

ROSETTA STONE INC
Form 10-Q
November 06, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended September 30, 2018
Commission file number: 1-34283
Rosetta Stone Inc.

(Exact name of registrant as specified in its charter)
043837082
Delaware (I.R.S. Employer
(State of incorporation) Identification No.)
1621 North Kent Street, Suite 1200 22209
Arlington, Virginia (Zip Code)
(Address of principal executive offices)

703-387-5800
(Registrant’s telephone number, including area code)

N/A
(Former name or former address, if changed since last report)

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 Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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.

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company	Emerging growth company
<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

(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 Exchange Act). Yes No

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

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As of October 30, 2018, there were 22,861,920 shares of the registrant's Common Stock, \$.00005 par value, outstanding.

ROSETTA STONE INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ROSETTA STONE INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	September 30, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 31,802	\$ 42,964
Restricted cash	95	72
Accounts receivable (net of allowance for doubtful accounts of \$341 and \$375, at September 30, 2018 and December 31, 2017, respectively)	32,597	24,517
Inventory	1,681	3,536
Deferred sales commissions	11,727	14,466
Prepaid expenses and other current assets	3,530	4,543
Total current assets	81,432	90,098
Deferred sales commissions	7,214	3,306
Property and equipment, net	34,765	30,649
Goodwill	49,424	49,857
Intangible assets, net	16,600	19,184
Other assets	2,020	1,661
Total assets	\$ 191,455	\$ 194,755
Liabilities and stockholders' (deficit) equity		
Current liabilities:		
Accounts payable	\$ 8,910	\$ 8,984
Accrued compensation	9,942	10,948
Income tax payable	1	384
Obligations under capital lease	454	450
Other current liabilities	12,863	16,454
Deferred revenue	117,478	110,670
Total current liabilities	149,648	147,890
Deferred revenue	47,047	40,593
Deferred income taxes	2,404	1,968
Obligations under capital lease	1,469	1,850
Other long-term liabilities	32	31
Total liabilities	200,600	192,332
Commitments and contingencies (Note 15)		
Stockholders' (deficit) equity:		
Preferred stock, \$0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	—	—
Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 24,277 and 23,783 shares issued and 23,277 and 22,783 shares outstanding at September 30, 2018 and December 31, 2017, respectively	2	2
Additional paid-in capital	200,579	195,644
Accumulated loss	(195,168)	(178,890)

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Accumulated other comprehensive loss	(3,123)	(2,898)
Treasury stock, at cost, 1,000 and 1,000 shares at September 30, 2018 and December 31, 2017, respectively	(11,435)	(11,435)
Total stockholders' (deficit) equity	(9,145	)	2,423	
Total liabilities and stockholders' (deficit) equity	\$ 191,455		\$ 194,755	

See accompanying notes to consolidated financial statements

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Revenue:				
Subscription and service	\$42,526	\$42,117	\$126,702	\$125,552
Product	224	4,089	2,358	14,252
Total revenue	42,750	46,206	129,060	139,804
Cost of revenue:				
Cost of subscription and service revenue	8,204	6,499	22,836	19,091
Cost of product revenue	564	2,949	3,296	6,089
Total cost of revenue	8,768	9,448	26,132	25,180
Gross profit	33,982	36,758	102,928	114,624
Operating expenses:				
Sales and marketing	24,948	23,654	74,013	71,859
Research and development	6,465	6,381	18,790	19,143
General and administrative	8,510	9,035	25,366	25,654
Total operating expenses	39,923	39,070	118,169	116,656
Loss from operations	(5,941)	(2,312)	(15,241)	(2,032)
Other income and (expense):				
Interest income	23	13	71	43
Interest expense	(82)	(138)	(246)	(383)
Other income and (expense)	99	85	(130)	821
Total other income and (expense)	40	(40)	(305)	481
Loss before income taxes	(5,901)	(2,352)	(15,546)	(1,551)
Income tax expense	588	879	1,503	2,361
Net loss	\$(6,489)	\$(3,231)	\$(17,049)	\$(3,912)
Loss per share:				
Basic	\$(0.31)	\$(0.14)	\$(0.75)	\$(0.18)
Diluted	\$(0.31)	\$(0.14)	\$(0.75)	\$(0.18)
Common shares and equivalents outstanding:				
Basic weighted average shares	20,831	22,285	22,647	22,220
Diluted weighted average shares	20,831	22,285	22,647	22,220

See accompanying notes to consolidated financial statements

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(in thousands)

(unaudited)

	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net loss	\$(6,489)	\$(3,231)	\$(17,049)	\$(3,912)
Other comprehensive (loss) income, net of tax:				
Foreign currency translation (loss) gain	(144)	289	(225)	623
Other comprehensive (loss) income	(144)	289	(225)	623
Comprehensive loss	\$(6,633)	\$(2,942)	\$(17,274)	\$(3,289)

See accompanying notes to consolidated financial statements

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

	Nine Months Ended September 30,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(17,049)	\$(3,912)
Adjustments to reconcile net loss to cash (used in) provided by operating activities:		
Stock-based compensation expense	3,388	3,058
Loss (gain) on foreign currency transactions	26	(461)
Bad debt expense (recovery)	110	(143)
Depreciation and amortization	10,891	9,077
Deferred income tax expense	437	963
Loss on disposal of equipment	12	5
Amortization of deferred financing fees	102	238
Loss from equity method investments	—	100
Gain on sale of subsidiary	—	(506)
Net change in:		
Accounts receivable	(8,314)	) 2,358
Inventory	1,856	2,605
Deferred sales commissions	(1,193)	) 321
Prepaid expenses and other current assets	875	(880)
Income tax receivable or payable	(397)	) (296)
Other assets	(407)	) 67
Accounts payable	(36)	) (2,084)
Accrued compensation	(979)	) 445
Other current liabilities	(3,969)	) (6,501)
Other long-term liabilities	—	(750)
Deferred revenue	14,384	8,608
Net cash (used in) provided by operating activities	(263)	) 12,312
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(11,700)	) (8,903)
Proceeds from sale of fixed assets	17	2
Proceeds from the sale of subsidiary	—	110
Net cash used in investing activities	(11,683)	) (8,791)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	1,547	463
Payment of deferred financing costs	(4)	) (232)
Payments under capital lease obligations	(336)	) (453)
Net cash provided by (used in) financing activities	1,207	(222)
(Decrease) increase in cash, cash equivalents, and restricted cash	(10,739)	) 3,299
Effect of exchange rate changes in cash, cash equivalents, and restricted cash	(400)	) 300
Net (decrease) increase in cash, cash equivalents, and restricted cash	(11,139)	) 3,599
Cash, cash equivalents, and restricted cash - beginning of period	43,036	36,597
Cash, cash equivalents, and restricted cash - end of period	\$31,897	\$40,196
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		

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Interest	\$144	\$145
Income taxes, net of refunds	\$1,342	\$1,474
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	\$1,793	\$1,268
Equipment acquired under capital lease	\$25	\$—
See accompanying notes to consolidated financial statements		

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

(unaudited)

