ROSETTA STONE INC
Form 10-Q
May 04, 2016
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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 March 31, 2016
Commission file number: 1-34283
Rosetta Stone Inc.
(Exact name of registrant as specified in its charter)

Delaware (State of incorporation)	043837082 (I.R.S. Employer Identification No.)
1919 North Lynn St., 7th Fl. Arlington, Virginia (Address of principal executive offices)	22209 (Zip Code)

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

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

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

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

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

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

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

As of April 29, 2016, there were 21,919,136 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)

	March 31, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$42,995	$ 47,782
Restricted cash	39	80
Accounts receivable (net of allowance for doubtful accounts of $1,241 and $1,196, at March 31, 2016 and December 31, 2015, respectively)	29,803	47,327
Inventory, net	7,229	7,333
Deferred sales commissions	12,368	13,526
Prepaid expenses and other current assets	5,004	3,612
Total current assets	97,438	119,660
Deferred sales commissions	5,023	5,614
Property and equipment, net	23,269	22,532
Goodwill	50,843	50,280
Intangible assets, net	27,168	28,244
Other assets	2,130	2,213
Total assets	$205,871	$ 228,543
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$11,364	$ 10,778
Accrued compensation	10,575	8,201
Income tax payable	464	121
Obligations under capital lease	546	521
Other current liabilities	27,400	35,318
Deferred revenue	99,279	106,868
Total current liabilities	149,628	161,807
Deferred revenue	32,978	35,880
Deferred income taxes	5,178	4,998
Obligations under capital lease	2,483	2,622
Other long-term liabilities	728	826
Total liabilities	190,995	206,133
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at March 31, 2016 and December 31, 2015, respectively	—	—
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 23,309 and 23,150 shares issued and 22,309 and 22,150 shares outstanding at March 31, 2016 and December 31, 2015, respectively	2	2
Additional paid-in capital	186,313	185,863
Accumulated loss	(157,301)	(149,794)
Accumulated other comprehensive loss	(2,703)	(2,226)

Treasury stock, at cost, 1,000 and 1,000 shares at March 31, 2016 and December 31, 2015, respectively	(11,435)	(11,435)
Total stockholders' equity	14,876	22,410
Total liabilities and stockholders' equity	$205,871	$ 228,543

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 March 31,	
	2016	2015
Revenue:		
Product	$10,031	$19,974
Subscription and service	37,971	38,468
Total revenue	48,002	58,442
Cost of revenue:		
Cost of product revenue	2,645	5,637
Cost of subscription and service revenue	5,403	5,665
Total cost of revenue	8,048	11,302
Gross profit	39,954	47,140
Operating expenses:		
Sales and marketing	30,793	40,150
Research and development	6,571	8,972
General and administrative	10,777	15,754
Impairment	—	291
Total operating expenses	48,141	65,167
Loss from operations	(8,187)	(18,027)
Other income and (expense):		
Interest income	13	4
Interest expense	(112)	(88)
Other income and (expense)	1,228	(1,581)
Total other income and (expense)	1,129	(1,665)
Loss before income taxes	(7,058)	(19,692)
Income tax expense	449	192
Net loss	$(7,507)	$(19,884)
Loss per share:		
Basic	$(0.34)	$(0.95)
Diluted	$(0.34)	$(0.95)
Common shares and equivalents outstanding:		
Basic weighted average shares	21,867	21,018
Diluted weighted average shares	21,867	21,018

See accompanying notes to consolidated financial statements

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

	Three Months Ended March 31,	
	2016	2015
Net loss	$(7,507)	$(19,884)
Other comprehensive loss, net of tax:		
Foreign currency translation loss	(477)	(1,147)
Other comprehensive loss	(477)	(1,147)
Comprehensive loss	$(7,984)	$(21,031)

