

**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, 2017

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:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 \$230.9 million as of June 30, 2017 (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 February 28, 2018, there were 22,473,537 shares of common stock outstanding.

**Documents incorporated by reference:** Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2018 Annual Meeting of Stockholders to be held on June 18, 2018 are incorporated by reference into Part III.

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**PART I**

**FORWARD-LOOKING STATEMENTS**

*This Annual Report on Form 10-K (this "Report") and other statements or presentations made from time to time by the Company, including the documents incorporated by reference, contain 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 or phrases. These statements may include, but are not limited to, statements related to: our business strategy; guidance or projections related to revenue, Adjusted EBITDA, sales, 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 and literacy 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 foundational 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 current portfolio of language and literacy products and transition to a SaaS-based delivery model provide multiple opportunities for long-term value creation. We believe the demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe, and we are uniquely positioned with the power of our global brand to meet the growing needs of global learners.

We continue to emphasize 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 Language segment, where we continue to make product investments serving the needs of passionate language-learners who are mobile, results- focused and value 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 ("E&E 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. Seek to maximize the benefit of the changes we have made in our Consumer Language products and successfully transition to SaaS delivery to seek additional growth opportunities with a greater emphasis on 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.

### Business Segments

Our business is organized into three operating segments: Literacy, E&E Language, and Consumer Language. The Literacy segment derives revenue under a Software-as-a-Service ("SaaS") model from the sales of literacy solutions to educational institutions serving grades K through 12. The E&E Language segment derives language-learning revenues from sales to educational institutions, corporations, and government agencies worldwide under a SaaS model. The Consumer Language segment derives revenue from sales to individuals and retail partners worldwide and is nearing the completion of a SaaS migration from a packaged software business. For additional information regarding our segments, see Note 19 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

#### Literacy:

*Literacy Solutions:* Our Literacy segment is comprised solely of our Lexia business. The Lexia Learning suite of subscription-based English literacy-learning and assessment solutions provide explicit, systematic, personalized learning on foundational literacy skills for students of all abilities. This research-proven technology based approach accelerates reading

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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. PowerUp Literacy is designed for non-proficient 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 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 service offerings provide schools with product implementation services to support strong educator and student use. These services are purchased through annual or multi-year service contracts.

### **E&E Language:**

*E&E 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 E&E Language customers may also purchase our audio practice products and live tutoring sessions to enhance the learning experience.

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, group and live tutoring, and language courses for mission-critical government programs.

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

*Administrative Tools:* Our E&E 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 E&E Language and Literacy solutions into technical infrastructure.

### **Consumer Language:**

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 25-year heritage in language-learning.

Many of our 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 is automatically synchronized across devices 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 primarily as a software subscription via the web, mobile in-app purchase, or through retail channels.

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 video service that provides either one-on-one or group conversational coaching sessions with native speakers to practice skills and experience direct interactive dialogue. 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 Development:**

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 teams build new solutions and enhance or maintain 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 \$24.7 million, \$26.3 million, and \$29.9 million for the years ended December 31, 2017, 2016 and 2015, respectively.

**Customers and Distribution Channels**

No customer accounted for more than 10% of consolidated revenue during the years ended December 31, 2017, 2016 or 2015. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, backlog is not significant.

**Literacy:**

Our Literacy distribution channel in the United States utilizes a direct sales force as well as relationships with third-party resellers focused on the sale of Lexia solutions to K-12 schools. International distribution is primarily managed through independent resellers based in the United Kingdom, Australia and New Zealand.

**E&E Language:**

Our E&E 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 E&E 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.

As part of our K-12 customer activities, our Literacy and E&E Language segments interact with employees of school districts including superintendents, procurement officers, principals and teachers. For instance, we participate in associations and events, including as a sponsor, at which such employees are present. We also invite these employees to events hosted by us, at which we discuss general educational developments as well as our products and services, and to serve on customer advisory boards to provide feedback on our products and services. We, sometimes and as permissible, pay the travel expenses of school district employees who attend company-sponsored events or serve on an advisory board.

**Consumer Language:**

Our Consumer Language distribution channel comprises a mix of our websites, third party e-commerce websites, app-stores, consignment distributors, select retailers, and call centers. 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 our e-commerce website at [www.rosettastone.com](http://www.rosettastone.com), app stores such as Google Play and Apple App Store and our call centers.

*Indirect to consumer.* Sales generated through arrangements with third-party e-commerce websites and consignment distributors such as Software Packaging Associates.

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*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 include Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Staples, and others in and outside of the U.S. We may also partner at times with daily deal and home shopping 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 Literacy and E&E Language segments, we have transitioned the Consumer Language segment away from CD-based product sales to a cloud-based software subscription in order to provide an improved learner experience with instant fulfillment and mobile availability, which has also allowed us to, over time, 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, suppliers and distributors to obtain substantially all of our product and packaging components and to manufacture and, increasingly, fulfill finished products. We believe that we have good relationships with our vendors and that there are alternative sources in the event that one or more of these vendors 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 literacy, enterprise and educational language learning, and consumer language learning.

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

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.

### **Seasonality**

Our business is affected by variations in seasonal trends. Within our Literacy segment and K-12 Language education sales channel, 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. E&E Language segment sales in our government and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Consumer Language sales are affected by seasonal trends associated with the holiday shopping season. In particular, we generate a significant portion of our Consumer Language 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 Language sales typically turn to cash more quickly than E&E 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.



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

We have registered a variety of trademarks, including our primary or house marks, *Rosetta Stone*, The Blue Stone Logo, *Lexia*, *Lexia PowerUP Literacy*, *TruAccent*, 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, 2017, we had 992 total employees, consisting of 701 full-time and 291 part-time employees. We have employees in France and Spain who benefit from 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 19 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 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 2, 2017 with the SEC for the period ended September 30, 2017. 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

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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 corporate and K-12 learners and passionate language learners.***

We are continuing to implement our strategy to emphasize 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 Language segment, where we continue to make product investments serving the needs of passionate language learners who are mobile, results-focused and value a quality language-learning experience. If we do not successfully execute our strategy, our revenue and profitability could decline, which could have an adverse effect on our business and financial results.

***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 the current and potential competitors in our Literacy and E&E Language segments 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, mobile applications, audio courses and lessons, videos, games, stories, news, digital textbooks, and through other means, which compete with our Consumer Language segment. 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

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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 Language 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 Literacy and E&E Language businesses could be impaired.

***We depend on discretionary consumer spending in the Consumer Language 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 portion of our Consumer Language 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, and Staples, and consignment distributors such as 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 E&E 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;
- 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;

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- 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.

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 may impose additional and unique risks.***

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 E&E Language offerings, transitioning to indirect sales channels through reseller and other arrangements with third parties in those geographies. We also have optimized certain of our website sales channels in Europe, Asia and Latin America. If we are unable to conduct our international operations successfully and market, sell, deliver and support our products and services internationally to the extent we expect, our business, revenue and financial results could be harmed.

### ***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 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 E&E 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 E&E Language and 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 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 E&E 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 E&E 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 E&E 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 E&E 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 Language 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 12- to 36-months) subscriptions with a corresponding license term. 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 which could have a substantially negative impact on our revenue, results of operations and cash flow in any quarterly reporting period.

***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 Language 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 E&E 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 E&E 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

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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 loss of information could result in legal claims or proceedings and regulatory penalties, disrupt our operations or 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.



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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 design product, service and business operations to limit personal data processing 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.

***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

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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 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.

***The U.S. Congress and Trump administration may make substantial changes to fiscal, political, regulatory and other federal policies that may adversely affect our business, financial condition, operating results and cash flows.***

Changes in general economic or political conditions in the United States or other regions could adversely affect our business. For example, the administration under President Donald Trump has indicated that it may propose significant changes with respect to a variety of issues, including education standards and funding, international trade agreements, import and export regulations, tariffs and customs duties, foreign relations, and immigration laws, that could have a materially adverse effect on 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 government will take with respect to world affairs and events. 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 recent years (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

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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 Language, Literacy and E&E 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 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.

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***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 we face economic difficulties, 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 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. For instance, on December 22, 2017, President Donald Trump signed into U.S. law the Tax Cuts and Jobs Act of 2017 (“Tax Reform”). The exact ramifications of the legislation are subject to interpretation and could have a material impact on our financial position and/or results of operations. We continue to analyze the full impact of enacted legislation and additional guidance as provided. 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 other 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.

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

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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 *Rosetta Stone*, the Blue Stone logo, *Lexia*, *TruAccent*, *Lexia PowerUP Literacy* 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

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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 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

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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.

***We rely on highly skilled personnel and, if we are unable to retain or motivate key personnel or hire qualified personnel, we may not be able to achieve results or grow effectively.***

Our performance is largely dependent on the talents and efforts of highly skilled individuals. Our future success depends on our continuing ability to identify, hire, develop, motivate and retain highly skilled personnel for all areas of our organization.

We compete with other companies both within and outside of our industry for talented employees, and we may lose talented employees or fail to attract, train, and retain other talented employees. Any such loss or failure could adversely affect our product sales, financial condition, and operating results. In addition, we may not be able to locate suitable replacements for certain critical employees who leave, or offer employment to potential replacements on reasonable terms, all of which could adversely affect our product sales, financial condition, and operating results.

***Our business could be impacted as a result of actions by activist stockholders 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, stockholder proposals, media campaigns and other such actions instituted by activist stockholders 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 stockholder 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 third 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 third 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



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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, 2017, 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 14 of Item 8, *Financial Statements and Supplementary Data*. We currently own one facility in Harrisonburg, Virginia, that provides operations and customer support services.

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**

In late December 2017, we received a demand letter on behalf of two California customers who allege that they were improperly charged for automatic renewal of their products. We express no opinion on the outcome or the potential risk of liability to the Company.

Additional 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 February 28, 2018 when the last reported sales price of our common stock on the NYSE was \$13.69 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.

	<b>High</b>	<b>Low</b>
<b>Year ended December 31, 2017</b>		
Fourth Quarter	\$ 13.46	\$ 9.51
Third Quarter	10.75	8.89
Second Quarter	12.18	9.79
First Quarter	9.75	7.58
<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

**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 by the Issuer and Affiliated Purchasers**

The following table presents the total number of shares of the Company's common stock that it purchased during the fourth quarter of 2017, the average price paid per share, the number of shares that the Company purchased as part of its publicly announced repurchase program, and the approximate dollar value of shares that still could have been purchased at the end of the applicable fiscal period pursuant to the share repurchase program:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Program (1)</b>	<b>Maximum Dollar Value of Shares that May Yet Be Purchased Under the Program (in thousands) (1)</b>
October 2017	—	\$ —	—	
November 2017	—	\$ —	—	
December 2017	—	\$ —	—	
Total	—	\$ —	—	\$ 13,565

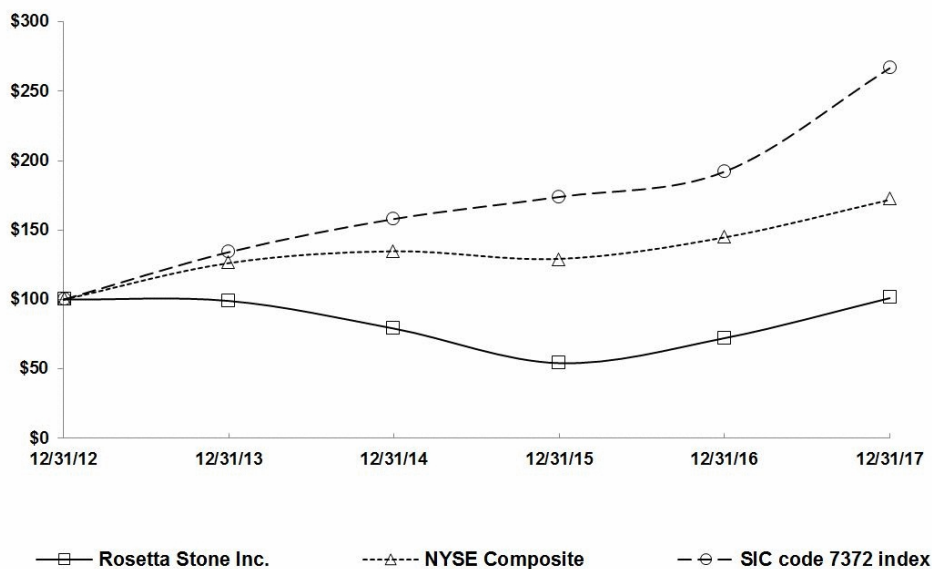
(1) A program covering the repurchase of up to \$25.0 million of the Company's common stock was initially announced on August 22, 2013.

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, 2012 through December 31, 2017, 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, 2012 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 12/31/12 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, 2017, 2016, 2015, 2014 and 2013, and the selected consolidated balance sheet data as of December 31, 2017, 2016, 2015, 2014 and 2013 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,				
	2017	2016(1)	2015(2)	2014(3)	2013(4)
	(in thousands, except per share data)				
<b>Selected Statements of Operations Data:</b>					
Revenue	\$ 184,593	\$ 194,089	\$ 217,670	\$ 261,853	\$ 264,645
Gross profit	150,972	159,768	179,143	208,799	218,931
Loss from operations	(4,501)	(26,920)	(43,813)	(78,850)	(18,442)
Net loss	(1,546)	(27,550)	(46,796)	(73,706)	(16,134)
<b>Loss per share attributable to common stockholders:</b>					
Basic	\$ (0.07)	\$ (1.25)	\$ (2.17)	\$ (3.47)	\$ (0.75)
Diluted	\$ (0.07)	\$ (1.25)	\$ (2.17)	\$ (3.47)	\$ (0.75)
<b>Other Selected Data:</b>					
Total stock-based compensation expense	\$ 4,141	\$ 4,906	\$ 7,195	\$ 6,762	\$ 9,241
Total intangible amortization expense	\$ 3,839	\$ 4,351	\$ 5,192	\$ 6,263	\$ 1,822

- (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 E&E 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) The Company undertook restructuring actions in the first quarter of 2015 to focus on the E&E Language business and optimize the Consumer Language business for profitability. Under this initiative, the Company undertook headcount and cost reductions to areas including Consumer Language sales and marketing, Consumer Language 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.

	As of December 31,				
	2017	2016	2015	2014	2013
	(in thousands)				
<b>Selected Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 42,964	\$ 36,195	\$ 47,782	\$ 64,657	\$ 98,825
Total assets	194,755	194,310	228,543	288,173	290,776
Total deferred revenue	151,263	141,457	142,748	128,169	78,857
Notes payable and capital lease obligation	2,300	2,559	3,143	3,748	242
Total stockholders' equity (deficit)	2,423	(1,659)	22,410	63,445	131,243

**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 foundational 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 Literacy segment derives the majority of its revenue from sales of literacy solutions to educational institutions serving grades K through 12. The E&E Language segment derives revenue from sales of language-learning solutions to educational institutions, corporations, and government agencies worldwide. The Consumer Language segment derives the majority of revenue from sales of language-learning solutions to individuals and retail partners. 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 E&E 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 Consumer Language 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, Staples, consignment distributors such as Software Packaging Associates, and daily deal partners. In September 2017, Wynit Distribution LLC, one of our retail partners, filed for bankruptcy. We are in the process of moving the impacted business to other retailers and do not expect this to have a significant operational or financial impact to our business.

As our Company has evolved, we believe that our current portfolio of language and literacy products and transition to a SaaS-based delivery model provides multiple opportunities for long-term value creation. We believe the demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe, and we are uniquely positioned with the power of our global brand to meet the growing needs of global learners.

We continue to emphasize 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 Language segment where we continue to make product investments serving the needs of passionate language learners who are mobile, results-focused and value a quality language-learning experience.

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

1. Grow literacy sales 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 E&E 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. Seek to maximize the benefit of the changes we have made in our Consumer Language products and successfully transition to SaaS delivery to seek additional growth opportunities with a greater emphasis on 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 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 E&E 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 substantially completed the closure of 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 U.S. 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 Language sales and marketing, Consumer Language product

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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.

Over the last few years, our Consumer Language strategy has been to shift more and more of our Consumer Language business to online subscriptions, which feature 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. We expect the trend in Consumer Language subscription sales to continue as customer preferences move towards mobile experiences. We expect the final portion of this transition to subscription sales will be complete in the first half of 2018.

We currently have three operating segments, Literacy, E&E Language, and Consumer Language. 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. Prior periods have been reclassified to reflect our current segment presentation and definition of segment contribution. See Note 19 of Item 8, *Financial Statements and Supplementary Data* for additional information about recent changes to the definition and presentation of segment contribution.

For the year ended December 31, 2017, Literacy segment contribution increased to \$5.0 million with segment contribution margin of 11% as compared to a segment contribution of \$1.5 million and a segment contribution margin of 4% for the year ended December 31, 2016. The dollar and margin increases were primarily due to the larger revenue base on which segment contribution is calculated, partially offset by increases in direct research and development expenses, cost of sales, and sales and marketing expenses due to the transition to a direct sales team and investments made to improve the Literacy product portfolio and infrastructure. Before shared Language research and development expense, E&E Language segment contribution decreased to \$26.9 million with a segment contribution margin of 41% for the year ended December 31, 2017, compared to \$29.1 million with a segment contribution margin of 40% for the year ended December 31, 2016. The dollar decrease was primarily due to lower revenue while the slight margin improvement reflects lower direct expenses, primarily sales and marketing expenses and cost of sales. Consumer Language segment contribution increased to \$24.8 million with a contribution margin of 33% for the year ended December 31, 2017, from \$21.5 million with a contribution margin of 24% for the year ended December 31, 2016. The dollar and margin increases were primarily due to a reduction in direct sales and marketing expense year over year.

For the year ended December 31, 2016, Literacy segment contribution increased to \$1.5 million with segment contribution margin of 4% for the year ended December 31, 2016 as compared to a segment contribution of negative \$3.5 million and a segment contribution margin of negative 16% 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. E&E Language segment contribution increased to \$29.1 million with a segment contribution margin of 40%, compared to \$22.8 million with a segment contribution margin of 30% 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. Consumer Language segment contribution decreased to \$21.5 million with a contribution margin of 24% for the year ended December 31, 2016, from \$30.7 million with a contribution margin of 26% for the year ended December 31, 2015. The dollar and margin decreases were primarily due to a decrease in Consumer Language revenue of \$31.7 million.

### **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 Language 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-

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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 Language 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 Language products through select third-party retailers and distributors. For purposes of explaining variances in our revenue, we separately discuss changes in our E&E Language, Literacy, and our Consumer Language segments because the customers and revenue drivers of these channels are different.

Literacy segment sales are seasonally strongest in the third quarter of the calendar year corresponding to school district budget years. Within our E&E 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. Consumer Language 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 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 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.

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

Interest and other income (expense) primarily consist of interest income, interest expense, foreign exchange gains and losses, and income from litigation settlements. 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 Tax (Benefit) Expense*

Income tax (benefit) expense 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, 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 Language 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



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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. 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 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.

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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. These methods require the use of estimates, including future stock price volatility, expected term, risk-free interest rate, and forfeitures.

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 for estimating the expected term. 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.

Our restricted stock and restricted stock unit grants are accounted for as equity awards. 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. Changes in the probability estimates associated with performance-based awards are accounted for in the period of change using a cumulative catch-up adjustment to retroactively apply the new probability estimate. In any period in which we determine the achievement of the performance metrics is not probable, we cease recording compensation expense and all previously recognized compensation expense for the performance-based award is reversed. 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 acquisition of Tell Me More in 2014.

We routinely review goodwill at the reporting unit level for potential impairment as part of our internal control framework and 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. The factors that we consider important in a qualitative assessment and which could trigger a quantitative test 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. 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 a quantitative impairment test by comparing the fair value of a reporting unit with its carrying amount. If the carrying value exceeds the fair value, we measure the amount of impairment loss, if any.

For our annual goodwill test performed at June 30 2017, we began our annual test with the qualitative test. We 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 our reporting units with remaining goodwill balances is less than the carrying value. Accordingly, a quantitative impairment test was not performed and no goodwill impairment charges were recorded in connection with the annual impairment test. There was no impairment of goodwill during the year ended December 31, 2017.

We recognized \$1.7 million and \$5.6 million in goodwill impairment expense associated with our Fit Brains business during the years ended December 31, 2016 and December 31, 2015, respectively. These impairment charges represent the full impairment of all intangible assets associated with the Fit Brains business.

For additional risk factors which could affect the assumptions used in our qualitative and quantitative evaluations of our reporting units, see the section titled "Risk Factors" in Part I, Item 1A of this Report. Accordingly, we cannot provide assurance that the assumptions, estimates and values used in our assessment will be realized and actual results could vary materially.

### ***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.

For our annual indefinite-lived intangible asset test performed at December 31, 2017, we began our annual test with the qualitative test. As of December 31, 2017, we concluded that there were no indicators of impairment that would cause us to believe that it is more likely than not that our indefinite-lived intangible asset was impaired.

We recognized intangible asset impairment expense of \$1.2 million in 2016 related to the full impairment of the tradename, developed technology, and customer relationship long-lived intangible assets associated with our Fit Brains business. There were no impairments of intangible assets during the years ended December 31, 2017 and December 31, 2015.

### ***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 and 2015, we recorded \$1.0 million and \$1.1 million in impairment expense related to the abandonment of software projects that were previously capitalized, while there were no such impairments in 2017.

### ***Restructuring Costs***

Restructuring or other employee severance plans have been initiated in each of the years ended December 31, 2017, 2016 and 2015 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 in Cost of sales and the 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.

During 2017, 2016, and 2015, we recorded \$1.2 million, \$5.2 million, and \$8.8 million in restructuring costs related to our recent restructuring plans and other employee severance actions.

### ***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.

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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
- 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, 2017, a full valuation allowance exists for the U.S., China, Hong Kong, Mexico, Spain, Brazil, and France where we have determined the deferred tax assets will not more likely than not be realized.

All of the jurisdictions mentioned above have cumulative losses for the most recent year ended December 31, 2017. 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, 2017 and 2016, our net deferred tax liability was \$2.0 million and \$6.2 million, respectively.

The SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118), which allows registrants to record provisional amounts during a one year “measurement period” similar to that used when accounting for business combinations. However, the measurement period is deemed to have ended earlier when the registrant has obtained, prepared and analyzed the information necessary to finalize its accounting. During the measurement period, impacts of Tax Reform are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed.

We have estimated the impact of certain tax effects of the Tax Reform enacted on December 22, 2017, including the reduction in the U.S. corporate income tax rate to 21 percent, deferred tax assets scheduled to reverse in subsequent years will result in net operating losses with an unlimited carryforward, and a one-time mandatory repatriation transition tax on the net accumulated earnings and profits of a U.S. taxpayer’s foreign subsidiaries. The final impact of Tax Reform may differ from these estimates, due to, among other things, changes in interpretations, additional guidance that may be issued by the Internal Revenue Service or state and local authorities, and any updates or changes to estimates we have utilized to calculate the transition impact. Therefore, our accounting for the elements of Tax Reform is incomplete. However, we were able to make reasonable estimates of the effects of Tax Reform. We will complete our accounting for these items during 2018, after completion of our 2017 U.S. income tax return.