	Non-Designated Common Stock Shares	Amount	Additional Paid-in Capital	Treasury Stock	Accumulated Loss	Accumulated Other Comprehensive Loss	Total Stockholders' Equity / (Deficit)
Balance - January 1, 2018	22,316	\$ 2	\$ 195,644	\$(11,435)	\$(178,890)	\$ (2,898)	\$ 2,423
Stock issued upon the exercise of stock options	54	—	467	—	—	—	467
Restricted stock award vesting	167	—	—	—	—	—	—
Stock-based compensation expense	—	—	583	—	—	—	583
Net loss	—	—	—	—	(6,402)	—	(6,402)
Cumulative effect adjustment - adoption of ASC 606	—	—	—	—	771	—	771
Other comprehensive income	—	—	—	—	—	529	529
Balance - March 31, 2018	22,537	\$ 2	\$ 196,694	\$(11,435)	\$(184,521)	\$ (2,369)	\$ (1,629)
Stock issued upon the exercise of stock options	85	—	850	—	—	—	850
Restricted stock award vesting	147	—	—	—	—	—	—
Stock-based compensation expense	—	—	1,352	—	—	—	1,352
Net loss	—	—	—	—	(4,158)	—	(4,158)
Other comprehensive loss	—	—	—	—	—	(610)	(610)
Balance - June 30, 2018	22,769	\$ 2	\$ 198,896	\$(11,435)	\$(188,679)	\$ (2,979)	\$ (4,195)
Stock issued upon the exercise of stock options	17	—	230	—	—	—	230
Restricted stock award vesting	10	—	—	—	—	—	—
Stock-based compensation expense	—	—	1,453	—	—	—	1,453
Net loss	—	—	—	—	(6,489)	—	(6,489)
Other comprehensive loss	—	—	—	—	—	(144)	(144)
Balance - September 30, 2018	22,796	\$ 2	\$ 200,579	\$(11,435)	\$(195,168)	\$ (3,123)	\$ (9,145)

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

(unaudited) (Continued)

	Non-Designated Common Stock Shares	Amount	Additional Paid-in Capital	Treasury Stock	Accumulated Loss	Accumulated Other Comprehensive Loss	Total Stockholders' Equity / (Deficit)
Balance - January 1, 2017	22,074	\$ 2	\$ 190,827	\$(11,435)	\$(177,344)	\$ (3,709)	\$ (1,659)
Stock issued upon the exercise of stock options	18	—	113	—	—	—	113
Restricted stock award vesting	86	—	—	—	—	—	—
Stock-based compensation expense	—	—	147	—	—	—	147
Net income	—	—	—	—	454	—	454
Other comprehensive loss	—	—	—	—	—	(43)	(43)
Balance - March 31, 2017	22,178	\$ 2	\$ 191,087	\$(11,435)	\$(176,890)	\$ (3,752)	\$ (988)
Stock issued upon the exercise of stock options	38	—	328	—	—	—	328
Restricted stock award vesting	20	—	—	—	—	—	—
Stock-based compensation expense	—	—	1,359	—	—	—	1,359
Net loss	—	—	—	—	(1,135)	—	(1,135)
Other comprehensive income	—	—	—	—	—	377	377
Balance - June 30, 2017	22,236	\$ 2	\$ 192,774	\$(11,435)	\$(178,025)	\$ (3,375)	\$ (59)
Stock issued upon the exercise of stock options	2	—	22	—	—	—	22
Restricted stock award vesting	22	—	—	—	—	—	—
Stock-based compensation expense	—	—	1,552	—	—	—	1,552
Net loss	—	—	—	—	(3,231)	—	(3,231)
Other comprehensive income	—	—	—	—	—	289	289
Balance - September 30, 2017	22,260	\$ 2	\$ 194,348	\$(11,435)	\$(181,256)	\$ (3,086)	\$ (1,427)

See accompanying notes to consolidated financial statements

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. NATURE OF OPERATIONS

Rosetta Stone Inc. and its subsidiaries ("Rosetta Stone," or the "Company") develop, market and support a suite of language-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, mobile applications, 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.

Basis of Presentation

The accompanying consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and applicable rules and regulations of the Securities and Exchange Commission ("SEC") regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's most recent Annual Report on Form 10-K filed with the SEC on March 7, 2018. The September 30, 2018 consolidated balance sheet included herein includes account balances as of December 31, 2017 that were derived from the audited financial statements as of that date. The Consolidated Financial Statements and the Notes to the Consolidated Financial Statements do not include all disclosures required for annual financial statements and notes.

As discussed in this Note 2, the Company adopted certain recently issued accounting standards effective January 1, 2018. The new revenue recognition standard ("ASC 606") was adopted using the modified retrospective method. As such, the comparative information has not been restated under ASC 606 and continues to be reported under the accounting standards in effect for those prior comparative periods. See the Company's Annual Report on Form 10-K filed with the SEC on March 14, 2017 for revenue recognition policies that were in effect in prior periods before adoption of ASC 606. Additionally, accounting standard update 2016-18 ("ASU 2016-18") related to the presentation of restricted cash in the statements of cash flow was adopted retrospectively for all comparative periods.

Except as noted above, the unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the Company's statements of financial position at September 30, 2018 and December 31, 2017, the Company's results of operations for the three and nine months ended September 30, 2018 and 2017 and its cash flows for the nine months ended September 30, 2018 and 2017 have been made. The results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results to be expected for the year ending December 31, 2018. All references to September 30, 2018 or to the three and nine months ended September 30, 2018 and 2017 in the notes to the consolidated financial statements are unaudited.

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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Issued Accounting Standards

Accounting Standards Adopted During the Period: During 2018, the Company adopted the following recently issued Accounting Standard Updates ("ASU"):

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230) Restricted Cash a consensus of the FASB Emerging Issues Task Force. 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 statements of cash flows. The Company retrospectively adopted ASU 2016-18 beginning January 1, 2018. The Company does not consider its restricted cash balances to be material for further disclosure or reconciliation. The adoption of this guidance did not impact the Company's consolidated financial position, results of operations, or footnote disclosures.

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 provided 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 Cuts and Jobs Act of 2017 (or portion thereof) was 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 adopted ASU 2018-02 effective January 1, 2018. Due to the presence of a full valuation allowance, adoption did not have a material impact on the Company's consolidated financial statements and the disclosure requirements under ASU 2018-02 were not applicable.

In May 2014, the FASB issued ASC 606 which provided a new standard related to revenue recognition. Under ASC 606, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The Company adopted ASC 606 effective January 1, 2018. As a result, the Company has changed its accounting for revenue. The Company adopted ASC 606 using the modified retrospective method applied using hindsight to those contracts that were not complete as of January 1, 2018. The cumulative effect of initially applying ASC 606 totaled \$0.8 million and was recognized as an adjustment to reduce the opening balance of accumulated loss at January 1, 2018. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods.

The Company implemented or modified certain internal controls and key system functionality to enable the preparation of financial information under ASC 606.