See accompanying notes to consolidated financial statements

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

	Three Months Ended March 31,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(7,507)	$(19,884)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense	421	1,287
(Gain) loss on foreign currency transactions	(1,525)	1,372
Bad debt expense	191	410
Depreciation and amortization	3,408	3,350
Deferred income tax expense	172	295
Gain on disposal of equipment	—	(1)
Amortization of deferred financing fees	62	32
Loss on impairment	—	291
Loss from equity method investments	27	—
Net change in:		
Restricted cash	41	17
Accounts receivable	17,555	24,546
Inventory	116	(1,957)
Deferred sales commissions	1,783	59
Prepaid expenses and other current assets	(1,331)	(1,322)
Income tax receivable	337	(444)
Other assets	88	(314)
Accounts payable	569	(4,401)
Accrued compensation	2,310	(1,146)
Other current liabilities	(8,189)	(9,041)
Other long-term liabilities	(99)	(225)
Deferred revenue	(10,975)	(6,231)
Net cash used in operating activities	(2,546)	(13,307)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,586)	(2,382)
Acquisitions, net of cash acquired	—	(1,688)
Net cash used in investing activities	(2,586)	(4,070)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	29	37
Payment of financing fees	(100)	(27)
Payments under capital lease obligations	(244)	(282)
Net cash used in financing activities	(315)	(272)
Decrease in cash and cash equivalents	(5,447)	(17,649)
Effect of exchange rate changes in cash and cash equivalents	660	(1,084)
Net decrease in cash and cash equivalents	(4,787)	(18,733)
Cash and cash equivalents—beginning of period	47,782	64,657
Cash and cash equivalents—end of period	$42,995	$45,924
SUPPLEMENTAL CASH FLOW DISCLOSURE:		

Cash paid (received) during the periods for:		
Interest	$50	$57
Income taxes, net of refunds	$(61)	$463
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	$357	$732
Equipment acquired under capital lease	$27	$—

See accompanying notes to consolidated financial statements

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

On March 14, 2016, the Company announced that it intends to exit the direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings (the "2016 Restructuring Plan"). Where appropriate, the Company seeks to operate through partners in the geographies being exited. The Company also looks to initiate processes to close the software development operations in France and China. These actions are additive to the plan announced on March 11, 2015 (the "2015 Restructuring Plan") to accelerate and prioritize its focus on satisfying the needs of more passionate Corporate and K-12 learners, and emphasizing those who need to speak and read English. See Note 2 "Summary of Significant Accounting Policies," Note 13 "Restructuring," Note 16 "Segment Information" and Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" within Part 1 for additional information about these strategic undertakings and the associated impact to the Company's financial statements and financial results.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

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

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 14, 2016. The March 31, 2016 consolidated balance sheet included herein includes account balances as of December 31, 2015 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.

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 statement of financial position at March 31, 2016 and December 31, 2015, the Company’s results of operations for the three months ended March 31, 2016 and 2015 and its cash flows for the three months ended March 31, 2016 and 2015 have been made. The results for the three months ended March 31, 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2016. All references to March 31, 2016 or to the three months ended March 31, 2016 and 2015 in the notes to the consolidated financial statements are unaudited.