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The Tax Reform also includes significant provisions that are not yet effective but may impact income taxes in future years. These provisions include: an exemption from U.S. tax on dividends of future foreign earnings, a limitation of net operating losses generated after 2017 to 80 percent of taxable income, the inclusion of commissions and performance-based compensation in determining the excess compensation limitation, and a minimum tax on certain foreign earnings in excess of 10 percent of the foreign subsidiaries tangible assets (i.e., global intangible low-taxed income or GILTI). We are still evaluating what our policy election will be to treat the GILTI tax as a period expense or to provide U.S. deferred taxes on foreign temporary differences that are expected to generate GILTI income when they reverse in future years.

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

As part of our internal control framework, we routinely perform an assessment to determine the Company's ability to continue as a going concern. As further described below, we have concluded based on projections that the cash balance, funds available from the line of credit, and the cash flows from operations are sufficient to meet the liquidity needs through the one year period following the financial statement issuance date.

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 7, 2018.

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 2018 cash flow forecast, 2018 operating budget, and long-term plan that extends beyond 2018. 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 7, 2018, 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,		
	2017	2016	2015
(in thousands, except per share data)			
<b>Statements of Operations Data:</b>			
Revenue:			
Subscription and service	\$ 168,442	\$ 154,336	\$ 151,701
Product	16,151	39,753	65,969
Total revenue	<u>184,593</u>	<u>194,089</u>	<u>217,670</u>
Cost of revenue:			
Cost of subscription and service revenue	26,082	23,676	21,629
Cost of product revenue	7,539	10,645	16,898
Total cost of revenue	<u>33,621</u>	<u>34,321</u>	<u>38,527</u>
Gross profit	<u>150,972</u>	<u>159,768</u>	<u>179,143</u>
Operating expenses			
Sales and marketing	96,660	114,340	136,084
Research and development	24,747	26,273	29,939
General and administrative	34,066	40,501	50,124
Impairment	—	3,930	6,754
Lease abandonment and termination	—	1,644	55
Total operating expenses	<u>155,473</u>	<u>186,688</u>	<u>222,956</u>
Loss from operations	<u>(4,501)</u>	<u>(26,920)</u>	<u>(43,813)</u>
Other income and (expense):			
Interest income	66	46	23
Interest expense	(491)	(470)	(378)
Other income and (expense)	881	2,297	(1,469)
Total other income and (expense)	<u>456</u>	<u>1,873</u>	<u>(1,824)</u>
Loss before income taxes	<u>(4,045)</u>	<u>(25,047)</u>	<u>(45,637)</u>
Income tax (benefit) expense	<u>(2,499)</u>	<u>2,503</u>	<u>1,159</u>
Net loss	<u>\$ (1,546)</u>	<u>\$ (27,550)</u>	<u>\$ (46,796)</u>
Loss per share:			
Basic	<u>\$ (0.07)</u>	<u>\$ (1.25)</u>	<u>(2.17)</u>
Diluted	<u>\$ (0.07)</u>	<u>\$ (1.25)</u>	<u>\$ (2.17)</u>
Common shares and equivalents outstanding:			
Basic weighted average shares	<u>22,244</u>	<u>21,969</u>	<u>21,571</u>
Diluted weighted average shares	<u>22,244</u>	<u>21,969</u>	<u>21,571</u>
<i>Stock-based compensation included in:</i>			
Cost of revenue	69	48	101
Sales and marketing	561	998	1,327
Research and development	255	709	841
General and administrative	3,256	3,151	4,926
Total stock-based compensation expense	<u>\$ 4,141</u>	<u>\$ 4,906</u>	<u>\$ 7,195</u>

**Comparison of the Year Ended December 31, 2017 and the Year Ended December 31, 2016**

Our total revenue decreased \$9.5 million to \$184.6 million for the year ended December 31, 2017, from \$194.1 million for the year ended December 31, 2016. The change in total revenue was primarily due to a decrease in Consumer Language revenue of \$12.2 million and a decrease in E&E Language revenue of \$6.8 million, which were partially offset by an increase in Literacy revenue of \$9.5 million.

We reported an operating loss of \$4.5 million for the year ended December 31, 2017, an improvement compared to an operating loss of \$26.9 million for the year ended December 31, 2016. Operating expense decreased \$31.2 million, comprised of decreases of \$17.7 million in sales and marketing expense, \$6.4 million in general and administrative expense, \$3.9 million in impairment expense, \$1.6 million in lease abandonment and termination expense, and \$1.5 million in research and development expense. The declines in operating expense reflect the continued savings as a result of the 2015 and 2016 Restructuring Plans and other ongoing expense reduction actions. The \$31.2 million reduction in operating expenses was partially offset by a decrease in gross profit of \$8.8 million, driven by a \$9.5 million decrease in revenue.

**Revenue by Operating Segment**

The following table sets forth revenue for our three operating segments for the years ended December 31, 2017 and 2016:

	Year ended December 31,				2017 versus 2016	
	2017		2016		Change	% Change
	(in thousands, except percentages)					
Literacy	\$ 43,608	23.6%	\$ 34,123	17.6%	\$ 9,485	27.8%
E&E Language	65,267	35.4%	72,083	37.1%	\$ (6,816)	(9.5)%
Consumer Language	75,718	41.0%	87,883	45.3%	\$ (12,165)	(13.8)%
Total Revenue	<u>\$ 184,593</u>	<u>100.0%</u>	<u>\$ 194,089</u>	<u>100.0%</u>	<u>\$ (9,496)</u>	<u>(4.9)%</u>

**Literacy Segment**

Literacy revenue increased \$9.5 million, or 28%, from \$34.1 million for the year ended December 31, 2016 to \$43.6 million for the year ended December 31, 2017, partially reflecting the impact of purchase accounting. Adjusting for the impact of purchase accounting on Literacy revenue, revenue would have been \$45.4 million for the year ended December 31, 2017 compared to \$38.4 million for the year ended December 31, 2016, and the Literacy pro-forma growth would have been 18% year-over-year. The organic growth in Literacy revenue was primarily driven by a larger and more mature direct sales force in 2017 as compared to 2016, which drove stronger renewal rates, an increase in new business, and an increase in professional services. We anticipate additional investments in product and sales personnel in the Literacy business to grow this segment and achieve scale.

**E&E Language Segment**

E&E Language revenue decreased \$6.8 million, or 9%, from \$72.1 million for the year ended December 31, 2016 to \$65.3 million for the year ended December 31, 2017. The decrease in E&E Language revenue reflects a decrease of \$3.6 million and \$2.9 million in the corporate channel and education channel, respectively. Included within these declines is the reduction in revenue of \$3.1 million from marketplaces exited due to the execution of our strategy to withdraw our direct presence in unprofitable geographies and manage the E&E Language business for profitable growth. Where appropriate, we will seek to operate in the geographies we exit through partners. We expect to continue to balance investments and adjust our cost structure to align scale without impacting growth.

**Consumer Language Segment**

Consumer Language revenue decreased \$12.2 million, or 14%, from \$87.9 million for the year ended December 31, 2016 to \$75.7 million for the year ended December 31, 2017. This decrease was largely due to a deliberate \$8.9 million reduction in revenue in the direct-to-consumer sales channel due to the completed transformation from perpetual products, that are recognized up front, to subscriptions that are recognized over time. Revenue from the global retail sales channel declined \$1.7 million as the sales channel began to experience the delay in revenue recognition associated with the shift from perpetual packaged products to subscription offerings. We expect revenue within the global retail sales channel will decline in 2018 as we complete the retail transition from perpetual to subscriptions. In connection with our recent shift in strategy, we will invest in the mobile and English-learning to drive growth. Our Consumer business is seasonal and consumer sales typically peak 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, 2017 and 2016:

	Year ended December 31,				2017 versus 2016	
	2017		2016		Change	% Change
	(in thousands, except percentages)					
Subscription and service revenue	\$ 168,442	91.3%	\$ 154,336	79.5%	\$ 14,106	9.1 %
Product revenue	16,151	8.7%	39,753	20.5%	(23,602)	(59.4)%
Total revenue	\$ 184,593	100.0%	\$ 194,089	100.0%	\$ (9,496)	(4.9)%

***Subscription and Service Revenue***

Subscription and service revenue increased \$14.1 million, or 9%, to \$168.4 million for the year ended December 31, 2017 from \$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 \$9.5 million of the \$14.1 million increase. As earlier noted, the 28% increase in Literacy revenue was due to organic growth and maturity of the direct sales force, which drove stronger renewal rates, an increase in new business, and an increase in professional services. Consumer Language subscription and service revenue increased by \$9.3 million, reflecting the migration from perpetual products, which were historically recognized up-front, to subscriptions, which are recognized over time. This SaaS migration was substantially completed in the direct-to-consumer sales channel in 2017. The revenue impact for the Consumer Language retail channel SaaS migration is expected to occur in 2018. In the Consumer Language segment, we have begun shifting sales from our box-based and perpetual download products to subscription products. Historically, customers in the Consumer Language segment using our longer-length subscription products (greater than a one-year term) have generally only stayed for the duration of the subscription period. We are selling shorter duration subscriptions, which if we are successful in achieving an adequate level of renewals, will allow pricing that has the potential to open up new segment demographics. As our Consumer Language products are sold through shorter-term subscriptions, cash from those sales will be spread over the initial sale period and any subsequent renewals. We expect the global retail transition to subscription sales will be complete in the first half of 2018. Within the E&E Language segment, the education channel and corporate channel declined by \$2.4 million and \$2.2 million, respectively, due in part to the marketplaces exited in unprofitable geographies.

***Product Revenue***

Product revenue decreased \$23.6 million, or 59%, to \$16.2 million during the year ended December 31, 2017 from \$39.8 million during the year ended December 31, 2016. Product revenue decreased \$19.5 million in the direct-to-consumer sales channel due to the SaaS migration completed in 2017 from perpetual products to subscription offerings. Product revenue also declined in the global retail channel by \$1.5 million. We expect the revenue impact from the SaaS migration on the retail channel will be realized in 2018 which will result in a decline in product revenue in the future. We expect the global retail transition to subscription sales will be complete in the first half of 2018.



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

The following table sets forth cost of subscription and service revenue, cost of product revenue, and gross profit for the years ended December 31, 2017 and 2016:

	Year ended December 31,		2017 versus 2016	
	2017	2016	Change	% Change
(in thousands, except percentages)				
<b>Revenue:</b>				
Subscription and service	\$ 168,442	\$ 154,336	\$ 14,106	9.1 %
Product	16,151	39,753	(23,602)	(59.4)%
Total revenue	184,593	194,089	(9,496)	(4.9)%
<b>Cost of revenue:</b>				
Cost of subscription and service revenue	26,082	23,676	2,406	10.2 %
Cost of product revenue	7,539	10,645	(3,106)	(29.2)%
Total cost of revenue	33,621	34,321	(700)	(2.0)%
<b>Gross profit</b>	<b>\$ 150,972</b>	<b>\$ 159,768</b>	<b>\$ (8,796)</b>	<b>(5.5)%</b>
Gross profit percentages	81.8%	82.3%	(0.5)%	

Total cost of revenue slightly decreased \$0.7 million, or 2%, for the year ended December 31, 2017 from \$34.3 million for the year ended December 31, 2016.

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

Cost of subscription and service revenue for the year ended December 31, 2017 was \$26.1 million, an increase of \$2.4 million, or 10% from \$23.7 million for the year ended December 31, 2016. As a percentage of subscription and service revenue, cost of subscription and service revenue remained flat at 15% for the years ended December 31, 2017 and December 31, 2016. The dollar increase in cost of subscription and service revenue was primarily due to increases in allocated costs from a higher allocation rate associated with the shift in revenue mix in favor of subscription and service revenue. We expect the cost of subscription and service revenue will increase as we complete the migration of our Consumer Language business to our subscription-based products.

***Cost of Product Revenue***

Cost of product revenue for the year ended December 31, 2017 was \$7.5 million, a decrease of 29% compared to \$10.6 million for the year ended December 31, 2016. As a percentage of product revenue, cost of product revenue increased to 47% for the year ended December 31, 2017 from 27% for the year ended December 31, 2016. The increase in cost as a percentage of revenue was primarily attributable to the intentional decline in product revenue and a \$1.9 million inventory write-down associated with our request to our retail partners to return inventory. The dollar decrease in cost of product revenue is primarily due to the continued migration to subscription-based products, specifically declines of \$1.2 million, \$0.4 million, and \$0.4 million in payroll and benefits, inventory costs, and freight costs, respectively.

***Gross Profit***

Gross profit was \$151.0 million for the year ended December 31, 2017, down \$8.8 million compared to the year ended December 31, 2016. Gross profit percentage remained flat at 82% for both the years ended December 31, 2017 and December 31, 2016. The dollar decrease in gross profit was primarily due to the decrease in revenue.

**Operating Expenses**

	Year ended December 31,		2017 versus 2016	
	2017	2016	Change	% Change
(in thousands, except percentages)				
Sales and marketing	\$ 96,660	\$ 114,340	\$ (17,680)	(15.5)%
Research and development	24,747	26,273	(1,526)	(5.8)%
General and administrative	34,066	40,501	(6,435)	(15.9)%
Impairment	—	3,930	(3,930)	(100.0)%
Lease abandonment and termination	—	1,644	(1,644)	(100.0)%
Total operating expenses	\$ 155,473	\$ 186,688	\$ (31,215)	(16.7)%

Included within our operating expenses are restructuring charges related to restructuring actions associated with 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. See Note 2 and Note 13 of Item 8, *Financial Statements and Supplementary Data* for additional information about these strategic undertakings. The following table presents restructuring costs included in the related line items of our results from operations:

	Year ended December 31,	
	2017	2016
(in thousands)		
Cost of revenue	\$ 378	\$ 573
Sales and marketing	411	2,324
Research and development	318	913
General and administrative	100	1,383
Total	\$ 1,207	\$ 5,193

While there were restructuring costs associated with each of the years ended December 31, 2017 and 2016, the severance expenses in 2017 were significantly less than the severance expenses in 2016.

***Sales and Marketing Expenses***

Sales and marketing expenses for the year ended December 31, 2017 were \$96.7 million, a decrease of \$17.7 million, or 15%, from \$114.3 million for the year ended December 31, 2016. As a percentage of total revenue, sales and marketing expenses decreased to 52% for the year ended December 31, 2017, from 59% for the year ended December 31, 2016. The decrease in sales and marketing expense was primarily due to decreases in media spend, payroll and benefits, professional services, and rent. Media expenses decreased \$11.9 million due to the change in focus in the general consumer market. Payroll and benefit expense decreased \$3.2 million primarily due to salary savings from a reduction in headcount and lower severance expenses. Professional services expenses declined \$1.4 million related to reduced spending in call centers. Rent expense declined \$0.8 million related to the relocation of the corporate headquarters. In the near term, we expect sales and marketing expenses to increase as we make targeted investments for sales growth.

***Research and Development Expenses***

Research and development expenses were \$24.7 million for the year ended December 31, 2017, a decrease of \$1.5 million, or 6%, from \$26.3 million for the year ended December 31, 2016. As a percentage of revenue, research and development expenses declined slightly to 13% for the year ended December 31, 2017, from 14% for the year ended December 31, 2016. In the near term we will focus our product investment on Lexia and key Language initiatives which are expected to increase our research and development expenses.

***General and Administrative Expenses***

General and administrative expenses for the year ended December 31, 2017 were \$34.1 million, a decrease of \$6.4 million, or 16%, from \$40.5 million for the year ended December 31, 2016. As a percentage of revenue, general and administrative expenses decreased to 18% for the year ended December 31, 2017 compared to 21% for year ended December 31, 2016. The decrease in general and administrative expenses was primarily due to reductions in professional

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services, amortization expense, and bad debt expense. Professional services declined \$3.3 million due to the absence of external strategic advisor costs compared to 2016 and also due to lower external audit fees and lower legal fees. Amortization expense decreased \$1.4 million due to the completed amortization of multiple projects in 2016. Bad debt expense decreased \$0.8 million due to better collection efforts and lower reserve balances. We expect our general and administrative expenses to increase slightly in the near term.

**Impairment**

There were no impairment expenses for the year ended December 31, 2017. The \$3.9 million impairment in the year ended December 31, 2016 was due to the 2016 impairments related to Fit Brains goodwill of \$1.7 million, Fit Brains intangible assets of \$1.2 million, and a \$1.0 million abandonment charge associated with a previously capitalized software project that no longer aligned to our strategic direction.

**Lease Abandonment and Termination**

There were no lease abandonment and termination expenses for the year ended December 31, 2017. The \$1.6 million lease abandonment and termination charge for the year ended December 31, 2016 related to the planned space consolidation of our former headquarters location in Arlington, VA in the fourth quarter of 2016.

**Other Income and (Expense)**

	Year ended December 31,		2017 versus 2016	
	2017	2016	Change	% Change
	(in thousands, except percentages)			
Interest income	\$ 66	\$ 46	\$ 20	43.5 %
Interest expense	(491)	(470)	(21)	4.5 %
Other income and (expense)	881	2,297	(1,416)	(61.6)%
Total other income and (expense)	\$ 456	\$ 1,873	\$ (1,417)	(75.7)%

Interest income for the year ended December 31, 2017 was \$0.1 million, a slight increase from the year ended December 31, 2016. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the years ended December 31, 2017 and December 31, 2016 was \$0.5 million. Interest expense primarily represents 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, 2017 was income of \$0.9 million, a decrease of \$1.4 million, as compared to income of \$2.3 million for the year ended December 31, 2016. The change was primarily attributable to foreign exchange fluctuations.

**Income Tax (Benefit) Expense**

	Year ended December 31,		2017 versus 2016	
	2017	2016	Change	% Change
	(in thousands, except percentages)			
Income tax (benefit) expense	\$ (2,499)	\$ 2,503	\$ (5,002)	(199.8)%

Our income tax benefit for the year ended December 31, 2017 was \$2.5 million, compared to an income tax expense of \$2.5 million for the year ended December 31, 2016. The favorable change was primarily related to the reduction in the corporate tax rate from 35% to 21% under the Tax Reform. This resulted in a deferred tax benefit of \$5.5 million, offset by current year tax expense due to profits of operations in Canada, Germany, and the U.K. Additionally, deferred tax expense in 2016 includes 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 certain foreign jurisdictions and in the U.S.

**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 Language revenue of \$31.7 million and a slight decrease in E&E 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 and 2015 Restructuring Plans 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 \$23.6 million decrease in revenue, partially offset by a decrease of \$4.2 million in cost of 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)					
Literacy	\$ 34,123	17.6%	\$ 21,928	10.1%	\$ 12,195	55.6 %
E&E Language	72,083	37.1%	76,129	35.0%	(4,046)	(5.3)%
Consumer Language	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)%

**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.

**E&E Language Segment**

Total E&E 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 E&E 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.

**Consumer Language Segment**

Consumer Language 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 Language revenue by \$3.6 million. The reduction in homeschool revenue was primarily due to the sale of the Korea entity in the third quarter of 2015.

**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, 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 E&E 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 Language 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 Language decline in revenue associated with our recent shift in strategy to focus on the passionate learner. In the Consumer Language 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.

### *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 Language 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.

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

The following table sets forth cost of subscription and service revenue, cost of product revenue, and 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 Language 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*

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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	\$ 186,688	\$ 222,956	\$ (36,268)	(16.3)%

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 E&E 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

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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.

**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.

**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 market and improvements in accounts receivable collections. Other costs decreased due to the ongoing cost saving measures.

**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)%

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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

	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.

## Liquidity and Capital Resources

### Liquidity

Our principal source of liquidity at December 31, 2017 consisted of \$43.0 million in cash and cash equivalents and short-term investments, an increase of \$6.8 million, from \$36.2 million compared to December 31, 2016. 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, 2017, we generated \$19.3 million cash flows from operations as reflected in our consolidated statements of cash flows.

Our operating segments are affected by different sales-to-cash patterns. Within our E&E 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 Language revenue is affected by seasonal trends associated with the holiday shopping season. Consumer Language sales typically turn to cash more quickly than E&E 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 the trend to use cash in the first half of the year and generate cash in the second half of the year to continue.

On October 28, 2014, we executed a Loan and Security Agreement with Silicon Valley Bank ("Bank") to obtain a \$25.0 million revolving credit facility. Since the original date of execution, we have executed several amendments to the credit facility to reflect updates to our financial outlook and extend the credit facility. 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 has a term that expires on April 1, 2020, during which time we 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 the Bank 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 accrues 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 \$15.1 million of available credit less \$4.0 million in letters of credit have been issued by the Bank on our behalf, resulting in a net borrowing availability of \$11.1 million. We are subject to certain financial and restrictive covenants under the credit facility. We are required to maintain compliance with a minimum liquidity ratio and maintain a minimum Adjusted EBITDA. As of December 31, 2017, we were in compliance with all of the covenants under the revolving credit agreement.



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The total amount of cash that was held by foreign subsidiaries as of December 31, 2017 was \$7.6 million. As of December 31, 2017, 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 cash flows from operations 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 loss 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, 2017 as compared to the year ended December 31, 2016

	Year ended December 31,		2017 versus 2016	
	2017	2016	Change	% Change
	(in thousands, except percentages)			
Net cash provided by operating activities	\$ 19,302	\$ 1,240	\$ 18,062	1,456.6 %
Net cash used in investing activities	\$ (12,822)	\$ (12,476)	\$ (346)	2.8 %
Net cash used in financing activities	\$ (118)	\$ (658)	\$ 540	(82.1)%

#### Net Cash Provided By Operating Activities

Net cash provided by operating activities was \$19.3 million for the year ended December 31, 2017 compared to \$1.2 million for the year ended December 31, 2016, a favorable change of \$18.1 million. The factors affecting our operating cash flows during the year were our improvement in net loss from \$27.6 million to \$1.5 million, driven primarily by a reduction in operating expenses. For a summary of the factors that led to the net loss for the year ended December 31, 2017 see "Results of Operations" section above. Non-cash items primarily consisted of \$12.0 million in depreciation and amortization expense and \$4.1 million in stock-based compensation expense, partially offset by \$4.2 million in deferred income tax benefit. The primary drivers of the change in operating assets and liabilities were a decrease in accounts receivable of \$7.6 million, an increase in deferred revenue of \$8.9 million, a decrease in inventory of \$3.3 million, partially offset by a decrease in other current liabilities of \$6.5 million, a decrease in accounts payable of \$1.8 million, and a decrease in other long-term liabilities of \$1.2 million. The decrease in accounts receivable was primarily related to improved collection efforts and lower revenues. The increase in deferred revenue was primarily due to the increase in sales in the Literacy segment, a sales shift from our box-based and perpetual download products to subscription product, and the increase in deferred revenue related to a significant transaction in Japan with SOURCENEXT. The decrease in inventory was primarily due to an inventory write down of finished packaged perpetual products due to the transition from box-based and perpetual download products to subscription product. The declines in other current liabilities, accounts payable, and other long-term liabilities reflect the ongoing cost reduction initiatives which resulted in lower operating expenses and fewer obligations due for marketing, advertising, rebates, and general business activities.

The dollar change between the net cash provided by operating activities for the year ended December 31, 2017 as compared to December 31, 2016 was due in part to the positive cash inflows totaling \$13.0 million related to the execution of agreements with SOURCENEXT Corporation for the perpetual license of certain intellectual property for exclusive use and sale in Japan. See Note 8 "Divestitures" of Item 8, *Financial Statements and Supplementary Data* for a further description of the SOURCENEXT transaction.