The most significant impact of ASC 606 to the Company related to the accounting for offerings that contained perpetual software for which customers took possession, which occurs only in the Company's Consumer Language segment. Prior to the adoption of ASC 606, revenue was recognized at the time of delivery for these perpetual software products due to the fact that the Company had established vendor specific objective evidence of the fair value ("VSOE") for the undelivered services in the arrangement. To the extent that VSOE was not established for undelivered services bundled with perpetual software, all revenue was deferred and recognized as the services were provided. Under the new guidance in ASC 606, the requirement to establish VSOE of the undelivered services in order to recognize revenue at the time of delivery no longer exists and revenue is allocated to performance obligations by estimating the standalone selling price and using a relative value allocation method. Revenue recognition related to subscription services and professional services remained substantially unchanged. Adoption had no tax impact due to the presence of a full valuation allowance. The impact of adoption to the Company's consolidated statement of operations for the three and nine months ended September 30, 2018 was as follows (in thousands):

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Consolidated Statement of Operations Data:	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	As reported	Effect of change higher/(lower)	Balances without adoption of ASC 606	As reported	Effect of change higher/(lower)	Balances without adoption of ASC 606
Revenue:						
Subscription and service	\$42,526	\$ (291)	\$42,817	\$126,702	\$ (511)	\$127,213
Product	224	455	(231)	2,358	1,947	411
Total revenue	42,750	164	42,586	129,060	1,436	127,624
Gross profit	33,982	164	33,818	102,928	1,436	101,492
Loss from operations	(5,941)	164	(6,105)	(15,241)	1,436	(16,677)
Loss before income taxes	(5,901)	164	(6,065)	(15,546)	1,436	(16,982)
Net loss	\$(6,489)	\$ 164	\$(6,653)	\$(17,049)	\$ 1,436	\$(18,485)

Adoption of ASC 606 had impacts to the consolidated balance sheet as well, primarily related to the presentation of deferred commissions and the reduction to deferred revenue. The Company's prior methodology was to bifurcate deferred commissions between current and non-current classifications. Under ASC 606, deferred commissions are classified as non-current unless the original amortization period is one year or less. Deferred revenue decreased on adoption of ASC 606 due to the changes in the timing of revenue recognition noted above. The impact of adoption to the Company's consolidated balance sheet as of September 30, 2018 was as follows (in thousands):

As of September 30, 2018

Consolidated Balance Sheet Data:	As reported	Effect of change higher/(lower)	Balances without adoption of ASC 606
Deferred sales commissions current	11,727	(4,061)	15,788
Total current assets	81,432	(4,061)	85,493
Deferred sales commissions non-current	7,214	4,061	3,153
Other current liabilities	12,863	(172)	13,035
Deferred revenue current	117,478	(2,035)	119,513
Total current liabilities	149,648	(2,207)	151,855
Total liabilities	200,600	(2,207)	202,807
Accumulated loss	(195,168)	2,207	(197,375)
Total stockholders' deficit	(9,145)	2,207	(11,352)

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The impact of adoption to the Company's reportable segments for the three and nine months ended September 30, 2018 was as follows (in thousands):

Consolidated Segment Data:	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	As reported	Effect of change higher/(lower)	Balances without adoption of ASC 606	As reported	Effect of change higher/(lower)	Balances without adoption of ASC 606
Revenue by Segment:						
Literacy	\$ 13,215	\$ 47	\$ 13,168	\$ 38,294	\$ 161	\$ 38,133
Enterprise & Education ("E&E") Language	14,990	(32)	15,022	45,782	20	45,762
Consumer Language	14,545	149	14,396	44,984	1,255	43,729
Total revenue	\$ 42,750	\$ 164	\$ 42,586	\$ 129,060	\$ 1,436	\$ 127,624

Accounting Standards Not Yet Adopted: The following ASUs were recently issued but have not yet been adopted by the Company:

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement ("ASU 2018-13"). ASU 2018-13 modifies the disclosure requirements for fair value measurements by removing, modifying, or adding certain disclosures. ASU 2018-13 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with early adoption permitted for any eliminated or modified disclosures. The Company is in the process of evaluating the effect of adopting this new accounting guidance to determine the impact it may have on the Company's consolidated financial statements.

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 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. However based on a preliminary assessment and as the Company does not hold significant financial instruments, the Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02") that requires lessees to recognize assets and liabilities for most leases. In July 2018, the FASB issued ASU No. 2018-10, Leases (Topic 842): Codification Improvements which impacts narrow aspects of the guidance issued under ASU 2016-02. In July 2018, the FASB issued ASU No. 2018-11, Leases (Topic 842): Targeted Improvements which provides a new transition method and a practical expedient for separating components of a contract. Collectively these ASUs comprise the new lease standard ("New Lease Standard"). Under the New Lease Standard, entities will be required to record most leases on their balance sheets. A lessee would recognize a lease liability for the obligation to make lease payments and a

right-of-use asset for the right to use the underlying asset for the lease term. Lease expense recognition is largely unchanged. The New Lease Standard is effective for public entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, however the Company does not expect to early adopt this guidance. The New Lease Standard is required to be adopted using a modified retrospective approach. The Company does not expect to recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption as the Company expects to elect the package of practical expedients. The Company will continue to report comparative prior period information under the accounting standards in effect for those prior comparative periods. The Company expects its leases designated as operating leases in Note 15, "Commitments and Contingencies," will be reported on the consolidated balance sheets upon adoption. The

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Company is in the process of evaluating the other impacts of the new guidance on the Company's consolidated financial statements and disclosures.

Revenue Recognition

Nature of Revenue: The Company accounts for revenue contracts with customers by applying the requirements of ASC 606, which includes the following steps:

1. Identification of the contract, or contracts with a customer.

2. Identification of the performance obligations in the contract.

3. Determination of the transaction price.

4. Allocation of the transaction price to the performance obligations in the contract.

5. Recognition of the revenue when, or as, the Company satisfies a performance obligation.

The Company's primary sources of revenue are web-based software subscriptions, mobile application, 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 and professional services.

Revenue is recognized upon transfer of control of promised goods or services to customers in an amount that reflects the consideration expected to be received in exchange for those goods or services. Revenue is recognized net of allowances for returns. Revenue is also recognized net of any taxes collected from customers, which are subsequently remitted to governmental authorities.

Subscription and service revenue consists of fees associated with non-cancellable web-based software subscriptions, online services, professional services, and mobile applications. Subscription revenue is generated from contracts with customers that provide access to hosted software over a contract term without the customer taking possession of the software. Subscription revenue is recognized ratably over the contract period as the performance obligation is satisfied. Subscription revenue is generated by all three reportable segments and range from short-term to multi-year contracts. 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. Professional services include implementation services. Online services revenue and professional services revenue are recognized as the services are provided. Expired services are forfeited and revenue is recognized upon expiry.

Product revenue primarily consists of revenue from perpetual language-learning software and audio practice products. Audio practice products are often combined with language-learning software and sold as a solution. Perpetual software revenue is recognized at the point in time when the software is made available to the customer. Audio practice products are recognized at the point in time that the audio practice products are delivered to the customer. As post-contract support ("PCS") is provided to customers who purchase perpetual software at no charge, a portion of the transaction price is allocated to PCS service revenue and recognized as the PCS services are provided, which is typically up to three months from the date of purchase.

See Note 16 - "Segment Information" for further information on the disaggregation of revenue, including revenue by reportable segment, geographic area, and revenue type.

Performance Obligations: A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASC 606. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. The Company's performance obligations are satisfied at a point in time or over time as delivery occurs or as work progresses.