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

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, and allowance for valuation of deferred tax assets. The Company bases its estimates and assumptions on historical experience and on various other judgments that are believed to be reasonable under the circumstances. The Company continuously evaluates its estimates and assumptions. Actual results may differ from these estimates and assumptions.
Revenue Recognition
The Company's primary sources of revenue are web-based software subscriptions, online services, perpetual product software, and bundles of perpetual product software and online services. The Company also generates revenue from the sale of audio practice products, mobile applications, and professional services. Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenue is recorded net of discounts.
The Company identifies the units of accounting contained within sales arrangements in accordance with Accounting Standards Codification ("ASC") subtopic 605-25, Revenue Recognition - Multiple Element Arrangements ("ASC 605-25"). In doing so, the Company evaluates a variety of factors including whether the undelivered element(s) have value to the customer on a stand-alone basis or if the undelivered element(s) could be sold by another vendor on a stand-alone basis.
For multiple element arrangements that contain perpetual software products and related online services, the Company allocates the total arrangement consideration to its deliverables based on the existence of vendor-specific objective evidence of fair value, or vendor-specific objective evidence ("VSOE"), in accordance with ASC subtopic 985-605-25, Software: Revenue Recognition-Multiple-Element Arrangements ("ASC 985-605-25"). The Company generates a substantial portion of its Consumer revenue from the CD and digital download formats of the Rosetta Stone language-learning product which is typically a multiple-element arrangement that includes two deliverables: the perpetual software, delivered at the time of sale, and the online service, which is considered an undelivered software-related element. The online service includes access to conversational coaching services. Because the Company only sells the perpetual language-learning software on a stand-alone basis in its homeschool version, the Company does not have a sufficient concentration of stand-alone sales to establish VSOE for the perpetual product. Where VSOE of the undelivered online services can be established, arrangement consideration is allocated using the residual method. The Company determines VSOE by reference to the range of comparable stand-alone renewal sales of the online service. The Company reviews these stand-alone sales on a quarterly basis. VSOE is established if at least 80% of the stand-alone sales are within a range of plus or minus 15% of a midpoint of the range of prices, consistent with generally accepted industry practice. Where VSOE of the undelivered online services cannot be established, revenue is deferred and recognized commensurate with the delivery of the online services.
For non-software multiple element arrangements the Company allocates revenue to all deliverables based on their relative selling prices. The Company's non-software multiple element arrangements primarily occur as sales to its Enterprise & Education Language and Literacy customers. These arrangements can include web-based subscription services, audio practice materials and professional services or any combination thereof. The Company does not have a sufficient concentration of stand-alone sales of the various deliverables noted above to its Enterprise & Education Language and Literacy customers, and therefore cannot establish VSOE for each deliverable. Third party evidence of fair value does not exist for the web-based subscription, audio practice and professional services due to the lack of interchangeable language-learning products and services within the market. Accordingly, the Company determines the relative selling price of the web-based subscription, audio practice tools and professional services deliverables

included in its non-software multiple-element arrangements using the best estimated selling price. The Company determines the best estimated selling price based on its internally published price list which includes suggested sales prices for each deliverable based on the type of client and volume purchased. This price list is derived from past experience and from the expectation of obtaining a reasonable margin based on what each deliverable costs the Company.

In the U.S. and Canada, the Company offers consumers who purchase packaged software and audio practice products directly from the Company a 30-day, unconditional, full money-back refund. The Company also permits some of our retailers and distributors to return unsold packaged products, subject to certain limitations. In accordance with ASC subtopic 985-605, Software: Revenue Recognition ("ASC 985-605"), the Company estimates and establishes revenue reserves for packaged

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

product returns at the time of sale based on historical return rates, estimated channel inventory levels, the timing of new product introductions and other factors.

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

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

Software products include sales to end user customers and resellers. In many cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products and audio practice products is recognized as the products are shipped and title passes and risks of loss have been transferred. For many product sales, these criteria are met at the time the product is shipped. For some sales to resellers and certain other sales, the Company defers revenue until the customer receives the product because the Company legally retains a portion of the risk of loss on these sales during transit. In other cases where packaged software products are sold to resellers on a consignment basis, revenue is recognized for these consignment transactions once the end user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with ASC subtopic 605-50, Revenue Recognition: Customer Payments and Incentives ("ASC 605-50"), cash sales incentives to resellers are accounted for as a reduction of revenue, unless a specific identified benefit is identified and the fair value is reasonably determinable. Price protection for changes in the manufacturer suggested retail value granted to resellers for the inventory that they have on hand at the date the price protection is offered is recorded as a reduction to revenue at the time of sale.

The Company offers customers the ability to make payments for packaged software purchases in installments over a period of time, which typically ranges between three and five months. Given that these installment payment plans are for periods less than 12 months, a successful collection history has been established and these fees are fixed and determinable, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met.

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

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

Restructuring Costs

As part of the 2016 Restructuring Plan and the 2015 Restructuring Plan, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. In connection with these plans, the Company incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included in our operating expense line items on the Statement of Operations.

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

Contract termination costs include penalties to cancel certain service and license contracts. 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 of the Company’s Consumer business. Such costs are recognized at fair value in the period in which the costs are incurred.

Income Taxes

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

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of March 31, 2016. 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.