[Table of Contents](#)*Net Cash Used in Investing Activities*

Net cash used in investing activities was \$12.8 million for the year ended December 31, 2017, compared to \$12.5 million for the year ended December 31, 2016. Purchases of property and equipment, which primarily relates to capitalized labor on product and corporate IT projects was slightly higher in 2017 as compared to 2016.

*Net Cash Used in Financing Activities*

Net cash used in financing activities was \$0.1 million for the year ended December 31, 2017, compared to \$0.7 million for the year ended December 31, 2016. The favorable change was primarily driven by an increase in proceeds from the exercise of stock options due to the rise in our stock price in 2017 as compared to 2016.

**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)%

*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.

**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, 2017 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	\$ 2,572	\$ 548	\$ 1,085	\$ 939	\$ —
Operating leases	7,755	4,419	2,746	590	—
Total	<u>\$ 10,327</u>	<u>\$ 4,967</u>	<u>\$ 3,831</u>	<u>\$ 1,529</u>	<u>\$ —</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 Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2017. 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-

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benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2017, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

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

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, 2017. 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).

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, 2017 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, 2017 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 2018 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," "Executive Officers," "Security Ownership of Certain Beneficial Owners and Management—Section 16(a) Beneficial Ownership Reporting Compliance," "Corporate Governance—Code of Ethics and Business Conduct," "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 2018 Annual Meeting of Stockholders to be filed with the SEC no later than 120 days after the fiscal year ended December 31, 2017 (the "2018 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 2018 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 Plan Information" in the 2018 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 2018 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 2018 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.

**EXHIBIT INDEX**

	<u>Index to exhibits</u>
2.1	<a href="#">Purchase and Sale Agreement by and among Rosetta Stone Ltd., Rosetta Stone Japan Inc., and SOURCENEXT Corporation, dated April 25, 2017 (incorporated herein by reference to Exhibit 2.1 filed with the Company's Current Report on Form 8-K filed on April 25, 2017).</a>
3.1	<a href="#">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).</a>
3.2	<a href="#">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).</a>
4.1	<a href="#">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).</a>
10.1 +	<a href="#">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).</a>
10.2 +	<a href="#">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).</a>
10.3 +	<a href="#">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).</a>
10.4 +	<a href="#">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).</a>
10.5 +	<a href="#">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.)</a>
10.6 +	<a href="#">Form of Annual Performance-Based Nonqualified Stock Option Award Agreement, dated April 4, 2016, between the Company and John Hass (incorporated herein by reference to Exhibit 10.3 in the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017).</a>
10.7 +	<a href="#">Form of Long-Term Performance-Based Nonqualified Stock Option Award Agreement, dated April 4, 2016, between the Company and John Hass (incorporated herein by reference to Exhibit 10.4 in the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017).</a>
10.8 +	<a href="#">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).</a>

**Index to exhibits**

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- 10.9 + [Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards after October 1, 2011 \(incorporated herein by reference to Exhibit 10.26 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011\).](#)
  - 10.10 + [Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards after February 1, 2016 \(incorporated herein by reference to Exhibit 10.11 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015\).](#)
  - 10.11 + [Director Form of Restricted Stock Unit Award Agreement under the 2009 Plan \(incorporated herein by reference to Exhibit 10.12 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014\).](#)
  - 10.12 + [Director Form of Restricted Stock Unit Award Agreement under the 2009 Plan \(for awards beginning June 2015\) \(incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2015\).](#)
  - 10.13 + [Form of Annual Performance-Based Restricted Stock Award Agreement, dated April 4, 2016, between the Company and John Hass \(incorporated herein by reference to Exhibit 10.1 in the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017\).](#)
  - 10.14 + [Form of Long-Term Performance-Based Restricted Stock Award Agreement, dated April 4, 2016, between the Company and John Hass \(incorporated herein by reference to Exhibit 10.2 in the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017\).](#)
  - 10.15 + [Policy on Recoupment of Performance Based Compensation \(Clawback Policy\) \(incorporated herein by reference to Exhibit 10.26 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014\).](#)
  - 10.16 + [Rosetta Stone Inc. Change in Control Severance Plan \(incorporated herein by reference to Exhibit 10.18 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.\)](#)
  - 10.17 [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\).](#)
  - 10.18 [Form of Indemnification Agreement to be entered into with each director and executive officer, revised as of August 2015 \(incorporated herein by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2015\).](#)
  - 10.19 + [Executive Employment Agreement between Rosetta Stone Ltd. and Thomas Pierno effective as of May 2, 2012 \(incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 1, 2012\).](#)
  - 10.20 + [Director Agreement between Rosetta Stone Inc. and A. John Hass III effective as of November 18, 2014 \(incorporated herein by reference to Exhibit 10.31 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014\).](#)
  - 10.21 + [Executive Employment Agreement between Rosetta Stone Ltd. and A. John Hass III effective as of April 1, 2016 \(incorporated herein by reference to Exhibit 10.1 in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016.\)](#)
  - 10.22 + [Executive Employment Agreement between the Company and Sonia Cudd, effective as of January 2, 2015 \(incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2015\).](#)
  - 10.23 \*+ [Executive Employment Agreement between the Company and Mathew Hulett, effective as of August 4, 2017.](#)
  - 10.24 \*+ [Executive Employment Agreement between the Company and Nicholas Gaehde, effective as of August 21, 2017.](#)
  - 10.25 [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\).](#)
  - 10.26 [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\).](#)
  - 10.27 [First Amendment to Sublease Agreement with The Corporate Executive Board, dated as of November 1, 2012 \(incorporated herein by reference to Exhibit 10.23 filed with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012\).](#)
  - 10.28 [Sub-Sublease Agreement dated as of April 3, 2014, by and between Rosetta Stone Ltd. and The Corporate Executive Board Company \(incorporated herein by reference to Exhibit 10.27 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014\).](#)
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**Index to exhibits**

10.29	<a href="#">Sub-Sublease Agreement dated as of July 14, 2016, by and between Rosetta Stone Ltd. and Snagajob.com, Inc. (incorporated herein by reference to Exhibit 10.37 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016).</a>
10.30	<a href="#">Software License Agreement by and between The Regents of the University of Colorado and Fairfield &amp; 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).***</a>
10.31	<a href="#">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).</a>
10.32	<a href="#">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).</a>
10.33	<a href="#">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).</a>
10.34	<a href="#">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).</a>
10.35	<a href="#">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.).</a>
10.36	<a href="#">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).</a>
10.37	<a href="#">Sixth Amendment to Loan and Security Agreement dated as of March 10, 2017 between Silicon Valley Bank and Rosetta Stone Ltd. (incorporated herein by reference to Exhibit 10.45 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016).</a>
21.1 *	<a href="#">Rosetta Stone Inc. Subsidiaries.</a>
23.1 *	<a href="#">Consent of Deloitte &amp; Touche LLP, independent registered public accounting firm.</a>
24.1 *	<a href="#">Power of Attorney.</a>
31.1 *	<a href="#">Certifications of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
31.2 *	<a href="#">Certifications of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
32.1 *	<a href="#">Certifications of Principal Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>
32.2 *	<a href="#">Certifications of Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>
101.INS *	XBRL Instance Document.
101.SCH *	XBRL Taxonomy Extension Schema.
101.CAL *	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF *	XBRL Taxonomy Extension Definition Linkbase.
101.LAB *	XBRL Taxonomy Extension Label Linkbase.
101.PRE *	XBRL Taxonomy Extension Presentation Linkbase.

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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.

**Item 16. Form 10-K Summary**

Not applicable.

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**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 stockholders and Board of Directors of Rosetta Stone Inc.

**Opinion on the Financial Statements**

We have audited the accompanying consolidated balance sheets of Rosetta Stone Inc. and subsidiaries (the "Company") as of December 31, 2017 and 2016, and the related consolidated statements of operations, comprehensive loss, changes in stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the "financial statements"). In our opinion the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of operations and its cash flows for each of the three years in the period ended December 31, 2017, 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) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 7, 2018, expressed an unqualified opinion on the Company's internal control over financial reporting.

**Basis of Opinion**

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ DELOITTE & TOUCHE LLP

McLean, Virginia

March 7, 2018

We have served as the Company's auditor since 2004.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the stockholders and Board of Directors of Rosetta Stone Inc.

**Opinion on Internal Control over Financial Reporting**

We have audited the internal control over financial reporting of Rosetta Stone Inc. and subsidiaries (the “Company”) as of December 31, 2017, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated financial statements as of and for the year ended December 31, 2017 of the Company and our report dated March 7, 2018, expressed an unqualified opinion on those financial statements.

**Basis for Opinion**

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 are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. 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.

**Definition and Limitations of Internal Control over Financial Reporting**

A company’s 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. 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 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.

/s/ DELOITTE & TOUCHE LLP

McLean, Virginia  
March 7, 2018

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

	As of December 31,	
	2017	2016
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 42,964	\$ 36,195
Restricted cash	72	402
Accounts receivable (net of allowance for doubtful accounts of \$375 and \$1,072, at December 31, 2017 and December 31, 2016, respectively)	24,517	31,788
Inventory	3,536	6,767
Deferred sales commissions	14,466	14,085
Prepaid expenses and other current assets	4,543	3,813
Total current assets	90,098	93,050
Deferred sales commissions	3,306	4,143
Property and equipment, net	30,649	24,795
Goodwill	49,857	48,251
Intangible assets, net	19,184	22,753
Other assets	1,661	1,318
<b>Total assets</b>	\$ 194,755	\$ 194,310
<b>Liabilities and stockholders' equity (deficit)</b>		
Current liabilities:		
Accounts payable	\$ 8,984	\$ 10,684
Accrued compensation	10,948	10,777
Income tax payable	384	785
Obligations under capital lease	450	532
Other current liabilities	16,454	22,150
Deferred revenue	110,670	113,821
Total current liabilities	147,890	158,749
Deferred revenue	40,593	27,636
Deferred income taxes	1,968	6,173
Obligations under capital lease	1,850	2,027
Other long-term liabilities	31	1,384
<b>Total liabilities</b>	192,332	195,969
Commitments and contingencies (Note 16)		
<b>Stockholders' equity (deficit):</b>		
Preferred stock, \$0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at December 31, 2017 and December 31, 2016, respectively	—	—
Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 23,783 and 23,451 shares issued and 22,783 and 22,451 shares outstanding at December 31, 2017 and December 31, 2016, respectively	2	2
Additional paid-in capital	195,644	190,827
Treasury stock, at cost; 1,000 and 1,000 shares at December 31, 2017 and December 31, 2016, respectively	(11,435)	(11,435)
Accumulated loss	(178,890)	(177,344)
Accumulated other comprehensive loss	(2,898)	(3,709)
<b>Total stockholders' equity (deficit)</b>	2,423	(1,659)
<b>Total liabilities and stockholders' equity (deficit)</b>	\$ 194,755	\$ 194,310

See accompanying notes to consolidated financial statements

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

	Years Ended December 31,		
	2017	2016	2015
<b>Revenue:</b>			
Subscription and service	\$ 168,442	\$ 154,336	\$ 151,701
Product	16,151	39,753	65,969
Total revenue	184,593	194,089	217,670
<b>Cost of revenue:</b>			
Cost of subscription and service revenue	26,082	23,676	21,629
Cost of product revenue	7,539	10,645	16,898
Total cost of revenue	33,621	34,321	38,527
Gross profit	150,972	159,768	179,143
<b>Operating expenses</b>			
Sales and marketing	96,660	114,340	136,084
Research and development	24,747	26,273	29,939
General and administrative	34,066	40,501	50,124
Impairment	—	3,930	6,754
Lease abandonment and termination	—	1,644	55
Total operating expenses	155,473	186,688	222,956
Loss from operations	(4,501)	(26,920)	(43,813)
<b>Other income and (expense):</b>			
Interest income	66	46	23
Interest expense	(491)	(470)	(378)
Other income and (expense)	881	2,297	(1,469)
Total other income and (expense)	456	1,873	(1,824)
Loss before income taxes	(4,045)	(25,047)	(45,637)
Income tax (benefit) expense	(2,499)	2,503	1,159
Net loss	\$ (1,546)	\$ (27,550)	\$ (46,796)
<b>Loss per share:</b>			
Basic	\$ (0.07)	\$ (1.25)	\$ (2.17)
Diluted	\$ (0.07)	\$ (1.25)	\$ (2.17)
<b>Common shares and equivalents outstanding:</b>			
Basic weighted average shares	22,244	21,969	21,571
Diluted weighted average shares	22,244	21,969	21,571

See accompanying notes to consolidated financial statements

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

	Years Ended December 31,		
	2017	2016	2015
Net loss	\$ (1,546)	\$ (27,550)	\$ (46,796)
Other comprehensive income (loss), net of tax:			
Foreign currency translation gain (loss)	811	(1,483)	(1,548)
Other comprehensive income (loss)	811	(1,483)	(1,548)
Comprehensive loss	<u>\$ (735)</u>	<u>\$ (29,033)</u>	<u>\$ (48,344)</u>

See accompanying notes to consolidated financial statements

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

	Non-Designated Common Stock		Additional Paid-in Capital	Treasury Stock	Accumulated Loss	Accumulated Other Comprehensive Loss	Total Stockholders' Equity / (Deficit)
	Shares	Amount					
Balance—January 1, 2015	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)
Stock Issued Upon the Exercise of Stock Options	79	—	676	—	—	—	676
Restricted Stock Award Vesting	163	—	—	—	—	—	—
Stock-based Compensation Expense	—	—	4,141	—	—	—	4,141
Net loss	—	—	—	—	(1,546)	—	(1,546)
Other comprehensive income	—	—	—	—	—	811	811
Balance—December 31, 2017	22,316	\$ 2	\$ 195,644	\$ (11,435)	\$ (178,890)	\$ (2,898)	\$ 2,423

See accompanying notes to consolidated financial statements



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

	Years Ended December 31,		
	2017	2016	2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (1,546)	\$ (27,550)	\$ (46,796)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:			
Stock-based compensation expense	4,141	4,906	7,195
(Gain) loss on foreign currency transactions	(573)	(2,449)	1,471
Bad debt (recovery) expense	(51)	709	1,657
Depreciation and amortization	12,009	13,322	13,660
Deferred income tax (benefit) expense	(4,201)	1,162	849
(Gain) loss on disposal of equipment	(5)	179	(15)
Amortization of deferred financing costs	296	274	160
Loss on impairment	—	3,930	6,754
Loss from equity method investments	100	45	23
Gain on divestiture of subsidiary	(506)	—	(660)
Net change in:			
Restricted cash	342	(378)	43
Accounts receivable	7,584	14,681	26,376
Inventory	3,266	538	(1,253)
Deferred sales commissions	491	919	(4,121)
Prepaid expenses and other current assets	(604)	(167)	1,080
Income tax receivable or payable	(447)	719	568
Other assets	(455)	668	(684)
Accounts payable	(1,765)	(74)	(8,636)
Accrued compensation	69	2,701	(5,485)
Other current liabilities	(6,450)	(13,261)	(14,223)
Other long-term liabilities	(1,243)	558	(486)
Deferred revenue	8,850	(192)	16,878
Net cash provided by (used in) operating activities	19,302	1,240	(5,645)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(12,944)	(12,514)	(8,856)
Proceeds from sale of fixed assets	12	38	1,642
Acquisitions, net of cash acquired	—	—	(1,688)
Proceeds (payments) on divestiture of subsidiary	110	—	(186)
Other investing activities	—	—	(286)
Net cash used in investing activities	(12,822)	(12,476)	(9,374)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from the exercise of stock options	676	58	114
Payment of deferred financing costs	(232)	(183)	(130)
Payments under capital lease obligations	(562)	(533)	(711)
Net cash used in financing activities	(118)	(658)	(727)
Increase (decrease) in cash and cash equivalents	6,362	(11,894)	(15,746)
Effect of exchange rate changes in cash and cash equivalents	407	307	(1,129)
Net increase (decrease) in cash and cash equivalents	6,769	(11,587)	(16,875)
Cash and cash equivalents—beginning of year	36,195	47,782	64,657
Cash and cash equivalents—end of year	\$ 42,964	\$ 36,195	\$ 47,782
<b>SUPPLEMENTAL CASH FLOW DISCLOSURE:</b>			
Cash paid during the periods for:			
Interest	\$ 195	\$ 197	\$ 218
Income taxes, net of refund	\$ 1,896	\$ 604	\$ 601
Noncash financing and investing activities:			
Accrued liability for purchase of property and equipment	\$ 967	\$ 270	\$ 258
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 web-based software subscriptions, perpetual software products, 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 web-based software subscriptions and packaged software, domestically and in certain international markets.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

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

**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.

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 Language 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 undelivered services cannot be established, revenue is deferred and recognized commensurate with the delivery of the services.

For non-software multiple element arrangements, the Company allocates revenue to all deliverables based on their relative selling prices. 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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 its 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 the 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 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/

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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 as 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 8 "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.

**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, 2017, 2016 or 2015. The four largest distributor and reseller receivable balances collectively represented 17% and 23% of accounts receivable as of December 31, 2017 and 2016, respectively. No customer accounted for more than 10% of accounts receivable as of December 31, 2017, while one customer accounted for 13% of accounts receivable as of December 31, 2016. 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:

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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 and Equipment" for the Company's additional disclosures.

**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. See Note 4 "Property and Equipment" for a discussion of the software developed for internal use.

**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").

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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 6 "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. 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 a quantitative 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.

See Note 5 "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 E&E 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, 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 the Company's 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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 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 including the impact and additional disclosures associated with the recent Tax Reform enacted on December 22, 2017.

**Stock-Based Compensation**

The Company accounts for its stock-based compensation in accordance with ASC topic 718, *Compensation—Stock Compensation* ("ASC 718"). Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date. 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. 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. Changes in the probability estimates associated with performance-based awards 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 performance-based award is reversed. For equity awards granted with market-based conditions,



## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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**

Restructuring plans have been initiated in each of the years ended December 31, 2017, 2016 and 2015 to reduce headcount and other costs in order to support the 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 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.

**Basic and Diluted 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 by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted loss per share is computed by dividing net loss by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares are included in the diluted computation when dilutive. Potentially dilutive shares are computed using the treasury stock method and primarily 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. See Note 12 "Basic and Diluted Net Loss Per Share" for additional disclosures.

**Comprehensive Loss**

Comprehensive loss consists of net loss and other comprehensive income (loss). Other comprehensive income (loss) refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' equity (deficit). For the years ended December 31, 2017, 2016 and 2015, the Company's comprehensive loss consisted of net loss and foreign currency translation gains (losses). The other comprehensive income (loss) presented in the consolidated financial statements and the notes are presented net of tax. There has been no tax expense or benefit associated with the components other comprehensive income (loss) due to the presence of a full valuation allowance for each of the years ended December 31, 2017, 2016 and 2015.

Components of accumulated other comprehensive loss as of December 31, 2017 are as follows (in thousands):

	Foreign Currency	Total
Balance at beginning of period	\$ (3,709)	\$ (3,709)
Other comprehensive income before reclassifications	886	886
Amounts reclassified from accumulated other comprehensive income	(75)	(75)
Net current period other comprehensive income	811	811
Accumulated other comprehensive loss	\$ (2,898)	\$ (2,898)

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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 income (loss) and reported as part of the gain or loss on sale or liquidation of the investment. During the year ended December 31, 2017, transfers totaling of \$0.1 million were made from accumulated other comprehensive income (loss) and recognized within net loss related to the sale of a foreign subsidiary.

**Foreign Currency Translation and Transactions**

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

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, 2017, 2016, and 2015 were \$24.9 million, \$37.0 million and \$46.9 million, respectively.

**Going Concern Assessment**

As part of its internal control framework, the Company routinely performs a quarterly going concern assessment in accordance with ASC sub-topic 205-40, Presentation of Financial Statements - Going Concern ("ASC 205-40"). Under ASC 205-40, management is required to assess the Company's ability to continue as a going concern. As further described below, management has concluded based on projections that the cash balance, funds available from the line of credit, and the cash flows from operations are sufficient to meet the liquidity needs through the one year period following the financial statement issuance date.

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 7, 2018.

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 2018 cash flow forecast, 2018 operating budget, and long-term plan that extends beyond 2018. 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 7, 2018, 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 2017, the Company adopted the following recently issued Accounting Standard Updates ("ASU"):

In March 2016, the Financial Accounting Standards Board ("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 adopted this ASU as of January 1, 2017. Due to the historical cumulative shortfall position, the

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

adoption of ASU 2016-09 did 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 has elected to continue to estimate the number of awards that are expected to vest. Other aspects of adoption ASU 2016-09 did not have a material impact to the Company's consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, *Business Combination (Topic 805) Clarifying the Definition of a Business* ("ASU 2017-01"). ASU 2017-01 clarifies 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 early adopted this guidance as of January 1, 2017. Due to the prospective application of this ASU, there was no impact to historical financial statements and no additional disclosures are required.

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

In February 2018, the FASB issued ASU No. 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* ("ASU 2018-02"). ASU 2018-02 provides financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Reform (or portion thereof) is recorded. ASU 2018-02 is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted for any interim period for which financial statements have not been issued. The Company does not believe that the adoption of this guidance will have a material impact on the Company's consolidated financial statements due the presence of a full valuation allowance. However, the Company is in the process of evaluating the impact of this new guidance on the Company's consolidated financial statements and disclosures.

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 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 will adopt this new guidance for its 2018 interim and annual reporting periods. The new guidance only impacts presentation of the Company's consolidated statement of cash flows.

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 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 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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 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 Company will adopt the New Revenue Standard using the modified retrospective method. 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 has substantially completed its evaluation of the impact the New Revenue Standard will have on its financial statements, disclosures, policies, processes, and system requirements. The Company has completed the development of its "recast tool" that enables the Company to determine the cumulative effect of adopting the new guidance as of January 1, 2018. As part of its evaluation, the Company has concluded the impact of the change in the New Revenue Standard on the E&E Language and Literacy segments will be minimal as the accounting outcome for the vast majority of these transactions remains unchanged. Due to the elimination of software specific accounting guidance, nearly all of the impact of adopting the New Revenue Standard will result from changes to the accounting for the packaged perpetual software product line that also includes non-software elements within the Consumer Language segment. Under the current revenue standard, the Company uses the residual method to allocate consideration between the software and non-software elements within a transaction. This results in a fixed amount being allocated to the non-software element, which is generally deferred and recognized over time, and any discount being fully allocated to the software element, which is recognized as revenue at the time of sale. Under the New Revenue Standard, any discounts will be allocated to all of the elements within a software transaction based on relative selling price. Accordingly, this will result in different amounts allocated to the various elements which are recognized into revenue at different times. As such, the Company currently estimates the adoption of the New Revenue Standard will increase the 2018 beginning retained earnings balance by approximately \$0.8 million, decrease deferred revenue by \$0.6 million, and decrease other current liabilities by \$0.2 million, associated with eliminating the Company's accrual for post-contract customer support.