Significant Judgments: Some of the Company's contracts with customers include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately, versus together, requires significant judgment. This includes determining whether distinct services are part of a series of distinct services that are substantially the same. When subscription services are sold with professional services, judgment is required to determine whether the professional services are distinct and can be accounted for separately. In the E&E Language segment, the Company has concluded that each promised service within the language-learning subscription is delivered concurrently with all other promised

services over the contract term and, as such, concluded that these promises are a single performance obligation that includes a series of distinct services that have the same pattern of transfer to the customer. When there are multiple performance obligations, revenue is allocated to each performance obligation based on its relative standalone selling price (“SSP”). Judgment is required to determine the SSP for each distinct performance

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

obligation where SSP is not directly observable, such as when the product or service is not sold separately, SSP is determined using internally published price lists which include suggested sales prices for each performance obligation based on the type of client and volume purchased. These price lists are derived from past experience and from the expectation of obtaining a reasonable margin based on the cost to fulfill each performance obligation.

Subscription revenue is recognized ratably over the contract period as the performance obligation is satisfied. Certain Consumer Language offerings have contracts with no fixed duration and are marketed as lifetime subscriptions. For these lifetime subscriptions, the Company estimates the expected contract period as the greater of the typical customer usage period or the longest fixed-period duration subscription that is currently marketed. The Company's current expected contract period for lifetime subscriptions is 24 months.

Certain Consumer Language offerings are sold with a right of return and the Company may provide other credits or incentives. These rights are accounted for as variable consideration when estimating the amount of revenue to recognize by utilizing the expected value method. Returns and credits are estimated at contract inception based on historical return rates, estimated channel inventory levels, the timing of new product introductions and other factors. Reserves for returns and credits are updated at the end of each reporting period as additional information becomes available.

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 amount to the end customer. The Company evaluates each of its reseller relationships to determine whether it is the principal (where revenue is recognized at the gross amount) or agent (where revenue is recognized net of the reseller commission). In making this determination the Company evaluates a variety of factors including the amount of control the Company is able to exercise over the transactions.

Contract Balances: The timing of revenue recognition, invoicing, and cash collection results in accounts receivable and deferred revenue in the consolidated balance sheets. Payment from customers is often received in advance of services being provided, resulting in deferred revenue. Accounts receivable is recorded when there is an executed customer contract and the right to the consideration becomes unconditional. Contract assets such as unbilled receivables are not material.

The allowance for doubtful accounts reflects the best estimate of probable losses inherent in the accounts receivable balance. The Company establishes an allowance for doubtful accounts based on specific risks identified, historical experience, and other currently available evidence.

Payment terms and conditions vary by contract type and customer. For the E&E Language and Literacy segments, payment terms generally range from 30 to 90 days. In the Consumer Language segment, resellers are generally granted payment terms of 45 days. Within Consumer Language, sales to end customers via the Rosetta Stone ecommerce website are done by credit card, which generally are settled within 7-10 days and may be made in installments. In instances where the timing of revenue recognition differs from the timing of invoicing, the Company has determined that contracts generally do not include a significant financing component. The primary purpose of invoicing terms is to provide customers with simplified and predictable ways of purchasing products and services and not to provide customers with financing.

Deferred revenue is comprised mainly of unearned revenue related to subscription services which is recognized ratably over the subscription period. Deferred revenue also includes payments for professional services and online services to be performed in the future which are earned as revenue when the service is provided. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, contract backlog is not material.

The opening and closing balances of the Company's accounts receivable and deferred revenue are as follows:

Accounts Receivable	Deferred Revenue (current)	Deferred Revenue (non-current)
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Opening balance as of January 1, 2018	\$ 24,517	\$ 110,670	\$ 40,593
Increase/(decrease), net	8,080	6,808	6,454
Ending balance as of September 30, 2018	\$ 32,597	\$ 117,478	\$ 47,047

The amount of revenue recognized in the three months ended September 30, 2018 that was included in the opening July 1, 2018 deferred revenue balance was \$34.1 million. The amount of revenue recognized in nine months ended September 30, 2018 that was included in the opening January 1, 2018 deferred revenue balance was \$93.8 million. The vast majority of this

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

revenue consists of deferred subscription revenue. The amount of revenue recognized from performance obligations satisfied in prior periods was not material.

The following table sets forth deferred revenue by reportable segment which represents the Company's unfulfilled performance obligations as of September 30, 2018 and the estimated revenue expected to be recognized in the future related to these performance obligations:

As of September 30, 2018

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Literacy	\$52,129	\$42,619	\$8,740	\$717	\$53
E&E Language	56,762	42,497	9,450	2,090	2,725
Consumer Language	55,634	32,362	9,536	1,764	11,972
Total	\$164,525	\$117,478	\$27,726	\$4,571	\$14,750

The Company entered into a series of agreements with SOURCENEXT Corporation, (“SOURCENEXT”), comprising a single performance obligation associated with the perpetual license of certain intellectual property, software, and product code for exclusive development and sale of language and education-related products in Japan. The Company estimated a 20 year period to recognize the performance obligation. As of September 30, 2018, deferred revenue associated with SOURCENEXT totaled \$16.4 million, which will be recognized ratably through April 2037 and comprised the majority of the Consumer Language non-current deferred revenue. As this customer relationship progresses, the Company will prospectively reassess the recognition period as needed.

Assets Recognized from Costs to Obtain a Contract with a Customer: The Company recognizes an asset for the incremental costs of obtaining a contract with a customer, which primarily represents sales commissions paid when a customer contract is either recorded as revenue or deferred revenue. Sales commissions paid to obtain non-cancellable subscription contracts are deferred and amortized in proportion to the period over which the revenue is recognized from the related contract. Deferred sales commissions are amortized to Sales and marketing expense on the consolidated statements of operations. Deferred sales commissions are classified as non-current unless the associated amortization period is one year or less. As of September 30, 2018, the total deferred sales commissions balance was \$18.9 million. Amortization of deferred sales commissions recognized during the three months ended September 30, 2018 was \$6.0 million. Amortization of deferred sales commission recognized during the Nine months ended September 30, 2018 was \$17.0 million.

Restructuring Costs

Restructuring plans were initiated in 2015, 2016 and 2017 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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes

The Company accounts for income taxes in accordance with ASC topic 740, Income Taxes ("ASC 740"), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax basis of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The impact of tax rate changes on deferred tax assets and liabilities is recognized in the year that the change is enacted. See Note 10 "Income Taxes" for additional disclosures including the impact and additional disclosures associated with the recent Tax Cuts and Jobs Act of 2017 enacted on December 22, 2017.

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of September 30, 2018. When measuring the need for a valuation allowance on a jurisdiction by jurisdiction basis, the Company assesses both positive and negative evidence regarding whether these deferred tax assets are realizable. In determining deferred tax assets and valuation allowances, the Company is required to make judgments and estimates related to projections of profitability, the timing and extent of the utilization of temporary differences, net operating loss carryforwards, tax credits, applicable tax rates, transfer pricing methodologies and tax planning strategies. The valuation allowance is reviewed quarterly and is maintained until sufficient positive evidence exists to support a reversal. Because evidence such as the Company's operating results during the most recent three-year period is afforded more weight than forecasted results for future periods, the Company's cumulative loss in certain jurisdictions represents significant negative evidence in the determination of whether deferred tax assets are more likely than not to be utilized in certain jurisdictions. This determination resulted in the need for a valuation allowance on the deferred tax assets of certain jurisdictions. The Company will release this valuation allowance when it is determined that it is more likely than not that its deferred tax assets will be realized. Any future release of valuation allowance may be recorded as a tax benefit increasing net income.