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

Divestitures
The Company deconsolidates divested subsidiaries when there is a loss of control or when appropriate when evaluated under the variable interest entity model. The Company recognizes a gain or loss at divestiture equal to the difference between the fair value of any consideration received and the carrying amount of the former subsidiary's assets and liabilities. Any resulting gain or loss is reported in "Other income and (expense)" on the consolidated statement of operations.
Stock-Based Compensation
The Company accounts for its stock-based compensation in accordance ASC topic 718, Compensation—Stock Compensation ("ASC 718"). Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date and recognized as expense in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.
The Company estimates the expected term of options using a combination of peer company information and the simplified method for estimating the expected term. The Company uses its own historical stock price data to estimate its forfeiture rate and expected volatility over the most recent period commensurate with the estimated expected term of the awards. For the risk-free interest rate, the Company uses a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.
The Company's restricted stock and restricted stock unit grants are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant.
Foreign Currency Translation and Transactions
The functional currency of the Company's foreign subsidiaries is their local currency. Accordingly, assets and liabilities of the foreign subsidiaries are translated into U.S. dollars at exchange rates in effect on the balance sheet date. Income and expense items are translated at average rates for the period. Translation adjustments are recorded as a component of other comprehensive loss in stockholders' 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 and cash equivalents during the period.
The following table presents the effect of exchange rate changes on total comprehensive loss (in thousands):

	Three Months Ended March 31,	
	2016	2015
Net loss	$(7,507)	$(19,884)
Foreign currency translation loss	(477)	(1,147)
Comprehensive loss	$(7,984)	$(21,031)

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

Costs for advertising are expensed as incurred. Advertising expense for the three months ended March 31, 2016 was $9.6 million and for the three months ended March 31, 2015 was $13.4 million.

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

Recently Issued Accounting Standards Not Yet Adopted
In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). Under ASU 2016-09, accounting for share-based payment award transactions was simplified related to the accounting for (a) income tax effects; (b) minimum statutory tax withholding requirements; (c) and forfeitures. ASU 2016-09 is effective for public entities in annual periods beginning after December 15, 2016, including interim periods within those annual periods. Early adoption is permitted. The Company is in the process of evaluating the adoption date and impact of the new guidance on the Company's consolidated financial statements and disclosures.
In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02"). Under ASU 2016-02, entities will be required to recognize a lease liability and a right-of-use asset for all leases. Lessor accounting is largely unchanged. ASU 2016-02 is effective for public entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is in the process of evaluating the impact of the new guidance on the Company's consolidated financial statements and disclosures.
In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 changes how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option that are attributable to their own credit. Under the new guidance, entities will be required to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. The accounting for other financial instruments, such as loans and investments in debt securities is largely unchanged. ASU 2016-01 is effective for public entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not believe that the adoption of this guidance will have a material impact on the Company's consolidated financial statements and disclosures.
In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40) ("ASU 2014-15"). ASU 2014-15 addresses management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued. ASU 2014-15 will be effective for the first interim period within annual reporting periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect to early adopt this guidance and does not believe that the adoption of this guidance will have a material impact on the Company's financial statements and disclosures.
In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which replaces the current revenue accounting guidance. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date which defers the effective date of the updated guidance on revenue recognition by one year. In March 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which clarifies and improves the operability and understandability of the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, which clarifies and improves the operability and understandability of the implementation guidance on identifying performance obligations and licensing. Collectively these ASUs comprise the new revenue standard ("New Revenue Standard"). The core principle of the New Revenue Standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply a five step model to 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract and 5) recognize revenue when (or as) the entity

satisfies a performance obligation. The New Revenue Standard is effective for annual periods beginning after December 31, 2017. Entities may choose from two adoption methods, with certain practical expedients. The Company expects that it will adopt the New Revenue Standard beginning in the first quarter of 2018 and is currently evaluating the appropriate transition method and any impact of the New Revenue Standard on the Company's consolidated financial statements and disclosures.

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

3. DIVESTITURES

As part of the shift in strategy initiated in early 2015, the Company determined that its ownership of the consumer-oriented Rosetta Stone Korea Ltd. ("RSK") entity no longer agreed with the Company's overall strategy to focus on the Enterprise & Education Language and Literacy businesses. In September 2015, the Company completed the divestiture of 100% of the Company's capital stock of RSK to the then-current President of RSK for consideration equal to the assumption of RSK's net liabilities at the date of sale.