As part of the Consumer Language migration to a fully SaaS business, the Company began to phase out the sale of perpetual product bundled with short-term online services (for which VSOE has been established) in the second half of 2017. The Company then began offering perpetual product bundled with a long-term web-based software subscription (for which VSOE has not been established). This shift in product offerings has impacted the timing of revenue recognition under existing revenue recognition rules and is expected to impact the timing of revenue recognized under the New Revenue Standard. Under existing revenue recognition rules, perpetual product bundled with undelivered services without VSOE are deferred in full and recognized ratably over the service period. Under the New Revenue Standard, the transaction price is allocated to each performance obligation based on relative selling price and recognized when the performance obligations are satisfied. Accordingly, the Company estimates that the adoption of the New Revenue Standard will result in earlier recognition of revenue from sales of its current Consumer Language bundled offering than would have otherwise been recognized under the prior revenue recognition rules. As the Company continues its path toward a 100% SaaS business, the timing of revenue

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

recognition will shift from partial up-front recognition to full recognition over time. Further, the Company does not expect any tax impact due to the presence of a full valuation allowance. The additional impacts to the financial statements include the new qualitative and quantitative disclosures that will be required upon adoption of the New Revenue Standard. The Company continues to evaluate the impact of the New Revenue Standard and any assessments made are subject to change.

**3. INVENTORY**

Inventory consisted of the following (in thousands):

	As of December 31,	
	2017	2016
Raw materials	\$ 2,893	\$ 4,384
Finished goods	643	2,383
Total inventory	\$ 3,536	\$ 6,767

The finished goods inventory balance as of December 31, 2017 reflected the Company's ongoing efforts to transition the Consumer Language segment to a SaaS model. In the third quarter of 2017, the Company requested its consignment retail partners to return inventory totaling \$1.9 million of finished packaged perpetual products. This non-cash inventory write-down was reflected as a cost of product revenue on the Company's statements of operations.

**4. PROPERTY AND EQUIPMENT**

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

	As of December 31,	
	2017	2016
Land	\$ 942	\$ 876
Buildings and improvements	10,030	9,503
Leasehold improvements	1,468	1,645
Computer equipment	15,635	15,866
Software	54,600	43,688
Furniture and equipment	2,427	2,393
	85,102	73,971
Less: accumulated depreciation	(54,453)	(49,176)
Property and equipment, net	\$ 30,649	\$ 24,795

The Company leases certain computer equipment, software, buildings, and machinery under capital lease agreements. As of December 31, 2017 and 2016, assets under capital lease included in property and equipment above were \$5.9 million and \$5.4 million, respectively. As of December 31, 2017 and 2016, accumulated depreciation and amortization relating to property and equipment under capital lease arrangements totaled \$2.8 million and \$2.1 million, respectively.

For the years ended December 31, 2017, 2016, and 2015 the Company capitalized \$12.7 million, \$11.4 million, and \$7.1 million respectively, of internal-use software development costs. During the years ended December 31, 2016 and 2015, the Company recorded \$1.0 million and \$1.1 million respectively, in impairment expense related to the abandonment of previously capitalized internal-use software projects. There were no impairment charges during the year ended December 31, 2017.

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. Depreciation and amortization expense associated with property and equipment consisted of the following (in thousands):

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

**4. PROPERTY AND EQUIPMENT**

	Years Ended December 31,		
	2017	2016	2015
Included in cost of revenue:			
Cost of subscription and service revenue	\$ 3,863	\$ 3,057	\$ 1,292
Cost of product revenue	1,117	1,377	1,010
Total included in cost of revenue	4,980	4,434	2,302
Included in operating expenses:			
Sales and marketing	546	489	722
Research and development	9	19	41
General and administrative	2,635	4,029	5,403
Total included in operating expenses	3,190	4,537	6,166
Total	\$ 8,170	\$ 8,971	\$ 8,468

**5. 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 acquisition of 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 350, or more frequently, if impairment indicators arise. The Company also routinely reviews goodwill at the reporting unit level for potential impairment.

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

**5. 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, 2017 and 2016 (in thousands):

	<u>E&amp;E Language</u>	<u>Literacy</u>	<u>Consumer Language</u>	<u>Total</u>
<b>Balance as of January 1, 2016</b>				
Gross Goodwill	\$ 38,700	\$ 9,962	\$ 27,392	\$ 76,054
Accumulated Impairment	—	—	(25,774)	(25,774)
Goodwill as of January 1, 2016	<u>\$ 38,700</u>	<u>\$ 9,962</u>	<u>\$ 1,618</u>	<u>\$ 50,280</u>
<b>Balance as of December 31, 2016</b>				
Gross Goodwill	\$ 38,289	\$ 9,962	\$ 27,514	\$ 75,765
Accumulated Impairment	—	—	(27,514)	(27,514)
Goodwill as of December 31, 2016	<u>\$ 38,289</u>	<u>\$ 9,962</u>	<u>\$ —</u>	<u>\$ 48,251</u>
<b>Balance as of December 31, 2017</b>				
Gross Goodwill	\$ 39,895	\$ 9,962	\$ 27,514	\$ 77,371
Accumulated Impairment	—	—	(27,514)	(27,514)
Goodwill as of December 31, 2017	<u>\$ 39,895</u>	<u>\$ 9,962</u>	<u>\$ —</u>	<u>\$ 49,857</u>
Effect of change in foreign currency rate	1,606	—	—	1,606

**2017 Activity**

The Company began its June 30, 2017 annual goodwill test with the qualitative test for the two reporting units with goodwill balances. 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 its reporting units is less than the carrying value. Accordingly, a quantitative impairment test was not performed and no goodwill impairment charges were recorded in connection with the annual impairment test. As such, there was no impairment of goodwill during the year ended December 31, 2017.

**2016 Activity**

The Company exercised its option to bypass the qualitative test for all reporting units with remaining goodwill balances in connection with the annual goodwill impairment analysis performed as of June 30, 2016. The E&E 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. As a result, the Company recorded a 2016 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. The Company had previously recorded a partial impairment of the Consumer Fit Brains reporting unit in 2015 of \$5.6 million

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

**6. 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	\$ 12,431	\$ 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	<u>\$ 10,924</u>	<u>\$ 4,232</u>	<u>\$ 7,536</u>	<u>\$ 61</u>	<u>\$ 22,753</u>
Gross Carrying Amount	\$ 12,505	\$ 15,636	\$ 26,656	\$ 312	\$ 55,109
Accumulated Amortization	(1,755)	(12,222)	(20,515)	(278)	(34,770)
Accumulated Impairment	(26)	(1,001)	(128)	—	(1,155)
Balance as of December 31, 2017	<u>\$ 10,724</u>	<u>\$ 2,413</u>	<u>\$ 6,013</u>	<u>\$ 34</u>	<u>\$ 19,184</u>

\* 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	0.58 years
Core technology	1.94 years
Customer relationships	5.00 years
Patents	1.25 years

Amortization expense consisted of the following (in thousands):

	Years Ended December 31,		
	2017	2016	2015
Included in cost of revenue:			
Cost of subscription and service revenue	\$ 455	\$ 404	\$ 322
Cost of product revenue	131	182	264
Total included in cost of revenue	<u>586</u>	<u>586</u>	<u>586</u>
Included in operating expenses:			
Sales and marketing	1,860	2,178	2,804
Research and development	1,393	1,587	1,802
General and administrative	—	—	—
Total included in operating expenses	<u>3,253</u>	<u>3,765</u>	<u>4,606</u>
Total	<u>\$ 3,839</u>	<u>\$ 4,351</u>	<u>\$ 5,192</u>

The following table summarizes the estimated future amortization expense related to intangible assets as of December 31, 2017 (in thousands):



## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 6. INTANGIBLE ASSETS (Continued)

	As of December 31, 2017
2018	\$ 3,335
2019	1,532
2020	1,282
2021	940
2022	940
Thereafter	548
Total	<u>\$ 8,577</u>

The Company evaluates its indefinite-lived intangible assets annually as of December 31 for indicators of impairment. 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.

The Company performed its annual indefinite-lived intangible asset impairment test on the Rosetta Stone tradename as of December 31, 2017 to determine if indicators of impairment exist. The Company elected to first assess qualitative factors to determine whether it is more likely than not that the Rosetta Stone trade name was impaired. Additionally, all other long-lived intangible assets were evaluated at December 31, 2017 to determine if indicators of impairment exist. As a result of these assessments, there were no indicators of impairment for the year ended December 31, 2017.

**2016 Activity**

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.

## 7. OTHER CURRENT LIABILITIES

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

	As of December 31,	
	2017	2016
Accrued marketing expenses	\$ 5,316	\$ 8,460
Accrued professional and consulting fees	1,609	2,050
Sales return reserve	1,176	1,338
Sales, withholding, and property taxes payable	3,616	3,772
Other	4,737	6,530
Total Other current liabilities	<u>\$ 16,454</u>	<u>\$ 22,150</u>

## 8. DIVESTITURES

On March 13, 2017, the Company entered into a Product and Intellectual Property Agreement, (the "PIPA") with SOURCENEXT Corporation, ("SOURCENEXT"), a leading software distributor and developer in Japan. Under the PIPA, the Company provided 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 PIPA, the Company received approximately \$9.0 million on March 13, 2017, and another \$2.0 million on June 19, 2017. In addition, the Company is guaranteed to receive minimum payments totaling an additional \$6.0 million over the next ten years.

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**8. DIVESTITURES (Continued)**

Finally, as part of the PIPA, 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.

On April 25, 2017, the Company and SOURCENEXT signed a Stock Purchase Agreement ("SPA") for the sale of the Company's Japanese subsidiary ("RST Japan") and certain other assets related to the language market in Japan. The Company received \$0.5 million associated with the SPA closure on June 29, 2017 when 100% of the Company's capital stock of RST Japan and the other assets related to the language market in Japan were transferred to SOURCENEXT.

The SPA and the PIPA were considered related and viewed as a multiple element arrangement. Of the nearly \$11.5 million that was received under the terms of the PIPA and SPA, approximately \$11.4 million was allocated to deferred revenue to be recognized over an estimated 20-year period. As this customer relationship progresses, the Company may prospectively reassess the 20-year recognition period as needed. Approximately \$0.1 million was allocated to RST Japan and the other assets related to the language market in Japan and was included in the gain calculation. At the time of closing, RST Japan was in a net liability position. The sale under the terms of the SPA resulted in a pre-tax gain of \$0.4 million, reported in "Other income and (expense)" on the consolidated statement of operations. This gain was comprised of a gain of \$0.5 million related to the sale of RST Japan and the other assets related to the language market in Japan, partially offset by a \$0.1 million loss on the transfer of the foreign subsidiary's cumulative translation adjustment on the date of sale.

In the third quarter of 2017, the PIPA was amended to provide SOURCENEXT with a two-year time-based license to the Company's speech recognition engine ("SRE") and software development kit ("SDK") in exchange for the acceleration of \$1.5 million of future cash receipts under the PIPA. The \$1.5 million associated with the amendment to the PIPA was collected and will be recognized as revenue ratably over the remaining life of the agreement.

**9. FINANCING ARRANGEMENTS**

*Credit Facility*

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"). Since the original date of execution, the Company and the Bank have executed several amendments to the credit facility to reflect updates to the Company's financial outlook and extend 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. 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 April 1, 2020, 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 accrues 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.

The credit facility contains customary affirmative and negative covenants, including covenants that limit or restrict the 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, 2017, the Company was in compliance with all covenants.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. FINANCING ARRANGEMENTS (Continued)

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, 2017, there were no borrowings outstanding and the Company was eligible to borrow \$15.1 million of available credit, less \$4.0 million in letters of credit that have been issued by the Bank on the Company's behalf, resulting in a net borrowing availability of \$11.1 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, 2017, 2016, and 2015, the Company acquired equipment or software through the issuance of capital leases totaling zero, \$27 thousand and \$0.5 million, respectively. This non-cash investing activity has been excluded from the consolidated statement of cash flows.

As of December 31, 2017, the future minimum payments under capital leases with initial terms of one year or more are as follows (in thousands):

Periods Ending December 31,		
2018	\$	548
2019		545
2020		540
2021		537
2022		402
Thereafter		—
Total minimum lease payments	\$	2,572
Less amount representing interest		272
Present value of net minimum lease payments	\$	2,300
Less current portion		450
Obligations under capital lease, long-term	\$	1,850

## 10. STOCK-BASED COMPENSATION

**2006 Stock Incentive Plan**

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

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. STOCK-BASED COMPENSATION (Continued)

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. Restricted stock awards are considered outstanding at the time of grant as the stockholder is entitled to voting rights and to receive any dividends declared subject to the loss of the right to receive accumulated dividends if the award is forfeited prior to vesting. Unvested restricted stock awards are not considered outstanding in the computation of basic earnings per share. 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. Since the establishment of the 2009 Plan, the Board of Directors authorized and the Company's shareholders' approved the allocation of additional shares of common stock to the 2009 Plan as follows:

Authorization Dates of 2009 Plan Additions	Number of Common Stock Shares Authorized to 2009 Plan
February 27, 2009	2,437,744
May 26, 2011	1,000,000
May 23, 2012	1,122,930
May 23, 2013	2,317,000
May 20, 2014	500,000
June 12, 2015	1,200,000
May 27, 2017	1,900,000

At December 31, 2017 there were 2,206,689 shares available for future grant under the 2009 Plan.

*Valuation Assumptions*

The determination of fair value of stock-based awards is affected by assumptions regarding subjective and complex variables. Generally, 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 determines the fair values of stock-based awards as follows:

- Service-Based Restricted Stock Awards, Restricted Stock Units, Performance-Based Restricted Stock Awards, and Performance-Based Share Units: Fair value is determined based on the quoted market price of 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 is determined using a Monte-Carlo simulation model. The Monte Carlo valuation also estimates the quantity that would be awarded which is reflected in the fair value on the grant date.

For the years ended December 31, 2017, 2016, and 2015 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,		
	2017	2016	2015
Expected stock price volatility	42%-45%	46%-47%	49%-63%
Expected term of options	6 years	5.5-6.5 years	6 years
Expected dividend yield	—	—	—
Risk-free interest rate	1.92%-2.05%	1.24%-1.50%	1.19%-1.75%

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

For the years ended December 31, 2017, 2016, and 2015 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,		
	2017	2016	2015
Expected stock price volatility	none	45%-49%	none
Expected term of options	none	1.7 years-7 years	none
Expected dividend yield	none	—	none
Risk-free interest rate	none	.71%-1.53%	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. Changes in the probability estimates associated with performance-based awards 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 performance-based award is reversed. 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,		
	2017	2016	2015
<b>Included in cost of revenue:</b>			
Cost of subscription and service revenue	\$ 15	\$ (4)	\$ 44
Cost of product revenue	54	52	57
Total included in cost of revenue	69	48	101
<b>Included in operating expenses:</b>			
Sales and marketing	561	998	1,327
Research & development	255	709	841
General and administrative	3,256	3,151	4,926
Total included in operating expenses	4,072	4,858	7,094
Total	\$ 4,141	\$ 4,906	\$ 7,195

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, 2017 and 2016, respectively:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2016	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
Awards granted	291,406	7.92	
Awards vested	(163,027)	9.84	
Awards canceled	(71,641)	8.03	
Nonvested Awards, December 31, 2017	431,118	8.07	3,477,484

During 2017 and 2016, 291,406 and 300,650 shares of service-based restricted stock were granted, respectively. The aggregate grant date fair value of the service-based restricted stock awards in 2017 and 2016 was \$2.3 million and \$2.3 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. Service-based restricted stock awards are granted at the discretion of the Board of Directors or the Compensation Committee (or its authorized member(s)) and generally vest over a four-year period based upon required service conditions and do not have performance or market conditions. 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 2017, 71,641 shares of restricted stock were forfeited. As of December 31, 2017 and 2016, future compensation cost, net of forfeitures, related to the non-vested portion of the service-based restricted stock awards not yet recognized in the statement of operations was \$2.2 million and \$2.6 million and is expected to be recognized over a period of 2.25 years and 2.06 years, respectively.

*Service-Based Stock Options*

The following table summarizes the Company's service-based stock option activity from January 1, 2017 to December 31, 2017:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2017	1,793,930	\$ 9.81	7.58	\$ 1,154,498
Options granted	55,610	11.24		
Options exercised	(79,365)	8.52		
Options cancelled	(141,464)	11.10		
Options Outstanding, December 31, 2017	1,628,711	9.81	6.79	5,203,196
Vested and expected to vest at December 31, 2017	1,594,473	9.86	6.77	5,044,582
Exercisable at December 31, 2017	1,250,476	\$ 10.19	6.47	\$ 3,733,000

As of December 31, 2017 and 2016, there was approximately \$1.3 million and \$3.1 million of unrecognized compensation expense, net of estimated forfeitures, related to non-vested service-based stock options that is expected to be recognized over a weighted average period of 1.60 and 2.36 years, respectively.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

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 grant-date fair value per share of service-based stock options granted was \$5.02 and \$3.41 for the years ended December 31, 2017 and 2016, 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, 2017, 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, 2017. This amount is subject to change based on changes to the fair market value of the Company's common stock.

**Restricted Stock Units**

The following table summarizes the Company's restricted stock unit activity from January 1, 2017 to December 31, 2017:

	Units Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Units Outstanding, January 1, 2017	188,057	\$ 9.93	\$ 1,675,588
Units granted	46,601	11.23	
Units released	—	—	
Units cancelled	—	—	
Units Outstanding, December 31, 2017	<u>234,658</u>	10.19	2,926,185
Vested and expected to vest at December 31, 2017	<u>126,166</u>	11.10	1,573,286
Vested and deferred at December 31, 2017	100,754	\$ 11.79	\$ 1,256,402

During 2017 and 2016, 46,601 and 67,663 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 2017 and 2016 was \$0.5 million and \$0.5 million, respectively. All restricted stock unit awards vest quarterly over a one year period from the date of grant, with expense recognized straight-line over the vesting period. 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-Based Restricted Stock Units**

On March 17, 2017, the Company granted performance-based restricted stock units ("PSUs") to certain employees which will become eligible to vest based on the Company's achievement of certain pre-defined key operating performance goals during the cumulative period from January 1, 2017 to December 31, 2018, which will be certified by the Compensation Committee in February 2019. Any PSUs that become eligible to vest are subject to additional service requirements where the eligible PSUs will vest annually on a pro-rata basis over the two-year period beginning March 17, 2019. The PSUs were granted at "target" (at 100% of target). Based upon actual attainment of the operating performance results relative to target and the recipient's terms, actual issuance of PSUs can be eligible for vest anywhere between a maximum of 200% and 0% of the target number of PSUs originally granted.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's PSU activity from January 1, 2017 to December 31, 2017:

	PSUs	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Non-vested PSUs, January 1, 2017	—	\$ —	\$ —
PSUs granted	462,870	9.43	
PSUs vested	—	—	
PSUs canceled	(29,282)	9.43	
Non-vested PSUs, December 31, 2017	433,588	\$ 9.43	\$ 5,406,842

As of December 31, 2017, future compensation cost, net of estimated forfeitures, related to the non-vested portion of the PSUs not yet recognized in the consolidated statement of operations was \$1.0 million and is expected to be recognized over a weighted average period of 1.5 years.

**CEO 2016 Performance and Market Conditioned Restricted Stock Awards and Stock Options Grants**

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 stockholder value. The package was comprised of 70,423 performance-based restricted stock awards (PRSAs), 314,465 performance-based stock options (PSOs), 70,423 market-based restricted stock awards (MRSAs), and 314,465 market-based stock options (MSOs). The April 4, 2016 grant date fair values associated with these grants were \$7.10, \$3.24, \$6.17 and \$0.94, respectively.

PRSAs and PSOs were eligible to vest based on the achievement of certain operating performance targets during the 2016 calendar year, related to defined measures of revenue, sales, adjusted free cash flow, and adjusted EBITDA, certified by the Compensation Committee in the first quarter of 2017. The PRSAs and PSOs are subject to additional service requirements where the eligible PRSAs and PSOs will vest 50%, 25%, and 25% on April 4, 2017, 2018 and 2019, respectively. Awards also vest if a majority change in control of the Company occurs during the performance or vesting period.

On February 20, 2017, the Compensation Committee approved 64,719 PRSAs and 144,497 PSOs as eligible under this plan, subject to the aforementioned service vesting requirements. The non-eligible 5,704 and 169,968 PRSAs and PSOs, respectively, were cancelled as of February 20, 2017. As of December 31, 2017, 32,359 PRSAs were vested and 72,248 PSOs were vested. As of December 31, 2017, no PSOs have been exercised. As of December 31, 2017 and 2016, future compensation cost related to the non-vested portion of the PRSAs and PSOs not yet recognized in the consolidated statement of operations was \$0.1 million and \$0.5 million and is expected to be recognized over a weighted average period of 1.09 years and 1.69 years, respectively.

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 stockholder 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, the Compensation Committee will certify the eligible quantity of MRSAs and MSOs which 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 stockholder return growth rate results through December 29, 2017 relative to target, actual issuance of MRSAs can fall anywhere between a maximum of 200% and 0% of the target number of MRSAs originally granted. The MSOs were granted at "maximum" (at 200% of target). Based on actual attainment of total stockholder 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, 2017 and 2016, future compensation cost related to the non-vested portion of the MRSAs and MSOs not yet recognized in the consolidated statement of operations was \$0.3 million and \$0.5 million and is expected to be recognized over a weighted average period of 1.79 years and 2.56 years, respectively.



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

**11. STOCKHOLDERS' EQUITY (DEFICIT)**

At December 31, 2017, 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, 2017 and 2016, the Company had shares of Common Stock issued of 23,782,773 and 23,450,864, respectively, and shares of Common Stock outstanding of 22,782,773 and 22,450,864, 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, 2016, or 2017. 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. BASIC AND DILUTED NET LOSS PER SHARE**

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

	Years Ended December 31,		
	2017	2016	2015
	(dollars in thousands, except per share amounts)		
<i>Numerator:</i>			
Net loss	\$ (1,546)	\$ (27,550)	\$ (46,796)
<i>Denominator:</i>			
Basic weighted average shares	22,244	21,969	21,571
Diluted weighted average shares	22,244	21,969	21,571
<i>Loss per share:</i>			
Basic	\$ (0.07)	\$ (1.25)	\$ (2.17)
Diluted	\$ (0.07)	\$ (1.25)	\$ (2.17)

The Company calculates dilutive common stock equivalent shares using the treasury stock method. In periods where the Company has a net loss, no dilutive common stock equivalent shares are included in the calculation for diluted shares as they are considered anti-dilutive. The following table sets forth the dilutive common stock equivalent shares calculated using the treasury stock method (in thousands).

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

**12. BASIC AND DILUTED NET LOSS PER SHARE (Continued)**

	Years Ended December 31,		
	2017	2016	2015
	(in thousands)		
Stock options	231	16	35
Restricted stock units	209	174	39
Restricted stocks	296	129	82
Total common stock equivalent shares	<u>736</u>	<u>319</u>	<u>156</u>

Share-based awards to purchase approximately 0.7 million, 2.0 million and 2.2 million shares of common stock that had an exercise price in excess of the average market price of the common stock during the years ended December 31, 2017, 2016 and 2015, respectively, were not included in the calculation of diluted loss per share because they were anti-dilutive.

**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 E&E Language offerings. The Company does not expect to incur any additional material restructuring costs in connection with the 2016 Restructuring Plan. The 2016 Restructuring Plan remaining balance is expected to be paid in early 2018.

