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, 2011

Commission File Number: 1-34283

ROSETTA STONE INC.

(Exact name of Registrant as specified in its charter)

Delaware	**043837082**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1919 North Lynn St., 7th Fl, Arlington, Virginia	**22209**
(Address of Principal Executive Offices)	(Zip Code)

800-788-0822

(Registrant s telephone number, including zip 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 x 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 o 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 x
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 x

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

As of October 26, 2011, 21,268,532 shares of the registrant s Common Stock, $.00005 par value, were outstanding.

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ROSETTA STONE INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ROSETTA STONE INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	September 30, 2011 (unaudited)	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 103,067	$ 115,756
Restricted cash	65	85
Short term investments	8,211	6,410
Accounts receivable (net of allowance for doubtful accounts of $1,765 and $1,761, respectively)	35,202	48,056
Inventory	8,538	9,928
Prepaid expenses and other current assets	6,372	7,763
Income tax receivable	14,381	2,210
Deferred income taxes	9,817	11,159
Total current assets	185,653	201,367
Property and equipment, net	21,880	21,073
Goodwill	34,831	34,856
Intangible assets, net	10,879	10,948
Deferred income taxes	7,456	6,498
Other assets	1,996	1,732
Total assets	$ 262,695	$ 276,474
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 8,377	$ 7,631
Accrued compensation	9,062	10,514
Other current liabilities	28,098	32,625
Deferred revenue	44,649	41,965
Total current liabilities	90,186	92,735
Deferred revenue	2,939	5,193
Other long-term liabilities	379	230
Total liabilities	93,504	98,158
Commitments and contingencies (Note 12)		
Stockholders equity:		
Preferred stock, $0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively		
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 21,245 and 20,975 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	2	2
Additional paid-in capital	144,608	139,022

Accumulated income		24,061		39,069
Accumulated other comprehensive income		520		223
Total stockholders equity		169,191		178,316
Total liabilities and stockholders equity	$	262,695	$	276,474

See accompanying notes to condensed consolidated financial statements

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ROSETTA STONE INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(unaudited)		(unaudited)	
Revenue:				
Product	$ 44,183	$ 49,407	$ 134,541	$ 154,025
Subscription and service	20,019	11,519	53,381	30,563
Total revenue	64,202	60,926	187,922	184,588
Cost of revenue:				
Cost of product revenue	7,862	8,749	25,430	23,041
Cost of subscription and service revenue	3,447	1,680	8,861	3,631
Total cost of revenue	11,309	10,429	34,291	26,672
Gross profit	52,893	50,497	153,631	157,916
Operating expenses				
Sales and marketing	39,821	34,093	118,175	91,896
Research and development	4,991	6,030	17,829	17,600
General and administrative	14,115	12,048	42,731	38,107
Total operating expenses	58,927	52,171	178,735	147,603
Income (loss) from operations	(6,034)	(1,674)	(25,104)	10,313
Other income and (expense):				
Interest income	62	85	224	191
Interest expense	(1)	(8)	(5)	(25)
Other income (expense)	34	53	83	(158)
Total other income (expense)	95	130	302	8
Income (loss) before income taxes	(5,939)	(1,544)	(24,802)	10,321
Income tax provision (benefit)	(4,762)	(1,159)	(9,794)	2,001
Net income (loss)	$ (1,177)	$ (385)	$ (15,008)	$ 8,320
Earnings (loss) per share:				
Basic	$ (0.06)	$ (0.02)	$ (0.72)	$ 0.41
Diluted	$ (0.06)	$ (0.02)	$ (0.72)	$ 0.39
Common shares and equivalents outstanding:				
Basic weighted average shares	20,780	20,490	20,724	20,367
Diluted weighted average shares	20,780	20,490	20,724	21,161

See accompanying notes to condensed consolidated financial statements

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ROSETTA STONE INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2011	2010
	(unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (15,008)	$ 8,320
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:		
Stock-based compensation expense	4,977	2,990
Bad debt expense	709	477
Depreciation and amortization	6,439	4,715
Deferred income tax benefit	471	(726)
Loss on disposal of equipment	18	34
Net change in:		
Restricted cash	19	(53)
Accounts receivable	12,345	(9,350)
Inventory	1,361	(2,793)
Prepaid expenses and other current assets	1,371	1,561
Income tax receivable	(12,232)	(7,508)
Other assets	(208)	(368)
Accounts payable	738	(342)
Accrued compensation	(1,462)	(2,627)
Other current liabilities	(3,712)	10,723
Income tax payable		
Excess tax benefit from stock options exercised	(365)	(1,342)
Other long term liabilities	152	(525)
Deferred revenue	370	13,447
Net cash (used) provided by operating activities	(4,017)	16,633
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(7,908)	(5,696)
Purchases of available-for-sale securities	(1,801)	
Acquisition, net of cash acquired	(75)	
Net cash used in investing activities	(9,784)	(5,696)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	639	2,042
Tax benefit of stock options exercised	365	1,342
Payments under capital lease obligations	(6)	(3)
Net cash provided by financing activities	998	3,381
Increase (decrease) in cash and cash equivalents	(12,803)	14,318
Effect of exchange rate changes in cash and cash equivalents	114	308
Net increase (decrease) in cash and cash equivalents	(12,689)	14,626
Cash and cash equivalents beginning of year	115,756	95,188
Cash and cash equivalents end of year	$ 103,067	$ 109,814
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	$ 5	$ 17
Income taxes	$ 1,667	$ 9,870
Noncash financing and investing activities:		

Accrued liability for purchase of property and equipment	$	653	$	1,740
Equipment acquired under capital lease	$	16	$	12

See accompanying notes to condensed consolidated financial statements

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ROSETTA STONE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. NATURE OF OPERATIONS

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Basis of Presentation

The accompanying condensed consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (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 Annual Report on Form 10-K filed with the SEC on March 14, 2011. The December 31, 2010 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures, including notes, required by GAAP.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and in the opinion of management include all adjustments necessary for the fair presentation of the Company s statement of financial position at September 30, 2011 and December 31, 2010, the Company s results of operations for the three and nine months ended September 30, 2011 and 2010 and its cash flows for the nine months ended September 30, 2011 and 2010. The results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results to be expected for the year ending December 31, 2011. All references to September 30, 2011 or to the three and nine months ended September 30, 2011 and 2010 in the notes to the condensed consolidated financial statements are unaudited.