As part of the transaction, the Company has agreed to continue to provide to RSK certain of its online product offerings for resale and distribution and RSK is committed to purchase those products, for an initial term ending December 31, 2025. In addition, the Company has loaned RSK $0.5 million as of October 2, 2015, which will be repaid in five equal installments due every six months beginning December 31, 2016. As a result of this loan receivable and the level of financial support it represents, the Company concluded that it holds a variable interest in RSK whereby the Company is not the primary beneficiary. The maximum exposure to loss as a result of this involvement in the variable interest entity is limited to the $0.5 million amount of the loan.

4. NET LOSS PER SHARE

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

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

	Three Months Ended March 31,	
	2016	2015
Numerator:		
Net loss	$(7,507)	$(19,884)
Denominator:		
Weighted average number of common shares:		
Basic	21,867	21,018
Diluted	21,867	21,018
Loss per common share:		
Basic	$(0.34)	$(0.95)
Diluted	$(0.34)	$(0.95)

For the three months ended March 31, 2016 and 2015, no common stock equivalent shares were included in the calculation of the Company's diluted net income per share.

The following is a summary of common stock equivalents for the securities outstanding during the respective periods that have been excluded from the earnings per share calculations as their impact was anti-dilutive (in thousands).

	Three Months Ended March 31,	
	2016	2015
Stock options	25	58

Restricted stock units	162	119
Restricted stocks	63	69
Total common stock equivalent shares	250	246

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

5. INVENTORY
Inventory consisted of the following (in thousands):

	March 31, 2016	December 31, 2015
Raw materials	$ 3,190	$ 3,375
Finished goods	4,039	3,958
Total inventory	$ 7,229	$ 7,333

6. GOODWILL
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 acquisitions of Vivity Labs, Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") in January 2014.
The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC topic 350, Intangibles - Goodwill and other ("ASC 350"), or more frequently, if impairment indicators arise.
The following table shows the balance and changes in goodwill for the Company's operating segments for the three months ended March 31, 2016 (in thousands):

	Enterprise & Education Language	Literacy	Consumer	Total
Balance as of December 31, 2015	$ 38,700	$ 9,962	$ 1,618	$ 50,280
Effect of change in foreign currency rate	456	—	107	563
Balance as of March 31, 2016	$ 39,156	$ 9,962	$ 1,725	$ 50,843

The Company also routinely reviews goodwill at the reporting unit level for potential impairment as part of the Company’s internal control framework. The Company's reporting units were evaluated to determine if a triggering event has occurred. As of March 31, 2016, the Company concluded that there are no indicators of impairment that would cause it to believe that it is more likely than not that the fair value of it's reporting units is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no goodwill impairment charges were recorded in connection with the interim impairment review.

7. INTANGIBLE ASSETS

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

	March 31, 2016			December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Tradename/trademark *	$12,471	$ (1,358)	$11,113	$12,442	$ (1,271)	$11,171
Core technology	15,397	(8,505)	6,892	15,149	(7,817)	7,332
Customer relationships	26,422	(17,348)	9,074	26,245	(16,603)	9,642
Website	12	(12)	—	12	(12)	—
Patents	300	(211)	89	300	(201)	99
Total	$54,602	$ (27,434)	$27,168	$54,148	$ (25,904)	$28,244

* Included in the tradename/trademark line above is the Rosetta Stone tradename, which is the Company's only indefinite-lived intangible asset. As of March 31, 2016, the carrying value of the tradename asset was $10.6 million.

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 March 31,	
	2016	2015
Included in cost of revenue:		
Cost of product revenue	$48	$79
Cost of subscription and service revenue	98	67
Total included in cost of revenue	146	146
Included in operating expenses:		
Sales and marketing	715	725
Research and development	442	456
General and administrative	—	—
Total included in operating expenses	1,157	1,181
Total	$1,303	$1,327

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining nine months of 2016 and years thereafter (in thousands):

	As of March 31, 2016
2016 - remaining	$3,423
2017	4,245
2018	3,651
2019	1,532
2020	1,282
Thereafter	2,428
Total	$16,561

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
7. INTANGIBLE ASSETS (Continued)

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 March 31, 2016 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 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.
8. OTHER CURRENT LIABILITIES
The following table summarizes other current liabilities (in thousands):

