject to abatement as set forth in Section 4(b) below.

\*\* Subject to extension pursuant to Section 3(c) above.

(b) **Subrent Payments.** The Annual Base Sub-Subrent for each Sub-Sublease Year shall be payable by Sub-Subtenant to Sub-Sublandlord in equal monthly installments in advance; provided, however, in lieu of payment to Sub-Sublandlord, such payments shall be made directly to Sublandlord by Sub-Subtenant, following prior written notice to Sub-Subtenant signed by both Sublandlord and Sub-Sublandlord, if and to the extent required pursuant to the Consent (defined in Section 23 hereof). All payments of Annual Base Sub-Subrent shall be due and payable on the first day of each and every calendar month during the Sub-Sublease Term. Sub-Subtenant's obligation to pay Annual Base Sub-Subrent hereunder that accrues during the Sub-Sublease Term shall survive the expiration or earlier termination of this Sub-Sublease. In the event that the Sub-Sublease Term commences on a date other than the first day of a calendar month or expires on a day other than the last day of a calendar month, Annual Base Sub-Subrent owed for less than a full month shall be prorated on the basis of a 30-day month. Notwithstanding anything herein to the contrary, the first three (3) full calendar months' installments of Annual Base Sub-Subrent shall be abated (e.g. if the Sub-Sublease Commencement Date is October 15, 2016, the monthly installment of Annual Base Sub-Subrent shall be abated for November 2016, December 2016 and January 2017).

(c) **Additional Sub-Subrent.** For purposes hereof "**Additional Sub-Subrent**" means all other amounts (other than Annual Base Sub-Subrent) payable by Sub-Subtenant to Sub-Sublandlord pursuant to this Sub-Sublease, including, without limitation, costs arising from Sub-Subtenant's use of the Supplemental HVAC for servicing the Sub-Subleased Premises or electrical usage or costs incurred by Sub-Sublandlord under the Sublease arising or resulting from Sub-

Subtenant's use of the Sub-Subleased Premises, including Sub-Subtenant's payment obligations pursuant to Section 10 below. Annual Base Sub-Subrent hereunder shall be gross rent, such that Sub-Subtenant shall not be responsible to pay any pass-through expense rental in connection with this Sub-Sublease, such as those in Sections 5 B. and C of the Prime Lease and the Pass-Through Expense Rental (as defined in the Sublease) which includes both Operating Expenses and Real Estate Tax Expenses. Sub-Sublandlord shall continue to be responsible at its sole cost and expense to pay all such Pass-Through Expense Rental required under the Sublease, including Pass-Through Expense Rental for the Sub-Subleased Premises. "**Rent**" as used herein shall mean Annual Base Sub-Subrent and Additional Sub-Subrent.

5. **Permitted Use; Access.** The Sub-Subleased Premises shall be used by Sub-Subtenant only for general office use and uses ancillary thereto in accordance with all applicable Laws and for no other purpose, except as may be permitted by Sublandlord and the Prime Lease to the contrary. Subject to the provisions of the Prime Lease and this Sublease, Sub-Sublandlord shall not interfere with Sub-Subtenant's accessing the Sub-Subleased Premises in accordance with Section 12.A.(7) of the Prime Lease. Unless a longer time period is required pursuant to the terms of the Sublease or Prime Lease, Sub-Sublandlord shall not access the Sub-Subleased Premises unless Sub-Sublandlord has provided Sub-Subtenant at least twenty-hour (24) hours' advance written notice (except in case of emergency).

6. **Compliance with Sublease.**

(a) **Obligations under the Sublease.** Sub-Subtenant hereby acknowledges that it has read the Sublease, a true, correct and complete copy of which is attached hereto as **Exhibit C** and, except as set forth below, such Sublease is incorporated herein by reference as fully as if the terms and provisions thereof were set forth herein. Sub-Subtenant agrees to assume the same responsibilities and duties that the Sub-Sublandlord has as "Subtenant" to the Sublandlord with respect to the Sub-Subleased Premises, excepting matters relating to the identification of the Sub-Subleased Premises, and the amount and due dates of the rentals payable therefor, and other excluded or modified terms set forth herein provided, however, in no event shall Sub-Sublandlord be deemed to have assumed the responsibilities of the Sublandlord under the Sublease, unless such responsibilities have been expressly assumed herein. Notwithstanding the foregoing, upon the written request of Sub-Subtenant, Sub-Sublandlord agrees to use commercially reasonable efforts to enforce its rights under the Sublease against Sublandlord with respect to the Sub-Subleased Premises. Sub-Subtenant shall have the right, at Sub-Subtenant's sole cost and expense, to obtain consents, approvals and waivers directly from Sublandlord, and shall have the right to contact Sublandlord directly for enforcement of obligations of Sublandlord with respect to the Sublease so long as the obligations of Sub-Sublandlord as Subtenant under the Sublease are not increased by any of the foregoing and Sub-Sublandlord does not incur any additional costs or expenses under the Sublease resulting therefrom (or Sub-Subtenant agrees to reimburse Sub-Sublandlord for such



costs or expenses). If both Sublandlord's and Sub-Sublandlord's consent, approval or waiver are required pursuant to the terms of this Sub-Sublease and there are additional costs and expenses in connection with Sublandlord's consent, approval or waiver, Sub-Sublandlord shall not charge Sub-Subtenant any additional amount in connection with its request for consent, approval or waiver.

(b) **Incorporation of Sublease Provisions.** In furtherance of the provisions of Section 6(a), except as otherwise specifically provided for herein and to the extent they are not inconsistent with the terms and conditions of this Sub-Sublease, the sub-subletting effected hereby shall be upon all of the terms and conditions of the letting effected by the Sublease, except the provisions of the Sublease relating to "Sublandlord" shall be deemed to refer to Sub-Sublandlord, the provisions thereof relating to "Subtenant" shall be deemed to refer to Sub-Subtenant, the provisions of the Sublease relating to the Sublet Premises (as defined in the Sublease) shall be deemed to refer to the Sub-Subleased Premises, the provisions of the Sublease referring to the Sublease shall be deemed to refer to this Sub-Sublease, and the provisions of the Sublease relating to "Rent" shall be deemed to refer to Annual Base Sub-Subrent and Additional Sub-Subrent (unless, in any of the foregoing cases, the context otherwise requires). The foregoing notwithstanding, the following provisions of the Sublease shall not be applicable to this Sub-Sublease (except for the definitions contained therein): Section 4, 5, 7, 8, 11 (except for the requirements of the Letter of Credit), 12, 13, 15, and 16. With respect to the relationship between the Sub-Sublandlord and the Sub-Subtenant, the express terms and conditions of the Sub-Sublease shall govern (and where the Sub-Sublease is silent, the Sublease shall govern). If Sublandlord shall default in the performance of any of its covenants or obligations under the Sublease, Sub-Subtenant shall have the right, in the name of Sub-Sublandlord, to make any demand or institute any action or proceeding at law or in equity or otherwise against Sublandlord permitted under the Sublease for the enforcement of Sublandlord's obligations or covenants under the Sublease.

(c) **Avoidance of Sublease Termination.** Sub-Sublandlord and Sub-Subtenant each shall take no action or permit anything to be done which would cause a termination of the Prime Lease or the Sublease (provided that Sub-Sublandlord shall be entitled to terminate the Sublease pursuant to Section 9 of the Sublease in connection with the exercise of its rights following any condemnation or casualty affecting the Sub-Subleased Premises). Each of Sub-Sublandlord and Sub-Subtenant shall indemnify, defend and hold the other harmless from and against any loss, cost, damage or expense (including, without limitation, court costs and reasonable attorneys' fees) incurred as a result of a breach by Sub-Sublandlord or Sub-Subtenant, as the case may be, of the foregoing covenant. Without limiting any other right or remedy of Sub-Subtenant, if Sublandlord seeks to terminate the Sublease in connection with the default or alleged default by Sub-Sublandlord (or Subtenant under the Sublease), Sub-Sublandlord shall take all action required to maintain the Sublease in full force and effect for the benefit of Sub-Subtenant, and Sub-Sublandlord shall take all action required to reinstate the Sublease.

(d) **Actions Requiring Sublandlord Consent.** Whenever Sub-Subtenant desires to take any action that would require the consent of Sublandlord under the Sublease, Sub-Subtenant shall only take such action if the consent of each of Sublandlord and Sub-Sublandlord is obtained, which consent, in the case of Sub-Sublandlord, shall automatically be deemed obtained if consented to by Sublandlord so long as the obligations of Sub-Sublandlord as Subtenant under the Sublease are not increased by any of the foregoing and Sub-Sublandlord does not incur any additional costs or expenses under the Sublease resulting therefrom (or Sub-Subtenant agrees to reimburse Sub-Sublandlord for such costs or expenses).

**7. Alterations, Electrical Usage.**

**(a) Alterations.**

( i ) Sub-Subtenant shall not make or permit to be made any alterations, additions, improvements, or modifications to the Sub-Subleased Premises (an **“alteration”**) without (i) the prior written consent of Sub-Sublandlord and Sublandlord, the latter’s consent to be deemed granted in accordance with Section 6(d) above or, if Section 6(d) is not applicable, such consent not to be unreasonably withheld, conditioned or delayed, and (ii), to the extent required by the Prime Lease, the prior written consent of Landlord. If the alteration is a Cosmetic Alteration, then Sub-Sublandlord’s consent shall not be required (but Sub-Subtenant shall notify Sub-Sublandlord of such alteration). A **“Cosmetic Alteration”** is an alteration that is (i) cosmetic in nature (e.g., painting, wallcoverings, carpeting, hanging of artwork, and the like), and (ii) does not require a building permit to perform. If the alteration is other than a Cosmetic Alteration, then Sub-Sublandlord’s consent shall be required, which consent shall not be unreasonably withheld, conditioned or delayed (and which consent shall be deemed obtained if no response is made by Sub-Sublandlord to Sub-Subtenant’s request for consent within ten (10) days after Sub-Subtenant’s delivery of such written request to Sub-Sublandlord). Any alterations shall be made at Sub-Subtenant’s expense, in a good and workmanlike manner by contractors and subcontractors approved by Sublandlord, and, if required by the Prime Lease, by Landlord, provided, however, with respect to alterations affecting the Walls/Partitions or Systems Furniture, Sub-Subtenant shall use contractors, subcontractors and vendors designated by Sublandlord. All alterations shall be made only after Sub-Subtenant: (i) has obtained all necessary permits from governmental authorities having jurisdiction and has furnished copies thereof to Sublandlord, and (ii) has complied with all other requirements reasonably imposed by Sublandlord, including without limitation any requirements due to the underwriting guidelines of Sublandlord’s insurance carriers. At Sub-Subtenant’s expense, Sub-Sublandlord shall join in submitting Sub-Subtenant’s plans for any necessary governmental approval, if required by applicable law. Sub-Sublandlord’s consent (or deemed consent) to any alterations and approval (or deemed approval) of any plans and specifications constitutes approval of no more than the concept of these alterations and not a representation or warranty with respect to the quality or functioning of such alterations, plans and specifications. Sub-Subtenant shall reimburse Sub-Sublandlord any

charge actually incurred by Sub-Sublandlord by invoice from Sublandlord in connection with any alteration performed by or on behalf of Sub-Subtenant hereunder, and Sub-Sublandlord shall not charge Sub-Subtenant any amount in addition thereto. Sub-Subtenant hereby agrees to indemnify and hold Sub-Sublandlord harmless against and from any and all claims, damages, costs, and fines arising solely out of the alterations performed by or on behalf of Sub-Subtenant hereunder, except to the extent caused by the negligence or willful misconduct of Sub-Sublandlord or anyone acting by or through Sub-Sublandlord.