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 tables summarize activity with respect to the restructuring charges for the 2016 Restructuring Plan during the years ended December 31, 2017 and 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
Total	<u>\$ —</u>	<u>\$ 5,122</u>	<u>\$ (4,340)</u>	<u>\$ (190)</u>	<u>\$ 592</u>

	Balance at January 1, 2017	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at December 31, 2017
Severance costs	\$ 500	\$ (50)	\$ (303)	\$ —	\$ 147
Contract termination costs	22	—	(22)	—	—
Other costs	70	14	(84)	—	—
Total	<u>\$ 592</u>	<u>\$ (36)</u>	<u>\$ (409)</u>	<u>\$ —</u>	<u>\$ 147</u>

(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.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

*2015 Restructuring Actions*

In 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 costs were incurred and final payments were made against the 2015 Restructuring Plan accruals. The Company does not expect to incur any additional restructuring costs in connection with the 2015 Plan.

*Other Employee Severance Actions*

In the first quarter of 2017, the Company initiated actions to reduce headcount in its Fit Brains business and in the U.S. and China locations within consumer product operations. Primarily comprised of severance costs associated with these actions, the Company recorded expense of \$1.2 million. Of these amounts, \$1.1 million has been paid and the remaining \$0.1 million is expected to be paid in the first half of 2018.

*Cost Table*

The following table summarizes the major types of costs associated with the 2016 and 2015 Restructuring Plans and other employee severance actions for the years ended December 31, 2017, 2016, and 2015 and total costs incurred through December 31, 2017 (in thousands):

	Years ended December 31,			Incurred through December 31, 2017
	2017	2016	2015	
Severance costs	\$ 1,144	\$ 4,438	\$ 7,240	\$ 12,822
Contract termination costs	37	165	1,134	1,336
Other costs	26	590	417	1,033
Total	\$ 1,207	\$ 5,193	\$ 8,791	\$ 15,191

As of December 31, 2017, the entire restructuring and other employee severance action liability of \$0.3 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 and other employee severance actions included in the related line items of the Statement of Operations (in thousands):

	Years ended December 31,		
	2017	2016	2015
Cost of revenue	\$ 378	\$ 573	\$ 113
Sales and marketing	411	2,324	4,492
Research and development	318	913	602
General and administrative	100	1,383	3,584
Total	\$ 1,207	\$ 5,193	\$ 8,791

These restructuring expenses are not allocated to any reportable segment under the Company's definition of segment contribution as defined in Note 19 "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.

## 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

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 14. LEASE ABANDONMENT AND TERMINATION (Continued)

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, 2017 and 2016 is as follows (in thousands):

	As of December 31,	
	2017	2016
Accrued lease abandonment costs, beginning of period	\$ 2,123	\$ 1,282
Costs incurred and charged to expense	—	1,644
Principal reductions	(1,042)	(803)
Accrued lease abandonment costs, end of period	\$ 1,081	\$ 2,123
Accrued lease abandonment costs liability:		
Short-term	\$ 1,081	\$ 1,047
Long-term	—	1,076
Total	\$ 1,081	\$ 2,123

## 15. INCOME TAXES

New tax legislation, commonly referred to as the Tax Cuts and Jobs Act ("Tax Reform"), was enacted on December 22, 2017. ASC 740, *Accounting for Income Taxes*, requires companies to recognize the effect of tax law changes in the period of enactment even though the effective date for most provisions is for tax years beginning after December 31, 2017, or in the case of certain other provisions, January 1, 2018.

Given the significance of the Tax Reform, the SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118), which allows registrants to record provisional amounts during a one year "measurement period" similar to that used when accounting for business combinations. However, the measurement period is deemed to have ended earlier when the registrant has obtained, prepared and analyzed the information necessary to finalize its accounting. During the measurement period, impacts of the Tax Reform law are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed.

SAB 118 summarizes the process to be applied at each reporting period to account for and qualitatively disclose: (1) the effects of the change in tax law for which accounting is complete; (2) provisional amounts (or adjustments to provisional amounts) for the effects of the tax law where accounting is not complete, but that a reasonable estimate has been determined; and (3) a reasonable estimate cannot yet be made and therefore taxes are reflected in accordance with law prior to the enactment of the Tax Reform.

Amounts recorded in the period ended December 31, 2017, principally relate to the reduction in the U.S. corporate income tax rate from 35% to 21%, which resulted in the Company reporting an income tax benefit of \$2.4 million to remeasure deferred tax liabilities associated with indefinite-lived intangible assets that will reverse at the new 21% rate. Absent this deferred tax liability, the Company is in a net deferred tax asset position that is offset by a full valuation allowance. Though the impact of the rate change has a net tax effect of zero, the accounting to determine the gross change in the deferred tax position and the offsetting valuation resulted in a \$26.3 million reduction in both.

Under the Tax Reform, deferred tax assets scheduled to reverse in subsequent years will result in net operating losses with an unlimited carryforward. The change in the carryforward period to post-2017 net operating losses allowed the Company to release valuation allowance associated with the reversing deferred tax assets to offset 80% of the deferred tax liability associated with indefinitely lived intangible asset. The release of valuation allowance resulted in the Company reporting an

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

**15. INCOME TAXES (Continued)**

income tax benefit of \$3.1 million.

The Tax Reform includes a one-time mandatory repatriation transition tax on the net accumulated earnings and profits of a U.S. taxpayer's foreign subsidiaries.

The final impact of Tax Reform may differ from these estimates, due to, among other things, changes in interpretations, additional guidance that may be issued by the Internal Revenue Service or state and local authorities, and any updates or changes to estimates the Company has utilized to calculate the transition impact. Therefore, the Company's accounting for the elements of Tax Reform is incomplete. However, the Company was able to make reasonable estimates of the effects of Tax Reform. The Company will complete the accounting for these items during 2018, after completion of the 2017 U.S. income tax return.

Other significant Tax Reform provisions that are not yet effective but may impact income taxes in future years include: an exemption from U.S. tax on dividends of future foreign earnings, a limitation of net operating losses generated after 2017 to 80% of taxable income, the inclusion of commissions and performance based compensation in determining the excess compensation limitation, and a minimum tax on certain foreign earnings in excess of 10% of the foreign subsidiaries tangible assets (i.e., global intangible low-taxed income or GILTI). The Company is still evaluating its policy election to treat the GILTI tax as a period expense or to provide U.S. deferred taxes on foreign temporary differences that are expected to generate GILTI income when they reverse in future years.

The following table summarizes the significant components of the Company's deferred tax assets and liabilities as of December 31, 2017 and 2016 (in thousands):

	As of December 31,	
	2017	2016
Deferred tax assets:		
Inventory	\$ 847	\$ 735
Net operating and capital loss carryforwards	46,683	61,174
Deferred revenue	11,534	10,862
Accrued liabilities	4,064	6,975
Stock-based compensation	3,790	4,440
Amortization and depreciation	773	1,056
Bad debt reserve	90	389
Foreign and other tax credits	2,047	1,881
Gross deferred tax assets	69,828	87,512
Valuation allowance	(60,302)	(78,363)
Net deferred tax assets	9,526	9,149
Deferred tax liabilities:		
Goodwill and indefinite lived intangibles	(5,033)	(6,098)
Deferred sales commissions	(4,996)	(7,060)
Prepaid expenses	(619)	(656)
Foreign currency translation	(846)	(1,508)
Gross deferred tax liabilities	(11,494)	(15,322)
Net deferred tax liabilities	\$ (1,968)	\$ (6,173)

For the year ended December 31, 2017, the Company recorded an income tax benefit of \$2.5 million. The tax benefit primarily related to the reduction in the corporate tax rate from 35% to 21% which resulted in a tax benefit of \$5.5 million, offset by current year profits of operations in Canada, 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 certain foreign jurisdictions and in the U.S.

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

**15. INCOME TAXES (Continued)**

For the year ending December 31, 2016, the Company recorded income tax expense of \$2.5 million. The tax expense was primarily related to current year profits in 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.

As of December 31, 2017, 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.

As of December 31, 2017, the Company had federal, state and foreign tax NOL carryforward amounts and expiration periods as follows (in thousands):

Year of Expiration	U.S. Federal	State	Brazil	France	Spain	Mexico	Total
2018-2022	\$ —	\$ 409	\$ —	\$ —	\$ —	\$ —	\$ 409
2023-2027	—	5,458	—	—	—	377	5,835
2028-2032	471	17,784	—	—	—	—	18,255
2033-2037	125,759	108,086	—	—	4	—	233,849
2038-2042	3,234	2,702	—	—	—	—	5,936
Indefinite	—	—	4,160	7,673	697	—	12,530
<b>Totals</b>	<b>\$ 129,464</b>	<b>\$ 134,439</b>	<b>\$ 4,160</b>	<b>\$ 7,673</b>	<b>\$ 701</b>	<b>\$ 377</b>	<b>\$ 276,814</b>

As of December 31, 2017, the Company had federal and state capital loss carryforward amounts and expiration periods as follows (in thousands):

Year of Tax Capital Loss Expiration	U.S. Federal	State
2018-2022	\$ 6,837	\$ 2,351
2023-2027	15,135	14,990
2028-2032	—	164
2033-2037	—	362
2038-2042	—	—
Indefinite	—	—
<b>Totals</b>	<b>\$ 21,972</b>	<b>\$ 17,867</b>

As of December 31, 2017, the Company had federal tax credit carryforward amounts and expiration periods as follows (in thousands):

Year of Tax Credit Expiration	U.S. Federal
2018-2022	\$ —
2023-2027	1,638
2028-2032	166
2033-2037	218
2038-2042	—
Indefinite	26
<b>Totals</b>	<b>\$ 2,048</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,		
	2017	2016	2015
United States	\$ (12,648)	\$ (24,963)	\$ (41,458)
Foreign	8,603	(84)	(4,179)
Loss before income taxes	<u>\$ (4,045)</u>	<u>\$ (25,047)</u>	<u>\$ (45,637)</u>
The provision for taxes on income consists of the following (in thousands):			
Federal	\$ —	\$ —	\$ (157)
State	(21)	78	96
Foreign	1,701	1,250	444
Total current	<u>\$ 1,680</u>	<u>\$ 1,328</u>	<u>\$ 383</u>
Deferred:			
Federal	\$ (4,541)	\$ 1,147	\$ 1,148
State	335	169	169
Foreign	27	(141)	(541)
Total deferred	<u>(4,179)</u>	<u>1,175</u>	<u>776</u>
(Benefit) provision for income taxes	<u>\$ (2,499)</u>	<u>\$ 2,503</u>	<u>\$ 1,159</u>

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

	Years Ended December 31,		
	2017	2016	2015
Income tax benefit at statutory federal rate	\$ (1,416)	\$ (8,766)	\$ (15,973)
Remeasurement of deferred tax liability related to indefinite-lived intangible due to U.S. rate reduction, effective January 1, 2018	(2,586)	—	—
Release of valuation allowance due to change in U.S. net operating loss carry forward period	(3,103)	—	—
Shortfall in tax benefit - stock compensation	233	—	—
State income tax expense, net of federal income tax effect	314	219	231
Tax capital loss in excess of book loss on sale of Japan subsidiary	(5,297)	—	—
Nondeductible goodwill impairment	—	604	1,961
Other nondeductible expenses	398	384	88
Tax rate differential on foreign operations	(816)	(474)	(1,019)
Increase in valuation allowance	9,446	10,404	15,713
Tax audit settlements	—	—	(96)
Change in prior year estimates	150	—	225
Other tax credits	173	129	29
Other	5	3	—
Income tax (benefit) expense	<u>\$ (2,499)</u>	<u>\$ 2,503</u>	<u>\$ 1,159</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.

## ROSETTA STONE INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**15. INCOME TAXES (Continued)**

The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income tax expense (benefit). As of December 31, 2017 and 2016, the Company had no unrecognized tax benefits or interest and penalties.

The Company is subject to taxation in the U.S. and various states and foreign jurisdictions. The Company's tax years 2011 and forward are subject to examination by the tax authorities.

Prior to the fourth quarter of 2017, the Company asserted that the unremitted earnings of its foreign subsidiaries with unremitted earnings were deemed indefinitely reinvested. As the Company is in an aggregate net foreign deficit position for U.S. tax purposes, the Company is not liable for the transition tax enacted as part of the Tax Reform. As such, all prior earnings of the foreign subsidiaries with unremitted earnings are deemed to be previously taxed income for U.S. tax purposes as of December 31, 2017. The Company's assessment is provisional and we continue to assess the impact of the transition tax on unremitted earnings and its impact to the Company's outside basis.

The Company made income tax payments of \$2.2 million, \$0.8 million, and \$1.4 million, in 2017, 2016 and 2015, 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.

The following table summarizes future minimum operating lease payments as of December 31, 2017 and the years thereafter (in thousands):

Periods Ending December 31,		As of December 31, 2017
2018	\$	4,419
2019		1,742
2020		1,004
2021		590
2022		—
Thereafter		—
Total future minimum operating lease payments	\$	7,755

Total expenses under operating leases were \$2.6 million, \$4.0 million and \$5.1 million during the years ended December 31, 2017, 2016 and 2015, 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



ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

expenses these amounts to cost of sales or research and development expense, as appropriate. Royalty expense was \$1.0 million, \$0.3 million, and \$0.2 million for the years ended December 31 2017, 2016 and 2015, 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. 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 \$2.1 million, \$2.0 million, and \$2.0 million for the years ended December 31, 2017, 2016 and 2015, respectively.

**18. RELATED PARTIES**

As of December 31, 2017 and 2016, the Company had outstanding receivables from employees in the amount of \$0.1 million and \$22,000, respectively.

**19. SEGMENT INFORMATION**

The Literacy segment derives the majority of its revenue from the sales of literacy solutions to educational institutions serving grades K through 12. The E&E Language segment derives revenue from sales of language-learning solutions to educational institutions, corporations, and government agencies worldwide. The Consumer Language segment derives the majority of its revenue from sales of language-learning solutions to individuals and retail partners. Revenue from transactions between the Company's operating segments is not material. The Company's current operating segments also represent the Company's reportable segments.

The Company and its Chief Operating Decision Maker ("CODM") assess profitability and performance of each of its current operating segments in terms of segment contribution. Segment contribution is calculated as segment revenue less expenses directly incurred by or allocated to the segment. Direct segment expenses include costs and expenses that are directly incurred by or allocated to the segment and include materials costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. In addition to the previously referenced expenses, the Literacy segment includes direct research and development expenses and Combined Language includes shared research and development expenses, cost of revenue, and sales and marketing expenses applicable to the Consumer Language and E&E Language segments. Segment contribution excludes depreciation, amortization, stock compensation, restructuring and other related 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, accounting related expenses, lease abandonment, impairment, and non-operating income and expense. These expenses are included below the segment contribution line in the unallocated expenses section of the tables presented below.

Beginning on January 1, 2017, the Company modified its definition and presentation of segment contribution. E&E Language segment and Consumer Language segment are now characterized as "Language" since both of these segments primarily address the language-learning market and share many of the same costs. These shared language costs are included in the "Shared Services" column of the tables presented below. General and administrative expenses directly incurred by the Language segments consist only of bad debt expense, net of recoveries. Additionally, research and developments expenses are now included in segment contribution. Further, the depreciation, amortization, stock compensation, restructuring and other related expenses which are included in cost of revenue, sales and marketing, research and development, and general and administrative are presented in total as unallocated costs. Prior periods have been reclassified to reflect the current segment presentation and definition of segment contribution. The Company will continue to evaluate its management reporting and will update its operating and reportable segments as appropriate.

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

**19. SEGMENT INFORMATION (Continued)**

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 year ended December 31, 2017 was as follows (in thousands, except percentages):

	Language					Total Company
	Literacy Segment	E&E Language Segment	Consumer Language Segment	Shared Services	Combined Language	
<b>Revenue</b>	\$ 43,608	\$ 65,267	\$ 75,718	\$ —	\$ 140,985	\$ 184,593
Cost of revenue	6,924	7,149	13,485	50	20,684	\$ 27,608
Sales and marketing	23,369	31,089	37,366	1,459	69,914	\$ 93,283
Research and development	6,479	—	—	15,860	15,860	\$ 22,339
General and administrative	1,872	132	18	—	150	\$ 2,022
<b>Segment contribution</b>	<b>\$ 4,964</b>	<b>\$ 26,897</b>	<b>\$ 24,849</b>	<b>\$ (17,369)</b>	<b>\$ 34,377</b>	<b>\$ 39,341</b>
<i>Segment contribution margin %</i>	<i>11.4%</i>	<i>41.2%</i>	<i>32.8%</i>			
<b>Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:</b>						
Cost of revenue						6,013
Sales and marketing						3,377
Research and development						2,408
General and administrative						6,348
Subtotal						18,146
<b>Corporate unallocated expenses, net:</b>						
Unallocated general and administrative						25,696
Unallocated lease abandonment expense						(456)
Subtotal						25,240
<b>Loss before income taxes</b>						<b>\$ (4,045)</b>

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

**19. SEGMENT INFORMATION (Continued)**

Operating results by segment for the year ended December 31, 2016 was as follows (in thousands, except percentages):

	Language				Total Company	
	Literacy Segment	E&E Language Segment	Consumer Language Segment	Shared Services		Combined Language
<b>Revenue</b>	\$ 34,123	\$ 72,083	\$ 87,883	\$ —	\$ 159,966	\$ 194,089
Cost of revenue	4,753	9,245	14,698	(17)	23,926	\$ 28,679
Sales and marketing	21,650	33,441	51,508	1,902	86,851	\$ 108,501
Research and development	4,111	—	—	18,874	18,874	\$ 22,985
General and administrative	2,077	315	175	—	490	\$ 2,567
<b>Segment contribution</b>	<u>\$ 1,532</u>	<u>\$ 29,082</u>	<u>\$ 21,502</u>	<u>\$ (20,759)</u>	<u>\$ 29,825</u>	<u>\$ 31,357</u>
<i>Segment contribution margin %</i>	<i>4.5%</i>	<i>40.3%</i>	<i>24.5%</i>			
<b>Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:</b>						
Cost of revenue						5,642
Sales and marketing						5,839
Research and development						3,288
General and administrative						10,935
Subtotal						<u>25,704</u>
<b>Corporate unallocated expenses, net:</b>						
Unallocated general and administrative						26,999
Unallocated lease abandonment expense						(1,873)
Unallocated impairment						3,930
Unallocated non-operating income						1,644
Subtotal						<u>30,700</u>
<b>Loss before income taxes</b>						<u><u>\$ (25,047)</u></u>

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

**19. SEGMENT INFORMATION (Continued)**

Operating results by segment for the year ended December 31, 2015 was as follows (in thousands, except percentages):

	Language					Total Company
	Literacy Segment	E&E Language Segment	Consumer Language Segment	Shared Services	Combined Language	
<b>Revenue</b>	\$ 21,928	\$ 76,129	\$ 119,613	\$ —	\$ 195,742	\$ 217,670
Cost of revenue	2,574	12,124	20,792	(19)	32,897	\$ 35,471
Sales and marketing	16,628	40,829	66,839	3,661	111,329	\$ 127,957
Research and development	4,542	—	—	22,101	22,101	\$ 26,643
General and administrative	1,647	400	1,244	—	1,644	\$ 3,291
<b>Segment contribution</b>	<b>\$ (3,463)</b>	<b>\$ 22,776</b>	<b>\$ 30,738</b>	<b>\$ (25,743)</b>	<b>\$ 27,771</b>	<b>\$ 24,308</b>
<i>Segment contribution margin %</i>	<i>(15.8)%</i>	<i>29.9%</i>	<i>25.7%</i>			

**Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:**

Cost of revenue	3,056
Sales and marketing	8,127
Research and development	3,296
General and administrative	15,565
Subtotal	30,044

**Corporate unallocated expenses, net:**

Unallocated general and administrative	31,268
Unallocated lease abandonment expense	1,824
Unallocated impairment	6,754
Unallocated non-operating income	55
Subtotal	39,901

**Loss before income taxes** **\$ (45,637)**

**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, 2017, 2016 and 2015, respectively (in thousands):

	Years Ended December 31,		
	2017	2016	2015
United States	\$ 158,825	\$ 162,815	\$ 177,966
International	25,768	31,274	39,704
<b>Total revenue</b>	<b>\$ 184,593</b>	<b>\$ 194,089</b>	<b>\$ 217,670</b>

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

**19. SEGMENT INFORMATION (Continued)**

The information below summarizes long-lived assets by geographic area classified as held and used for the years ended December 31, 2017 and 2016, respectively (in thousands):

	As of December 31,	
	2017	2016
United States	\$ 27,647	\$ 21,652
International	3,002	3,143
Total property and equipment, net	<u>\$ 30,649</u>	<u>\$ 24,795</u>

**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, 2017, 2016 and 2015, respectively (in thousands):

	As of December 31,		
	2017	2016	2015
Language learning	\$ 138,082	\$ 155,532	\$ 191,568
Literacy	43,608	34,123	21,928
Brain Fitness	2,903	4,434	4,174
Total revenue	<u>\$ 184,593</u>	<u>\$ 194,089</u>	<u>\$ 217,670</u>

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

**20. 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,		
	2017	2016	2015
<b>Allowance for doubtful accounts:</b>			
Beginning balance	\$ 1,072	\$ 1,196	\$ 1,434
Charged to costs and expenses	(51)	709	1,657
Deductions—accounts written off	(646)	(833)	(1,895)
Ending balance	<u>\$ 375</u>	<u>\$ 1,072</u>	<u>\$ 1,196</u>
<b>Promotional rebate and coop advertising reserves:</b>			
Beginning balance	\$ 5,968	\$ 16,910	\$ 23,437
Charged to costs and expenses	6,421	18,337	40,563
Deductions - reserves utilized	(10,014)	(29,279)	(47,090)
Ending balance	<u>\$ 2,375</u>	<u>\$ 5,968</u>	<u>\$ 16,910</u>
<b>Sales return reserve:</b>			
Beginning balance	\$ 1,338	\$ 3,728	\$ 3,570
Charged against revenue	4,943	5,034	11,474
Deductions—reserves utilized	(5,105)	(7,424)	(11,316)
Ending balance	<u>\$ 1,176</u>	<u>\$ 1,338</u>	<u>\$ 3,728</u>
<b>Deferred income tax asset valuation allowance:</b>			
Beginning balance	\$ 78,363	70,464	53,809
Charged to costs and expenses	(16,806)	7,899	16,655
Deductions	(1,255)	—	—
Ending balance	<u>\$ 60,302</u>	<u>\$ 78,363</u>	<u>\$ 70,464</u>

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

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

Summarized quarterly supplemental consolidated financial information for 2017 and 2016 are as follows (in thousands, except per share amounts):

	Three Months Ended			
	March 31,	June 30,	September 30,	December 31,
<b>2017</b>				
Revenue	\$ 47,693	\$ 45,905	\$ 46,206	\$ 44,789
Gross profit	\$ 39,552	\$ 38,314	\$ 36,758	\$ 36,348
Net income (loss)	\$ 454	\$ (1,135)	\$ (3,231)	\$ 2,366
Basic earnings (loss) per share	\$ 0.02	\$ (0.05)	\$ (0.14)	\$ 0.11
Shares used in basic per share computation	22,125	22,248	22,285	22,316
Diluted earnings (loss) per share	\$ 0.02	\$ (0.05)	\$ (0.14)	\$ 0.10
Shares used in diluted per share computation	22,590	22,248	22,285	23,248
<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

**22. SUBSEQUENT EVENTS**

On February 26, 2018, the Company entered into the second amendment to the PIPA with SOURCENEXT. See Note 8 "Divestitures" for a description of the PIPA and the relationship with SOURCENEXT. Under the second amendment, the Company agreed to extend the SRE and SDK time-based license to a five-year term from the date of the second amendment and also provide additional foreign language speech modules under the same license term. In exchange, the Company will receive an accelerated cash receipt of \$4.5 million of the \$6.0 million in guaranteed minimum payments that were scheduled to be received in future periods under the terms of the PIPA.