	March 31, 2016	December 31, 2015
Accrued marketing expenses	$ 16,211	$ 20,022
Accrued professional and consulting fees	1,918	1,746
Sales return reserve	2,104	3,728
Sales, withholding and property taxes payable	3,702	3,879
Other	3,465	5,943
Total other current liabilities	$ 27,400	$ 35,318

9. FINANCING ARRANGEMENTS
Revolving Line of Credit
On October 28, 2014, Rosetta Stone Ltd. ("RSL"), a wholly owned subsidiary of parent company Rosetta Stone Inc., executed a Loan and Security Agreement with Silicon Valley Bank ("Bank") to obtain a $25.0 million revolving credit facility (the "credit facility"). The Company executed the First Amendment to the credit facility with the Bank effective March 31, 2015, the Second Amendment effective May 1, 2015, the Third Amendment effective June 29, 2015, and the Fourth Amendment effective December 29, 2015. The Company is subject to certain covenants under the Loan and Security Agreement, including financial covenants and limitations on indebtedness, encumbrances, investments and distributions and dispositions of assets, certain of which covenants were amended in the First, Second, Third, and Fourth Amendments, which were primarily amended to reflect updates to the Company's financial outlook. The Third Amendment also changed the definition of "change of control" to eliminate a clause referring to a change in a portion of the Board of Directors within a twelve-month period.
On March 14, 2016, the Company executed the Fifth Amendment to the credit facility. Under the amended agreement, the Company may borrow up to $25.0 million, including a sub-facility, which reduces available borrowings, for letters of credit in an 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 January 1, 2018, during which time RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.
The total obligations under the credit facility cannot exceed the lesser of (i) the total revolving commitment of $25.0 million or (ii) the borrowing base, which is calculated as 80% of eligible accounts receivable. As a result, the borrowing base will fluctuate and the Company expects it will follow the general seasonality of cash and accounts receivable (lower in the first half of the year and higher in the second half of the year). If the borrowing base less any outstanding amounts, plus the cash held at SVB ("Availability") is greater than $25.0 million, then the Company may borrow up to an additional $5.0 million, but in no case can borrowings exceed $25.0 million. Interest on borrowings accrue at the Prime Rate provided that the Company maintains a minimum cash and Availability balance of $17.5 million. If cash and Availability is below $17.5 million, interest will accrue at the Prime Rate plus 1%.
Proceeds of loans made under the credit facility may be used as working capital or to fund general business requirements. All obligations under the credit facility, including letters of credit, are secured by a security interest on substantially all of the Company's assets including intellectual property rights and by a stock pledge by the Company

of 100% of its ownership interests in U.S. subsidiaries and 66% of its ownership interests in certain foreign subsidiaries.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
9. FINANCING ARRANGEMENTS (Continued)

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

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

As of March 31, 2016, there were no borrowings outstanding and the Company was eligible to borrow $13.5 million of available credit, less $4.0 million in letters of credit that have been issued by the Bank on the Company's behalf. A quarterly commitment fee accrues on any unused portion of the credit facility at a nominal annual rate.

Capital Leases

The Company enters into capital leases under non-committed arrangements for equipment and software. In addition, the Company holds a capital lease for a building near Versailles, France.

During the three months ended March 31, 2016 and 2015, the Company acquired $27,000, and zero, respectively, of 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 March 31, 2016
2016-remaining	$391
2017	670
2018	518
2019	515
2020	510
Thereafter	887
Total minimum lease payments	$3,491
Less amount representing interest	462
Present value of net minimum lease payments	$3,029
Less current portion	546
Obligations under capital lease, long-term	$2,483

10. INCOME TAXES

In accordance with ASC topic 740, Income Taxes ("ASC 740"), and ASC subtopic 740-270, Income Taxes: Interim Reporting, the income tax provision for the three months ended March 31, 2016 is based on the estimated annual effective tax rate for fiscal year 2016. 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