Use of Estimates

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

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Revenue Recognition

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe.* Rosetta Stone *TOTALe* online, which was released in July 2009, combines dedicated conversational coaching and an online software subscription. Rosetta Stone V4 *TOTALe*, which was released in September 2010, combines packaged software and dedicated conversational coaching. The Company recognizes revenue for software products and related services in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition* (ASC 985-605).

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

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

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

Revenue for online service subscriptions for dedicated conversational coaching are recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically range from three months to 15 months. Rosetta Stone V4 *TOTALe* bundles, which include dedicated conversational coaching online services and packaged software, allow customers to begin their online services at any point during a registration window, which is 6 months from the date of purchase from the Company or an authorized reseller. Dedicated conversational coaching online service subscriptions

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that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Accounts receivable and deferred revenue are recorded at the time a customer purchases the online services.

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

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

Revenue Recognition for Arrangements with Multiple Deliverables

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

The Company has identified two deliverables generally contained in arrangements involving the sale of online services bundled with auxiliary items. The first deliverable is the auxiliary items, which are delivered at the time of sale, and the second deliverable is the online services. The Company allocates revenue between these two deliverables using the relative selling price method. Amounts allocated to the auxiliary items are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services. The auxiliary item cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

The Company has identified two deliverables generally contained in Rosetta Stone V4 *TOTALe* software arrangements. The first deliverable is the packaged software, which is delivered at the time of sale, and the second deliverable is the dedicated conversational coaching online services. The Company allocates revenue between these two deliverables using the relative selling price method. Amounts allocated to the software are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services or upon expiry of the online services. The language learning software cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

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

Income Taxes

The Company accounts for income taxes in accordance with Accounting Standards Codification topic 740, *Income Taxes* (ASC 740), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax bases of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more

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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.

Fair Value of Financial Instruments

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

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

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

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

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.

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

	Fair Value as of September 30, 2011 using:				Fair Value as of September 30, 2010 using:			
	September 30, 2011	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**September 30, 2010**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:								
Short-term investments	$ 8,211	$ 8,211	$	$	$	$	$	$
Total	$ 8,211	$ 8,211	$	$	$	$	$	$
Liabilities:								
Contingent purchase price accrual	$ 573	$	$	$ 573	$ 850	$	$	$ 850

Total	$	573	$		$		$	573	$	850	$		$		$	850

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

Stock-Based Compensation

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

Stock Options

During the nine months ended September 30, 2011, 544,239 stock options were granted at a weighted average exercise price of $14.67 per share. The aggregate grant date fair value of options issued during the period was $4.3 million, which will be

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recognized as expense over the requisite service period of the options, which is also the vesting period. During the nine months ended September 30, 2010, 407,908 stock options were granted at a weighted average exercise price of $24.99 per share. During the nine months ended September 30, 2011 and 2010, 181,778 and 336,154 stock options were exercised, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2011 and 2010 was approximately $1.6 million and $4.5 million, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. For the nine months ended September 30, 2011 and 2010, the fair value of options granted was calculated using the following assumptions:

	Nine Months Ended September 30,	
	2011	**2010**
Expected stock price volatility	57.1% - 58.2%	61.2% - 66.0%
Expected term of options	6 years	6 years
Expected dividend yield		
Risk-free interest rate	0.95% - 2.35%	1.38% - 2.59%

Since the Company s stock has been publicly quoted since April 2009 and the Company has a limited history of stock option activity, the Company reviewed a group of comparable industry-related companies to estimate its expected volatility over the most recent period commensurate with the estimated expected term of the awards. In addition to analyzing data from the peer group, the Company also considered the contractual option term and vesting period when determining the expected option life and forfeiture rate. 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.

Restricted Stock

During the nine months ended September 30, 2011, 133,789 shares of restricted stock were granted. The aggregate grant date fair value of the awards was $2.1 million, which will be recognized as expense on a straight-line basis over the requisite service period of the awards, which is also the vesting period. The Company s restricted stock grants are accounted for as equity awards. The grant date fair value is based on the market price of the Company s common stock at the date of grant. During the nine months ended September 30, 2010, 91,397 shares of restricted stock were granted. The aggregate grant date fair value of the awards was $2.4 million.

Restricted Stock Units

During the nine months ended September 30, 2011, 17,471 restricted stock units were granted. The aggregate grant date fair value of the awards was $238,000, which will be recognized as expense on the grant date, as the awards were immediately vested. The Company s 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 grant date. During the nine months ended September 30, 2010, 12,096 restricted stock units were granted. The aggregate grant date fair value of the awards was $210,000.

Long Term Incentive Program

On January 4, 2011, the Company s Board of Directors approved the Rosetta Stone Inc. Long Term Incentive Program (LTIP), a long-term incentive plan for certain of the Company s executives. The LTIP will be administered under the Rosetta Stone Inc. 2009 Omnibus Incentive Plan (the Plan), and the 1,000,000 shares allocated to the LTIP will be taken from the shares reserved under the Plan. Executives designated by the Board of Directors will be eligible to receive shares of restricted common stock for each milestone level of total market capitalization achieved, as specified in individual award agreements. The shares received will be restricted in that after issuance of the shares, they are subject to vesting over a two year period. For each milestone level of market capitalization reached above the base market capitalization as of October 1, 2010, the compensation committee of the Board of Directors will allocate a share incentive pool amongst the participating executives as specified in individual award agreements.