(ii) All alterations performed by or on behalf of Sub-Subtenant shall remain in place at the end of the Sub-Sublease Term unless Sublandlord requires removal of same in writing, in which event, Sub-Subtenant shall be responsible to restore those portions of the Sub-Subleased Premises altered by Sub-Subtenant that are required to be restored by Sublandlord, at Sub-Subtenant's sole cost and expense on or prior to the end of the Sub-Sublease Term (including any early termination thereof). Unless Sublandlord requires removal of any or all alterations performed by or on behalf of Sub-Subtenant, Sub-Subtenant shall have no obligation to remove the same. Upon written request from Sub-Subtenant to Sub-Sublandlord, as permitted under Section 8(B) of the First Amendment to Sublease, Sub-Sublandlord shall promptly request Sublandlord's determination of the restoration or removal of Walls/Partitions and Systems Furniture proposed by Sub-Sublandlord to be modified in accordance with the provisions of this Sub-Sublease, by delivering written request of such determination to Sublandlord, accompanied by a set of plans and specifications showing the proposed modifications (including identifying items that will be removed or altered). Sub-Sublandlord shall use commercially reasonable efforts to enforce its right under the Sublease to cause Sublandlord to respond within ten (10) business days following receipt of Sub-Sublandlord's written request for Sublandlord's determination (together with the plans and specifications regarding the proposed modification) as to whether Sublandlord will require the restoration or removal of the proposed modifications to the Walls/Partitions and/or Systems Furniture. Sublandlord's determination shall be promptly delivered to Sub-Subtenant after Sub-Sublandlord's receipt thereof. Notwithstanding anything to the contrary in this Sub-Sublease, the Sublease or the Prime Lease, Sub-Subtenant shall have no obligation to make or cause improvements or alterations the Sub-Subleased Premises and shall have no liability or responsibility to remove or restore any alterations made to the Sub-Subleased Premises prior to the Commencement Date of this Sub-Sublease.

(iii) **Electrical Usage.** Except to the extent caused by the negligence or willful misconduct of Sub-Sublandlord, Sub-Subtenant hereby agrees to indemnify and hold Sub-Sublandlord harmless against and from any and all claims, damages, costs, and fines arising out of or connected with Sub-Subtenant's use of electricity in the Sub-Subleased Premises in excess of the Sub-Subleased Premises Standard Electrical Capacity, which is five (5) watts per rentable square foot of the Sub-Subleased Premises (convenience) and 1.5 watts per rentable square foot Sub-Subleased Premises (lighting).

## 8. Liability for Damage or Injury and Indemnification.

(a) **Limitation of Liability; Indemnification.** Sub-Sublandlord shall not be liable for any damage to the Sub-Subleased Premises or any injury to persons sustained by Sub-Subtenant or its employees, agents, invitees, guests, or other persons caused by conditions or activities on the Sub-Subleased Premises or the Building (including, without limitation, the Cafeteria, Fitness Center, Bike Room or Shower Facilities), or activities of Sub-Subtenant in or upon the Building (including, without limitation, use of the Cafeteria, Fitness Center, Bike Room or Shower Facilities), except to the extent any loss, cost, damage or expense is attributable to the gross negligence or intentional misconduct of Sub-Sublandlord or its agents or employees, and subject to the waiver of subrogation provisions hereof and in the Sublease. Subject to the waiver of subrogation provisions set forth in subsection (b), below, except to the extent caused by the negligence or willful misconduct of Sub-Sublandlord or its agents or employees, (each of the foregoing, an **“Indemnified Party”**), Sub-Subtenant hereby indemnifies and saves harmless the non-negligent Indemnified Parties from any liability, loss, cost or expense (including, without limitation, reasonable attorneys’ fees) arising out of (i) Sub-Subtenant’s use or occupancy of the Sub-Subleased Premises, the Cafeteria, Fitness Center, Bike Room or Shower Facilities and (ii) Sub-Subtenant’s failure to keep, observe or perform any of the terms, provisions, covenants, conditions and obligations on Sub-Subtenant’s part to be kept, observed or performed under this Sub-Sublease. Subject to the waiver of subrogation provisions set forth in subsection (b), below, except to the extent caused by the gross negligence or willful misconduct of Sub-Subtenant, Sub-Sublandlord hereby indemnifies and saves harmless Sub-Subtenant from any liability, loss, cost or expense (including, without limitation, reasonable attorneys’ fees) arising out of (x) Sub-Sublandlord’s failure to keep, observe or perform any of the terms, provisions, covenants, conditions and obligations on Sub-Sublandlord’s part to be kept, observed or performed under this Sub-Sublease and (y) the negligence or willful misconduct of Sub-Sublandlord or anyone acting by or through Sub-Sublandlord. Sub-Subtenant’s and Sub-Sublandlord’s obligation hereunder shall survive the termination of this Sub-Sublease. Unless carried by Sublandlord, Sub-Subtenant shall carry all insurance, in form and substance as required of Sub-Sublandlord under the Sublease.

(b) **Waiver of Subrogation.** Notwithstanding anything to the contrary in this Sub-Sublease, whether the loss or damage is due to the negligence of Sub-Sublandlord or its agents or employees, Sub-Subtenant hereby releases Sub-Sublandlord and its agents and employees from responsibility for and waives its entire claim of recovery for (i) any and all loss or damage to the personal property of Sub-Subtenant located in the Sub-Subleased Premises arising out of any of the perils which are covered by Sub-Subtenant’s property insurance policy or which would be covered by an all-risk property insurance policy required to be obtained by the terms herein if such policy was obtained by Sub-Subtenant, or (ii) loss resulting from business interruption at the Sub-Subleased Premises, arising out of any of the perils which may be covered by the business interruption insurance policy carried by Sub-Subtenant or which would be covered by a business

interruption insurance policy required to be obtained by the terms herein, with twenty-four (24) months coverage if such policy was obtained by Sub-Subtenant. Similarly, notwithstanding anything to the contrary in this Sub-Sublease, whether the loss or damage is due to the negligence of Sub-Subtenant or its agents or employees, Sub-Sublandlord hereby releases Sub-Subtenant and its agents and employees from responsibility for and waives its entire claim of recovery for any and all loss or damage to personal property of Sub-Sublandlord located in the Sub-Subleased Premises, arising out of any of the perils which are covered by any such property insurance or business interruption insurance which Sub-Sublandlord obtains or would be covered if any such policy was obtained by Sub-Sublandlord if such policy was required to be obtained by the terms herein. Sub-Sublandlord and Sub-Subtenant shall each cause its respective insurance carrier(s) to consent to such waiver of all rights of subrogation against the other, and to issue an endorsement to all policies of insurance obtained by such party confirming that the foregoing release and waiver will not invalidate such policies. Sub-Subtenant shall only be required to obtain such insurance waiver if and to the extent Sublandlord has not done so for the benefit of Subtenant under the Sublease.

#### 9. Assignments and Subleases.

(a) Sub-Subtenant shall not have the right to assign, mortgage, pledge or otherwise encumber this Sub-Sublease or any interest herein (including any assignment by operation of law), or sub-sublet all or any part of the Sub-Subleased Premises (any of the foregoing, a “**transfer**”) without the prior written consent of either Sub-Sublandlord or Sublandlord, including, without limitation, transfers to Permitted Transferees (hereinafter defined). Sub-Sublandlord’s approval shall be deemed given in accordance with Section 6(d) of this Sub-Sublease and if Section 6(d) of this Sub-Sublease does not apply, such approval shall not be unreasonably withheld, conditioned or delayed. No assignment or sub-subletting shall relieve Sub-Subtenant from primary liability for all obligations of Sub-Subtenant under this Sub-Sublease, whether accruing before or after the date of such assignment or sub-subletting. For purposes of this Sub-Sublease, the term “sublet” or “sub-sublet” shall be deemed to include the granting of any rights of occupancy of any portion of the Sub-Subleased Premises. Any attempted transfer in violation of the requirements of this Section 9 shall be null and void and of no force or effect. Notwithstanding anything to the contrary in the Prime Lease or Sublease, Sub-Sublandlord shall not have recapture rights.

(b) Except for transfers to Permitted Transferees, if Sub-Subtenant wishes to enter into a transfer, Sub-Subtenant must provide not less than ten (10) days’ prior written notice thereof to Sub-Sublandlord, which notice shall include the proposed effective date of such assignment or sublease, and in the case of a proposed sublease, shall specify the space to be sublet.

(c) The consent (or deemed consent) by Sub-Sublandlord to any transfer shall neither be construed as a waiver or release of Sub-Subtenant from any covenant or obligation of Sub-Subtenant under this Sub-Sublease, nor as relieving Sub-Subtenant from giving Sub-

Sublandlord the aforesaid ten (10) days' notice of, or from obtaining the consent of Sub-Sublandlord as and in accordance with subsection (a) above, to, any further transfer. The collection or acceptance of rent from any such transferee shall not constitute a waiver or release of Sub-Subtenant from any covenant or obligation of Sub-Subtenant under this Sub-Sublease, except as expressly agreed by Sub-Sublandlord in writing.

(d) Notwithstanding anything contained herein to the contrary, the Sub-Subleased Premises may be occupied by, or subleased or assigned to, a Sub-Subtenant Affiliate (as hereinafter defined), and such occupancy, assignment or sublease shall be permitted provided Sub-Subtenant delivers notice thereof to Sub-Sublandlord prior to such occupancy, assignment or sublease and such Sub-Subtenant Affiliate agrees in writing to assume all obligations of Sub-Subtenant under this Sub-Sublease. For purposes of this subparagraph, a **"Sub-Subtenant Affiliate"** shall mean an entity that, directly or indirectly Controls, is Controlled by, or is under common Control with Sub-Subtenant. For purposes of this subparagraph, **"Control"** shall mean ownership of sufficient stock or membership or partnership interests of an entity to have voting control of such entity (such as ownership of 50% or more of the outstanding voting stock of a corporation or of the outstanding membership, partnership or other similar interest if such entity is not a corporation). Notwithstanding anything contained herein to the contrary, Sub-Subtenant may assign this Sub-Sublease to an entity with which Sub-Subtenant merges, consolidates or which purchases all or substantially all of Sub-Subtenant's stock or assets (a **"Successor"**) without Sub-Sublandlord's prior written approval. The term **"Permitted Transferee"** shall mean a Sub-Subtenant Affiliate or Successor, and the term **"Permitted Transfer"** shall mean a transfer to Permitted Transferee in accordance with this Section 9(d). In the event of a transfer to a Sub-Subtenant Affiliate, Sub-Subtenant shall not be released from any covenant or obligation of Sub-Subtenant under this Sub-Sublease, but shall remain jointly and severally liable with Sub-Subtenant Affiliate for the performance of all covenants and obligations hereunder. In the event of a transfer to a Successor, such Successor shall expressly assume all obligations of Sub-Subtenant under this Sub-Sublease in writing.