Fair Value of Financial Instruments

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

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

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

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

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

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 statements 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 statements 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 expense is recognized in the statements of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions. See Note 11 "Stock-Based Compensation" 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 3 "Basic and Diluted Net Loss Per Share" for additional disclosures.

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 accumulated other comprehensive loss in stockholders' (deficit) equity.

Cash flows of consolidated foreign subsidiaries, whose functional currency is their 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, cash equivalents and restricted cash during the period.

The following table presents the effect of exchange rate changes on total comprehensive (loss) income (in thousands):

	Three Months		Nine Months	
	Ended		Ended	
	September 30,	September 30,	September 30,	September 30,
	2018	2017	2018	2017
Net loss	\$(6,489)	\$(3,231)	\$(17,049)	\$(3,912)
Foreign currency translation (loss) gain	(144)	289	(225)	623
Comprehensive loss	\$(6,633)	\$(2,942)	\$(17,274)	\$(3,289)
Comprehensive Loss				

Comprehensive loss consists of net loss and other comprehensive (loss) income. Other comprehensive (loss) income refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' (deficit) equity. For the three and nine months ended September 30, 2018 and 2017, the Company's comprehensive loss consisted of net loss and foreign currency translation (losses) and gains.

The other comprehensive (loss) income 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 of other comprehensive (loss) income due to the presence of a full valuation allowance for each of the three and nine months ended September 30, 2018 and 2017.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three months ended September 30, 2018 and September 30, 2017 was \$5.6 million and \$5.3 million, respectively. Advertising expense for the nine months ended September 30, 2018 and September 30, 2017 was \$17.3 million and \$18.1 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 reasonably knowable as of November 6, 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 November 6, 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.

3. 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 using net loss and the weighted average number of shares of common stock outstanding. Diluted loss per share reflects the weighted average number of shares of common stock outstanding plus any dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, restricted stock awards, and restricted stock units.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. BASIC AND DILUTED NET LOSS PER SHARE (Continued)

The following table sets forth the computation of basic and diluted net loss per common share (in thousands, except per share amounts):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Numerator:				
Net loss	\$(6,489)	\$(3,231)	\$(17,049)	\$(3,912)
Denominator:				
Basic shares:				
Weighted average number of common shares - basic	20,831	22,285	22,647	22,220
Diluted shares:				
Weighted average number of common shares - basic	20,831	22,285	22,647	22,220
Number of dilutive common stock equivalent shares included in diluted shares calculation	—	—	—	—
Weighted average number of common shares - diluted	20,831	22,285	22,647	22,220
Loss per common share:				
Basic	\$(0.31)	\$(0.14)	\$(0.75)	\$(0.18)
Diluted	\$(0.31)	\$(0.14)	\$(0.75)	\$(0.18)

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 dilutive common stock equivalent shares calculated using the treasury stock method (in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Stock options	686	219	631	209
Restricted stock units	230	223	230	203
Restricted stocks	638	286	634	250
Total common stock equivalent shares	1,554	728	1,495	662

Share-based awards to purchase approximately 0.1 million and 0.7 million shares of common stock that had an exercise price in excess of the average market price of the common stock during the three months ended September 30, 2018 and 2017, respectively, were not included in the calculation of diluted loss per share because they were anti-dilutive. Share-based awards to purchase approximately 0.2 million and 0.7 million shares of common stock that had an exercise price in excess of the average market price of the common stock during the nine months ended September 30, 2018 and 2017, respectively, were not included in the calculation of diluted loss per share because they were anti-dilutive.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. INVENTORY

Inventory consisted of the following (in thousands):

	September 30, 2018	December 31, 2017
Raw materials	\$ 922	\$ 2,893
Finished goods	759	643
Total inventory	\$ 1,681	\$ 3,536

The total inventory balance as of September 30, 2018 reflected the Company's ongoing efforts to transition the Consumer Language segment to a software-as-a-service ("SaaS") model. The September 30, 2018 inventory balance also reflected a \$1.6 million inventory obsolescence charge during the nine months ended September 30, 2018 in the retail and direct-to-consumer channels of the Consumer Language business.

5. PROPERTY AND EQUIPMENT

For the three months ended September 30, 2018 and September 30, 2017 the Company capitalized \$3.7 million and \$3.2 million, respectively, of internal-use software development costs. For the nine months ended September 30, 2018 and September 30, 2017 the Company capitalized \$11.6 million and \$9.1 million, respectively, of internal-use software development costs.

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):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Included in cost of revenue:				
Cost of subscription and service revenue	\$2,181	\$874	\$5,356	\$2,842
Cost of product revenue	180	415	773	907
Total included in cost of revenue	2,361	1,289	6,129	3,749
Included in operating expenses:				
Sales and marketing	177	132	589	411
Research and development	2	1	6	8
General and administrative	495	619	1,600	2,045
Total included in operating expenses	674	752	2,195	2,464
Total	\$3,035	\$2,041	\$8,324	\$6,213

6. GOODWILL

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisition 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 topic 350, Intangibles - Goodwill and other ("ASC 350"), or more frequently, if impairment indicators arise.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. GOODWILL (Continued)

The following table shows the balance and changes in goodwill for the Company's operating segments for the nine months ended September 30, 2018 (in thousands):

	Literacy	E&E Language	Consumer Language	Total
Balance as of January 1, 2018				
Gross Goodwill	\$ 9,962	\$ 39,895	\$ 27,514	\$ 77,371
Accumulated Impairment	—	—	(27,514)	(27,514)
Goodwill as of January 1, 2018	\$ 9,962	\$ 39,895	\$ —	\$ 49,857
Effect of change in foreign currency rate	—	(433)	—	(433)
Balance as of September 30, 2018				
Gross Goodwill	\$ 9,962	\$ 39,462	\$ 27,514	\$ 76,938
Accumulated Impairment	—	—	(27,514)	(27,514)
Goodwill as of September 30, 2018	\$ 9,962	\$ 39,462	\$ —	\$ 49,424

Annual Impairment Testing of Goodwill

The Company exercised its option to bypass the qualitative test and began its June 30, 2018 annual goodwill test with the quantitative test for its reporting units with remaining goodwill balances. At June 30, 2018, the Company determined that the fair values of the Literacy and E&E Language reporting units substantially exceeded their carrying values. Therefore, no goodwill impairment charges were recorded in connection with the annual analysis for these reporting units.