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In accordance with the agreements communicated to the executives after the approval of the plan by the Board of Directors, the LTIP participants were granted minimum participation percentages of each tranche of shares issued at each milestone level reached. For these minimum shares to be received, the Company determined that a grant date was achieved. The grant date fair value of the minimum awards was $6.1 million which was derived using a Monte Carlo valuation model. This value will be amortized as stock-based compensation expense over the derived service period of 5 years. Stock-based compensation expense for unallocated LTIP shares will be recognized when the milestones are met, the Board determines the allocation to each individual, and the shares are granted. The grant date fair value determined at that time will be amortized over the vesting period.

During the nine months ended September 30, 2011, the Company recorded $0.9 million in stock-based compensation expense related to the LTIP, and as of September 30, 2011, there was $5.2 million of unrecognized stock-based compensation expense related to minimum awards that is expected to be recognized over a period of 5 years.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Cost of Revenue	$ 14	$ 7	$ 34	$ 29
Sales and marketing	322	208	856	547
Research & development	404	320	1,101	889
General and administrative	1,096	530	2,986	1,525
Total	$ 1,836	$ 1,065	$ 4,977	$ 2,990

Foreign Currency Translation and Transactions

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net Income (loss)	$ (1,177)	$ (385)	$ (15,008)	$ 8,320
Foreign currency translation gain (loss)	(188)	398	313	339

Unrealized gain (loss) on available-for-sale securities						(16)		
Total comprehensive income (loss)	$	(1,365)	$	13	$	(14,711)	$	8,659

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Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three and nine months ended September 30, 2011 were $18.0 million and $53.1 million, respectively, and for the three and nine months ended September 30, 2010 were $14.6 million and $36.7 million, respectively.

Recently Issued Accounting Standards

In August 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft on lease accounting that would require entities to recognize assets and liabilities arising from lease contracts on the balance sheet. The proposed exposure draft states that lessees and lessors should apply a right-of-use model in accounting for all leases. Under the proposed model, lessees would recognize an asset for the right to use the leased asset, and a liability for the obligation to make rental payments over the lease term. The lease term is defined as the longest possible term that is more likely than not to occur. The accounting by a lessor would reflect its retained exposure to the risks or benefits of the underlying leased asset. A lessor would recognize an asset representing its right to receive lease payments based on the expected term of the lease. The final standard is expected to be issued in calendar year 2011. The proposed standard, as currently drafted, will have a material impact on the Company s reported results of operations and financial position. This exposure draft is non-cash in nature and will not impact the Company s cash position.

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

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

3. NET INCOME (LOSS) PER SHARE

Net income (loss) per share is computed under the provisions of Accounting Standards Codification topic 260, *Earnings Per Share*. Basic income per share is computed using net income (loss) and the weighted average number of shares of common stock outstanding. Diluted

earnings per share reflect the weighted average number of shares of common stock outstanding plus any potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, restricted stock awards, restricted stock units and conversion of shares of preferred stock. Common stock equivalent shares are excluded from the diluted computation if their effect is anti-dilutive.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(dollars in thousands, except per share amounts)			
Numerator:				
Net Income (loss)	$ (1,177)	$ (385)	$ (15,008)	$ 8,320
Denominator:				
Weighted average number of common shares:				
Basic	20,780	20,490	20,724	20,367
Diluted	20,780	20,490	20,724	21,161
Income (loss) per common share:				
Basic	$ (0.06)	$ (0.02)	$ (0.72)	$ 0.41
Diluted	$ (0.06)	$ (0.02)	$ (0.72)	$ 0.39

For the three and nine months ended September 30, 2011 and 2010, the following common stock equivalent shares were included in the calculation of the Company s diluted net income per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Equity Instruments:				
Restricted common stock units				12
Restricted common stock				98
Stock options				686
Total common stock equivalent shares				796

For the three and nine months ended September 30, 2011, outstanding stock options, restricted stock units and restricted stock of 2.2 million, 40,000 and 347,000, respectively, were not included in the diluted net loss per share calculation, as they were anti-dilutive.

Share based awards to purchase 1.3 million and 922,000 shares of common stock that had an exercise price in excess of the average market price of the common stock during the three and nine months ended September 30, 2010, were not included in the calculation of diluted earnings per share because they were anti-dilutive.

4. INVENTORY

Inventory consisted of the following (dollars in thousands):

	September 30, 2011	December 31, 2010
Raw materials	$ 4,781	$ 4,423
Finished goods	3,757	5,505
Total inventory	$ 8,538	$ 9,928

5. GOODWILL

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006 and the acquisition of certain assets of SGLC in November 2009. The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of Accounting Standards Codification topic 350, *Intangibles Goodwill and Other* (ASC 350). If an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value, goodwill will be evaluated for impairment between annual tests. For income tax purposes, the goodwill balance is amortized over a period of 15 years. Beginning in 2011, the Company began reporting its results in two reportable segments, which resulted in two reporting units for goodwill impairment purposes Consumer and Institutional. The Company s annual testing resulted in no impairments of goodwill since the dates of acquisition.