**EXECUTIVE EMPLOYMENT AGREEMENT**

THIS EXECUTIVE EMPLOYMENT AGREEMENT (this “**Agreement**”) is effective as of August 4, 2017, between Rosetta Stone Ltd., a Virginia corporation (together with its successors and assigns, the “**Company**”), and Mr. Mathew N. Hulett (“**Executive**”).

**Recitals**

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

**Agreement**

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

**1. Employment.**

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

**2. Duties.**

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

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

**3. Employment Term.**

Unless Executive’s employment under this Agreement is sooner terminated as a result of Executive’s resignation or termination in accordance with the provisions of Section 5 below, Executive’s term of employment (“**Service Term**”) under this Agreement shall commence on the date hereof and shall continue for a period of one (1) year, and at the end of each year it shall renew and extend automatically for an additional one (1) year (such date and each annual anniversary thereof, a “**Renewal Date**”), unless the Company or Executive provides written notice of its intention



not to extend the term of the Agreement at least 90 days' prior to the applicable Renewal Date provided, however, that either party may terminate this Agreement pursuant to Section 5.

#### **4. Salary, Bonus and Benefits.**

The Compensation Committee (the "**Compensation Committee**") of the Board of Directors (the "**Board**") shall make all decisions related to Executive's compensation

(a) **Base Salary.** During the Service Term, the Company will pay Executive a base salary (the "**Annual Base Salary**") as the Board may designate from time to time. The initial Annual Base Salary shall be at the rate of \$350,000 per annum paid in accordance with the Company's customary payroll practices (minus all applicable withholdings and deductions). Executive's Annual Base Salary for any partial year will be prorated based upon the number of days elapsed in such year. The Annual Base Salary may be increased (but not decreased) from time to time during the Service Term by the Board based upon the Company's and Executive's performance.

(b) **Annual Bonus.** The Executive will be eligible to participate in the annual bonus plan (the "**Annual Bonus**") and be eligible to receive an Annual Bonus with a target value of Sixty percent (60%) of his Annual Base Salary upon one hundred percent (100%) achievement of annual objectives, beginning with the Company's 2018 fiscal year. For subsequent years, the Annual Bonus target as a percentage of then-current Annual Base Salary, may be adjusted, but may not be less than Sixty percent (60%) of the Executive's then-current Annual Base Salary. The bonus, if any, will be determined by the Board based upon the Company's achievement of financial performance goals and other objectives, as determined by the Compensation Committee for each fiscal year of the Company.

(c) **Annual Equity.** The Executive will be eligible to participate in the annual equity plan (the "**Annual Equity**") and be eligible to receive an Annual Equity with a target value of Seventy-Five percent (75%) of his Annual Base Salary upon one hundred percent (100%) achievement of annual objectives, beginning with the Company's 2018 fiscal year. For subsequent years, the Annual Equity target as a percentage of then-current Annual Base Salary, may be adjusted, but may not be less than Seventy-Five percent (75%) of the Executive's then-current Annual Base Salary. The equity, if any, will be determined by the Board based upon the Company's achievement of financial performance goals and other objectives, as determined by the Compensation Committee for each fiscal year of the Company. Executive shall be eligible to receive annual equity awards in accordance with equity compensation arrangements established by the Compensation Committee. The grants shall have such terms as are determined by the Compensation Committee in accordance with the current stock plan in place at time of grant.

#### **(d) Benefits.**

(i) Executive and, to the extent eligible, his dependents, shall be entitled to participate in and receive all benefits under any welfare or pension benefit plans and programs made available to the Company's senior level executives or to its employees generally (including, without limitation, medical, disability and life insurance programs, accidental death and dismemberment protection, leave and

participation in retirement plans and deferred compensation plans), subject to the generally applicable eligibility, participation, and other provisions of the various plans and programs and laws and regulations in effect from time to time.

(ii) The Company shall reimburse Executive for all reasonable, ordinary and necessary business expenses incurred during the Service Term in the performance of his services hereunder in accordance with the policies of the Company as they are from time to time in effect and subject to Section 15.

(iii) Executive shall be provided paid time off including vacation, sick days, holidays and shall be entitled to medical, disability, family and other leave in accordance with Company policies as in effect from time to time for senior executives.

(iv) Notwithstanding anything to the contrary contained above, the Company shall be entitled to terminate or reduce any employee benefit enjoyed by Executive pursuant to the provisions of this Section 3(d).

(e) **Sign-on Equity.** Executive will receive an initial equity grant, of Twenty-Five Thousand Shares (with an estimated total value of Two Hundred Sixty Seven Thousand Five Hundred Dollars (\$267,500)), consisting of a performance stock unit award representing Fifty percent (50%) of such value and a restricted stock award grant representing Fifty percent (50%) of such value, subject to the terms of the Rosetta Stone Inc. 2009 Omnibus Incentive Plan, as amended, and the applicable form of award agreement. The performance stock unit award subject to being earned by the achievement of the 2018 financial performance targets of the 2017/2018 LTIP set by the Compensation Committee, and to vest 50% by March 2018 and 50% by March 2019. The restricted stock award shall each vest annually in four (4) equal installments on the first, second, third and fourth anniversaries of the date of employment, provided that Executive remains employed with the Company on such vesting date.

(f) **Sign On Bonus.** Executive shall receive a one-time cash signing bonus in the amount of \$50,000, subject to taxes and applicable withholdings, payable within the first sixty (60) days following hire date. If Executive voluntarily terminates employment with the Company, without Good Reason, or if the Executive is terminated by the Company for Cause, as defined below, within twelve (12) months of receiving the cash signing bonus, the Executive agrees to reimburse the Company 100% of the cash signing bonus within thirty (30) days of the effective date of termination.

## 5. **Termination.**

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

(a) Immediately upon Executive's death.

(b) Upon thirty (30) days' prior written notice by Executive to the Company of Executive's voluntary retirement at age 65 or older.

(c) Upon thirty (30) days' prior written notice by the Company to Executive of the Executive's termination due to Disability. "**Disability**" means (i) Executive is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, or (ii) Executive is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, receiving income replacement benefits for a period of not less than three (3) months under an accident and health plan covering employees of the Company. A determination of Disability may be made by a physician selected or approved by the Company and, in this respect, Executive shall submit to an examination by such physician upon request by the Company. Immediately upon delivery to Executive of a written notice from the Company that Executive has been terminated with or without Cause. "**Cause**" shall mean termination for any of the following:

(i) Executive (a) commits a felony or a crime involving moral turpitude or commits any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of his employment by the Company which conduct damages the Company or an Affiliate; (b) substantially and repeatedly fails to perform duties of the office held by Executive as reasonably directed by the Board of Directors (the "Board") and/or the Chief Executive Officer, (c) commits gross negligence or willful misconduct with respect to the Company or an Affiliate; (d) commits a material breach of this Agreement that is not cured within ten (10) days after receipt of written notice thereof from the Board and/or Chief Executive Officer; (e) fails, within ten (10) days after receipt by Executive of written notice thereof from the Board and/or Chief Executive Officer, to correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board and/or Chief Executive Officer reasonably believes does or may materially or adversely affect the Company's or an Affiliate's business or operations, (h) misappropriates funds or assets of the Company or an Affiliate for personal use or willfully violates the Company policies or standards of business conduct as determined in good faith by the Board and/or Chief Executive Officer.

(d) Upon Executive's voluntary resignation by the delivery to the Chief Executive Officer of a written notice from Executive that Executive has resigned with or without Good Reason. "**Good Reason**" shall mean Executive's resignation from employment with the Company after the occurrence of any of the following events without Executive's consent: (i) a material diminution in Executive's Annual Base Salary, duties, authority or responsibilities from the Annual Base Salary, duties, authority or responsibilities as in effect at the commencement of the Service Term, (ii) a material breach of the Agreement by the Company, or (iii) a relocation of Executive's primary place of employment to a geographic area more than fifty (50) miles from the Company's office in Seattle, Washington; provided, that the foregoing events shall not be deemed to constitute Good Reason unless Executive has notified the Company in writing of the occurrence of such event(s) within sixty (60) days of such occurrence and the Company has failed to have cure such event(s) within thirty (30) business days of its receipt of such written notice and termination occurs within one hundred (100) days of the event.

**6. Rights on Termination.**

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

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

(1) the Accrued Obligation;

(2) a single lump sum payment in cash equal to one times the Annual Base Salary in effect immediately prior to the Termination Date; and

(3) a single lump sum payment in cash equal to the product of (x) the monthly basic life insurance premium applicable to Executive's basic life insurance coverage immediately prior to the Termination Date and (y) twelve (12).

(4) The Company will pay Executive his Annual Bonus for the fiscal year of termination, in an amount equal to a pro rata portion of the bonus payout based on actual performance as if Executive had remained an employee throughout the fiscal year of the Termination Date, paid at the same time as other recipients receive their Annual Bonus for that fiscal year and in accordance with the terms of the then-current Company bonus policy.

The amounts described in Section 6(a)(i)(2), (3) and (4) above shall be referred to herein as the "**Severance Payments.**"

(ii) The Company shall provide professional outplacement and counseling services through an outplacement firm chosen by the Company for twelve (12) months from the Termination Date to assist Executive in his search for other employment.

(iii) Upon Executive's termination, Executive and his spouse and eligible dependents, as applicable, may elect health care coverage for up to eighteen (18) months from his last day of work at the Company pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended ("**COBRA**"). Subject to Section 6(a)(v) below, the Company will pay for up to [twelve (12) months], on an after-tax basis, the portion of Executive's COBRA premiums for such coverage that exceeds the amount that Executive would have incurred in premiums for such coverage under the Company's health plan if then employed by the Company; provided, however, the Company's obligation shall only apply to the extent COBRA coverage is elected and in effect and Executive remains eligible for COBRA coverage during such period.

The amounts described in Section 6(a)(ii) and (iii) above shall be referred to herein as the "**Severance Benefits.**"

(iv) Payments and benefits provided to Executive under this Section 6 (other than the Accrued Obligation) are contingent upon Executive's execution of a release substantially in the form of **Exhibit A** hereto and such release becoming irrevocable within sixty (60) days following his termination of employment.

(v) The Company shall pay Executive the amounts specified in Sections 6(a)(i)(1), (2), and (3) within sixty (60) days after the Termination Date and the amounts specified in Section 6(a)(i)(4) in accordance with the terms of the then-current Company bonus policy, except that the Accrued Obligation will be paid earlier if required by law; provided, however, that in no event shall the timing of Executive's execution of the release, directly or indirectly, result in his designating the calendar year of payment, and if a payment that is subject to execution of the release could be made in more than one taxable year, such payment shall be made in the later taxable year. Notwithstanding the foregoing, if the Executive is deemed on the Termination Date to be a Specified Employee, then with regard to any Severance Payment or other payment or benefit under this Agreement that is "deferred compensation" within the meaning of Section 409A and which is paid as a result of the Executive's Separation from Service, such payment or benefit shall be made or provided at the date which is the earlier of (A) the expiration of the six (6)-month period measured from the date of such Separation from Service of the Executive, and (B) the date of the Executive's death (the "**Delay Period**"). Upon the expiration of the Delay Period, all payments and benefits delayed pursuant to the preceding sentence (whether they would have otherwise been payable in a single sum or in installments in the absence of such delay) shall be paid or reimbursed to the Executive in a lump sum with interest at the six (6)-month U.S. Treasury Rate in effect on the date of Executive's Separation From Service, and any remaining payments and benefits due under this Agreement shall be paid or provided in accordance with the normal payment dates specified for them herein.

(b) If the Company terminates Executive's employment for Cause, if Executive dies or is Disabled, or if Executive resigns without Good Reason, the Company's obligations to pay any compensation or benefits under this Agreement will cease effective as of the Termination Date and the Company shall pay to Executive the Accrued Obligation within sixty (60) days following the Termination Date or earlier if required by law. Following such payments, the Company shall have no further obligations to Executive, other than as may be required by law or the terms of an employee benefit plan of the Company.

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

(d) Notwithstanding the foregoing, if Executive retires at age sixty-five (65) or older, the Company shall pay the Executive: (i) the Accrued Obligation within sixty (60) days after the Termination Date or earlier if required by law, and (ii) a pro rata portion of the Annual Bonus payout based on actual performance as if Executive had remained an employee throughout the fiscal year

of the Termination Date, paid at the same time as other recipients receive their Annual Bonus for that fiscal year and in accordance with the terms of the then-current Company bonus policy. No other amounts will be payable by the Company, other than as may be required by law or the terms of an employee benefit plan of the Company.

**7. Representations of Executive.**

Executive hereby represents and warrants to the Company that the statements contained in this Section 7 are true and accurate as of the date of this Agreement and understands that [his/her] employment and the effectiveness of this agreement is subject to the successful results of a pre-employment background check and verification of immigration status.

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

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

**(a) Obligation to Maintain Confidentiality.** Executive acknowledges that any Proprietary Information disclosed or made available to Executive or obtained, observed or known by Executive as a direct or indirect consequence of his employment with or performance of services for the Company or any of its Affiliates from the time the Executive enters this Agreement through the duration of his performance of services for, or employment with, any of the foregoing Persons (whether or not compensated for such services) are the property of the Company and its Affiliates. Therefore, Executive agrees that, other than in the course of performance of his duties as an employee of the Company, he will not at any time from the time the Executive enters into this Agreement (whether before, during or after Executive's term of employment) disclose or permit to be disclosed to any Person or, directly or indirectly, utilize for his own account or permit to be utilized by any Person any Proprietary Information or records pertaining to the Company, its Affiliates and their respective business for any reason whatsoever without the Chief Executive Officer's consent, unless and to the extent that (except as otherwise provided in the definition of Proprietary Information) the aforementioned matters become generally known to and available for use by the public other than as a direct or indirect result of Executive's acts or omissions to act. Executive agrees to deliver to the Company at the termination of his employment, as a condition to receipt of the Severance Payments, or at any other time the Company may request in writing (whether during or after Executive's term of employment), all records pertaining to the Company, its Affiliates and their respective business which he may then possess or have under his control. Executive further agrees that any property situated on the Company's or its Affiliates' premises and owned by the Company or its Affiliates, including disks and other storage media, filing cabinets or other work areas, is subject to inspection by Company or its Affiliates and their personnel at any time with or without notice. Nothing in this Section 8(a) shall be construed to prevent Executive from using his general knowledge and experience in future employment so long as Executive complies with this Section 8(a) and the other restrictions contained in this Agreement.

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

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

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

(e) **Compelled Disclosure.** If Executive is required by law or governmental regulation or by subpoena or other valid legal process to disclose any Proprietary Information or Third Party

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

**(f) Permitted Disclosure.** Executive acknowledges that nothing in this Agreement, in any other agreement between Executive and the Company, or in any policy of the Company, restricts or prohibits Executive from reporting possible violations of law or regulation to, or from filing a claim or assisting with an investigation directly with, a self-regulatory authority or a government agency or entity, including without limitation the U.S. Equal Employment Opportunity Commission, the Department of Labor, the National Labor Relations Board, the Department of Justice, the Securities and Exchange Commission, the Congress, and any agency Inspector General, or from making other disclosures that are protected under the whistleblower provisions of state or federal law or regulation, whether Executive does so as a result of Executive initiating communications directly with or responding to any inquiries from such government agency or entity. Executive further acknowledges that Executive does not need the prior authorization of the Company to engage in such conduct, and Executive does not need to notify the Company that Executive has engaged in such conduct. In addition, Executive acknowledges that such conduct shall not be deemed a breach of any provision of this Agreement or any other agreement with or policy of the Company.

**(g) Defend Trade Secrets Act Notice.** U.S. federal law (18 U.S.C. § 1833(b)) states that an individual shall not be held criminally or civilly liable under any Federal or State trade secret law for the disclosure of a trade secret that: (A) is made (i) in confidence to a Federal, State, or local government official, either directly or indirectly, or to an attorney and (ii) solely for the purpose of reporting or investigating a suspected violation of law; or (B) is made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal. That law further states that an individual who files a lawsuit for retaliation by an employer for reporting a suspected violation of law may disclose the trade secret to the attorney of the individual and use the trade secret information in the court proceeding, if the individual: (Y) files any document containing the trade secret under seal; and (Z) does not disclose the trade secret, except pursuant to court order. For the avoidance of doubt, nothing in this Agreement is intended to, nor shall be construed to, conflict with 18 U.S.C. § 1833(b).

## **9. Noncompetition and Nonsolicitation.**

### **(a) Noncompetition and Nonsolicitation.**

During Executive's employment, and for a period of twelve (12) months following the termination of Executive's employment for any reason, Executive will not, directly or indirectly



through another entity, within any geographic area served or supervised by Executive during the twelve (12)-month period immediately preceding the Termination Date:

- (i) render or offer any Competing Service or Product to any client or customer for whom Executive provided a Competing Service/Product on behalf of Company;
- (ii) render or offer any Competing Service or Product to any Prospective Customer of Company; or,
- (iii) participate in the recruitment or hiring of any Company Employee nor induce or attempt to induce any Company employee to leave the employ of the Company, or in any way interfere with the relationship between the Company and the employee thereof.

“**Competing Service or Product**” means producing or selling software or services used for learning foreign languages, including English as a foreign language, and any other business carried on by the Company during Executive’s employment. A “**Prospective Customer**” means any Person that the Executive, or other employee working under the Executive, has entertained discussions with to become a client or customer of Company at any time during the twelve (12) -month periods immediately preceding the Termination Date and who has not explicitly rejected a business relationship with the Company. A “Company Employee” is any person who was an employee of the Company at any time within the six (6) months prior to the date of solicitation. For purposes of this Section 9(a), “**Company**” includes Company and any Affiliate to which Executive provided services during his employment.

(b) **Acknowledgment.** Executive acknowledges that in the course of his employment with the Company and its Affiliates, he has and will become familiar with the trade secrets and other Proprietary Information of the Company and its Affiliates. Executive further acknowledges that as the General Counsel and Secretary of the Company, Executive has and will have direct or indirect responsibility, oversight or duties with respect to the businesses of the Company and its Affiliates and its and their current and prospective employees, vendors, customers, clients and other business relations, and that, accordingly, the geographical restriction contained in this Section 9 is reasonable in all respects and necessary to protect the goodwill and Proprietary Information of the Company and that without such protection the Company’s customer and client relations and competitive advantage would be materially adversely affected. It is specifically recognized by Executive that his services to the Company and its Affiliates are special, unique and of extraordinary value, that the Company has a protectable interest in prohibiting Executive as provided in this Section 9, that Executive is responsible for the growth and development of the Company and the creation and preservation of the Company’s goodwill, that money damages are insufficient to protect such interests, that there is adequate consideration being provided to Executive hereunder, that such prohibitions are necessary and appropriate without regard to payments being made to Executive hereunder and that the Company would not enter this Agreement with Executive without the restriction of this Section 9. Executive further acknowledges that the restrictions contained in this Section 9 do not impose an undue hardship on [her/him] and, since he has general business skills that may be used in industries other than that in which the Company and its Affiliates conduct their

business, do not deprive Executive of his livelihood. Executive further acknowledges that the provisions of this Section 9 are separate and independent of the other sections of this Agreement.

(c) **Enforcement, etc.** The parties agree that, in the event that any provision of Section 8 or 9 hereof shall be determined by any court of competent jurisdiction to be unenforceable by reason of its being extended over too great a time or too great a range of activities, such provision shall be deemed to be modified to permit its enforcement to the maximum extent permitted by law. The length of time for which the non-compete and non-solicitation shall be in force shall be extended by an amount of time equal to the period of time during which a violation of such covenant is deemed by a court of competent jurisdiction to have occurred (including any period required for litigation during which the Company seeks to enforce such covenant). If, notwithstanding such provision, a court concludes that the restrictions stated herein are unenforceable or unreasonable under circumstances then existing, the parties hereto agree that the unenforceable or unreasonable restriction should be severed from the Agreement and shall not affect the validity of enforceability of the other restrictions in Section 8 or 9. Because Executive's services are unique, because Executive has access to Proprietary Information and for the other reasons set forth herein, the parties hereto agree that money damages would be an inadequate remedy for any breach of this Agreement. Therefore, without limiting the generality of Section 12(f), in the event of a breach or threatened breach of this Agreement, the Company or its successors or assigns may, in addition to other rights and remedies existing in their favor, apply to any court of competent jurisdiction for specific performance and/or injunctive or other relief in order to enforce, or prevent any violations of, the provisions hereof (without posting a bond or other security).

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

## GENERAL PROVISIONS

### 10. **Definitions.**

**"Accrued Obligation"** means the sum of (1) Executive's Annual Base Salary, (2) reimbursement of any unreimbursed business expenses existing on Executive's Termination Date, in accordance with the Company's normal reimbursement policies and practices, (3) vested account balance under and subject to the terms and provisions of the Company's 401(k) Plan, and (4) any other amounts Executive is entitled to under the Company's benefit plans through the Termination Date for periods through but not following his Separation From Service to the extent not theretofore paid

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

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

“**Code**” means the Internal Revenue Code of 1986, as amended and the regulations and guidance issued thereunder.

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

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

“**Section 409A**” means Section 409A of the Code.

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

“**Specified Employee**” means a person who is a “specified employee” within the meaning of Section 409A.

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

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

## 11. Notices.

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

If to the Company:

Rosetta Stone Ltd.  
1621 North Kent Street  
12<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: Chief Executive Officer

With a copy to:

Rosetta Stone Ltd.  
1621 North Kent Street  
12<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: General Counsel and Secretary

If to Executive:

The last address on file with the Company.

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

## 12. Miscellaneous.

**(a) Clawback/Recoupment.** Notwithstanding any other provisions in this Agreement to the contrary, any incentive-based compensation, or any other compensation, paid to Executive pursuant to this Agreement or any other agreement or arrangement with the Company which is subject to recovery under any law, government regulation or stock exchange listing requirement, will be subject to such deductions and clawback as may be required to be made pursuant to such law, government regulation or stock exchange listing requirement (or any policy adopted by the Company to comply with any such law, government regulation or stock exchange listing requirement).

**(b) Severability.** Whenever possible, each provision of this Agreement will be interpreted in such manner as to be effective and valid under applicable law, but if any provision

of this Agreement is held to be invalid, illegal or unenforceable in any respect under any applicable law or rule in any jurisdiction, such invalidity, illegality or unenforceability will not affect any other provision or any other jurisdiction, but this Agreement will be reformed, construed and enforced in such jurisdiction as if such invalid, illegal or unenforceable provision had never been contained herein.

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

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

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

(f) **Choice of Law; Jurisdiction.** All questions or disputes concerning this Agreement and the exhibits hereto will be governed by and construed in accordance with the internal laws of the Commonwealth of Virginia, without giving effect to any choice of law or conflict of law provision or rule (whether of the Commonwealth of Virginia or any other jurisdiction) that would cause the application of the laws of any jurisdiction other than the Commonwealth of Virginia. The parties hereby: (i) submit to the non-exclusive jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding arising out of or relating to this Agreement; and (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court. Each party hereby waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law.