#### 10. **Services and Amenities.**

(a) **Services.** Anything contained in this Sub-Sublease to the contrary notwithstanding, the only services or rights to which Sub-Subtenant is entitled hereunder are those to which Sub-Sublandlord is entitled under the Sublease from Sublandlord. In the event Sub-Sublandlord is entitled to any rental abatement on account of any interruption of essential services to the Sub-Subleased Premises (and not other portions of the Subleased Premises subleased by Sub-Sublandlord pursuant to the Sublease) pursuant to the terms of the Sublease, Sub-Subtenant shall be entitled to proportionately abate its rental obligations hereunder for the same period of time. Sub-Subtenant shall, within thirty (30) days of demand, pay or reimburse Sub-Sublandlord for all costs and expenses actually incurred by Sub-Sublandlord (i) payable under the Sublease arising

solely out of Sub-Subtenant's acts or omissions with respect to this Sub-Sublease or the Sub-Subleased Premises or Sub-Subtenant's requests for services in excess of those provided by Landlord and included in Operating Expenses under the Prime Lease in connection with the Sub-Subleased Premises and (ii) for services to the Sub-Subleased Premises requested in writing by Sub-Subtenant which are provided directly by Sublandlord and billed to Sub-Sublandlord, including (a) supplemental chilled or condenser water, (b) above building standard or overtime HVAC, (c) extra cleaning, (d) overtime or dedicated freight elevator service, and (e) any maintenance, repair or other service for which a separate charge is payable to Landlord under the Prime Lease or which is provided by Sublandlord, and (f) any janitorial service in excess of those described on Exhibit E of the Prime Lease. Sublandlord currently causes the carpeting in the elevator lobby of the Sub-Subleased Premises to be cleaned approximately once per quarter, which frequency exceeds that set forth in the standard janitorial specifications set forth on Exhibit E of the Prime Lease; such excess is not subject to a separate charge.. To the extent Sub-Sublandlord is billed for such costs, Sub-Subtenant shall pay the excess charge to Sub-Sublandlord that is allocable to the Sub-Subleased Premises as Additional Sub-Subrent from time to time. Sublandlord currently maintains the Supplemental HVAC, as well as the water heaters, water filters, VAV boxes, and appurtenances thereto. To the extent Sub-Sublandlord is billed by Sublandlord for such costs attributable to the Sub-Subleased Premises, Sub-Subtenant shall pay its proportionate share of such maintenance costs to Sub-Sublandlord as Additional Sub-Subrent from time to time. Sub-Sublandlord shall charge Sub-Subtenant the actual costs of those excess services set forth in this Section 10(a) and in no event add any costs or expenses to Sub-Subtenant's proportionate share of such costs, such as a management fee, administration fee, or other markup. Notices from Sub-Subtenant requesting overtime HVAC services shall be delivered to the Director fo Support Services for the Corporate Executive Board Company (or such other contact of which Sub-Sublandlord notifies Sub-Subtenant from time to time). The current cost for overtime HVAC services is: i) Eighty-nine dollars and 50 cents (\$89.50) per hour for up to three (3) hours; and ii) One hundred and ninety-six dollars and 50 cents (\$196.50) per hour for four (4) or more hours. Sub-Sublandlord shall provide Sub-Subtenant with up to two hundred twenty-five (225) access card keys for its employees at Five and 00/100 Dollars (\$5.00) per card. Sub-Subtenant may obtain additional or replacement access card keys for its employees by written request to Sub-Sublandlord, at Sub-Sublandlord's actual cost therefor. Security management is provided to Building by Kastle Systems.

(b) **Amenities.** Subject to Sublandlord's prior written approval, Sub-Subtenant shall have access to and use of, at no cost to Sub-Subtenant, the Cafeteria and Fitness Facility (as such terms are defined in the Sublease) upon the same terms and conditions set forth in the Sublease. If Sublandlord does not provide such written, Sections 28(a), (b) and (d) of the Sublease shall not apply. Sub-Subtenant shall have access to and use of the bike room and shower facilities provided by Landlord in accordance with the terms of the Sublease. Sub-Subtenant acknowledges that Sub-Sublandlord does not have sole authority over the amenities in this Subsection 10(b); however, Sub-Sublandlord shall not take any action or permit anything to be done which would cause Sub-Subtenant to lose its rights to the use and access of the Cafeteria, Fitness Facility, bike room and shower facilities.

11. **Default.** In the event that Sub-Subtenant shall be in default beyond any applicable notice and cure period of any covenant or obligation under this Sub-Sublease, or if any other default set forth in Section 19 of the Prime Lease occurs with respect to Sub-Subtenant and is not cured within the applicable notice and cure periods set forth in such Section 19, then Sub-Sublandlord shall have available to it all of the remedies available to Sublandlord under the Sublease in the event of a like default or failure on the part of the Subtenant thereunder. Sub-Subtenant shall have the same cure periods and notice rights in connection with a default under this Sub-Sublease as Tenant has under the Prime Lease; provided, however, if Sub-Sublandlord receives a notice of default from Sublandlord relating to a default by Sub-Subtenant, then Sub-Sublandlord shall immediately provide the notice to Sub-Subtenant and the period of time to cure such Sub-Subtenant default set forth in such default notice shall govern. Sub-Sublandlord shall use commercially reasonable efforts to mitigate its damages resulting from a default under this Sub-Sublease by Sub-Subtenant beyond any applicable notice and cure period. Notwithstanding anything contained herein to the contrary, except with respect to payments that are required to be made by Sub-Subtenant directly to Sub-Sublandlord hereunder which fail to be paid within the timeframes required hereby, Sub-Sublandlord shall not declare a default against Sub-Subtenant unless Sublandlord has delivered a notice of such default to Subtenant under the Sublease with respect to the actions or omissions of Sub-Subtenant (including failure of Sub-Subtenant to pay Sub-Subrent directly to Sublandlord). In no event shall Sub-Subtenant be liable for consequential or punitive damages.

12. **No Waiver.** The failure of either party to insist at any time upon the strict performance of any covenant or agreement herein, or to exercise any option, right, power or remedy contained in this Sub-Sublease shall not be construed as a waiver or a relinquishment thereof for the future. No act or thing done by Sub-Sublandlord or its agents during the term hereof shall be deemed an acceptance or surrender of the Sub-Subleased Premises, and no agreement to accept a surrender of the Sub-Subleased Premises shall be valid unless in writing and signed by Sub-Sublandlord.

13. **Surrender of Sub-Subleased Premises; Holdover.** Upon the expiration or other termination of the Sub-Sublease Term, Sub-Subtenant shall quit and surrender to Sub-Sublandlord



the Sub-Subleased Premises, broom clean, in good order and condition, ordinary wear and tear and damage from casualty excepted, and Sub-Subtenant shall remove all of its property as provided in Section 10.B. of the Prime Lease. Sub-Subtenant shall only be required to remove alterations that are required to be removed by Sublandlord in writing and are not the obligation of Sub-Sublandlord to be removed pursuant to the terms of the Sublease. In the event of holding over by Sub-Subtenant or any person or entity claiming under Sub-Subtenant after expiration or other termination of the Sub-Sublease Term, or in the event Sub-Subtenant continues to occupy the Sub-Subleased Premises after the termination of Sub-Subtenant's right of possession due to a default by Sub-Subtenant, such holding over or possession shall constitute a tenancy at sufferance. In the event of any such holding over, Sub-Sublandlord shall have the right, in accordance with applicable law, to enter upon and take possession of the Sub-Subleased Premises. Sub-Subtenant shall, throughout the entire holdover period, pay Rent at the times and in the manner required by this Sub-Sublease; provided, however, if Sub-Subtenant holds over in the Sub-Subleased Premises after the Sub-Sublease Expiration Date, and if Sub-Sublandlord desires to repossess the Sub-Subleased Premises at any time after the Sub-Sublease Expiration Date, then Sub-Sublandlord shall deliver written notice requiring Sub-Subtenant to vacate the Sub-Subleased Premises (the "**Vacation Notice**"), which vacation and surrender shall occur not earlier than the later of (x) thirty (30) days after the Vacation Notice or (y) the Termination Date (the "**Vacation Date**"). If Sub-Subtenant has not vacated and surrendered the Sub-Subleased Premises to Sub-Sublandlord on or before the Vacation Date, then, from and after the Vacation Date, and during the holdover period, in addition to Sub-Sublandlord's other rights and remedies, Sub-Subtenant shall pay Monthly Base Sub-Subrent to Sub-Sublandlord in an amount equal to 150% of the Monthly Base Sub-Subrent in effect during the last month of the Sub-Sublease Term, prorated for the number of days of holdover past the Vacation Date. No holding over by Sub-Subtenant after the expiration of the Sub-Sublease Term and no acceptance of Rent by Sub-Sublandlord during a holdover period, whether with or without the consent of Sub-Sublandlord, shall be construed to extend the Sub-Sublease Term or prevent Sub-Sublandlord from recovering immediate possession of the Sub-Subleased Premises by summary proceedings or otherwise. In addition, in the event of any unauthorized holding over by Sub-Subtenant which results in holdover under the Sublease by Sub-Sublandlord, Sub-Subtenant will protect, defend, indemnify and hold Sub-Sublandlord harmless from and against any claims, demands, liability, costs, expenses or damages (including reasonable attorneys' fees) for which Sub-Sublandlord may become liable to Sublandlord under the Sublease due to such holding over.