The following table represents the balance and changes in goodwill, by reporting unit, for the nine months ended September 30, 2011 (in thousands):

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	Consumer Operating Segment	Institutional Operating Segment	Total
Balance as of December 31, 2010	$ 15,685	$ 19,171	$ 34,856
Effect of change in foreign currency rate	(11)	(14)	(25)
Balance as of September 30, 2011	$ 15,674	$ 19,157	$ 34,831

6. INTANGIBLE ASSETS

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

	September 30, 2011			December 31, 2010		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trade name/ trademark	$ 10,607	$	$ 10,607	$ 10,607	$	$ 10,607
Core technology	2,453	(2,453)		2,453	(2,453)	
Customer relationships	10,841	(10,836)	5	10,844	(10,800)	44
Website	12	(12)		12	(12)	
Patents	300	(33)	267	300	(3)	297
Total	$ 24,213	$ (13,334)	$ 10,879	$ 24,216	$ (13,268)	$ 10,948

Amortization of intangible assets for the three months ended September 30, 2011 and 2010 totaled $24,000 and $13,000, respectively. For the three months ended September 30, 2011 and 2010, $10,000 and zero was included in research and development expense and $14,000 and $ 13,000 was included in sales and marketing expense, respectively.

Amortization of intangible assets for the nine months ended September 30, 2011 and 2010 totaled $71,000 and $41,000, respectively. For the nine months ended September 30, 2011 and 2010, $30,000 and zero was included in research and development expense and $41,000 and $41,000 was included in sales and marketing expense, respectively.

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining three months of 2011 and years thereafter (in thousands):

2011 remaining	$ 14
2012	40
2013	40
2014	40
2015	40
Thereafter	98
Total	$ 272

In accordance with Accounting Standards Codification topic 360, *Property, Plant, and Equipment*, the Company reviews its long-lived assets, including property and equipment and intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be fully recoverable. If the total of the expected undiscounted future net cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between the fair value and carrying amount of the asset. There were no impairment charges for the nine months ended September 30, 2011 or September 30, 2010.

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7. OTHER CURRENT LIABILITIES

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

	September 30, 2011	December 31, 2010
Marketing expenses	$ 12,269	$ 11,075
Professional and consulting fees	3,909	2,820
Sales return reserve	4,011	8,391
Taxes payable	1,737	2,722
Other	6,172	7,617
	$ 28,098	$ 32,625

8. BORROWING AGREEMENT

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

Interest expense for the three months ended September 30, 2011 and 2010 was $1,000 and $8,000, respectively.

Interest expense for the nine months ended September 30, 2011 and 2010 was $5,000 and $25,000, respectively.

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

9. INCOME TAXES

In accordance with Accounting Standards Codification topic 740, *Income Taxes*, and Accounting Standards Codification subtopic 740-270, *Income Taxes: Interim Reporting*, the income tax provision for the nine month period ended September 30, 2011 is based on the

estimated annual effective tax rate for fiscal year 2011. 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, change and create a different relationship between domestic and foreign income and loss.

The Company adopted Accounting Standards Codification topic 740-10-25, *Income Taxes: Overall: Background* (ASC 740-10-25) on January 1, 2007, which clarified the accounting for uncertainty in income taxes recognized in an enterprise s financial statements. 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.

At the adoption date, the Company had no material unrecognized tax benefits and no adjustments to liabilities or operations were required under ASC 740-10-25. During the three months ended September 30, 2011, the Company established a liability of $143,000 for unrecognized tax benefits associated with certain tax credits. The Company s practice is to recognize interest and penalty expense related to uncertain tax positions in income tax expense, which were zero at the adoption date and $3,000 for the nine months ended September 30, 2011.

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10. STOCK PLANS

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.

2009 Omnibus Incentive Plan

On February 27, 2009, the Company s Board of Directors approved a new Stock Incentive and Award Plan (the 2009 Plan) that provides for the ability of the Company to grant up to 2,437,744 new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. The stock incentive awards and options granted under the 2009 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. On May 26, 2011 the Board of Directors authorized and the Company s shareholders approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan.

Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants. At September 30, 2011 there were 1,627,642 shares available for future grant under the 2009 Plan.

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

Stock Options

The following table summarized the Company s stock option activity from January 1, 2011 to September 30, 2011:

	Options Outstanding		Weighted Average Exercise Price		Weighted Average Contractual Life (years)		Aggregate Intrinsic Value
Options Outstanding, January 1, 2011	2,020,927	$	13.25	$	7.36	$	17,733,080
Options granted	544,239		14.66				
Options exercised	(181,778)		4.37				
Options cancelled	(225,529)		18.70				
Options Outstanding, September 30, 2011	2,157,859		13.78		7.23		3,243,256
Vested and expected to vest at September 30, 2011	2,005,216		13.47		7.08		3,243,256
Exercisable at September 30, 2011	1,126,095		9.46		5.78		3,243,256

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As of September 30, 2011, there was approximately $8.9 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 2.8 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 using the simplified method in accordance with ASC 718.

Restricted Stock Awards

During the nine months ended September 30, 2011, 133,789 shares of restricted stock were granted. The aggregate grant date fair value of the awards was $2.1 million, which will be recognized on a straight-line basis as expense over the requisite service period of the awards, which is also the vesting period. During the nine months ended September 30, 2011, 44,556 shares of restricted stock were forfeited. As of September 30, 2011, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the statement of operations was $5.2 million and is expected to be recognized over a period of 2.62 years.

The following table summarized the Company s restricted stock award activity from January 1, 2011 to September 30, 2011:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2011	307,524	$ 21.69	
Awards granted	133,789	15.41	
Awards vested	(49,655)	20.77	
Awards cancelled	(45,235)	19.2	
Nonvested Awards, September 30, 2011	346,423	19.73	$ 6,834,926

Restricted Stock Units

During the nine months ended September 30, 2011, 17,471 restricted stock units were granted. The aggregate grant date fair value of the awards was $238,000, which was recognized as expense on the grant date, as the awards were immediately vested. The Company s 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 grant date.