7. INTANGIBLE ASSETS

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

	Trademark / tradename *	Core technology	Customer relationships	Patents and Other	Total
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 January 1, 2018	\$ 10,724	\$ 2,413	\$ 6,013	\$ 34	\$ 19,184
Gross Carrying Amount	12,330	13,482	25,742	312	51,866
Accumulated Amortization	(1,696)	(11,224)	(20,884)	(299)	(34,103)
Accumulated Impairment	(26)	(1,008)	(129)	—	(1,163)
Balance as of September 30, 2018	\$ 10,608	\$ 1,250	\$ 4,729	\$ 13	\$ 16,600

* Included in the tradename/trademark line above is the Rosetta Stone tradename, which is the Company's only indefinite-lived intangible asset. As of September 30, 2018, the carrying value of the tradename asset was \$10.6 million.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. INTANGIBLE ASSETS (Continued)

Amortization Expense for the Long-lived Intangible Assets

The following table presents amortization of intangible assets included in the related financial statement line items during the respective periods (in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Included in cost of revenue:				
Cost of subscription and service revenue	\$ 137	\$ 118	\$ 384	\$ 352
Cost of product revenue	9	28	55	87
Total included in cost of revenue	146	146	439	439
Included in operating expenses:				
Sales and marketing	437	472	1,393	1,387
Research and development	183	356	735	1,038
General and administrative	—	—	—	—
Total included in operating expenses	620	828	2,128	2,425
Total	\$ 766	\$ 974	\$ 2,567	\$ 2,864

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining three months of 2018 and years thereafter (in thousands):

	As of September 30, 2018
2018 - remaining	\$ 751
2019	1,532
2020	1,282
2021	940
2022	940
2023	548
Thereafter	—
Total	\$ 5,993

Impairment Reviews of Intangible Assets

The Company also routinely reviews indefinite-lived intangible assets and long-lived assets for potential impairment as part of the Company's internal control framework. As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of September 30, 2018 to determine if indicators of impairment exist. The Company concluded that there were no potential indicators of impairment related to this indefinite-lived intangible asset. Additionally all other long-lived intangible assets were evaluated to determine if indicators of impairment exist and the Company concluded that there are no potential indicators of impairment.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. OTHER CURRENT LIABILITIES

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

	September 30, December 31,	
	2018	2017
Accrued marketing expenses	\$ 3,168	\$ 5,316
Accrued professional and consulting fees	1,233	1,609
Sales return reserve	270	1,176
Sales, withholding and property taxes payable	3,506	3,616
Other	4,686	4,737
Total other current liabilities	\$ 12,863	\$ 16,454

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 the Bank ("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 September 30, 2018, the Company was in compliance with all covenants.

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

As of September 30, 2018, there were no borrowings outstanding and the Company was eligible to borrow \$23.3 million of available credit. During the third quarter of 2018, a \$4.0 million letter of credit that was previously issued by the Bank on the Company's behalf was cancelled as it was deemed no longer necessary. A quarterly commitment

fee accrues on any unused portion of the credit facility at a nominal annual rate.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. FINANCING ARRANGEMENTS (Continued)

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 acquisition, the Company assumed a capital lease for a building near Versailles, France, where Tell Me More's headquarters were located. The fair value of the lease liability at the date of acquisition was \$4.0 million.

During the nine months ended September 30, 2018, the Company acquired \$25,000 in equipment or software through the issuance of capital leases.

Future minimum payments under capital leases with initial terms of one year or more are as follows (in thousands):

	As of September 30, 2018
2018-remaining	\$ 134
2019	532
2020	527
2021	525
2022	394
Thereafter	1
Total minimum lease payments	\$ 2,113
Less amount representing interest	190
Present value of net minimum lease payments	\$ 1,923
Less current portion	454
Obligations under capital lease, long-term	\$ 1,469

10. INCOME TAXES

New tax legislation, commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Tax Act"), was enacted on December 22, 2017. Given the significance of the Tax Act, the SEC staff issued Staff Accounting Bulletin No. 118 ("SAB 118"), which allowed 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 Act 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 Act.

During the year of enactment, the Company recorded reasonable estimates of the effects of the Tax Act which principally related to a) the reduction in the U.S. corporate income tax rate from 35% to 21% and b) the change in the carryforward period of net operating losses. In the fourth quarter of 2017, the Company recorded 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 was in a net deferred tax asset position that was 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. Additionally, the Company recorded an income tax benefit of \$3.1 million in the fourth quarter of 2017 related to the release of the valuation allowance associated with the post-2017 reversing deferred tax

assets to offset 80% of the deferred tax liability associated with the Company's indefinite-lived intangible asset. During the nine months ended September 30, 2018, the Company recorded a \$0.2 million tax expense in addition to the estimates made in the year of enactment. The accounting for the Tax Act are considered final as the Company has obtained,

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. INCOME TAXES (Continued)

prepared, and analyzed the information necessary to finalize the accounting and the 2017 U.S. income tax return. The Tax Act included a one-time mandatory repatriation transition tax on the net accumulated earnings and profits of a U.S. taxpayer's foreign subsidiaries. The Company had a deficit in net accumulated earnings and profits so no transition tax was reported on the Company's 2017 U.S. income tax return.

Other Tax Act provisions that may impact income taxes 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 will treat the GILTI tax as a period expense in future years. In accordance with ASC topic 740, Income Taxes ("ASC 740"), and ASC subtopic 740-270, Income Taxes: Interim Reporting, the income tax provision for the nine months ended September 30, 2018 is based on the estimated annual effective tax rate for fiscal year 2018. The estimated effective tax rate may be subject to adjustment in subsequent quarterly periods as the estimates of pretax income for the year, along with other items that may affect the rate, may change and may create a different relationship between domestic and foreign income and loss.

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

Valuation Allowance Recorded for Deferred Tax Assets

The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of September 30, 2018, the analysis of the need for a valuation allowance on U.S. deferred tax assets considered that the U.S. entity has incurred a three-year cumulative loss. As previously disclosed, if the Company does not have sufficient objective positive evidence to overcome a three-year cumulative loss, a valuation allowance may be necessary. In evaluating whether to record a valuation allowance, the guidance in ASC 740 deems that the existence of cumulative losses in recent years is a significant piece of objectively verifiable negative evidence that is difficult to overcome. An enterprise that has cumulative losses is generally prohibited from using an estimate of future earnings to support a conclusion that realization of an existing deferred tax asset is more likely than not.

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

- Three-year cumulative evaluation period ended September 30, 2018 results in a cumulative U.S. pre-tax loss;
 - from 2006, when the U.S. entity began filing as a C-corporation for income tax purposes, through 2010, the U.S. entity generated taxable income each year;
- the Company has a history of utilizing all operating tax loss carryforwards and has not had any tax loss carryforwards or credits expire unused;
- lengthy or indefinite loss carryforward periods for U.S. federal and most state jurisdictions apply; and
- the Company incurred a U.S. federal jurisdiction net operating loss for the most recently completed calendar year and has additional net operating loss carryforwards subject to limitation pursuant to IRC Section 382.

As of September 30, 2018, a valuation allowance was provided for the U.S., Hong Kong, Mexico, Spain, France, and Brazil where the Company has determined the deferred tax assets will not more likely than not be realized.

Evaluation of the remaining jurisdictions as of September 30, 2018, resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation allowance will be adjusted accordingly, which could materially affect the Company's financial position and results of operations.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. INCOME TAXES (Continued)

As of September 30, 2018, and December 31, 2017, the Company's U.S. deferred tax liability was \$2.3 million and \$1.9 million, respectively, related to its goodwill and indefinite lived intangibles. As of September 30, 2018 the Company had foreign net deferred tax liabilities of \$0.1 million compared to foreign net deferred tax liabilities of \$0.1 million at December 31, 2017. As of September 30, 2018, and December 31, 2017, the Company had no unrecognized tax benefits.