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

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 March 31, 2016, 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 March 31, 2016 results in a cumulative U.S. pre-tax loss;
- from 2006, when the U.S. entity began filing as a C-corporation for income tax purposes, through 2010, the U.S. entity generated taxable income each year;
- the Company has a history of utilizing all operating tax loss carryforwards and has not had any tax loss carryforwards or credits expire unused;
- lengthy loss carryforward periods of 20 years for U.S. federal and most state jurisdictions apply; and
- 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 March 31, 2016, a valuation allowance was provided for the U.S., Japan, China, 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 March 31, 2016 resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation will be adjusted accordingly, which could materially affect the Company’s financial position and results of operations.
As of March 31, 2016, and December 31, 2015, the Company’s U.S. deferred tax liability was $5.1 million and $4.8 million, respectively, related to its goodwill and indefinite lived intangibles. As of March 31, 2016 the Company had foreign net deferred tax liabilities of $0.1 million compared to foreign net deferred tax liabilities of $0.2 million at December 31, 2015. As of March 31, 2016, and December 31, 2015, the Company had no unrecognized tax benefits.
For the three months ended March 31, 2016 the Company recorded an income tax expense of $0.4 million. The expense in the current period is made up of tax expense related to current year profits of operations in Germany and the U.K. Additionally, the tax expense relates to the tax impact of the amortization of indefinite-lived intangible assets and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities. These tax expenses are partially offset by tax benefits related to current year losses in Canada.
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.

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2009 Omnibus Incentive Plan

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

On May 26, 2011 the Board of Directors authorized and the Company's shareholders' approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan. On May 23, 2012, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,122,930 additional shares of common stock to the 2009 Plan. On May 23, 2013, the Board of Directors authorized and the Company's shareholders approved the allocation of 2,317,000 additional shares of common stock to the 2009 Plan. On May 20, 2014, the Board of Directors authorized and the Company's shareholders approved the allocation of 500,000 additional shares of common stock to the 2009 Plan. On June 12, 2015, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,200,000 additional shares of common stock to the 2009 Plan. At March 31, 2016 there were 2,358,514 shares available for future grant under the 2009 Plan.

In accordance with ASC 718, the fair value of stock-based awards to employees is calculated as of the date of grant. Compensation expense is then recognized on a straight-line basis over the requisite service period of the award. The Company uses the Black-Scholes pricing model to value its stock options, which requires the use of estimates, including future stock price volatility, expected term and forfeitures. Stock-based compensation expense recognized is based on the estimated portion of the awards that are expected to vest. Estimated forfeiture rates were applied in the expense calculation.

For the three months ended March 31, 2016 and 2015, the fair value of options granted was calculated using the following assumptions:

	Three Months Ended March 31,	
	2016	2015
Expected stock price volatility	46.1%-47.0%	62.6%-63.1%
Expected term of options	6 years	6 years
Expected dividend yield	—	—
Risk-free interest rate	1.24%-1.50%	1.19%-1.57%

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

	Three Months Ended March 31,	
	2016	2015
Included in cost of revenue:		
Cost of product revenue	$1	$22
Cost of subscription and service revenue	(17)	11
Total included in cost of revenue	(16)	33
Included in operating expenses:		
Sales and marketing	79	361

Research and development	(119)	140
General and administrative	477	753
Total included in operating expenses	437	1,254
Total	$421	$1,287

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

Stock Options

The following table summarizes the Company's stock option activity from January 1, 2016 to March 31, 2016:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2016	1,837,165	$ 10.58	7.70	$ 130,262
Options granted	391,939	7.46		
Options exercised	(7,117)	4.09		
Options canceled	(67,749)	11.59		
Options Outstanding, March 31, 2016	2,154,238	10.01	7.91	112,622
Vested and expected to vest March 31, 2016	1,966,909	10.16	7.74	112,622
Exercisable at March 31, 2016	1,269,498	$ 10.49	7.12	$ 112,622

As of March 31, 2016, there was approximately $4.9 million of unrecognized stock-based compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 2.92 years.

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

Restricted Stock Awards

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

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2016	341,579	$ 10.61	$ 3,624,153
Awards granted	143,655	7.46	
Awards vested	(75,511)	10.62	
Awards canceled	(11,972)	11.37	
Nonvested Awards, March 31, 2016	397,751	$ 9.45	$ 3,757,554

As of March 31, 2016, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the consolidated statement of operations was $3.5 million and is expected to be recognized over a period of 2.54 years.