#### 14. **Security Deposit.**

(a) Within one (1) business day after Sub-Sublandlord provides Sub-Subtenant with written notice of Landlord's and Sublandlord's acceptance of this Sub-Sublease, Sub-Subtenant shall deliver to Sub-Sublandlord a security deposit ("**Security Deposit**") in the amount of the then-current amount of three (3) Monthly Installments of Annual Base Sub-Subrent, which Security Deposit may be in the form of cash or a letter of credit that conforms to the requirements for the

form of Letter of Credit set forth in Section 11(b) of the Sublease, to secure the payment and performance by Sub-Subtenant of all of Sub-Subtenant's obligations, covenants, conditions and agreements under this Sub-Sublease. If in the form of cash, Sub-Sublandlord shall not be required to keep the Security Deposit separate from other funds or accounts of Sub-Sublandlord and the Security Deposit shall not bear interest. If Sub-Subtenant defaults in the observance or performance of any of such terms and conditions (beyond any applicable notice and cure period of any covenant or obligation under this Sub-Sublease), Sub-Sublandlord may use or apply all or any part of the Security Deposit for the payment of any Rent not paid when due or for the payment of any other amounts due Sub-Sublandlord by reason of such default, including any actual and reasonable costs of Sub-Sublandlord's observing or performing such terms or conditions on Sub-Subtenant's behalf and any deficiencies in reletting or damages incurred by Sub-Sublandlord. If Sub-Sublandlord shall use or apply all or any part of the Security Deposit, Sub-Subtenant shall, within five (5) business days' after receipt of written notice of such use or application, deliver to Sub-Sublandlord additional funds so as to restore the Security Deposit to the amount specified above. If Sub-Subtenant shall faithfully observe and perform all of the terms and conditions of this Sub-Sublease or cure any default thereof, the Security Deposit, or so much thereof as shall not have been used or applied in accordance with this Section 14, shall be returned to Sub-Subtenant within thirty (30) days after the expiration or sooner termination of this Sub-Sublease and the vacation and surrender of the Sub-Sublet Premises in accordance with this Sub-Sublease. In the event of any assignment of Sub-Sublandlord's interest in this Sub-Sublease, Sub-Sublandlord shall transfer the Security Deposit to such assignee, in which event such assignee shall hold, use and apply the Security Deposit in accordance with the covenants, terms and conditions of this Sub-Sublease. Following receipt of written notice of transfer of the Security Deposit, Sub-Subtenant shall look solely to the assignee for the return of the Security Deposit and Sub-Sublandlord shall thereupon be released from all liability to Sub-Subtenant for the return of the Security Deposit. Sub-Subtenant shall not assign (other than to a permitted assignee of this Sub-Sublease) or encumber its interest in the Security Deposit and no such assignment or encumbrance shall be valid or binding upon Sub-Sublandlord unless Sub-Sublandlord provides written consent to such assignment or encumbrance. **Broker.** Each party represents and warrants to the other that, except for CBRE, Inc. ("**Sub-Sublandlord's Broker**") and Jones Lang LaSalle Brokerage, Inc. ("**Sub-Subtenant's Broker**") and, together with Sub-Sublandlord's Broker, "**Brokers**") (i) no broker brought about this transaction or dealt with either party in connection herewith, and (ii) neither party has had any dealings with any real estate broker, finder or other person, with respect to this Sub-Sublease in any manner. Each party agrees to indemnify, defend and hold harmless the other against and from any and all losses, costs, claims, damages and expenses (including, without limitation, reasonable attorneys' fees) which may be claimed by any broker (other than the Brokers) by reason of any dealings, actions or agreements with the indemnifying party. Sub-Sublandlord agrees to compensate the Brokers pursuant to the terms of a separate agreement between Sub-Sublandlord and the Brokers.

(b) If Tenant is not currently in a monetary default beyond any applicable notice and cure periods as of April 15, 2017 and October 15, 2017 respectively (a) prior to April 15, 2017, then the amount of the Security Deposit shall be reduced to two (2) Monthly Installments of Annual Base Sub-Subrent, and (b) prior to October 15, 2017, then the amount of the Security Deposit shall be reduced to one and one half (1.5) Monthly Installments of Annual Base Sub-Subrent. If the Security Deposit is held in cash, Landlord shall return to Tenant one (1) Monthly Installment of Annual Sub-Subrent within five (5) days following each applicable reduction date (i.e. by April 20, 2017 and October 20, 2017). If the Security Deposit is held in the form of a letter of credit, Landlord and Tenant shall cooperate to cause the appropriate reduction in the letter of credit within five (5) days after each applicable reduction date.

15. **Notices.** Sub-Sublandlord shall concurrently send to Sub-Subtenant copies of any notices to Sublandlord or Landlord and shall immediately deliver to Sub-Subtenant copies of any notices from Sublandlord or Landlord. All notices given or required to be given pursuant to the provisions hereof shall be in writing and shall only be sent by reputable overnight delivery service or certified mail, postage prepaid, return receipt requested, to the following addresses, or to such other address as the party to be notified shall specify in writing by such notice:

Sub-Sublandlord: Rosetta Stone Ltd.  
135 West Market Street  
Harrisonburg, VA 22801  
Attention: General Counsel

Sub-Subtenant: **SNAGAJOB.COM**  
At the Sub-Subleased Premises  
Attn: Alisha A. Rodrigues

With a copy to:  
Cooley LLP  
11951 Freedom Drive  
Suite 1500  
Reston, Virginia 20190  
Attn: Michelle G. Schulman

Notices shall be deemed given and effective upon the date of delivery (or refusal to accept delivery) if delivered by hand or overnight delivery service, and upon the date set forth on the return receipt therefor if delivered by certified mail.

16. **Parking.** Sub-Subtenant shall have the ongoing right, but not the obligation, to obtain non-reserved, first-come, first-served parking contracts, by contracting directly with the Garage Operator, for the parking of up to thirty-seven (37) automobiles in the Garage upon the same rental, terms and conditions in the parking contracts that the Garage makes available to Sub-Sublandlord,

and Sub-Sublandlord hereby relinquishes and shall have no further rights with respect to such spaces under the Sublease. The current rates paid by Sub-Sublandlord to Garage are: i) One hundred and seventy-five dollars (\$175) per general parking space; and ii) Three hundred and fifty dollars (\$350) per reserved parking space. All parking rights granted to Sub-Subtenant shall be at Sub-Subtenant's sole risk. Sub-Subtenant shall obtain parking access keys directly from Sublandlord at Sub-Subtenant's expense. Notwithstanding anything to the contrary in the Sublease, Sub-Sublandlord shall not have the right to issue permits (or to cause such issuance) or establish other reasonable parking controls (or cause such controls to be established) in addition to those in place as of the date hereof.

17. **Sub-Subtenant Signage.** Subject to written approval by Sublandlord, Sub-Subtenant shall have the right to install, at its expense, (a) signage in the Building lobby and (b) suite entry signage at the entrance to the Sub-Subleased Premises, in a location and with dimensions as approved by Sublandlord. Sub-Subtenant shall be permitted to remove Sub-Sublandlord's signage in order to install its signage. Sub-Subtenant acknowledges and agrees that the Building does not have a lobby directory. Sub-Sublandlord shall cooperate in good faith to obtain any required approvals to lobby and suite entry signage; provided, however, if Sublandlord and Landlord (if required under the Prime Lease) do not approve the signage, the Sub-Sublandlord and Sub-Subtenant shall work together in good faith to redesign the signage package and resubmit to the necessary parties.

18. **Waiver of Jury Trial.** THE PARTIES HERETO EACH HEREBY WAIVES ALL RIGHT TO TRIAL BY JURY IN ANY CLAIM, ACTION, PROCEEDING OR COUNTERCLAIM BY EITHER PARTY AGAINST THE OTHER ON ANY MATTERS ARISING OUT OF OR IN ANY WAY CONNECTED WITH THIS SUB-SUBLEASE, THE RELATIONSHIP OF THE PARTIES HERETO OR SUB-SUBTENANT'S USE OR OCCUPANCY OF THE SUB-SUBLEASED PREMISES.

19. **Reciprocal Litigation Costs.** In the event of any litigation between Sub-Sublandlord and Sub-Subtenant, the unsuccessful party as determined by a court of competent jurisdiction shall reimburse the successful party for all reasonable legal fees, court costs and out-of-pocket expenses incurred by the successful party in prosecuting or defending any such action. For the purposes of this Section 20, "litigation" shall include any legal proceeding or retention of an attorney to enforce any right or obligation under this Sub-Sublease.

20. **Estoppel Certificates.** Each party shall, from time to time, within ten (10) business days following request by the other party, execute and deliver to such persons as requested by such party, a statement certifying that this Sub-Sublease is unmodified and in full force and effect (or if there have been modifications, that the same is in full force and effect as so modified), stating the dates to which Annual Base Sub-Subrent and other charges payable under this Sub-Sublease have

been paid, and stating that, to the certifying party's knowledge, the requesting party is not in default hereunder (or if a default is alleged to exist, stating the nature of such alleged default).

21. **Representations.** Sub-Sublandlord represents and warrants that, as of the date hereof: (a) to the best of Sub-Sublandlord's knowledge, as of the Sub-Sublease Commencement Date the Sub-Subleased Premises are in compliance with all applicable Laws and all systems servicing the Sub-Subleased Premises, including mechanical, electrical and plumbing systems and the Supplemental HVAC, are in good working order and repair, (b) Sub-Sublandlord has not caused the presence of Hazardous Materials in, on or under the Sub-Subleased Premises, (c) Sub-Sublandlord has not received any notice from the Sublandlord asserting that Sub-Sublandlord is in Default under the Sublease and, to its knowledge, it is not aware of any default on its part under the Sublease, (d) the Sublease is unmodified and in full force and effect; and (e) Sub-Sublandlord has the power and authority to enter into this Sub-Sublease. Sub-Subtenant represents and warrants that it has the power and authority to enter into this Sub-Sublease.

22. **Consent of Sublandlord.** The parties shall enter into the Consent of Sublandlord letter agreement substantially in the form attached hereto as **Exhibit A** on or about the date hereof the ("**Consent**"). If Sublandlord fails to execute the Consent within thirty (30) days after written request therefor, following full execution and delivery by both parties of this Sub-Sublease, then either party shall have the right to terminate this Sub-Sublease by written notice thereof to the other party and Sublandlord, which must be delivered within five (5) business days after expiration of such thirty (30) day period (time being of the essence), else such right to terminate is automatically waived and of no further force or effect.

23. **Miscellaneous.**

(a) **Time of the Essence.** Time is of the essence in the performance by both parties with respect to their obligations hereunder.

(b) **Severability.** In the event any part of this Sub-Sublease is held to be unenforceable or invalid for any reason, the balance of this Sub-Sublease shall not be affected and shall remain in full force and effect during the term of this Sub-Sublease.

(c) **Binding Effect.** The covenants, conditions, agreements, terms and provisions of this Sub-Sublease shall be binding upon and shall inure to the benefit of the parties hereof and each of their respective successors and assigns, subject to the restrictions and limitations set forth herein.

(d) **Governing Law.** It is the intention of the parties hereto that this Sub-Sublease (and the terms and provisions hereof) shall be construed and enforced in accordance with the laws of the Commonwealth of Virginia.

(e) **Entirety.** It is understood and agreed by and between the parties hereto that this Sub-Sublease and the Consent contain the final and entire agreement between the parties relative to the subject matter hereof, and that they shall not be bound by any terms, statements, conditions or representations relative to the subject matter hereof, oral or written, express or implied, not herein contained. This Sub-Sublease may not be changed or terminated orally or in any manner other than by an agreement in writing and signed by all parties hereto.

(f) **Submission Not an Offer.** The submission of this Sub-Sublease by either party to the other shall not constitute an offer by such party and neither party shall be bound in any way unless and until this Sub-Sublease is executed and delivered by both parties.

(g) **Counterparts.** This Sub-Sublease may be executed in two (2) or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

(h) **Exhibits.** The exhibits attached hereto are made a substantive part of this Sub-Sublease.

(i) **Appointment of Resident Agent.** For purposes of § 55-218.1 of the Code of Virginia, Sub-Sublandlord appoints as its resident agent: \_\_\_\_\_.

(j) **No Recordation.** Neither party shall have the right to record this Sub-Sublease or the Sublease.

(k) **Intentionally omitted.**

(l) **Quiet Enjoyment.** Sub-Sublandlord covenants and agrees with Sub-Subtenant that so long as no default by Sub-Subtenant exists under this Sub-Sublease after notice and applicable cure periods have passed, Sub-Subtenant shall have quiet and undisturbed and continuous possession of the premises, free from any claims against the Sub-Sublandlord and all persons claiming under it, by or through the Sub-Sublandlord.