For the nine months ended September 30, 2018 the Company recorded an income tax expense of \$1.5 million for deferred tax expense related to the tax impact of amortization of indefinite lived intangible assets and current tax expense related to our operations in U.K., Germany, Canada and China.

11. 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 provided the Company the ability to grant up to 2,437,744 of new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. Service, performance and market-based 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. Performance units and restricted stock units do not have voting rights. 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

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June 12, 2015	1,200,000
May 24, 2017	1,900,000

At September 30, 2018, there were 1,138,453 shares available for future grant under the 2009 Plan.

Valuation Assumptions

The determination of fair value of our stock-based awards is affected by assumptions regarding subjective and complex variables. Generally, our assumptions are based on historical information and judgment is required to determine if historical trends may be indicators of future outcomes. In accordance with ASC 718, the fair value of stock-based awards to employees is

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

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 is 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 Share Units: Fair value is determined based on the quoted market price of our common stock on the date of grant.

Service-Based Stock Options and Performance-Based Stock Options: Fair value is determined using the Black-Scholes pricing model, which requires the use of estimates, including the risk-free interest rate, expected volatility, expected dividends, and expected term.

Market-Based Restricted Stock Awards and Market-Based Stock Options: The fair value of the market-based awards is determined using a Monte-Carlo simulation model. The Monte Carlo valuation also estimates the number of market-based awards that would be awarded which is reflected in the fair value on the grant date. There have been no market based awards or options granted in the periods presented.

For the nine months ended September 30, 2018 and September 30, 2017, the fair value of stock options granted was calculated using the following assumptions in the Black-Scholes model:

	Nine Months Ended	
	September 30,	
	2018	2017
Expected stock price volatility	39.0% - 39.8%	44.6%
Expected term of options	6 years	6 years
Expected dividend yield	—	—
Risk-free interest rate	2.73% - 2.85%	1.92%

Stock-Based Compensation Expense

Stock compensation expense associated with service-based equity awards is recognized in the statements 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 statements 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 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 statements of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

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

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Included in cost of revenue:				
Cost of subscription and service revenue	\$13	\$9	\$(13)	\$(2)
Cost of product revenue	2	12	(10)	36
Total included in cost of revenue	15	21	(23)	34
Included in operating expenses:				
Sales and marketing	312	349	548	366
Research and development	156	185	326	215
General and administrative	969	997	2,537	2,443
Total included in operating expenses	1,437	1,531	3,411	3,024
Total	\$1,452	\$1,552	\$3,388	\$3,058

Service-Based Restricted Stock Awards

The following table summarizes the Company's service-based restricted stock award activity from January 1, 2018 to September 30, 2018:

	Service Based Awards	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Non-vested Service-based Awards, January 1, 2018	431,118	\$ 8.07	\$3,477,484
Service-based awards granted	218,006	13.87	
Service-based awards vested	(175,468)	8.61	
Service-based awards canceled	(28,377)	8.92	
Non-vested Service-Based Awards, September 30, 2018	445,279	\$ 10.64	\$4,737,501

As of September 30, 2018, future compensation cost, net of estimated forfeitures, related to the non-vested portion of the service-based restricted stock awards not yet recognized in the consolidated statement of operations was \$3.1 million and is expected to be recognized over a weighted average period of 2.51 years.

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

Performance-Based Restricted Stock Units

Beginning in the first quarter of 2017, the Company began granting annual performance-based restricted stock units ("PSUs") to certain employees which will become earned or eligible to vest based on the Company's achievement of certain pre-defined key operating performance goals during a one to three-year period. The number of PSUs earned or eligible to vest following the performance period is subject to approval by the Compensation Committee of the Board of Directors. Once earned, certain PSUs are then subject to additional service and vesting requirements, while certain PSUs vest shortly after being earned. PSUs were granted at "target" (at 100% of target). Based upon actual attainment of the operating performance results relative to target, 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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's PSU activity from January 1, 2018 to September 30, 2018:

	PSUs	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Non-vested PSUs, January 1, 2018	433,588	\$ 9.43	\$5,406,842
PSUs granted	331,216	13.90	
PSUs vested	(54,298)	9.43	
PSUs canceled	(39,984)	10.22	
Non-vested PSUs, September 30, 2018	670,522	\$ 11.59	\$13,336,683

As of September 30, 2018, 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 \$1.7 million and is expected to be recognized over a weighted average period of 1.32 years.

Service-Based Stock Options

The following table summarizes the Company's service-based stock option activity from January 1, 2018 to September 30, 2018:

	Service-based Options	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Service-based Options Outstanding, January 1, 2018	1,628,711	\$ 9.81	6.79	\$5,203,196
Service-based options granted	60,603	16.05		
Service-based options exercised	(156,211)	9.90		
Service-based options canceled	(65,985)	14.90		
Service-based Options Outstanding, September 30, 2018	1,467,118	9.83	6.29	14,795,151
Vested and expected to vest September 30, 2018	1,453,676	9.84	6.28	14,651,166
Exercisable at September 30, 2018	1,224,559	\$ 9.91	6.04	\$12,261,827

As of September 30, 2018, future compensation cost, net of estimated forfeitures, related to the non-vested portion of the service-based stock option awards not yet recognized in the consolidated statement of operations was \$0.8 million and is expected to be recognized over a weighted average period of 1.06 years.

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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

Restricted Stock Units

The following table summarizes the Company's restricted stock unit activity from January 1, 2018 to September 30, 2018:

	Units Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Units Outstanding, January 1, 2018	234,658	\$ 10.19	\$2,926,185
Units granted	31,929	16.03	511,761
Units released	(30,682)	8.74	
Units cancelled	—	—	
Units Outstanding, September 30, 2018	235,905	11.17	4,692,150
Vested and expected to vest at September 30, 2018	234,597	15.73	4,666,125
Vested and deferred at September 30, 2018	211,401	\$ 10.64	\$4,204,766

Restricted stock units are granted to members of the Board of Directors as part of their compensation packages.

Restricted stock units convert to common stock following the separation of service with the Company. 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.

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.

On February 20, 2017, the Compensation Committee approved 64,719 PRSAs and 144,497 PSOs as eligible for further service vesting requirements. The non-eligible 5,704 and 169,968 PRSAs and PSOs, respectively, were cancelled as of February 20, 2017. PRSAs and PSOs vest 50%, 25%, and 25% on April 4, 2017, 2018 and 2019, respectively. During the nine months ended September 30, 2018, 16,180 PRSAs vested and 36,124 PSOs vested. Future compensation cost related to the non-vested portion of the PRSAs and PSOs not yet recognized in the consolidated statement of operations was \$40,000 and is expected to be recognized over a weighted average period of 0.51 years.

On February 22, 2018, the Compensation Committee approved the maximum quantity of 140,846 MRSAs and 314,465 MSOs as eligible for further service vesting requirements. MRSAs and MSOs vest annually on a pro-rata basis over three years beginning April 4, 2018. During the nine months ended September 30, 2018, 46,949 MRSAs vested and 104,822 MSOs vested. Future compensation cost related to the non-vested portion of the MRSAs and MSOs not yet recognized in the consolidated statement of operations was \$0.1 million and is expected to be recognized over a weighted average period of 1.26 years.