Long Term Incentive Program

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

In accordance with the agreements communicated to the executives after the approval of the plan by the Board of Directors, the LTIP participants were granted minimum participation percentages of each tranche of shares issued at each milestone level reached. As of September 30, 2011, the target market capitalization required to trigger the first issuance of

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shares was below the minimum threshold, and no shares were issued. The minimum participation percentages given to plan participants were considered grants in accordance with the provisions of ASC 718. The grant date fair value of the minimum awards was $6.1 million which was derived using a Monte Carlo valuation model. This value will be amortized as stock-based compensation expense over the derived service period of 5 years. Stock-based compensation expense for unallocated LTIP shares will be recognized when the milestones are met, the Board determines the allocation to each individual, and the shares will be granted. The grant date fair value determined at that time will be amortized over the vesting period.

Stock-based compensation expense related to the LTIP was $0.3 million and $0.9 million for the three and nine months ended September 30, 2011, respectively. As of September 30, 2011, there was $5.2 million of unrecognized stock-based compensation expense related to minimum awards that is expected to be recognized over a period of 5 years.

As a result of the Company s stock price performance, the compensation committee of the board of directors is considering evaluating the effectiveness of the program. The compensation committee and the board of directors may consider taking actions regarding this program that could result in a non-cash charge of up to $5.0 million.

11. STOCKHOLDERS EQUITY

At September 30, 2011, the Company s Board of Directors had the authority to issue 200,000,000 shares of stock, of which 190,000,000 were designated as Common Stock, with a par value of $0.00005 per share, and 10,000,000 were designated as Preferred Stock, with a par value of $0.001 per share. At September 30, 2011, the Company had shares of common stock issued and outstanding of 21,244,981.

12. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases many kiosks, copiers, parking spaces, buildings, a warehouse, and office space under operating lease and site license arrangements, some of which contain renewal options. The rental payments under some kiosk site licenses are based on a minimum rental plus a percentage of the kiosk s sales in excess of stipulated amounts. Kiosk site licenses range from a period of one month to 89 months. Building, warehouse and office space leases range from 12 months to 89 months. Certain leases also include lease renewal options.

The following table summarizes future minimum operating lease payments for the remaining three months of 2011 and the years thereafter (in thousands):

Periods Ending December 31,

2011-remaining	$	2,767
2012		6,193
2013		4,267
2014		1,840
2015 and thereafter		388
	$	15,455

Rent expense was $3.2 million and $2.7 million for the three months ended September 30, 2011 and 2010, respectively. Rent expense was $10.2 million and $9.0 million for the nine months ended September 30, 2011 and 2010, respectively.

The Company accounts for its leases under the provisions of Accounting Standards Codification topic 840, *Accounting for Leases* (ASC 840), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense. The deferred rent liability was $0.7 million at September 30, 2011. The deferred rent asset was

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$16,000 at September 30, 2011. The deferred rent asset is classified in prepaid and other assets as all associated leases have less than one year remaining on their term.

Litigation

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

On or about April 28, 2010, a purported class action lawsuit was filed against the Company in the Superior Court of the State of California, County of Alameda for damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and other persons similarly situated who are or were employed as salaried managers by the Company in its retail locations in California are due unpaid wages and other relief for the Company s violations of state wage and hour laws. Plaintiffs moved to amend their complaint to include a nationwide class on January 21, 2011. On March 16, 2011, the case was removed to the United States District Court for the Northern District of California, Oakland Division. On October 27, 2011, a mediation of the case was held. In November 2011, the plantiffs attorneys and the Company agreed to the mediator s proposed settlement terms. As of September 30, 2011, we reserved $0.6 million with respect to the proposed settlement. Approval of the proposed settlement by the court is pending. We dispute the plantiffs claims and have not admitted any wrongdoing with respect to the case.

On or about March 24, 2011, a purported securities class action lawsuit was filed on behalf of persons who purchased the Company s publicly traded securities between February 25, 2010 and February 28, 2011 against the Company and certain of its present and former officers in the United States District Court for the Eastern District of Virginia alleging violations of federal securities law in connection with various public statements and alleged material omissions made by the Company. The complaint names as defendants Rosetta Stone Inc., Tom P.H. Adams, President and Chief Executive Officer, Brian D. Helman, former Chief Financial Officer, and Matthew C. Sysak, Vice President and Controller. On September 19, 2011, the United States District Court for the Eastern District of Virginia granted plaintiff s motion for leave to voluntarily dismiss its claims with prejudice. Although no settlement was paid, we incurred legal fees and other costs in the defense of these claims.

On June 23, 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG (Langenscheidt) in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone s use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. Langenscheidt is seeking, among other things, to enjoin Rosetta Stone GmbH from using the color yellow in Germany, a declaratory judgment that Rosetta Stone GmbH is liable for damages based on our activities in Germany, and the award of costs and attorneys fees associated with the legal proceeding. A hearing was held on October 27, 2011 and the presiding judge indicated his opinion that Rosetta Stone GmbH has infringed on Langenscheidt s German trademark. The court has encouraged the parties to enter into settlement discussions and has postponed rendering its decision until January 19, 2012. If settlement discussions are unsuccessful we intend to vigorously defend this matter including appealing of any decision by the District Court of Cologne. The outcome of the matter is currently not known, and the range of any potential loss is not reasonably estimatable at this time. Even if the plaintiff is unsuccessful in its claims against us, we will incur legal fees and other costs in the defense of these claims.

From time to time, 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, including those listed above, the ultimate outcome of which, in its judgment based on information currently available, are expected to have a material impact on its business, financial condition or results of operations.

13. SEGMENT INFORMATION

Beginning in 2011, we started to manage our business in two operating segments Consumer and Institutional. These segments also represent our reportable segments.