(m) **No Merger or Imputed Obligations.** The covenants, representations, warranties, and obligations of Sub-Subtenant under this Sub-Sublease shall apply only to Sub-Subtenant and shall not be conferred or imputed to Sublandlord under the Sublease or to Tenant under the Prime Lease, regardless of any unity of identity among the entities comprising Sub-Subtenant, Sublandlord and Tenant. Each of the Prime Lease, Sublease, and Sub-Sublease shall be and remain separate and distinct documents and none of the rights and obligations among them shall merge notwithstanding unity of identity among parties thereto.

*[Signature Page Follows]*

IN WITNESS WHEREOF, the parties hereto have made and entered into this Sub-Sublease Agreement under seal as of the date and year first set forth above.

WITNESS/ATTEST:  <u>[signed as witness]</u>	<b>SUB-SUBTENANT:</b>  <b>SNAGAJOB.COM</b>  By: <u>/s/ Keith Haas</u>  Name: <u>Keith Haas</u> Title: <u>CFO</u>
WITNESS/ATTEST:  <u>Vivian Dinh</u>	<b>SUB-SUBLANDLORD:</b>  <b>ROSETTA STONE LTD.</b>  By: <u>/s/ Thomas M. Pierno</u>  Name: <u>Thomas M. Pierno</u> Title: <u>CFO</u>

Exhibits to be attached:

- Exhibit A: Form of Consent of Sublandlord
- Exhibit B-1: Walls/Partitions and Systems Furniture
- Exhibit B-2: Personal Property
- Exhibit B-3: Supplemental HVAC
- Exhibit C: Prime Lease and Sublease
- Exhibit D: Sub-Subleased Premises

## SIXTH AMENDMENT TO LOAN AND SECURITY AGREEMENT

This Sixth Amendment to Loan and Security Agreement (this “**Amendment**”) is entered into this 10<sup>th</sup> day of March, 2017, by and between (i) **SILICON VALLEY BANK**, a California corporation with a loan production office located at 275 Grove Street, Suite 2-200, Newton, Massachusetts 02466 (“**Bank**”), and (ii) **ROSETTA STONE LTD.**, a Virginia corporation, and **LEXIA LEARNING SYSTEMS LLC**, a Delaware limited liability company (individually and collectively, jointly and severally, the “**Borrower**”).

### RECITALS

**A.** Bank and Borrower have entered into that certain Loan and Security Agreement dated as of October 28, 2014, as amended by a certain First Amendment to Loan and Security Agreement dated March 31, 2015, as further amended by a certain Second Amendment to Loan and Security Agreement dated May 1, 2015, as further amended by a certain Third Amendment to Loan and Security Agreement dated June 26, 2015, as further amended by a certain Fourth Amendment to Loan and Security Agreement dated December 29, 2015, and as further amended by a certain Joinder and Fifth Amendment to Loan and Security Agreement dated March 14, 2016 (as the same may from time to time be further amended, modified, supplemented or restated, the “**Loan Agreement**”).

**B.** Bank has extended credit to Borrower for the purposes permitted in the Loan Agreement.

**C.** Borrower has requested that Bank amend the Loan Agreement to make certain revisions to the Loan Agreement as more fully set forth herein.

**D.** Bank has agreed to so amend certain provisions of the Loan Agreement, but only to the extent, in accordance with the terms, subject to the conditions and in reliance upon the representations and warranties set forth below.

### AGREEMENT

**NOW, THEREFORE**, in consideration of the foregoing recitals and other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, and intending to be legally bound, the parties hereto agree as follows:

**1. Definitions.** Capitalized terms used but not defined in this Amendment shall have the meanings given to them in the Loan Agreement.

**2. Amendments to Loan Agreement.**

**2.1 Section 2.1.2(e) (Letters of Credit).** Section 2.1.2(e) is deleted in its entirety and replaced with the following:

“(e) To guard against fluctuations in currency exchange rates, upon the issuance of any Letter of Credit payable in a Foreign Currency, Bank shall create a

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reserve (the “**Letter of Credit Reserve**”) under the Revolving Line in an amount equal to a percentage (which percentage shall be determined by Bank in its sole discretion) of the face amount of such Letter of Credit. The amount of the Letter of Credit Reserve may be adjusted by Bank from time to time to account for fluctuations in the exchange rate. The availability of funds under the Revolving Line shall be reduced by the amount of such Letter of Credit Reserve for as long as such Letter of Credit remains outstanding.”

**2.2 Section 2.5(c) (Fees; Termination Fee).** Subsection (c) of Section 2.5 is deleted in its entirety and replaced with the following:

“( c ) Termination Fee. Upon termination of this Agreement by Borrower for any reason (or upon the acceleration of the Obligations in accordance with Section 9.1 hereof) prior to the first anniversary of the Sixth Amendment Effective Date, in addition to the payment of any other amounts then-owing, a termination fee in an amount equal to one percent (1.00%) of the Revolving Line; provided that no termination fee shall be charged if the credit facility hereunder is replaced with a new facility from Bank;”

**2.3 Section 3.2 (Conditions Precedent to all Advances).** Subsections (a) and (b) of Section 3.2 are deleted in their entirety and replaced with the following:

“(a) timely receipt of the Credit Extension request and any materials and documents required by Section 3.4;

(b) the representations and warranties in this Agreement shall be true, accurate, and complete in all material respects on the date of the proposed Credit Extension and on the Funding Date of each Credit Extension; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, and no Event of Default shall have occurred and be continuing or result from the Credit Extension. Each Credit Extension is Borrower’s representation and warranty on that date that the representations and warranties in this Agreement remain true, accurate, and complete in all material respects; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date; and”

**2.4 Section 3.4 (Procedures for Borrowing).** Section 3.4 is deleted in its entirety and replaced with the following:

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**“3.4 Procedures for Borrowing.** Subject to the prior satisfaction of all other applicable conditions to the making of an Advance (other than Advances under Sections 2.1.2) set forth in this Agreement, to obtain an Advance, Borrower shall notify Bank (which notice shall be irrevocable) by electronic mail by 12:00 p.m. Eastern time on the Funding Date of the Advance. Such notice shall be made by Borrower through Bank’s online banking program, provided, however, if Borrower is not utilizing Bank’s online banking program, then such notice shall be in a written format acceptable to Bank that is executed by an Authorized Signer. Bank shall have received satisfactory evidence that the provision of such notices and the requests for Advances have been approved by the Board. In connection with any such notification, Borrower must promptly deliver to Bank by electronic mail or through Bank’s online banking program such reports and information, including without limitation, sales journals, cash receipts journals, accounts receivable aging reports, as Bank may request in its sole discretion. Bank shall credit proceeds of an Advance to the Designated Deposit Account. Bank may make Advances under this Agreement based on instructions from an Authorized Signer or without instructions if the Advances are necessary to meet Obligations which have become due.”

**2.5 Section 6.2(h) (Financial Statements, Reports, Certificates).** Subsection (h) of Section 6.2 is deleted in its entirety and replaced with the following:

“(h) a Borrowing Base Report (and any schedules related thereto and including any other information requested by Bank with respect to Borrower’s Accounts) (i) on the first Business Day of each month and the fifteenth (15<sup>th</sup>) day of each month when a Streamline Period is not in effect and there are Advances outstanding under the Revolving Line, (ii) within thirty (30) days after the end of each month when a Streamline Period is in effect and there are Advances outstanding under the Revolving Line, and (iii) within forty-five (45) days after the end of each fiscal quarter if there are no Advances outstanding under the Revolving Line;”

**2.6 Section 6.4(c) (Accounts Receivable; Collection of Accounts).** Subsection (c) of Section 6.4 is deleted in its entirety and replaced with the following:

“(c) Collection of Accounts. Each Credit Party shall direct Account Debtors to deliver or transmit all proceeds of Accounts into a lockbox account (with respect to check receipts) or such other “blocked account” as may be specified by Bank (either such account, the “**Cash Collateral Account**”). Whether or not an Event of Default has occurred and is continuing, Borrower shall immediately deliver all payments on and proceeds of Accounts to the Cash Collateral Account. Subject to Bank’s right to maintain a reserve pursuant to Section 6.3(g), all amounts received in the Cash Collateral Account shall be (i) applied to immediately reduce the Obligations when a Streamline Period is not in effect (unless Bank, in its sole discretion, at times when an Event of Default exists, elects not to so apply such amounts), or (ii) transferred on a daily basis to the Designated Deposit Account when a Streamline Period is in effect. Borrower hereby authorizes Bank to transfer to the

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Cash Collateral Account any amounts that Bank reasonably determines are proceeds of the Accounts (provided that Bank is under no obligation to do so and this allowance shall in no event relieve Borrower of its obligations hereunder).”

**2.7 Section 6.4(e) (Accounts Receivable).** Subsection (e) of Section 6.4 is deleted in its entirety and replaced with the following:

“(e) Verifications; Confirmations; Credit Quality; Notifications. Bank may, from time to time, (i) verify and confirm directly with the respective Account Debtors the validity, amount and other matters relating to the Accounts, either in the name of Borrower or Bank or such other name as Bank may choose, and notify any Account Debtor of Bank’s security interest in such Account and/or (ii) conduct a credit check of any Account Debtor to approve any such Account Debtor’s credit.”

**2.8 Section 6.4(g) (Accounts Receivable).** The following new subsection (g) is hereby inserted in Section 6.4 immediately following subsection (h) thereof:

“(g) Reserves. Notwithstanding any terms in this Agreement to the contrary, at times when an Event of Default exists, Bank may hold any proceeds of the Accounts and any amounts in the Cash Collateral Account that are not applied to the Obligations pursuant to Section 6.4(c) above (including amounts otherwise required to be transferred to Borrower’s operating account with Bank when a Streamline Period is in effect) as a reserve to be applied to any Obligations regardless of whether such Obligations are then due and payable.”

**2.9 Section 6.11 (Access to Collateral; Books and Records).** Section 6.11 is amended in its entirety and replaced with the following:

“**6.11 Access to Collateral; Books and Records.** At reasonable times, on three (3) Business Days’ notice (provided no notice is required if an Event of Default has occurred and is continuing), Bank, or its agents, shall have the right to inspect the Collateral and the right to audit and copy Borrower’s Books. Such inspections and audits shall be conducted no more often than once every twelve (12) months unless an Event of Default has occurred and is continuing in which case such inspections and audits shall occur as often as Bank shall determine is necessary. The foregoing inspections and audits shall be conducted at Borrower’s expense and the charge therefor shall be One Thousand Dollars (\$1,000) per person per day (or such higher amount as shall represent Bank’s then-current standard charge for the same), plus reasonable out-of-pocket expenses. In the event Borrower and Bank schedule an audit more than ten (10) days in advance, and Borrower cancels or seeks to or reschedules the audit with less than ten (10) days written notice to Bank, then (without limiting any of Bank’s rights or remedies) Borrower shall pay Bank a fee of One Thousand Dollars (\$1,000) plus any out-of-pocket expenses incurred by Bank to compensate Bank for the anticipated costs and expenses of the cancellation or rescheduling.”