(g) **Remedies.** Each of the parties to this Agreement will be entitled to enforce its rights under this Agreement specifically, to recover damages and costs (including attorney's fees) caused by any breach of any provision of this Agreement and to exercise all other rights existing in its favor. The parties hereto agree and acknowledge that money damages may not be an adequate remedy for any breach of the provisions of this Agreement and that any party may in its sole discretion apply to any court of law or equity of competent jurisdiction (without posting any bond or deposit) for specific performance and/or other injunctive relief in order to enforce or prevent any violations of the provisions of this Agreement.

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

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

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

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

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

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

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

receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting "parachute payments" is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) payments which do not constitute nonqualified deferred compensation subject to Section 409A; (B) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (C) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced. Any reduction shall be made in accordance with Section 409A.

(b) The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is selected by the Company (the "**Accounting Firm**"). The Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder

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

#### **14. Indemnification.**

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

#### **15. Section 409A.**

Although the Company does not guarantee to Executive any particular tax treatment relating to the payments and benefits under this Agreement, the parties acknowledge that this Agreement is intended to comply with, or be exempt from, the requirements of Section 409A.

For purposes of this Agreement, a termination of employment will mean a “separation from service” as defined in Section 409A, where required for compliance with Section 409A.

With regard to any provision of this Agreement that provides for reimbursement of costs and expenses or in-kind benefits, except as permitted by Section 409A, (i) the right to reimbursement or in-kind benefits shall not be subject to liquidation or exchange for another benefit; (ii) the amount of expenses eligible for reimbursement, or in-kind benefits, provided during any taxable year shall not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year; and (iii) such payments shall be made on or before the last day of the service provider’s taxable year following the taxable year in which the expense was incurred.

Whenever a payment under this Agreement specifies a payment period with reference to a number of days (e.g., “payment shall be made within sixty (60) days after termination”), the actual date of payment within the specified period shall be within the sole discretion of the Company.

*[Signature pages follow]*



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

**ROSETTA STONE LTD.**

**By:** /s/ A. John Hass III \_\_\_\_\_

Name: A. John Hass III

Title: President and Chief Executive Officer

**EXECUTIVE**

/s/ Mathew N. Hulett \_\_\_\_\_

Name: Mathew N. Hulett

**EXHIBIT A**  
**Form of Release**

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

### **Agreement and General Release**

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

#### ***Recitals***

A. Executive and the Company are parties to an Employment Agreement to which this Release is appended as **Exhibit A** (the “**Employment Agreement**”).

B. In addition to the Accrued Obligation (as defined in the Employment Agreement), Executive wishes to receive the other payments and benefits described Section 6(a) of the Employment Agreement.

C. Executive and the Company wish to resolve, except as specifically set forth herein, all claims between them arising from or relating to any act or omission predating the Separation Date defined below.

#### ***Agreement***

The Parties agree as follows:

1. **Confirmation of Severance Package Obligation.** The Company shall pay or provide to Executive the entire Severance Payments and Severance Benefits as provided in Section 6(a) of the Employment Agreement, if Executive executes and does not revoke this Release. The Severance Payments, together with the Severance Benefits described in Sections 6(a)(i), (ii), (iii) and (iv) of the Employment Agreement, are referred to herein as the “**Severance Package.**”

2. **Legal Releases**

(a) Executive, on behalf of Executive and Executive’s heirs, personal representatives and assigns, and any other person or entity that could or might act on behalf of Executive, including, without limitation, Executive’s counsel (all of whom are collectively referred to as “**Executive Releasers**”), hereby fully and forever releases and discharges the Company, its present and future affiliates and subsidiaries, and each of their past, present and future officers, directors, employees, shareholders, independent contractors, attorneys, insurers and any and all other persons or entities that are now or may become liable to any Executive Releaser due to any Executive Releasee’s act or omission, (all of whom are collectively referred to as “**Executive**

**Releasees**”) of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys’ fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that Executive Releasers, or any person acting under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission occurring on or before the Effective Date, without regard to present actual knowledge of such acts or omissions, including specifically, but not by way of limitation, matters which may arise at common law, such as breach of contract, express or implied, promissory estoppel, wrongful discharge, tortious interference with contractual rights, infliction of emotional distress, defamation, or under federal, state or local laws, such as the Fair Labor Standards Act, the Employee Retirement Income Security Act, the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Equal Pay Act, the Americans with Disabilities Act, the Family and Medical Leave Act, and any civil rights law of any state or other governmental body; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Release, the release set forth in this Section shall not extend to: (i) any rights arising under this Release; (ii) any vested rights under any pension, retirement, profit sharing or similar plan; (iii) any rights Executive has under any grants of stock options, restricted stock, or other forms of equity that may have been provided to Executive during Executive’s employment (such grants to be governed by the applicable equity plan and grant agreement); (iv) any rights Executive has under applicable workers compensation laws; (v) Executive’s rights, if any, to indemnification, and/or defense under any Company certificate of incorporation, bylaw and/or policy or procedure, or under any insurance contract or any indemnification agreement with the Company, in connection with Executive’s acts and omissions within the course and scope of Executive’s employment with the Company; (vi) Executive’s ability to communicate with the Equal Employment Opportunity Commission (EEOC) or any other governmental agency, provided Executive does not seek any personal relief for any claims released herein; (vii) any claims arising after the date of Executive’s execution of this Release; (viii) any obligations of the Company under the Employment Agreement which survive Executive’s termination of employment; or (ix) any other claims that cannot lawfully be released. Executive hereby warrants that Executive has not assigned or transferred to any person any portion of any claim, which is released, waived and discharged above. Executive further states and agrees that Executive has not experienced any illness, injury, or disability that is compensable or recoverable under the worker’s compensation laws of any state that was not reported to the Company by Executive before the Effective Date, and Executive agrees not to not file a worker’s compensation claim asserting the existence of any such previously undisclosed illness, injury, or disability. Executive has specifically consulted with counsel with respect to the agreements, representations, and declarations set forth in the previous sentence. Executive understands and agrees that by signing this Release Executive is giving up any right to bring any legal claim against the Company concerning, directly or indirectly, Executive’s employment relationship with the Company, including Executive’s separation from employment. Executive agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of the Company, to include all actual or potential legal claims that Executive may have against the Company, except as specifically provided otherwise in this Release.

(b) In order to provide a full and complete release, each of the Parties understands and agrees that this Release is intended to include all claims, if any, covered under this Section 2 that such Party may have and not now know or suspect to exist in such Party’s favor against any

other Party and that this Release extinguishes such claims. Thus, each of the Parties expressly waives all rights under any statute or common law principle in any jurisdiction that provides, in effect, that a general release does not extend to claims which the releasing party does not know or suspect to exist in such Party's favor at the time of executing the release, which if known by such Party must have materially affected such Party's settlement with the party being released.

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

3. Executive acknowledges that he has received all compensation to which he is entitled for [her/him] work up to his last day of employment with the Company, and that he is not entitled to any further pay or benefit of any kind, for services rendered or any other reason, other than the Severance Package, and any expense reimbursement due pursuant Section 3(d)(ii) of the Employment Agreement.

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

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

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

8. During the Service Term and thereafter, Executive covenants never to, and the Company agrees not to and to cause its Board and Section 16 reporting officers not to, utter, publish, or communicate, or cause the utterance, publication or communication of any defamatory, disparaging, or untrue, inaccurate, or misleading statements or opinions intended to cause the other to be held in lower regard, nor shall Executive at any time harass or behave unprofessionally toward any past, present or future the Company employee, officer or director, nor or the Company, its Board and Section 16 reporting officers at any time harass or behave unprofessionally toward the Executive.

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

10. Miscellaneous Terms and Conditions

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

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

(c) All covenants and warranties contained in this Release are contractual and shall survive the closing of this Release.

(d) This Release shall be binding in all respects upon, and shall inure to the benefit of, the parties' heirs, successors and assigns.

(e) This Release shall be governed by the internal laws of the Commonwealth of Virginia, irrespective of the choice of law rules of any jurisdiction.

(f) Should any provision of this Release be declared illegal or unenforceable by any court of competent jurisdiction and cannot be modified to be enforceable, such provision shall immediately become null and void, leaving the remainder of this Release in full force and effect. Notwithstanding the foregoing, if Section 2(a), above, is declared void or unenforceable, then this Release shall be null and void and both parties shall be restored to the positions that they occupied before the Release's execution (meaning that, among other things, all sums paid by the Company pursuant to Section 1, above, shall be immediately refunded to the Company); provided that in such circumstances this Release and the facts and circumstances relating to its execution shall be inadmissible in any later proceeding between the parties, and the statutes of limitations applicable to claims asserted in the proceeding shall be deemed to have been tolled for the period between the Effective Date and 10 days after the date on which Section 2(a) is declared unenforceable.

(g) This Release constitutes the entire agreement of the parties and a complete merger of prior negotiations and agreements.

(h) This Release shall not be modified except in a writing signed by the parties.

(i) No term or condition of this Release shall be deemed to have been waived, nor shall there be an estoppel against the enforcement of any provision of this Release, except by a writing signed by the party charged with the waiver or estoppel. No waiver of any breach of this Release shall be deemed a waiver of any later breach of the same provision or any other provision of this Release.

(j) Headings are intended solely as a convenience and shall not control the meaning or interpretation of any provision of this Release.

(k) Pronouns contained in this Release shall apply equally to the feminine, neuter and masculine genders. The singular shall include the plural, and the plural shall include the singular.

(l) Each party shall promptly execute, acknowledge and deliver any additional document or agreement that the other party reasonably believes is necessary to carry out the purpose or effect of this Release.

(m) Any party contesting the validity or enforceability of any term of this Release shall be required to prove by clear and convincing evidence fraud, concealment, failure to disclose material information, unconscionability, misrepresentation or mistake of fact or law.

(n) The parties acknowledge that they have reviewed this Release in its entirety and have had a full and fair opportunity to negotiate its terms and to consult with counsel of their own choosing concerning the meaning and effect of this Release. Each party therefore waives all applicable rules of construction that any provision of this Release should be construed against its drafter, and agrees that all provisions of the agreement shall be construed as a whole, according to the fair meaning of the language used.

(o) Every dispute arising from or relating to this Release shall be tried only in the state or federal courts situated in the Commonwealth of Virginia. The parties consent to venue

in those courts, and agree that those courts shall have personal jurisdiction over them in, and subject matter jurisdiction concerning, any such action.

(p) In any action relating to or arising from this Release, or involving its application, the party substantially prevailing shall recover from the other party the expenses incurred by the prevailing party in connection with the action, including court costs and reasonable attorneys' fees. If Executive is the substantially prevailing party, the Company shall pay such expenses within 60 days following the determination that he is the substantially prevailing party.

(q) This Release may be executed in counterparts, or by copies transmitted by telecopier, all of which shall be given the same force and effect as the original.

[SIGNATURES FOLLOW]



**NOTE: DO NOT SIGN THIS SUPPLEMENTAL LEGAL RELEASE UNTIL AFTER EXECUTIVE'S FINAL DAY OF EMPLOYMENT.**

ROSETTA STONE LTD.

EXECUTIVE

By:\_\_\_\_  
A. John Hass III

\_\_\_\_  
Mathew N. Hulett

Date:\_\_\_\_

Date:\_\_\_\_

**EXECUTIVE EMPLOYMENT AGREEMENT**

THIS EXECUTIVE EMPLOYMENT AGREEMENT (this “**Agreement**”) is effective as of August 21, 2017, between Rosetta Stone Ltd., a Virginia corporation (together with its successors and assigns, the “**Company**”), and Nicholas C. Gahde (“**Executive**”).

**Recitals**

The Company and Executive desire to enter into an agreement pursuant to which the Company will employ Executive as its President, Literacy (Lexia) subject to the terms and conditions of this Agreement.

**Agreement**

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

**1. Employment.**

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

**2. Duties.**

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

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

**3. Employment Term.**

Unless Executive’s employment under this Agreement is sooner terminated as a result of Executive’s resignation or termination in accordance with the provisions of Section 5 below, Executive’s term of employment (“**Service Term**”) under this Agreement shall commence on the date hereof and shall continue for a period of one (1) year, and at the end of each year it shall renew and extend automatically for an additional one (1) year (such date and each annual anniversary thereof, a “**Renewal Date**”), unless the Company or Executive provides written notice of its intention

not to extend the term of the Agreement at least 90 days' prior to the applicable Renewal Date provided, however, that either party may terminate this Agreement pursuant to Section 5.

#### **4. Salary, Bonus and Benefits.**

The Compensation Committee of the Board (the "Compensation Committee") shall make all decisions related to Executive's compensation

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

(b) **Annual Bonus.** The Executive will be eligible to participate in the annual bonus plan (the "**Annual Bonus**") and be eligible to receive an Annual Bonus target of sixty percent (60%) of his Annual Base Salary upon one hundred percent (100%) achievement of annual objectives, beginning with the Company's 2017 fiscal year. For subsequent years, the Annual Bonus target as a percentage of then-current Annual Base Salary, may be adjusted, but may not be less than sixty percent (60%) of the Executive's then-current Annual Base Salary. The bonus, if any, will be determined by the Board based upon the Company's achievement of financial performance goals and other objectives, as determined by the Compensation Committee for each fiscal year of the Company.

(c) **Annual Equity.** The Executive will be eligible to participate in the annual equity plan (the "**Annual Equity**") and be eligible to receive an Annual Equity with a target value of Seventy-Five percent (75%) of his Annual Base Salary upon one hundred percent (100%) achievement of annual objectives. The Annual Equity target as a percentage of then-current Annual Base Salary, may be adjusted, but may not be less than Seventy-Five percent (75%) of the Executive's then-current Annual Base Salary. The equity, if any, will be determined by the Board based upon the Company's achievement of financial performance goals and other objectives, as determined by the Compensation Committee for each fiscal year of the Company. Executive shall be eligible to receive annual equity awards in accordance with equity compensation arrangements established by the Compensation Committee. The grants shall have such terms as are determined by the Compensation Committee in accordance with the current stock plan in place at time of grant.

(d) **Benefits.**

(i) Executive and, to the extent eligible, his dependents, shall be entitled to participate in and receive all benefits under any welfare or pension benefit plans and programs made available to the Company's senior level executives or to its employees generally (including, without limitation, medical, disability and life insurance programs, accidental death and dismemberment protection, leave and participation in retirement plans and deferred compensation plans), subject to the

generally applicable eligibility, participation, and other provisions of the various plans and programs and laws and regulations in effect from time to time.

(ii) The Company shall reimburse Executive for all reasonable, ordinary and necessary business expenses incurred during the Service Term in the performance of his services hereunder in accordance with the policies of the Company as they are from time to time in effect and subject to Section 15.

(iii) Executive shall be provided paid time off including vacation, sick days, holidays and shall be entitled to medical, disability, family and other leave in accordance with Company policies as in effect from time to time for senior executives.

(iv) Notwithstanding anything to the contrary contained above, the Company shall be entitled to terminate or reduce any employee benefit enjoyed by Executive pursuant to the provisions of this Section 3(d).

## 5. Termination.

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

(a) Immediately upon Executive's death.

(b) Upon thirty (30) days' prior written notice by Executive to the Company of Executive's voluntary retirement at age 65 or older.

(c) Upon thirty (30) days' prior written notice by the Company to Executive of the Executive's termination due to Disability. "**Disability**" means (i) Executive is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, or (ii) Executive is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than twelve (12) months, receiving income replacement benefits for a period of not less than three (3) months under an accident and health plan covering employees of the Company. A determination of Disability may be made by a physician selected or approved by the Company and, in this respect, Executive shall submit to an examination by such physician upon request by the Company. Immediately upon delivery to Executive of a written notice from the Company that Executive has been terminated with or without Cause. "**Cause**" shall mean termination for any of the following:

(i) Executive (a) commits a felony or a crime involving moral turpitude or commits any other act or omission involving fraud, embezzlement or any other act of dishonesty in the course of his employment by the Company which conduct damages the Company or an Affiliate; (b) substantially and repeatedly fails to perform duties of the office held by Executive as reasonably directed by the Board

of Directors (the “Board”) and/or the Chief Executive Officer, (c) commits gross negligence or willful misconduct with respect to the Company or an Affiliate; (d) commits a material breach of this Agreement that is not cured within ten (10) days after receipt of written notice thereof from the Board and/or Chief Executive Officer; (e) fails, within ten (10) days after receipt by Executive of written notice thereof from the Board and/or Chief Executive Officer, to correct, cease or otherwise alter any failure to comply with instructions or other action or omission which the Board and/or Chief Executive Officer reasonably believes does or may materially or adversely affect the Company’s or an Affiliate’s business or operations, (h) misappropriates funds or assets of the Company or an Affiliate for personal use or willfully violates the Company policies or standards of business conduct as determined in good faith by the Board and/or Chief Executive Officer

(d) Upon Executive’s voluntary resignation by the delivery to the Chief Executive Officer of a written notice from Executive that Executive has resigned with or without Good Reason. “**Good Reason**” shall mean Executive’s resignation from employment with the Company after the occurrence of any of the following events without Executive’s consent: (i) a material diminution in Executive’s Annual Base Salary, duties, authority or responsibilities from the Annual Base Salary, duties, authority or responsibilities as in effect at the commencement of the Service Term, (ii) a material breach of the Agreement by the Company, or (iii) a relocation of Executive’s primary place of employment to a geographic area more than fifty (50) miles from the Company’s office in Concord, MA ; provided, that the foregoing events shall not be deemed to constitute Good Reason unless Executive has notified the Company in writing of the occurrence of such event(s) within sixty (60) days of such occurrence and the Company has failed to have cure such event(s) within thirty (30) business days of its receipt of such written notice and termination occurs within one hundred (100) days of the event.

## **6. Rights on Termination.**

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

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

(1) the Accrued Obligation;

(2) a single lump sum payment in cash equal to one times the Annual Base Salary in effect immediately prior to the Termination Date; and

(3) a single lump sum payment in cash equal to the product of (x) the monthly basic life insurance premium applicable to Executive’s basic life insurance coverage immediately prior to the Termination Date and (y) twelve (12).

(4) The Company will pay Executive his Annual Bonus for the fiscal year of termination, in an amount equal to a pro rata portion of the bonus payout

based on actual performance as if Executive had remained an employee throughout the fiscal year of the Termination Date, paid at the same time as other recipients receive their Annual Bonus for that fiscal year and in accordance with the terms of the then-current Company bonus policy.

The amounts described in Section 6(a)(i)(2), (3) and (4) above shall be referred to herein as the “**Severance Payments.**”

(ii) The Company shall provide professional outplacement and counseling services through an outplacement firm chosen by the Company for twelve (12) months from the Termination Date to assist Executive in his search for other employment.

(iii) Upon Executive’s termination, Executive and his spouse and eligible dependents, as applicable, may elect health care coverage for up to eighteen (18) months from his last day of work at the Company pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended (“**COBRA**”). Subject to Section 6(a)(v) below, the Company will pay for up to twelve (12) months, on an after-tax basis, the portion of Executive’s COBRA premiums for such coverage that exceeds the amount that Executive would have incurred in premiums for such coverage under the Company’s health plan if then employed by the Company; provided, however, the Company’s obligation shall only apply to the extent COBRA coverage is elected and in effect and Executive remains eligible for COBRA coverage during such period.

The amounts described in Section 6(a)(ii) and (iii) above shall be referred to herein as the “**Severance Benefits.**”

(iv) Payments and benefits provided to Executive under this Section 6 (other than the Accrued Obligation) are contingent upon Executive’s execution of a release substantially in the form of **Exhibit A** hereto and such release becoming irrevocable within sixty (60) days following his termination of employment.

(v) The Company shall pay Executive the amounts specified in Sections 6(a)(i)(1), (2), and (3) within sixty (60) days after the Termination Date and the amounts specified in Section 6(a)(i)(4) in accordance with the terms of the then-current Company bonus policy, except that the Accrued Obligation will be paid earlier if required by law; provided, however, that in no event shall the timing of Executive’s execution of the release, directly or indirectly, result in his designating the calendar year of payment, and if a payment that is subject to execution of the release could be made in more than one taxable year, such payment shall be made in the later taxable year. Notwithstanding the forgoing, if the Executive is deemed on the Termination Date to be a Specified Employee, then with regard to any Severance Payment or other payment or benefit under this Agreement that is “deferred compensation” within the meaning of Section 409A and which is paid as a result of the Executive’s Separation from Service, such payment or benefit shall be made or provided at the date which is the earlier of (A) the expiration of the six (6)-month period measured from the date of such Separation from Service of the Executive, and (B) the date of the Executive’s death (the “**Delay Period**”). Upon the expiration of the Delay Period, all payments and benefits delayed pursuant to the preceding sentence (whether they would have otherwise been payable in a single sum or in installments in the absence of such delay) shall be paid or reimbursed to the

Executive in a lump sum with interest at the six (6)-month U.S. Treasury Rate in effect on the date of Executive's Separation From Service, and any remaining payments and benefits due under this Agreement shall be paid or provided in accordance with the normal payment dates specified for them herein.

(b) If the Company terminates Executive's employment for Cause, if Executive dies or is Disabled, or if Executive resigns without Good Reason, the Company's obligations to pay any compensation or benefits under this Agreement will cease effective as of the Termination Date and the Company shall pay to Executive the Accrued Obligation within sixty (60) days following the Termination Date or earlier if required by law. Following such payments, the Company shall have no further obligations to Executive, other than as may be required by law or the terms of an employee benefit plan of the Company.

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

(d) Notwithstanding the foregoing, if Executive retires at age sixty-five (65) or older, the Company shall pay the Executive: (i) the Accrued Obligation within sixty (60) days after the Termination Date or earlier if required by law, and (ii) a pro rata portion of the Annual Bonus payout based on actual performance as if Executive had remained an employee throughout the fiscal year of the Termination Date, paid at the same time as other recipients receive their Annual Bonus for that fiscal year and in accordance with the terms of the then-current Company bonus policy. No other amounts will be payable by the Company, other than as may be required by law or the terms of an employee benefit plan of the Company.

## **7. Representations of Executive.**

Executive hereby represents and warrants to the Company that the statements contained in this Section 7 are true and accurate as of the date of this Agreement and understands that his employment and the effectiveness of this agreement is subject to the successful results of a pre-employment background check and verification of immigration status.

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

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

(a) **Obligation to Maintain Confidentiality.** Executive acknowledges that any Proprietary Information disclosed or made available to Executive or obtained, observed or known by Executive as a direct or indirect consequence of his employment with or performance of services for the Company or any of its Affiliates during the course of his performance of services for, or employment with, any of the foregoing Persons (whether or not compensated for such services) [and for the twelve (12) months following the Termination Date][NTD: Consider deleting this and

making the confidentiality obligation perpetual], are the property of the Company and its Affiliates. Therefore, Executive agrees that, other than in the course of performance of his duties as an employee of the Company, he will not at any time (whether during or after Executive's term of employment) disclose or permit to be disclosed to any Person or, directly or indirectly, utilize for his own account or permit to be utilized by any Person any Proprietary Information or records pertaining to the Company, its Affiliates and their respective business for any reason whatsoever without the Chief Executive Officer's consent, unless and to the extent that (except as otherwise provided in the definition of Proprietary Information) the aforementioned matters become generally known to and available for use by the public other than as a direct or indirect result of Executive's acts or omissions to act. Executive agrees to deliver to the Company at the termination of his employment, as a condition to receipt of the Severance Payments, or at any other time the Company may request in writing (whether during or after Executive's term of employment), all records pertaining to the Company, its Affiliates and their respective business which he may then possess or have under his control. Executive further agrees that any property situated on the Company's or its Affiliates' premises and owned by the Company or its Affiliates, including disks and other storage media, filing cabinets or other work areas, is subject to inspection by Company or its Affiliates and their personnel at any time with or without notice. Nothing in this Section 8(a) shall be construed to prevent Executive from using his general knowledge and experience in future employment so long as Executive complies with this Section 8(a) and the other restrictions contained in this Agreement.