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

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

Operating results by segment for the three and nine months ended September 30, 2011 and 2010 were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenue:				
Consumer	$ 48,712	$ 46,610	$ 141,993	$ 144,230
Institutional	15,490	14,316	45,929	40,358
Total Revenue	$ 64,202	$ 60,926	$ 187,922	$ 184,588
Segment contribution:				
Consumer	$ 16,220	$ 15,325	$ 44,820	$ 60,304
Institutional	8,874	9,447	28,060	27,326
Total segment contribution	25,094	24,772	72,880	87,630
Unallocated expenses, net:				
Amortization of acquired intangibles	10		30	
Stock-based compensation	1,654	959	4,489	2,741
Unallocated cost of sales	5,440	3,835	16,161	8,253
Unallocated sales and marketing	6,829	4,698	21,569	13,505
Unallocated research and development	4,577	5,709	16,698	16,711
Unallocated general and administrative	12,618	11,245	39,037	36,107
Total unallocated expenses, net	31,128	26,446	97,984	77,317
Operating income (loss)	**(6,034)**	**(1,674)**	**(25,104)**	**10,313**
Other income, net	95	130	302	8
Income (loss) before provision for income taxes	$ (5,939)	$ (1,544)	$ (24,802)	$ 10,321

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Geographic Information

Revenue by major geographic region is based primarily upon the geographic location of the customers who purchase our products. The geographic locations of distributors and resellers who purchase and resell our products may be different from the geographic locations of end customers. The information below summarizes revenue from customers by geographic area for the three and nine months ended September 30, 2011 and 2010 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
United States	$ 51,708	$ 50,390	$ 146,396	$ 155,005
International	12,494	10,536	41,526	29,583
Total Revenue	$ 64,202	$ 60,926	$ 187,922	$ 184,588

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q (this Report) contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward- looking statements. The statements contained in this Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are often identified by the use of words such as, but not limited to, anticipate, believe, can, continue, could, estimate, expect, intend, may, will, plan, project, seek, should, target, would, and similar expressions or variations intende forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2011. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. Unless the context otherwise requires, references in this Report to we , us or our shall mean the Company.

Overview

We are a leading provider of technology-based language learning solutions. We develop, market, and sell language learning solutions consisting of software, online services and audio practice tools primarily under our *Rosetta Stone* brand. Our teaching method, which we call *Dynamic Immersion*, is designed to leverage the innate, natural language learning ability that children use to learn their native language. Our courses are based on our proprietary interactive technologies and pedagogical content and utilize a sophisticated sequencing of images, text and sounds to teach a new language without translation or grammar explanation. We believe our award-winning solutions provide an effective, convenient and fun way to learn languages. We currently offer our self-study language learning solutions in 34 languages. Our customers include individuals, educational institutions, armed forces, government agencies and corporations.

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages, which have enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 82% of our revenue for the year ended December 31, 2010 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Barnes & Noble, Best Buy, Books-a-Million, Staples, Costco and Office Depot.

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

- our ability to expand our presence and penetration of existing markets;

- the extent to which we can sell new products and services to existing customers;
- our success in expanding our brand;
- the evolution of our product and service offerings; and
- our ability to expand our presence and reach geographically.

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

- customer acceptance of our product and service offerings;

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

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

Components of Our Statement of Operations

Revenue

We derive revenue from sales of language learning solutions consisting of packaged software and audio practice products and online software subscriptions. Revenue is presented as product revenue or subscription and service revenue in our consolidated financial statements. Our audio practice products are normally combined with our packaged software products and sold as a solution.

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

We sell our solutions directly to individuals, educational institutions, corporations, government agencies and armed forces. We distribute our consumer products predominantly through our direct sales channels, primarily our websites and call centers, which we refer to as our direct-to-consumer channel. We also distribute our consumer products through our kiosks, which we own, as well as through select retailers. The majority of our consumer customers purchase our packaged software and audio practice products, online software subscriptions and professional services. We sell to institutions primarily through our direct institutional sales force. Many institutions elect to license our products on a subscription basis. For purposes of explaining variances in our revenue, we separately discuss changes in our consumer and institutional sales channels because the customers and revenue drivers of these channels are different. Revenues were flat during the first nine months of 2011. We anticipate that in the fourth quarter of 2011, revenues will be flat to down due to softness in the U.S. Consumer, Japanese Consumer, and Worldwide Institutional businesses.

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For the three and nine months ended September 30, 2011, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current year presentation. This presentation is also consistent with how we manage the home school channel.

Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2010 accounted for 29% of our annual revenue in 2010. Our institutional revenue is seasonally stronger in the second and third quarters of the calendar year due to education and government purchasing cycles. We expect these trends to continue, however government budget reductions may negatively affect future revenue.

Cost of Product and Subscription and Service Revenue

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

Operating Expenses

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

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

Sales and Marketing. Our sales and marketing expenses consist primarily of direct advertising expenses related to television, print, radio, online and other direct marketing activities, personnel costs for our sales and marketing staff, rental payments for our kiosks and commissions paid to our sales personnel. Sales and marketing expenses also include amortization expense of intangible assets related to customer relationships associated with the 2006 acquisition of Fairfield & Sons, Ltd. These intangible assets were fully amortized by January 2009. In 2007, we began to make significant investments to expand our sales and marketing operations in Europe and Japan. In 2009, we began to make significant investments to expand our sales and marketing operations in South Korea, in 2010 we established an office in Germany, and in 2011 we established offices in Brazil and China. In each case we established local sales offices, added employees and launched marketing and public relations campaigns within the region. We intend to continue to expand our sales activities within these regions as well as to expand our presence into new countries, in addition to expanding our media and advertising campaigns in the United States. As a result, we expect sales and marketing expenses to continue to increase in future periods.

Research and Development. Research and development expenses consist primarily of personnel costs and contract development fees associated with the development of our solutions. Our development efforts are primarily based in the United States and are devoted to expanding our product portfolio through the addition of new content and new complimentary products and services to our language learning solutions. We expect our investment in research and development expenses to increase in future years but provide us with significant benefits in the future.