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**2.10 Section 6.16 (Online Banking).** The following new Section 6.16 is hereby inserted immediately following Section 6.15:

**“6.16 Online Banking.** Utilize Bank’s online banking platform for all matters requested by Bank which shall include, without limitation (and without request by Bank for the following matters), uploading information pertaining to Accounts and Account Debtors, requesting approval for exceptions, requesting Credit Extensions, and uploading financial statements and other reports required to be delivered by this Agreement (including, without limitation, those described in Section 6.2 of this Agreement).”

**2.11 Section 8.2(a) (Covenant Default).** Section 8.2(a) is amended in its entirety and replaced with the following:

“(a) Any Credit Party fails or neglects to perform any obligation in Sections 6.2 (and has failed to cure such default within three (3) Business Days), 6.3 (and has failed to cure such default within three (3) Business Days), 6.4, 6.5 (and has failed to cure such default within ten (10) Business Days), 6.6 (and has failed to cure such default within ten (10) Business Days), 6.7 (and has failed to cure such default within three (3) Business Days), 6.8, 6.11, 6.12 (and has failed to cure such default within ten (10) Business Days), 6.14 or 6.16 or violates any covenant in Section 7; or”

**2.12 Section 9.2 (Power of Attorney).** Section 9.2 is deleted in its entirety and replaced with the following:

**“9.2 Power of Attorney.** Borrower hereby irrevocably appoints Bank as its lawful attorney-in-fact, exercisable following the occurrence of an Event of Default, to: (a) endorse Borrower’s name on any checks, payment instruments, or other forms of payment or security; (b) sign Borrower’s name on any invoice or bill of lading for any Account or drafts against Account Debtors; (c) demand, collect, sue, and give releases to any Account Debtor for monies due, settle and adjust disputes and claims about the Accounts directly with Account Debtors, and compromise, prosecute, or defend any action, claim, case, or proceeding about any Collateral (including filing a claim or voting a claim in any bankruptcy case in Bank’s or Borrower’s name, as Bank chooses); (d) make, settle, and adjust all claims under Borrower’s insurance policies; (e) pay, contest or settle any Lien, charge, encumbrance, security interest, or other claim in or to the Collateral, or any judgment based thereon, or otherwise take any action to terminate or discharge the same; and (f) transfer the Collateral into the name of Bank or a third party as the Code permits. Borrower hereby appoints Bank as its lawful attorney-in-fact to sign Borrower’s name on any documents necessary to perfect or continue the perfection of Bank’s security interest in the Collateral regardless of whether an Event of Default has occurred until all Obligations have been satisfied in full and the Loan Documents

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have been terminated. Bank's foregoing appointment as Borrower's attorney in fact, and all of Bank's rights and powers, coupled with an interest, are irrevocable until all Obligations have been fully repaid and performed and the Loan Documents have been terminated."

**2.13 Section 13 (Definitions).** The following terms and their respective definitions set forth in Section 13.1 are deleted in their entirety and replaced with the following:

**"Adjusted EBITDA"** means (a) GAAP Net Income plus (b) Interest Expense (less interest income), (c) income tax benefit and expense, (c) depreciation, (d) amortization and (e) stock-based compensation expense, (f) other non-operating expense (less other income) (as such amount is shown on the "Other income and (expense)" line item below the operating income line in the Ultimate Parent's relevant income statement, determined in accordance with GAAP), (g) goodwill impairment, (h) the change in Deferred Revenue (excluding acquired Deferred Revenue), less (i) the change in deferred commissions, (j) any items related to the litigation with Google Inc., (k) restructuring and related wind down costs, consulting and other related costs associated with development and implementation of Borrower's revised business strategy, severance costs and transaction and other costs associated with mergers and acquisitions, and (l) all adjustments related to recording the non-cash tax valuation allowance for deferred tax assets (with items (k) and (l) not to exceed an aggregate amount of \$6,000,000 in any trailing twelve (12) month period following the Sixth Amendment Effective Date).

**"Borrowing Base"** is (a) eighty percent (80%) of Eligible Accounts, as determined by Bank from Borrower's most recent Borrowing Base Report (and as may subsequently be updated by Bank in Bank's sole discretion based upon information received by Bank including, without limitation, Accounts that are paid and/or billed following the date of the Borrowing Base Report) (provided, however, Eligible Accounts with respect to clauses (b), (c), (d) and (q) shall not include Accounts in excess of ninety (90) days of invoice date to the extent the aggregate amount of such Accounts exceeds ten percent (10%) of Eligible Accounts), plus (b) during a Non-Formula Period, the Non-Formula Amount; provided, however, that Bank has the right to decrease the foregoing percentage in its good faith business judgment upon prior consultation with Borrower to mitigate the impact of events, conditions, contingencies, or risks which may adversely affect the Collateral or its value; provided, further that in the event Bank exercises such right to decrease the foregoing percentage, such circumstance shall not in and of itself constitute a Material Adverse Change or create an inference that a Material Adverse Change has occurred.

**"Immaterial Subsidiary"** means (a) any Foreign Subsidiary of Ultimate Parent organized or incorporated under the laws of The People's Republic of China, and (b) any Subsidiary which (i) for the most recent fiscal year had less than Two Million Dollars (\$2,000,000) of revenues and (ii) as of the end of such fiscal year

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was the owner of less than Two Million Dollars (\$2,000,000) of assets (or, with respect to any Subsidiary formed or acquired after the most recent fiscal year end, which has less than such amount of revenues and assets); provided that (i) at no time shall the Persons designated as Immaterial Subsidiaries have aggregate revenues for the most recent fiscal year in excess of Twenty Million Dollars (\$20,000,000), (ii) for the first year following the Effective Date, the Ultimate Parent's Japanese subsidiary, Rosetta Stone Japan Inc., shall be deemed an "Immaterial Subsidiary", and (iii) notwithstanding the foregoing, Ultimate Parent's Brazilian subsidiary, Rosetta Stone Ensino de Linguas Ltda, shall be deemed an "Immaterial Subsidiary" provided that such Subsidiary (a) for the most recent fiscal year had less than Two Million Dollars (\$2,000,000) of revenues and (b) as of the end of such fiscal year was the owner of less than Two Million Dollars (\$2,000,000) of assets.

**"Prime Rate"** is the rate of interest per annum from time to time published in the money rates section of The Wall Street Journal or any successor publication thereto as the "prime rate" then in effect; provided that, in the event such rate of interest is less than zero, such rate shall be deemed to be zero for purposes of this Agreement; and provided further that if such rate of interest, as set forth from time to time in the money rates section of The Wall Street Journal, becomes unavailable for any reason as determined by Bank, the "Prime Rate" shall mean the rate of interest per annum announced by Bank as its prime rate in effect at its principal office in the State of California (such Bank announced Prime Rate not being intended to be the lowest rate of interest charged by Bank in connection with extensions of credit to debtors); provided that, in the event such rate of interest is less than zero, such rate shall be deemed to be zero for purposes of this Agreement.

**"Revolving Line Maturity Date"** is April 1, 2020.

**"Streamline Period"** is, on and after the Sixth Amendment Effective Date, provided no Event of Default has occurred and is continuing, the period (a) commencing on the first day of the month following the day that Borrower provides to Bank a written report that Borrower has maintained, for each consecutive day in the immediately preceding calendar month, Liquidity in an amount at all times greater than (A) from April 1<sup>st</sup> through and including August 31<sup>st</sup> of each year, Fourteen Million Dollars (\$14,000,000) and (B) from September 1<sup>st</sup> through and including March 31<sup>st</sup> of each year, Seventeen Million Five Hundred Thousand Dollars (\$17,500,000) (either such amount, the **"Streamline Balance"**); and (b) terminating on the earlier to occur of (i) the occurrence of an Event of Default, and (ii) the first day thereafter in which Borrower fails to maintain the Streamline Balance. Upon the termination of a Streamline Period, Borrower must maintain the Streamline Balance each consecutive day for one (1) calendar month prior to entering into a subsequent Streamline Period. Borrower shall give Bank prior written notice of Borrower's election to enter into any such Streamline Period, and each such Streamline Period shall commence on the first day of the monthly period following the date the Bank determines, in its reasonable discretion, that the Streamline Balance

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has been achieved, subject, however, in each such case to Bank's reasonable determination made within a reasonable time after receipt of the relevant report that Borrower has maintained the requisite Liquidity in the relevant time periods.

**2.14 Section 13 (Definitions).** The preamble in the definition of Eligible Accounts set forth in Section 13.1 is deleted in its entirety and replaced with the following:

“**Eligible Accounts**” means Accounts which arise in the ordinary course of Borrower's business that meet all Borrower's representations and warranties in Section 5.12, that have been, at the option of Bank, confirmed in accordance with Section 6.4(e) of this Agreement, and are due and owing from Account Debtors deemed creditworthy by Bank in its good faith business judgment. Bank reserves the right, upon prior consultation with Borrower, at any time after the Effective Date to adjust any of the criteria set forth below and to establish new criteria in its good faith business judgment. Unless Bank otherwise agrees in writing, Eligible Accounts shall not include:

**2.15 Section 13 (Definitions).** The following new defined terms are hereby inserted alphabetically in Section 13.1:

“**Borrowing Base Report**” is that certain report of the value of certain Collateral in the form attached hereto as Exhibit B.

“**Credit Extension**” is any Advance, any Overadvance, Letter of Credit, or any other extension of credit by Bank for Borrower's benefit.

“**Sixth Amendment Effective Date**” is March 10, 2017.

**2.16 Section 13 (Definitions).** The following defined terms set forth in Section 13.1 are deleted in their entirety:

“**Transaction Report**” is that certain report of transactions and schedule of collections in the form attached hereto as Exhibit B, with appropriate insertions.

**2.17 Exhibit B (Borrowing Base Report).** The Transaction Report (as defined in the Loan Agreement until the date of this Amendment) appearing as Exhibit B to the Loan Agreement is deleted in its entirety and replaced with the Borrowing Base Report in the form of Exhibit B attached hereto.

**2.18 Exhibit D (Compliance Certificate).** The Compliance Certificate appearing as Exhibit D to the Loan Agreement is deleted in its entirety and replaced with the Compliance Certificate in the form of Exhibit D attached hereto.

**2.19 Exhibit E (Financial Covenants).** The financial covenants set forth in Exhibit E to the Loan Agreement are deleted in their entirety and replaced with the financial covenants set forth on Exhibit E attached hereto.

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**3. Conditions Precedent to Effectiveness.** This Amendment shall not be effective until each of the following conditions precedent have been fulfilled to the satisfaction of Bank:

**3.1** This Amendment shall have been duly executed and delivered by the respective parties hereto. Bank shall have received a fully executed copy hereof.

**3.2** All necessary consents and approvals to this Amendment shall have been obtained by Borrower.

**3.3** After giving effect to this Amendment, no Default or Event of Default shall have occurred and be continuing.

**3.4** Bank shall have received the fees costs and expenses required to be paid pursuant to Section 5 of this Amendment (including the reasonable and documented fees and disbursements of legal counsel required to be paid thereunder).