12. STOCKHOLDERS' (DEFICIT) EQUITY

At September 30, 2018, 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 September 30, 2018, the Company had shares of common stock issued of 24,276,722 and shares of common stock outstanding of 23,276,722.

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 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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. STOCKHOLDERS' EQUITY (DEFICIT) (Continued)

\$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 2014, 2015, 2016, 2017 or the nine months ended September 30, 2018. Shares repurchased under the program were recorded as treasury stock on the Company's consolidated balance sheets. 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.

13. RESTRUCTURING AND OTHER EMPLOYEE SEVERANCE

2016 Restructuring Plan

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. There was approximately \$0.1 million of remaining accrued severance costs as of December 31, 2017 and September 30, 2018, with only minor changes in activity during the nine months ended September 30, 2018. The remaining amount is expected to be settled in 2018 or 2019.

Other Employee Severance Actions

In 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. There was approximately \$0.1 million of remaining accrued severance costs as of December 31, 2017. During the nine months ended September 30, 2018, the Company made final payments of \$0.1 million in accrued severance costs.

Restructuring Cost

The following table summarizes the major types of costs associated with the restructuring actions for the three and nine months ended September 30, 2018 and 2017 (in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Severance costs	\$(8)	\$186	\$(21)	\$1,118
Contract termination costs	—	1	—	37
Other costs	—	9	21	26
Total	\$(8)	\$196	\$—	\$1,181

The following table presents total restructuring costs associated with the restructuring actions included in the related line items of our statements of operations (in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Cost of revenue	\$(6)	\$108	\$16	\$313
Sales and marketing	—	91	(2)	426
Research and development	(2)	(13)	(2)	332
General and administrative	—	10	(12)	110
Total	\$(8)	\$196	\$—	\$1,181

These restructuring expenses are not allocated to any reportable segment under our definition of segment contribution as defined in Note 16 "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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 lease abandonment charges of \$3.2 million in the first quarter of 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 operating lease agreements and accrued lease abandonment costs in accordance with ASC 420, Exit or Disposal Cost Obligation ("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, 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 nine months ended September 30, 2018 and 2017 is as follows (in thousands):

	As of September 30,	
	2018	2017
Accrued lease abandonment costs, beginning of period	\$1,081	\$2,123
Costs incurred and charged to expense	—	—
Principal reductions	(693)	(759)
Accrued lease abandonment costs, end of period	\$388	\$1,364
Accrued lease abandonment costs liability:		
Short-term - included in "Other current liabilities"	\$388	\$1,078
Long-term	—	286
Total	\$388	\$1,364

15. 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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. COMMITMENTS AND CONTINGENCIES (Continued)

The following table summarizes future minimum operating lease payments for the remaining three months of 2018 and the years thereafter (in thousands):

	As of September 30, 2018
Periods Ending December 31,	
2018-remaining	\$ 1,248
2019	2,397
2020	1,155
2021	948
2022	977
2023	743
Thereafter	—
Total	\$ 7,468

Total expenses under operating leases are \$0.6 million and \$0.6 million for the three months ended September 30, 2018 and 2017, respectively. Total expenses under operating leases are \$1.8 million and \$1.9 million for the nine months ended September 30, 2018 and 2017, respectively.

The Company accounts for its leases under the provisions of ASC topic 840, Accounting for Leases ("ASC 840"), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense.

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.

16. 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. Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Segment revenue in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

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 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,

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. SEGMENT INFORMATION (Continued)

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.

The E&E Language segment and Consumer Language segment are 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 development expenses are included as shared Language costs. The Company will continue to evaluate its management reporting and will update its operating and reportable segments as appropriate.

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 three months ended September 30, 2018 were as follows (in thousands):

	Literacy Segment	Language E&E Language Segment	Consumer Language Segment	Shared Services	Combined Language	Total Company
Revenue	\$13,215	\$14,990	\$14,545	\$—	\$29,535	\$42,750
Cost of revenue	2,189	1,733	2,311	19	4,063	6,252
Sales and marketing	7,263	7,551	8,915	273	16,739	24,002
Research and development	2,218	—	—	3,615	3,615	5,833
General and administrative	520	40	18	—	58	578
Segment contribution	\$1,025	\$5,666	\$3,301	\$(3,907)	\$5,060	\$6,085
Segment contribution margin %	7.8	% 37.8	% 22.7	%		

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

Cost of revenue	2,516
Sales and marketing	946
Research and development	632
General and administrative	1,468
Subtotal	5,562

Corporate unallocated expenses, net:

Unallocated general and administrative	6,464
Unallocated non-operating income	(40)
Subtotal	6,424

Loss before income taxes \$ (5,901)

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. SEGMENT INFORMATION (Continued)

Operating results by segment for the three months ended September 30, 2017 were as follows (in thousands):

	Literacy Segment	Language E&E Language Segment	Consumer Language Segment	Shared Services	Combined Language	Total Company
Revenue ⁽¹⁾	\$11,028	\$16,529	\$18,649	\$—	\$35,178	\$46,206
Cost of revenue	1,666	1,756	4,464	(3)	6,217	7,883
Sales and marketing	6,402	7,511	8,428	269	16,208	22,610
Research and development	1,820	—	—	3,882	3,882	5,702
General and administrative	558	86	74	—	160	718
Segment contribution	\$582	\$7,176	\$5,683	\$(4,148)	\$8,711	\$9,293
Segment contribution margin %	5.3	% 43.4	% 30.5	%		

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

Cost of revenue	1,565
Sales and marketing	1,044
Research and development	679
General and administrative	1,724
Subtotal	5,012

Corporate unallocated expenses, net:

Unallocated general and administrative	6,593
Unallocated non-operating income	40
Subtotal	6,633

Loss before income taxes \$(2,352)

(1) Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Segment revenue in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. SEGMENT INFORMATION (Continued)

Operating results by segment for the nine months ended September 30, 2018 were as follows (in thousands):

	Literacy Segment	Language E&E Language Segment	Consumer Language Segment	Shared Services	Combined Language	Total Company
Revenue	\$38,294	\$45,782	\$44,984	\$—	\$ 90,766	\$129,060
Cost of revenue	6,069	5,037	8,409	57	13,503	19,572
Sales and marketing	20,248	23,467	26,570	889	50,926	71,174
Research and development	5,765	—	—	11,191	11,191	16,956
General and administrative	1,492	59	69	—	128	1,620
Segment contribution	\$4,720	\$17,219	\$9,936	\$(12,137)	\$ 15,018	\$19,738
Segment contribution margin %	12.3	% 37.6	% 22.1	%		

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

Cost of revenue	6,560
Sales and marketing	2,839
Research and development	1,834
General and administrative	4,148
Subtotal	15,381

Corporate unallocated expenses, net:

Unallocated general and administrative	19,598
Unallocated non-operating expense	305
Subtotal	19,903

Loss before income taxes	\$(15,546)
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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. SEGMENT INFORMATION (Continued)

Operating results by segment for the nine months ended September 30, 2017 were as follows (in thousands):

	Language					
Literacy	E&E	Consumer	Shared	Combined	Total	
Segment	Language	Language	Services	Language	Company	
	Segment	Segment				
Revenue ⁽¹⁾	\$ 31,568	\$ 50,289	\$ 57,947	\$ —	\$ 108,236	\$ 139,804