General and Administrative. General and administrative expenses consist primarily of personnel costs of our executive, finance, legal, human resources and other administrative personnel, as well as accounting and legal professional services fees and other corporate expenses. In 2011, there have been and we expect that there will continue to be increases to certain general and administrative expenses to support our expansion into new international markets. However, we also are taking steps to reduce certain general and administrative expenses as we realign our resources with our business priorities.

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Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Interest expense is primarily related to our long-term debt, the outstanding balance of which was zero as of September 30, 2011 and December 31, 2010. Interest income represents interest received on our cash and cash equivalents.

Income Tax Expense (Benefit)

For the nine months ended September 30, 2011, our worldwide effective tax rate was approximately 39%. For the year ended December 31, 2010, our effective tax rate was approximately (3%) primarily as a result of the release of the valuation allowance on deferred tax assets in the United Kingdom and Japan subsidiaries. The effective rate includes federal, state and international components. Our worldwide rate may vary on a quarterly and annual basis based upon the contribution of international operations to taxable income and any changes in applicable federal, state or international income tax rates. We expect our worldwide rate to be approximately 35-40% in 2011, and 28-35% in subsequent years assuming no general change in federal, state or foreign income tax rates applicable to companies such as ours.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition for Arrangements with Multiple Deliverables

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

We have identified two deliverables generally contained in arrangements involving the sale of online services bundled with auxiliary items. The first deliverable is the auxiliary items, which are delivered at the time of sale, and the second deliverable is the online services. We allocate revenue between these two deliverables using the relative selling price method. Amounts allocated to the auxiliary items are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services. The auxiliary item cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

We have identified two deliverables generally contained in Rosetta Stone V4 *TOTALe* software arrangements. The first deliverable is the packaged software, which is delivered at the time of sale, and the second deliverable is the dedicated conversational coaching online services. We allocate revenue between these two deliverables using the relative selling price method. Amounts allocated to the software are recognized at the time of sale, provided the other conditions for revenue recognition have been met. Amounts allocated to the online services are deferred and recognized on a straight-line basis over the term of the online services or upon expiry of the online services. The language learning software cost of sales are generally recognized at the time of sale. Costs for online services and sales and marketing are expensed as incurred.

We account for multiple element arrangements that consist only of software or software related products, in accordance with industry specific accounting guidance for software and software related transactions. For such transactions,

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revenue on arrangements that include multiple elements is allocated to each element based on the relative fair value of each element, and fair value is generally determined by VSOE. If we cannot objectively determine the fair value of any undelivered element included in such multiple element arrangements, we defer revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements.

Goodwill

In accordance with ASC 350, goodwill is not amortized and is tested for impairment annually on June 30th and whenever events and circumstances occur indicating goodwill might be impaired. Beginning in 2011, we began reporting our results in two reporting units Consumer and Institutional. The first step is a screen for potential impairment by comparing the fair value of our reporting units with their carrying amount. The second step measures the amount of impairment loss, if any. As of the last annual testing date, we reviewed the goodwill for impairment and determined that no impairment of goodwill was identified during any of the periods presented, nor are the reporting units at risk of failing step one of the goodwill impairment test. If in the forth quarter or any subsequent quarter, we identify events or changes in circumstances that could impact the fair value of our reporting units (e.g. dramatic decrease in our stock price), we will evaluate if an impairment exists at that time.

For further information on our critical and other significant accounting policies, see our Annual Report on Form 10-K filed with the SEC on March 14, 2011.

We believe that the following critical accounting policies involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements:

- Revenue Recognition
- Stock-based Compensation
- Income Taxes
- Allowance for Doubtful Accounts Receivable
- Sales Return Reserve
- Goodwill
- Other Intangible Assets

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Results of Operations

The following table sets forth our consolidated statements of operations for the periods specified, including dollar and percentage of change from the prior periods indicated:

	Three months ended September 30,		2011 versus 2010	
	2011	2010	Change	% Change
	(in thousands, except percentages)			
Revenue				
Product	$ 44,183	$ 49,407	$ (5,224)	-10.6%
Subscription and service	20,019	11,519	8,500	73.8%
Total revenue	64,202	60,926	3,276	5.4%
Cost of revenue				
Cost of product revenue	7,862	8,749	(887)	-10.1%
Cost of subscription and service revenue	3,447	1,680	1,767	105.2%
Total cost of revenue	11,309	10,429	880	8.4%
Gross margin	52,893	50,497	2,396	4.7%
Operating Expenses:				
Sales and marketing	39,821	34,093	5,728	16.8%
Research and development	4,991	6,030	(1,039)	-17.2%
General and administrative	14,115	12,048	2,067	17.2%
Total operating expenses	58,927	52,171	6,756	12.9%
Income (loss) from operations	(6,034)	(1,674)	(4,360)	260.5%
Other income and expense:				
Interest income	62	85	(23)	-27.1%
Interest expense	(1)	(8)	7	-87.5%
Other (expense) income	34	53	(19)	35.8%
Total interest and other income (expense), net	95	130	(35)	26.9%
Income (loss) before income taxes	(5,939)	(1,544)	(4,395)	284.7%
Income tax expense (benefit)	(4,762)	(1,159)	(3,603)	310.9%
Net income (loss)	(1,177)	$ (385)	$ (792)	205.7%

Comparison of the three months ended September 30, 2011 and the three months ended September 30, 2010

Our revenue increased to $64.2 million for the three months ended September 30, 2011 from $60.9 million for the three months ended September 30, 2010. The increase in revenue was primarily due to international growth of $1.3 million and US consumer growth of $0.8 million over the prior year period. Bookings, calculated as revenue plus the change in deferred revenue, decreased to $66.1 million for the three months ended September 30, 2011 from $73.3 million for the three months ended September 30, 2010. The decrease in bookings was due to a $3.5

million decrease in consumer net bookings, primarily in the U.S. and Asia, and a $3.7 million decrease in institutional net bookings. The consumer average selling price per unit decreased from $397 to $326, resulting in a $10.4 million decrease in revenue, which was partially offset by an increase in consumer units sold from 128,000 to 146,000, or 14%, during the three months ended September 30, 2011, compared to the prior year period, resulting in a $6.9 million increase in revenue. Institutional net bookings decreased from $22.3 million for the three months ended September 30,

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2010 to $18.5 million for the three months ended September 30, 2011. This decrease was primarily related to the non-renewal of two annual online subscriptions by the U.S. Army and the U.S. Marines Corps.