**4. Representations and Warranties.** Borrower hereby represents and warrants to Bank as follows:

**4.1** This Amendment is, and each other Loan Document to which it is or will be a party, when executed and delivered by Borrower, will be the legally valid and binding obligation of Borrower, enforceable against Borrower in accordance with its respective terms, except as enforcement may be limited by bankruptcy, insolvency, reorganization, moratorium or similar laws relating to or limiting creditors' rights generally and equitable principals (whether enforcement is sought by proceedings in equity or at law).

**4.2** Its representations and warranties set forth in this Amendment, the Loan Agreement, as amended by this Amendment and after giving effect hereto, and the other Loan Documents to which it is a party are (i) to the extent qualified by materiality, true and correct in all respects and (ii) to the extent not qualified by materiality, true and correct in all material respects, in each case, on and as of the date hereof, as though made on such date (except to the extent that such representations and warranties relate solely to an earlier date, in which case such representations and warranties shall have been true and correct in all material respects as of such earlier date).

**4.3** The execution and delivery by Borrower of this Amendment, the performance by Borrower of its obligations hereunder and the performance of Borrower under the Loan Agreement, as amended by this Amendment, (i) have been duly authorized by all necessary organizational action on the part of Borrower and (ii) will not (A) violate any provisions of the certificate of incorporation or formation or organization or by-laws or limited liability company agreement or limited partnership agreement of Borrower or (B) constitute a violation by Borrower of any applicable material Requirement of Law.

Borrower acknowledges that Bank has acted in good faith and have conducted in a commercially reasonable manner their relationships with Borrower in connection with this Amendment and in connection with the other Loan Documents. Borrower understands and acknowledges that Bank is entering into this Amendment in reliance upon, and in partial

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consideration for, the above representations, warranties, and acknowledgements, and agrees that such reliance is reasonable and appropriate.

**5. Payment of Costs and Expenses.** Borrower shall pay to Bank a fully-earned, non-refundable amendment fee equal to One Hundred Twenty Five Thousand Dollars (\$125,000), which fee shall be paid on the Sixth Amendment Effective Date. In addition, Borrower shall pay to Bank all reasonable costs and out-of-pocket expenses of every kind in connection with the preparation, negotiation, execution and delivery of this Amendment and any documents and instruments relating hereto or thereto (which costs include, without limitation, the reasonable and documented fees and expenses of any attorneys retained by Bank).

**6. Choice of Law. THIS AMENDMENT AND THE RIGHTS AND OBLIGATIONS OF THE PARTIES HEREUNDER SHALL BE GOVERNED BY, AND SHALL BE CONSTRUED AND ENFORCED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK .** Each party hereto submits to the exclusive jurisdiction of the State and Federal courts in the Southern District of the State of New York; provided, however, that nothing in the Loan Agreement as amended by this Amendment shall be deemed to operate to preclude Bank from bringing suit or taking other legal action in any other jurisdiction to realize on the Collateral or any other security for the Obligations, or to enforce a judgment or other court order in favor of such Agent. **TO THE EXTENT PERMITTED BY APPLICABLE LAW, EACH PARTY HERETO WAIVES ITS RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF OR BASED UPON THIS AMENDMENT, THE OTHER LOAN DOCUMENTS OR ANY CONTEMPLATED TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. EACH PARTY HERETO ACKNOWLEDGES THAT THIS WAIVER IS A MATERIAL INDUCEMENT TO ENTER INTO A BUSINESS RELATIONSHIP, THAT EACH HAS ALREADY RELIED ON THIS WAIVER IN ENTERING INTO THIS AMENDMENT, AND THAT EACH WILL CONTINUE TO RELY ON THIS WAIVER IN ITS RELATED FUTURE DEALINGS. EACH PARTY HERETO FURTHER WARRANTS AND REPRESENTS THAT IT HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL AND THAT IT KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL.**

**7. Counterpart Execution.** This Amendment may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, shall be deemed to be an original, and all of which, when taken together, shall constitute but one and the same Amendment. Delivery of an executed counterpart of this Amendment by telefacsimile or by e-mail transmission of an Adobe file format document (also known as a PDF file) shall be equally as effective as delivery of an original executed counterpart of this Amendment. Any party delivering an executed counterpart of this Amendment by telefacsimile or by e-mail transmission of an Adobe file format document (also known as a PDF file) also shall deliver an original executed counterpart of this Amendment but the failure to deliver an original executed counterpart shall not affect the validity, enforceability, and binding effect of this Amendment.

**8. Effect on Loan Documents.**

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**8.1** The amendments set forth herein shall be limited precisely as written and shall not be deemed (a) to be a forbearance, waiver, or modification of any other term or condition of the Loan Agreement or of any Loan Documents or to prejudice any right or remedy which Bank may now have or may have in the future under or in connection with the Loan Documents; (b) to be a consent to any future consent or modification, forbearance, or waiver to the Loan Agreement or any other Loan Document, or to any waiver of any of the provisions thereof; or (c) to limit or impair Bank's right to demand strict performance of all terms and covenants as of any date. Borrower hereby ratifies and reaffirms its obligations under the Loan Agreement and the other Loan Documents to which it is a party and agrees that none of the amendments or modifications to the Loan Agreement set forth in this Amendment shall impair Borrower's obligations under the Loan Documents or Bank's rights under the Loan Documents. Borrower hereby further ratifies and reaffirms the validity and enforceability of all of the Liens heretofore granted, pursuant to and in connection with the Loan Agreement or any other Loan Document, to Bank as collateral security for the obligations under the Loan Documents, in accordance with their respective terms, and acknowledges that all of such Liens, and all collateral heretofore pledged as security for such obligations, continues to be and remain collateral for such obligations from and after the date hereof. Borrower acknowledges and agrees that the Loan Agreement and each other Loan Document is still in full force and effect and acknowledges as of the date hereof that Borrower has no defenses to enforcement of the Loan Documents. Borrower waives any and all defenses to enforcement of the Loan Agreement as amended hereby and each other Loan Documents that might otherwise be available as a result of this Amendment of the Loan Agreement. To the extent any terms or provisions of this Amendment conflict with those of the Loan Agreement or other Loan Documents, the terms and provisions of this Amendment shall control.

**8.2** To the extent that any terms and conditions in any of the Loan Documents shall contradict or be in conflict with any terms or conditions of the Loan Agreement, after giving effect to this Amendment, such terms and conditions are hereby deemed modified or amended accordingly to reflect the terms and conditions of the Loan Agreement as modified or amended hereby.

**8.3** This Amendment is a Loan Document.

**9. Entire Agreement.** This Amendment constitutes the entire agreement between Borrower and Bank pertaining to the subject matter contained herein and supersedes all prior agreements, understandings, offers and negotiations, oral or written, with respect hereto and no extrinsic evidence whatsoever may be introduced in any judicial or arbitration proceeding, if any, involving this Amendment. All of the terms and provisions of this Amendment are hereby incorporated by reference into the Loan Agreement, as applicable, as if such terms and provisions were set forth in full therein, as applicable. All references in the Loan Agreement to "this Agreement", "hereto", "hereof", "hereunder" or words of like import shall mean the Loan Agreement as amended hereby.

**10. Release.** Borrower may have certain Claims against the Released Parties, as those terms are defined below, regarding or relating to the Loan Agreement or the other Loan Documents. Bank and Borrower desire to resolve each and every one of such Claims in conjunction with the

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execution of this Amendment and thus Borrower makes the releases contained in this Section 10. In consideration of Bank entering into this Amendment, Borrower hereby fully and unconditionally releases and forever discharges Bank and its directors, officers, employees, subsidiaries, branches, affiliates, attorneys, agents, representatives, successors and assigns and all persons, firms, corporations and organizations acting on any of their behalf (collectively, the "**Released Parties**"), of and from any and all claims, allegations, causes of action, costs or demands and liabilities, of whatever kind or nature, from the beginning of the world to the date on which this Amendment is executed, whether known or unknown, liquidated or unliquidated, fixed or contingent, asserted or unasserted, foreseen or unforeseen, matured or unmatured, suspected or unsuspected, anticipated or unanticipated, which Borrower has, had, claims to have had or hereafter claims to have against the Released Parties by reason of any act or omission on the part of the Released Parties, or any of them, occurring prior to the date on which this Amendment is executed, including all such loss or damage of any kind heretofore sustained or that may arise as a consequence of the dealings among the parties up to and including the date on which this Amendment is executed, including the administration or enforcement of the Loans, the Obligations, the Loan Agreement or any of the Loan Documents (collectively, all of the foregoing, the "**Claims**"). Borrower represents and warrants that it has no knowledge of any claim by it against the Released Parties or of any facts or acts of omission of the Released Parties which on the date hereof would be the basis of a claim by Borrower against the Released Parties which is not released hereby. Borrower represents and warrants that the foregoing constitutes a full and complete release of all Claims.

**11. Severability.** The provisions of this Amendment are severable, and if any clause or provision shall be held invalid or unenforceable in whole or in part in any jurisdiction, then such invalidity or unenforceability shall affect only such clause or provision, or part thereof, in such jurisdiction and shall not in any manner affect such clause or provision in any other jurisdiction, or any other clause or provision in this Amendment in any jurisdiction.

[Remainder of page intentionally left blank; signature page follows]

**IN WITNESS WHEREOF**, the parties hereto have caused this Amendment to be duly executed and delivered by their proper and duly authorized officers as of the day and year first above written.

**BORROWER:**

**ROSETTA STONE LTD.**

By /s/ Thomas Pierno  
Name: Thomas Pierno  
Title: Chief Financial Officer

**NEW BORROWER:**

**LEXIA LEARNING SYSTEMS LLC**

By: /s/ Sonia Galindo  
Name: Sonia Galindo  
Title: Manager

**BANK:**

**SILICON VALLEY BANK**

By Will Deevy  
Name: Will Deevy  
Title: Vice President

Each Guarantor hereby acknowledges and confirms that it has reviewed and approved the terms and conditions of the Amendment. Each Guarantor hereby consents to the Amendment and agrees that the Guaranty of such Guarantor relating to the Obligations of Borrower under the Loan Agreement shall continue in full force and effect, shall be valid and enforceable and shall not be impaired or otherwise affected by the execution of the Amendment or any other document or instruction delivered in connection herewith. Each Guarantor represents and warrants that, after giving effect to the Amendment, all representations and warranties contained in each Loan Document which such Guarantor is a party are true, accurate and complete as if made the date hereof, and all such Loan Documents are hereby ratified and confirmed and shall remain in full force and effect.