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



relating to the Company's business; or (ii) result from any work that Executive performs for the Company or its Affiliates.

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

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

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

(f) **Permitted Disclosure.** Executive acknowledges that nothing in this Agreement, in any other agreement between Executive and the Company, or in any policy of the Company, restricts or prohibits Executive from reporting possible violations of law or regulation to, or from filing a claim or assisting with an investigation directly with, a self-regulatory authority or a government agency or entity, including without limitation the U.S. Equal Employment Opportunity Commission, the Department of Labor, the National Labor Relations Board, the Department of Justice, the Securities and Exchange Commission, the Congress, and any agency Inspector General, or from making other disclosures that are protected under the whistleblower provisions of state or federal law or regulation, whether Executive does so as a result of Executive initiating communications directly with or responding to any inquiries from such government agency or entity. Executive further acknowledges that Executive does not need the prior authorization of the Company to engage in such conduct, and Executive does not need to notify the Company that Executive has engaged in such conduct. In addition, Executive acknowledges that such conduct

shall not be deemed a breach of any provision of this Agreement or any other agreement with or policy of the Company.

(g) **Defend Trade Secrets Act Notice.** U.S. federal law (18 U.S.C. § 1833(b)) states that an individual shall not be held criminally or civilly liable under any Federal or State trade secret law for the disclosure of a trade secret that: (A) is made (i) in confidence to a Federal, State, or local government official, either directly or indirectly, or to an attorney and (ii) solely for the purpose of reporting or investigating a suspected violation of law; or (B) is made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal. That law further states that an individual who files a lawsuit for retaliation by an employer for reporting a suspected violation of law may disclose the trade secret to the attorney of the individual and use the trade secret information in the court proceeding, if the individual: (Y) files any document containing the trade secret under seal; and (Z) does not disclose the trade secret, except pursuant to court order. For the avoidance of doubt, nothing in this Agreement is intended to, nor shall be construed to, conflict with 18 U.S.C. § 1833(b).

## **9. Noncompetition and Nonsolicitation.**

### **(a) Noncompetition and Nonsolicitation.**

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

- (1) render or offer any Competing Service or Product to any client or customer for whom Executive provided a Competing Service/Product on behalf of Company;
- (2) render or offer any Competing Service or Product to any Prospective Customer of Company; or,
- (3) participate in the recruitment or hiring of any Company Employee nor induce or attempt to induce any Company employee to leave the employ of the Company, or in any way interfere with the relationship between the Company and the employee thereof.

**"Competing Service or Product"** means producing or selling software or services used for learning foreign languages, including English as a foreign language, and any other business carried on by the Company during Executive's employment. A **"Prospective Customer"** means any Person that the Executive, or other employee working under the Executive, has entertained discussions with to become a client or customer of Company at any time during the twelve (12) -month periods immediately preceding the Termination Date and who has not explicitly rejected a business relationship with the Company. A **"Company Employee"** is any person who was an employee of the Company at any time within the six (6) months prior to the date of solicitation. For purposes of this Section 9(a), **"Company"** includes Company and any Affiliate to which Executive provided services during his employment.

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

**(c) Enforcement, etc.** The parties agree that, in the event that any provision of Section 8 or 9 hereof shall be determined by any court of competent jurisdiction to be unenforceable by reason of its being extended over too great a time or too great a range of activities, such provision shall be deemed to be modified to permit its enforcement to the maximum extent permitted by law. The length of time for which the non-compete and non-solicitation shall be in force shall be extended by an amount of time equal to the period of time during which a violation of such covenant is deemed by a court of competent jurisdiction to have occurred (including any period required for litigation during which the Company seeks to enforce such covenant). If, notwithstanding such provision, a court concludes that the restrictions stated herein are unenforceable or unreasonable under circumstances then existing, the parties hereto agree that the unenforceable or unreasonable restriction should be severed from the Agreement and shall not affect the validity of enforceability of the other restrictions in Section 8 or 9. Because Executive's services are unique, because Executive has access to Proprietary Information and for the other reasons set forth herein, the parties hereto agree that money damages would be an inadequate remedy for any breach of this Agreement. Therefore, without limiting the generality of Section 12(f), in the event of a breach or threatened breach of this Agreement, the Company or its successors or assigns may, in addition to other rights and remedies existing in their favor, apply to any court of competent jurisdiction for specific performance and/or injunctive or other relief in order to enforce, or prevent any violations of, the provisions hereof (without posting a bond or other security).

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

## GENERAL PROVISIONS

### 10. Definitions.

**“Accrued Obligation”** means the sum of (1) Executive’s Annual Base Salary, (2) reimbursement of any unreimbursed business expenses existing on Executive’s Termination Date, in accordance with the Company’s normal reimbursement policies and practices, (3) vested account balance under and subject to the terms and provisions of the Company’s 401(k) Plan, and (4) any other amounts Executive is entitled to under the Company’s benefit plans through the Termination Date for periods through but not following his Separation From Service to the extent not theretofore paid

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

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

**“Code”** means the Internal Revenue Code of 1986, as amended and the regulations and guidance issued thereunder.

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

**“Proprietary Information”** means any and all data and information concerning the business affairs of the Company or any of its Affiliates and not generally known in the industry in which the Company or any of its Affiliates is or may become engaged, and any other information concerning any matters affecting or relating to the Company’s or its Affiliates businesses, but in any event Proprietary Information shall include, any of the Company’s and its Affiliates’ past, present or prospective business opportunities, including information concerning acquisition opportunities in or reasonably related to the Company’s or its Affiliates’ businesses or industries, customers, customer lists, clients, client lists, the prices the Company and its Affiliates obtain or have obtained from the sale of, or at which they sell or have sold, their products, unit volume of sales to past or present customers and clients, or any other information concerning the business of the Company and its

Affiliates, their manner of operation, their plans, processes, figures, sales figures, projections, estimates, tax records, personnel history, accounting procedures, promotions, supply sources, contracts, know-how, trade secrets, information relating to research, development, inventions, technology, manufacture, purchasing, engineering, marketing, merchandising or selling, or other data without regard to whether all of the foregoing matters will be deemed confidential, material or important. Proprietary Information does not include any information that Executive has obtained from a Person other than an employee of the Company or an Affiliate, which was disclosed to [her/him] without a breach of a duty of confidentiality.

“**Section 409A**” means Section 409A of the Code.

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

“**Specified Employee**” means a person who is a “specified employee” within the meaning of Section 409A.

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

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

## **11. Notices.**

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

If to the Company:

Rosetta Stone Ltd.  
1621 North Kent St  
12<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: Chief Executive Officer

With a copy to:

Rosetta Stone Ltd.  
1621 North Kent St  
12<sup>th</sup> Floor  
Arlington, VA 22209  
Attention: General Counsel and Secretary

If to Executive:

The last address on file with the Company.

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

**12. Miscellaneous.**

**(a) Clawback/Recoupment.** Notwithstanding any other provisions in this Agreement to the contrary, any incentive-based compensation, or any other compensation, paid to Executive pursuant to this Agreement or any other agreement or arrangement with the Company which is subject to recovery under any law, government regulation or stock exchange listing requirement, will be subject to such deductions and clawback as may be required to be made pursuant to such law, government regulation or stock exchange listing requirement (or any policy adopted by the Company to comply with any such law, government regulation or stock exchange listing requirement).

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

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

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

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

**(f) Choice of Law; Jurisdiction.** All questions or disputes concerning this Agreement and the exhibits hereto will be governed by and construed in accordance with the internal laws of the Commonwealth of Virginia, without giving effect to any choice of law or conflict of law provision or rule (whether of the Commonwealth of Virginia or any other jurisdiction) that would cause the application of the laws of any jurisdiction other than the Commonwealth of Virginia. The parties hereby: (i) submit to the non-exclusive jurisdiction of any state or federal court sitting in the Commonwealth of Virginia in any action or proceeding arising out of or relating to this Agreement; and (ii) agree that all claims in respect of such action or proceeding may be heard or determined in any such court. Each party hereby waives any defense of inconvenient forum to the maintenance of any action or proceeding so brought. The parties hereby agree that a final judgment in any action or proceeding so brought shall be conclusive and may be enforced by suit on the judgment or in any other manner provided by law.

**(g) Remedies.** Each of the parties to this Agreement will be entitled to enforce its rights under this Agreement specifically, to recover damages and costs (including attorney's fees) caused by any breach of any provision of this Agreement and to exercise all other rights existing in its favor. The parties hereto agree and acknowledge that money damages may not be an adequate remedy for any breach of the provisions of this Agreement and that any party may in its sole discretion apply to any court of law or equity of competent jurisdiction (without posting any bond or deposit) for specific performance and/or other injunctive relief in order to enforce or prevent any violations of the provisions of this Agreement.

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

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

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

**(k) Taxes; Withholding of Taxes on Behalf of Executive.** Executive shall be solely responsible for any and all taxes imposed on Executive by reason of any compensation and benefits provided under this Agreement, and all such compensation and benefits shall be subject to applicable withholding. Without limiting the scope of the preceding sentence, the Company and its Affiliates shall be entitled to deduct or withhold from any amounts owing from the Company or any of its Affiliates to Executive any federal, state, provincial, local or foreign withholding taxes, excise taxes, or employment taxes imposed with respect to Executive's compensation or other payments from the Company or any of its Affiliates or Executive's ownership interest in the Company, including,

but not limited to, wages, bonuses, dividends, the receipt or exercise of stock options and/or the receipt or vesting of restricted stock.

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

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

**(a)** Anything in this Agreement to the contrary notwithstanding, if any payment or benefit Executive would receive pursuant to this Agreement ("**Payment**") would (i) constitute a "parachute payment" within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the "**Excise Tax**"), then such Payment shall be reduced to the Reduced Amount. The "**Reduced Amount**" shall be either (x) the largest portion of the Payment that would result in no portion of the Payment being subject to the Excise Tax or (y) the largest portion, up to and including the total, of the Payment, whichever amount, after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate), results in Executive's receipt, on an after-tax basis, of the greater amount of the Payment notwithstanding that all or some portion of the Payment may be subject to the Excise Tax. If a reduction in payments or benefits constituting "parachute payments" is necessary so that the Payment equals the Reduced Amount, reduction shall occur in the following order: (A) payments which do not constitute nonqualified deferred compensation subject to Section 409A; (B) cash payments shall be reduced first and in reverse chronological order such that the cash payment owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first cash payment to be reduced; and (C) employee benefits shall be reduced last (but only to the extent such benefits may be reduced under applicable law, including, but not limited to the Code and the Employee Retirement Income Security Act of 1974, as amended) and in reverse chronological order such that the benefit owed on the latest date following the occurrence of the event triggering such Excise Tax will be the first benefit to be reduced. Any reduction shall be made in accordance with Section 409A.

**(b)** The determinations and calculations required hereunder shall be made by nationally recognized accounting firm that is selected by the Company (the "**Accounting Firm**"). The Company shall bear all expenses with respect to the determinations by the Accounting Firm required to be made hereunder

**(c)** The Accounting Firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and Eligible Employee within fifteen (15) business days after the date on which right to a Payment is triggered (if requested at that time by the Company or Executive) or such other time as requested by the



Company or Executive. Any good faith determinations of the Accounting Firm made hereunder shall be final, binding and conclusive upon the Company and Executive.

**14. Indemnification.**

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

**15. Section 409A.**

Although the Company does not guarantee to Executive any particular tax treatment relating to the payments and benefits under this Agreement, the parties acknowledge that this Agreement is intended to comply with, or be exempt from, the requirements of Section 409A.

For purposes of this Agreement, a termination of employment will mean a "separation from service" as defined in Section 409A, where required for compliance with Section 409A.

With regard to any provision of this Agreement that provides for reimbursement of costs and expenses or in-kind benefits, except as permitted by Section 409A, (i) the right to reimbursement or in-kind benefits shall not be subject to liquidation or exchange for another benefit; (ii) the amount of expenses eligible for reimbursement, or in-kind benefits, provided during any taxable year shall not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year; and (iii) such payments shall be made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred.

Whenever a payment under this Agreement specifies a payment period with reference to a number of days (e.g., "payment shall be made within sixty (60) days after termination"), the actual date of payment within the specified period shall be within the sole discretion of the Company.

*[Signature pages follow]*

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

**ROSETTA STONE LTD.**

**By:** /s/ John Hass

**Name:** John Hass

**Title:** President & Chief Executive Officer

**EXECUTIVE**

/s/ Nicholas C. Gaehde

**Nicholas C. Gaehde**

**EXHIBIT A**  
**Form of Release**

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

### **Agreement and General Release**

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

#### ***Recitals***

A. Executive and the Company are parties to an Employment Agreement to which this Release is appended as **Exhibit A** (the “**Employment Agreement**”).

B. In addition to the Accrued Obligation (as defined in the Employment Agreement), Executive wishes to receive the other payments and benefits described Section 6(a) of the Employment Agreement.

C. Executive and the Company wish to resolve, except as specifically set forth herein, all claims between them arising from or relating to any act or omission predating the Separation Date defined below.

#### ***Agreement***

The Parties agree as follows:

1. **Confirmation of Severance Package Obligation.** The Company shall pay or provide to Executive the entire Severance Payments and Severance Benefits as provided in Section 6(a) of the Employment Agreement, if Executive executes and does not revoke this Release. The Severance Payments, together with the Severance Benefits described in Sections 6(a)(i), (ii), (iii) and (iv) of the Employment Agreement, are referred to herein as the “**Severance Package.**”

2. **Legal Releases**

(a) Executive, on behalf of Executive and Executive’s heirs, personal representatives and assigns, and any other person or entity that could or might act on behalf of Executive, including, without limitation, Executive’s counsel (all of whom are collectively referred to as “**Executive Releasers**”), hereby fully and forever releases and discharges the Company, its present and future affiliates and subsidiaries, and each of their past, present and future officers, directors, employees, shareholders, independent contractors, attorneys, insurers and any and all other persons or entities that are now or may become liable to any Executive Releaser due to any Executive Releasee’s act or omission, (all of whom are collectively referred to as “**Executive**

**Releasees**”) of and from any and all actions, causes of action, claims, demands, costs and expenses, including attorneys’ fees, of every kind and nature whatsoever, in law or in equity, whether now known or unknown, that Executive Releasers, or any person acting under any of them, may now have, or claim at any future time to have, based in whole or in part upon any act or omission occurring on or before the Effective Date, without regard to present actual knowledge of such acts or omissions, including specifically, but not by way of limitation, matters which may arise at common law, such as breach of contract, express or implied, promissory estoppel, wrongful discharge, tortious interference with contractual rights, infliction of emotional distress, defamation, or under federal, state or local laws, such as the Fair Labor Standards Act, the Employee Retirement Income Security Act, the National Labor Relations Act, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Equal Pay Act, the Americans with Disabilities Act, the Family and Medical Leave Act, and any civil rights law of any state or other governmental body; PROVIDED, HOWEVER, that notwithstanding the foregoing or anything else contained in this Release, the release set forth in this Section shall not extend to: (i) any rights arising under this Release; (ii) any vested rights under any pension, retirement, profit sharing or similar plan; (iii) any rights Executive has under any grants of stock options, restricted stock, or other forms of equity that may have been provided to Executive during Executive’s employment (such grants to be governed by the applicable equity plan and grant agreement); (iv) any rights Executive has under applicable workers compensation laws; (v) Executive’s rights, if any, to indemnification, and/or defense under any Company certificate of incorporation, bylaw and/or policy or procedure, or under any insurance contract or any indemnification agreement with the Company, in connection with Executive’s acts and omissions within the course and scope of Executive’s employment with the Company; (vi) Executive’s ability to communicate with the Equal Employment Opportunity Commission (EEOC) or any other governmental agency, provided Executive does not seek any personal relief for any claims released herein; (vii) any claims arising after the date of Executive’s execution of this Release; (viii) any obligations of the Company under the Employment Agreement which survive Executive’s termination of employment; or (ix) any other claims that cannot lawfully be released. Executive hereby warrants that Executive has not assigned or transferred to any person any portion of any claim, which is released, waived and discharged above. Executive further states and agrees that Executive has not experienced any illness, injury, or disability that is compensable or recoverable under the worker’s compensation laws of any state that was not reported to the Company by Executive before the Effective Date, and Executive agrees not to not file a worker’s compensation claim asserting the existence of any such previously undisclosed illness, injury, or disability. Executive has specifically consulted with counsel with respect to the agreements, representations, and declarations set forth in the previous sentence. Executive understands and agrees that by signing this Release Executive is giving up any right to bring any legal claim against the Company concerning, directly or indirectly, Executive’s employment relationship with the Company, including Executive’s separation from employment. Executive agrees that this legal release is intended to be interpreted in the broadest possible manner in favor of the Company, to include all actual or potential legal claims that Executive may have against the Company, except as specifically provided otherwise in this Release.

(b) In order to provide a full and complete release, each of the Parties understands and agrees that this Release is intended to include all claims, if any, covered under this Section 2 that such Party may have and not now know or suspect to exist in such Party’s favor against any

other Party and that this Release extinguishes such claims. Thus, each of the Parties expressly waives all rights under any statute or common law principle in any jurisdiction that provides, in effect, that a general release does not extend to claims which the releasing party does not know or suspect to exist in such Party's favor at the time of executing the release, which if known by such Party must have materially affected such Party's settlement with the party being released.

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

3. Executive acknowledges that he has received all compensation to which he is entitled for his work up to his last day of employment with the Company, and that he is not entitled to any further pay or benefit of any kind, for services rendered or any other reason, other than the Severance Package, and any expense reimbursement due pursuant Section 3(d)(ii) of the Employment Agreement.

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

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

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

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

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

10. Miscellaneous Terms and Conditions

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

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

(c) All covenants and warranties contained in this Release are contractual and shall survive the closing of this Release.

(d) This Release shall be binding in all respects upon, and shall inure to the benefit of, the parties' heirs, successors and assigns.

(e) This Release shall be governed by the internal laws of the Commonwealth of Virginia, irrespective of the choice of law rules of any jurisdiction.

(f) Should any provision of this Release be declared illegal or unenforceable by any court of competent jurisdiction and cannot be modified to be enforceable, such provision shall immediately become null and void, leaving the remainder of this Release in full force and effect. Notwithstanding the foregoing, if Section 2(a), above, is declared void or unenforceable, then this

Release shall be null and void and both parties shall be restored to the positions that they occupied before the Release's execution (meaning that, among other things, all sums paid by the Company pursuant to Section 1, above, shall be immediately refunded to the Company); provided that in such circumstances this Release and the facts and circumstances relating to its execution shall be inadmissible in any later proceeding between the parties, and the statutes of limitations applicable to claims asserted in the proceeding shall be deemed to have been tolled for the period between the Effective Date and 10 days after the date on which Section 2(a) is declared unenforceable.

(g) This Release constitutes the entire agreement of the parties and a complete merger of prior negotiations and agreements.

(h) This Release shall not be modified except in a writing signed by the parties.

(i) No term or condition of this Release shall be deemed to have been waived, nor shall there be an estoppel against the enforcement of any provision of this Release, except by a writing signed by the party charged with the waiver or estoppel. No waiver of any breach of this Release shall be deemed a waiver of any later breach of the same provision or any other provision of this Release.

(j) Headings are intended solely as a convenience and shall not control the meaning or interpretation of any provision of this Release.

(k) Pronouns contained in this Release shall apply equally to the feminine, neuter and masculine genders. The singular shall include the plural, and the plural shall include the singular.

(l) Each party shall promptly execute, acknowledge and deliver any additional document or agreement that the other party reasonably believes is necessary to carry out the purpose or effect of this Release.

(m) Any party contesting the validity or enforceability of any term of this Release shall be required to prove by clear and convincing evidence fraud, concealment, failure to disclose material information, unconscionability, misrepresentation or mistake of fact or law.

(n) The parties acknowledge that they have reviewed this Release in its entirety and have had a full and fair opportunity to negotiate its terms and to consult with counsel of their own choosing concerning the meaning and effect of this Release. Each party therefore waives all applicable rules of construction that any provision of this Release should be construed against its drafter, and agrees that all provisions of the agreement shall be construed as a whole, according to the fair meaning of the language used.

(o) Every dispute arising from or relating to this Release shall be tried only in the state or federal courts situated in the Commonwealth of Virginia. The parties consent to venue in those courts, and agree that those courts shall have personal jurisdiction over them in, and subject matter jurisdiction concerning, any such action.



(p) In any action relating to or arising from this Release, or involving its application, the party substantially prevailing shall recover from the other party the expenses incurred by the prevailing party in connection with the action, including court costs and reasonable attorneys' fees. If Executive is the substantially prevailing party, the Company shall pay such expenses within 60 days following the determination that he is the substantially prevailing party.

(q) This Release may be executed in counterparts, or by copies transmitted by telecopier, all of which shall be given the same force and effect as the original.

[SIGNATURES FOLLOW]

**NOTE: DO NOT SIGN THIS SUPPLEMENTAL LEGAL RELEASE UNTIL AFTER EXECUTIVE'S FINAL DAY OF EMPLOYMENT.**

ROSETTA STONE LTD.

EXECUTIVE

By:\_\_\_\_  
A. John Hass III

By:\_\_\_\_  
Nicholas C. Gahde

Date:\_\_\_\_

Date:\_\_\_\_

## ROSETTA STONE INC. SUBSIDIARIES

As of March 7, 2018

<u>Entity</u>	<u>Jurisdiction of Incorporation</u>
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 Holdings LLC	Delaware
Rosetta Stone (UK) Limited	England and Wales
Rosetta Stone GmbH	Germany
Rosetta Stone Canada Inc.	Canada
Rosetta Stone Hong Kong Limited	Hong Kong
Rosetta (Shanghai) Software Trading Co., Ltd.	Shanghai
Rosetta Stone Ensino de Linguas Ltda.	Brazil
Rosetta Stone France SAS	France
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
Rosetta Stone Mexico SA de CV (formerly Auralog SA de CV)	Mexico
Auralog Software Development (Beijing) Company Ltd.	China
Rosetta Stone Spain SL	Spain

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement Nos. 333-218215, 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 7, 2018, 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, 2017.

*/s/ DELOITTE & TOUCHE LLP*

McLean, Virginia  
March 7, 2018

**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 7, 2018

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/ STEVEN P. YANKOVICH Steven P. Yankovich	Director
<hr/> /s/ CAROLINE J. TSAY Caroline J. Tsay	Director
<hr/> /s/ JESSIE WOOLLEY-WILSON Jessie Woolley-Wilson	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 7, 2018

**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, 2017, 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 7, 2018



**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, 2017, 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

Thomas M. Pierno  
(Principal Financial Officer)

Date: March 7, 2018