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

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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, 2016 to March 31, 2016:

	Units Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Units Outstanding, January 1, 2016	187,942	$ 11.16	$1,257,332
Units granted	—	—	—
Units released	(20,201)	10.77	
Units cancelled	(5,589)	8.50	
Units Outstanding, March 31, 2016	162,152	11.30	1,088,040
Vested and expected to vest at March 31, 2016	123,674	8.50	85,226
Vested and deferred at March 31, 2016	110,973	$ 12.60	$744,629

As of March 31, 2016, no restricted stock units were 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. Beginning June 2015, all restricted stock unit awards vest quarterly over a one year period from the date of grant, with expense recognized straight-line over the vesting period. Prior to June 2015, all restricted stock unit awards were immediately vested with expense recognized in full on the grant date. The Company's restricted stock units are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant. The Company did not grant any restricted stock units prior to April 2009.

12. STOCKHOLDERS' EQUITY

At March 31, 2016, the Company's Board of Directors had the authority to issue 200,000,000 shares of stock, of which 190,000,000 were designated as Common Stock, with a par value of $0.00005 per share, and 10,000,000 were designated as Preferred Stock, with a par value of $0.001 per share. At March 31, 2016, the Company had shares of common stock issued of 23,308,635 and shares of common stock outstanding of 22,308,635.

On May 8, 2013, the Company filed a universal shelf registration statement to offer equity or issue debt in the amount of $150.0 million, which became effective on May 30, 2013. The registration statement permitted certain holders of the Company’s stock to offer the shares of common stock held by them. On June 11, 2013 the selling shareholders, ABS Capital Partners IV Trust and Norwest Equity Partners VIII, LP, sold a combined total of 3,490,000 shares at an offering price of $16.00 per share. During November and December 2013, ABS Capital Partners IV Trust sold the remainder of its common stock holdings in the Company. The Company issued and sold an additional 10,000 shares of common stock at a per share price of $16.00 in the offering.

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 $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, or the three months ended March 31, 2016. Shares repurchased under the program were recorded as treasury stock on the Company’s consolidated balance sheet. The shares repurchased under this program during the year ended December 31, 2013 were not the result of an accelerated share repurchase agreement. Management has not made a decision on whether shares purchased under this program will be retired or reissued.

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

13. RESTRUCTURING
2016 Restructuring Plan
In the first quarter of 2016, the Company announced and initiated actions with an intent to exit the direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of Enterprise & Education Language offerings. The Company will also look to initiate processes to close its software development operations in France and China.
Restructuring charges included in the Company's unaudited consolidated statement of operations related to the 2016 Restructuring Plan include the following:

- Employee severance and related benefits costs incurred in connection with headcount reductions involving employees primarily in China, Brazil, Canada, Spain, Mexico, U.S. and the U.K.; and
- Other related costs.

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

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at March 31, 2016
Severance costs	$ —	$ 2,149	$ (369)	$ —	$ 1,780
Other costs	—	256	—	—	256
Total	$ —	$ 2,405	$ (369)	$ —	$ 2,036

(1) Other Adjustments includes non-cash period changes in the liability balance, which may include non-cash stock compensation expense and foreign currency translation adjustments.
2015 Restructuring Plan
In the first quarter of 2015, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. The Company committed to the 2015 Restructuring Plan and has completed a large portion of the 2015 Restructuring Plan as of March 31, 2016. The Company does not expect to incur any additional restructuring costs in connection with the 2015 Restructuring Plan.
Restructuring charges included in the Company's unaudited consolidated statement of operations related to the 2015 Restructuring Plan include the following:

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

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

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at March 31, 2016
Severance costs	$ 252	$ 104	$ (238)	$ —	$ 118
Contract termination costs	—	—	—	—	—
Other costs	—	—	—	—	—
Total	$ 252	$ 104	$ (238)	$ —	$ 118

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
13. RESTRUCTURING (Continued)

Restructuring Cost

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

	Three Months Ended March 31,		Incurred through
	2016	2015	March 31, 2016
Severance costs	$2,253	$6,013	$9,493
Contract termination costs	—	—	1,134
Other costs	256	246	673
Total	$2,509	$6,259	$11,300

As of March 31, 2016, the entire restructuring liability of $2.2 million was classified as a current liability within accrued compensation and other current liabilities on the consolidated balance sheets.

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

	Three Months Ended March 31, 2016