**GUARANTORS:**

**ROSETTA STONE INC.**

By: /s/ Thomas Pierno  
Name: Thomas Pierno  
Title: Chief Financial Officer

**ROSETTA STONE HOLDINGS INC.**

By: /s/ Thomas Pierno  
Name: Thomas Pierno  
Title: Chief Financial Officer

**ROSETTA STONE INTERNATIONAL INC.**

By: /s/ Thomas Pierno  
Name: Thomas Pierno  
Title: Chief Financial Officer

**LIVEMOCHA LLC**

By: /s/ Sonia Galindo  
Name: Sonia Galindo  
Title: Manager

**EXHIBIT B**

Borrowing Base Report

[To be provided by Bank]

**EXHIBIT D**

**COMPLIANCE CERTIFICATE**

TO: SILICON VALLEY BANK                      Date: \_\_\_\_\_  
FROM: ROSETTA STONE LTD. and LEXIA LEARNING SYSTEMS LLC

The undersigned authorized officer of Rosetta Stone Ltd. and Lexia Learning Systems LLC (each and together, jointly and severally, "Borrower") certifies that under the terms and conditions of the Loan and Security Agreement between Borrower and Bank (the "Agreement"): (1) Each Credit party is in complete compliance for the period ending \_\_\_\_\_ with all required covenants except as noted below; (2) there are no Events of Default; (3) all representations and warranties in the Agreement are true and correct in all material respects on this date except as noted below; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date; (4) each Credit Party and each of its Subsidiaries, has timely filed all required tax returns and reports, and each Credit Party and each of its Subsidiaries has timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by such Credit Party or Subsidiary except as otherwise permitted pursuant to the terms of Section 5.8 of the Agreement; and (5) no Liens have been levied or claims made against any Credit Party or any of its Subsidiaries relating to unpaid employee payroll or benefits of which Borrower has not previously provided written notification to Bank.

Attached are the required documents supporting the certification. The undersigned certifies that these are prepared in accordance with GAAP consistently applied from one period to the next except as explained in an accompanying letter or footnotes. The undersigned acknowledges that no borrowings may be requested at any time or date of determination that Borrower is not in compliance with any of the terms of the Agreement, and that compliance is determined not just at the date this certificate is delivered. Capitalized terms used but not otherwise defined herein shall have the meanings

given them in the Agreement.

Please indicate compliance status by circling Yes/No under “Complies” column.

<u>Reporting Covenants</u>	<u>Required</u>	<u>Complies</u>
Monthly or Quarterly financial statements with Compliance Certificate	Monthly within 30 days when there are Advances outstanding; quarterly within 45 days when there are no Advances outstanding	Yes No
Annual financial statement (CPA Audited) with Compliance Certificate	FYE within 90 days	Yes No
10-Q, 10-K and 8-K	Within 5 days after filing with SEC	Yes No
Projections	FYE within 90 days	Yes No
A/R Agings & A/P Report	Bi-weekly when a Streamline Period is not in effect and there are Advances outstanding; monthly within 30 days when a Streamline Period is in effect and there are Advances outstanding; quarterly within 45 days when there are no Advances outstanding	Yes No
Borrowing Base Reports	Bi-weekly when a Streamline Period is not in effect and there are Advances outstanding; monthly within 30 days when a Streamline Period is in effect and there are Advances outstanding; quarterly within 45 days when there are no Advances outstanding	Yes No
The following Intellectual Property was registered (or a registration application submitted) after the Effective Date (if no registrations, state “None”)		

<u>Financial Covenants</u>	<u>Required</u>	<u>Actual</u>	<u>Complies</u>
Achieve on a Quarterly Basis:			
Minimum Liquidity	\$12,500,000	\$	Yes No
Minimum Adjusted EBITDA	*	\$	Yes No

\*See Exhibit E

<u>Streamline Period</u>	<u>Applies</u>
Liquidity > \$14,000,000 (4/1 – 8/31)	Yes No
Liquidity > \$17,500,000 (9/1 – 3/31)	Yes No

<u>Non-Formula Period</u>	<u>Applies</u>
Liquidity > \$25,000,000	Yes No

The following financial covenant analyses and information set forth in Schedule 1 attached hereto are true and accurate as of the date of this Certificate.

**Other Matters**

Have there been any amendments of or other changes to the capitalization table of the Credit Parties and to the Operating Documents of any Credit Party or any of its Subsidiaries since the date of the most recently delivered Compliance Certificate? If yes, provide copies of any such amendments or changes with this Compliance Certificate to the extent not previously delivered to Bank.

Yes No

The following are the exceptions with respect to the certification above: (If no exceptions exist, state “No exceptions to note.”)

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**Schedule 1 to Compliance Certificate**

**Financial Covenants of Borrower**

In the event of a conflict between this Schedule and the Loan Agreement, the terms of the Loan Agreement shall govern.

**I. Liquidity (Section 6.8(a))**

Required: \$12,500,000

Actual:

A.	Aggregate value of the unrestricted cash maintained in Deposit Accounts or Securities Accounts at Bank or its Affiliates	\$
B.	Availability Amount (excluding the Non-Formula Amount from the Borrowing Base)	\$
C.	Liquidity (line A plus line B)	\$

Is line C equal to or greater than \$12,500,000?

No, not in compliance       Yes, in compliance

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II. **ADJUSTED EBITDA** (Section 6.8(b))

Required: Adjusted EBITDA, measured on a trailing twelve (12) month basis as of the end of each fiscal quarter during the periods specified below, of at least (loss not worse than) the following:

Quarterly Period	Adjusted EBITDA
March 31, 2017	(\$7,500,000)
June 30, 2017 and each fiscal quarter thereafter	(\$5,000,000)

Actual (for the cumulative period referenced):

A.	Net Income	\$
B.	To the extent included in the determination of Net Income	
	1. Interest Expense	\$
	2. Income tax benefit and expense	\$
	3. Depreciation expense	\$
	4. Amortization expense	\$
	5. Stock-based compensation expense	\$
	6. other non-operating expense (less other income) (as such amount is shown on the "Other income and (expense)" line item below the operating income line in the Ultimate Parent's relevant income statement, determined in accordance with GAAP)	
	7. Goodwill impairment	\$
	8. Change in Deferred Revenue	\$
	9. Change in deferred commissions	\$
	10. items related to the litigation with Google Inc.	
	11. restructuring and related wind down costs, consulting and other related costs associated with development and implementation of Borrower's revised business strategy, severance costs and transaction and other costs associated with mergers and acquisitions (not to exceed an aggregate amount, when added to the adjustments listed in line 12, of \$6,000,000 in any trailing twelve (12) month period following the Sixth Amendment Effective Date)	
	12. adjustments related to recording the non-cash tax valuation allowance for deferred tax assets (not to exceed an aggregate \$ amount, when added to the costs listed in line 11, of \$6,000,000 in any trailing twelve (12) month period following the Sixth Amendment Effective Date)	
	13. Total Line B: The sum of lines 1 through 8 minus lines 9 through 12	\$
C.	ADJUSTED EBITDA (line A plus line B)	\$

Is line C at least (loss not worse than) \$\_\_\_\_\_?

No, not in compliance       Yes, in compliance



**EXHIBIT E**

**FINANCIAL COVENANTS**

Achieve on a consolidated basis with respect to Ultimate Parent and its Subsidiaries:

(a) Liquidity. Maintain at all times, to be certified to Bank as of the last day of each month, Liquidity equal to or greater than Twelve Million Five Hundred Thousand Dollars (\$12,500,000).

(b) Adjusted EBITDA. Adjusted EBITDA, measured on a trailing twelve (12) month basis as of the end of each fiscal quarter during the periods specified below, of at least (loss not worse than) the following:

<b>Quarterly Period</b>	<b>Adjusted EBITDA</b>
March 31, 2017	(\$7,500,000)
June 30, 2017 and each fiscal quarter thereafter	(\$5,000,000)

2102364.6

## ROSETTA STONE INC. SUBSIDIARIES

As of March 14, 2017

Entity	Jurisdiction of Incorporation
Rosetta Stone Holdings Inc.	Delaware
Rosetta Stone Ltd. (Formerly Fairfield & Sons Ltd. d/b/a Fairfield Language Technologies)	Virginia
Rosetta Stone International Inc.	Delaware
Rosetta Stone Brazil Holding LLC	Delaware
Rosetta Stone (UK) Limited	England and Wales
Rosetta Stone Japan Inc.	Japan
Rosetta Stone GmbH	Germany
Rosetta Stone Canada Inc.	Canada
Rosetta Stone Hong Kong Limited	Hong Kong
Rosetta Stone International inc. Shanghai Representative Office	Shanghai
Rosetta (Shanghai) Software Trading Co., Ltd.	Shanghai
Rosetta Stone Ensino de Linguas Ltda.	Brazil
Rosetta Stone France SAS	France
Livemocha LLC (formerly Livemocha Inc.)	Delaware
Lexia Learning Systems LLC (formerly Lexia Learning Systems Inc.)	Delaware
Rosetta Stone S.A. (formerly Tell Me More S.A.)	France
Auralog Studios SARL	France
Auralog SL	Spain
Rosetta Stone Mexico SA de CV (formerly Auralog SA de CV)	Mexico
Auralog Software Development (Beijing) Company Ltd.	China

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement Nos. 333-204904, 333-201025, 333-190528, 333-183148, 333-180483, and 333-158828 on Form S-8 and Registration Statement No. 333-188444 on Form S-3 of our reports dated March 14, 2017, relating to the consolidated financial statements of Rosetta Stone Inc. and subsidiaries, and the effectiveness of Rosetta Stone Inc. and subsidiaries' 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, 2016.

*/s/ DELOITTE & TOUCHE LLP*

McLean, Virginia

March 14, 2017

**ROSETTA STONE INC.  
POWER OF ATTORNEY**

Each person whose signature appears below hereby constitutes and appoints A. John Hass, Thomas M. Pierno and Sonia Galindo, or any of them, each with power to act without the other, a true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution, for each person whose signature appears below and in his or her 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.

March 14, 2017

Signature	Title
<hr/> /s/ A. JOHN HASS III A. John Hass III	President, Chief Executive Officer and Chairman of the Board (Principal Executive Officer)
<hr/> /s/ THOMAS M. PIERNO Thomas M. Pierno	Chief Financial Officer (Principal Financial Officer)
<hr/> /s/ Patrick W. Gross Patrick W. Gross	Director
<hr/> /s/ LAURENCE FRANKLIN Laurence Franklin	Director
<hr/> /s/ DAVID P. NIERENBERG David P. Nierenberg	Director
<hr/> /s/ CAROLINE J. TSAY Caroline J. Tsay	Director
<hr/> /s/ STEVEN P. YANKOVICH Steven P. Yankovich	Director



**CERTIFICATION OF  
PRINCIPAL FINANCIAL OFFICER  
OF ROSETTA STONE INC.  
PURSUANT TO SECURITIES EXCHANGE ACT RULES 13a-14 AND 15d-14, AS ADOPTED  
PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002**

I, Thomas M. Pierno, certify that:

1. I have reviewed this Annual Report on Form 10-K of Rosetta Stone Inc. (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
  - c. evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
  - d. disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's Board of Directors (or persons performing the equivalent functions):
  - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

By:           /s/ THOMAS M. PIERNO            
Thomas M. Pierno  
(Principal Financial Officer)

Date: March 14, 2017

**CERTIFICATION OF  
PRINCIPAL EXECUTIVE 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 year ended December 31, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, A. John Hass, President, Chief Executive Officer, and Chairman of the Board 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.

/s/ A. JOHN HASS

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A. John Hass

*(Principal Executive Officer)*

Date: March 14, 2017

**CERTIFICATION OF  
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 year ended December 31, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Thomas M. Pierno, Chief Financial 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.

/s/ THOMAS M. PIERNO

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Thomas M. Pierno  
*(Principal Financial Officer)*

Date: March 14, 2017