We reported an operating loss of $6.0 million during the three months ended September 30, 2011 compared to an operating loss of $1.7 million during the three months ended September 30, 2010. The operating loss was primarily due to an increase in operating expenses of $6.8 million partially offset by an increase in gross profit of $2.4 million. The increase in operating expenses was primarily due to $0.6 million in personnel-related costs, $3.4 million in increased media and marketing activities, primarily in Asia, $1.2 million increase in professional services and $0.5 million increase in depreciation and amortization expenses incurred to support the business expansion outside of the U.S., and $0.6 million increase in lease abandonment due to the reversal of the lease abandonment expenses in Q310.

As of September 30, 2011 and September 30, 2010 we employed approximately 1,800 and 2,000 personnel, respectively, including full time, part-time and temporary employees.

Revenue by Operating Segment

The following table sets forth revenue for each of our two operating segments for the three months ended September 30, 2011 and 2010:

	Three months ended September 30,				2011 versus 2010	
	2011		2010		Change	% Change
	(in thousands, except percentages)					
Consumer:						
Direct-to-Consumer	$ 31,177	48.6%	$ 27,500	45.1%	$ 3,677	13.4%
Kiosk	6,987	10.9%	7,392	12.1%	(405)	-5.5%
Retail	9,015	14.0%	9,832	16.1%	(817)	-8.3%
Homeschool	1,533	2.4%	1,886	3.1%	(353)	-18.7%
Total consumer revenue	48,712	75.9%	46,610	76.5%	2,102	4.5%
Institutional	15,490	24.1%	14,316	23.5%	1,174	8.2%
Total Revenue	$ 64,202	100.0%	$ 60,926	100.0%	$ 3,276	5.4%

Consumer Segment

Consumer revenue was $48.7 million for the three months ended September 30, 2011, an increase of $2.1 million, or 5%, from the three months ended September 30, 2010. Consumer bookings, calculated as revenue plus the change in deferred revenue, decreased to $47.5 million for the three months ended September 30, 2011 from $51.0 million for the three months ended September 30, 2010. The decrease in bookings was due to lower sales in the U.S. The consumer average selling price per unit decreased from $397 to $326, resulting in a $10.4 million decrease in revenue, which was partially offset by an increase in consumer units sold from 128,000 to 146,000, or 14% during the three months ended September 30, 2011, compared to the prior year period, resulting in a $6.9 million increase in revenue. The decrease in average selling price per unit was the result of our ongoing price testing across all channels in the U.S. market.

There was a $5.6 million decrease in consumer deferred revenue during the three months ended September 30, 2011 compared to the prior year period, which was primarily related to revenue recognized for Version 4 *TOTALe* online services.

Product revenue represented 83% of total consumer revenue for the three months ended September 30, 2011, with the balance attributable to subscription and service revenue. We began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions in the U.S. consumer market during the third quarter of 2010, Japan during the first quarter of 2011 and the United Kingdom during the second quarter of 2011, with the launch of Rosetta Stone Version 4 *TOTALe*. As a result, we defer approximately 10% - 25% of the

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revenue of each of these bundled sales. We will recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition.*

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

Direct-to-Consumer

Direct-to-consumer revenue was $31.2 million for the three months ended September 30, 2011, an increase of $3.7 million, or 13%, from the three months ended September 30, 2010. The increase in direct-to-consumer revenue was primarily driven by $1.7 million in growth in our international direct-to-consumer markets and a $2.0 million increase in our U.S. direct-to-consumer business. The worldwide average selling price per unit increased 1% during the three months ended September 30, 2011 compared to the prior year period, resulting in a $0.3 million increase in revenue. The number of units sold increased 10% during the three months ended September 30, 2011 compared to the prior year period, resulting in a $2.7 million increase in revenue. There was a $0.7 million decrease in direct-to-consumer deferred revenue during the three months ended September 30, 2011 compared to the prior year period, which was primarily related to revenue recognized for Version 4 *TOTALe* online services.

During the quarter, we experienced softness in the DTC channel in Japan and we are working to improve our messaging and performance. At this point it is unclear our new messaging will be successful.

Kiosk

Kiosk revenue was $7.0 million for the three months ended September 30, 2011, a decrease of $0.4 million, or 5%, from the three months ended September 30, 2010. The number of worldwide kiosks decreased 23% from 257 as of September 30, 2010 to 197 as of September 30, 2011. The number of units sold decreased 2% during the three months ended September 30, 2011 compared to the prior year period, resulting in a $0.2 million decrease in revenue, primarily related to the decrease in kiosks. The worldwide average selling price per unit decreased 24% as a result of changes to the pricing of our products in the U.S. market during the three months ended September 30, 2011, compared to the prior year period, resulting in a $2.0 million decrease in revenue. There was a $1.8 million decrease in kiosk deferred revenue during the three months ended September 30, 2011 compared to the prior year period, primarily related to revenue recognized for Version 4 *TOTALe* online services. We plan to continually review kiosk performance in 2011 and we may close more underperforming kiosk locations.

Retail

Retail revenue was $9.0 million for the three months ended September 30, 2011, a decrease of $0.8 million or 8% from the three months ended September 30, 2010. The worldwide average selling price per unit decreased 46% during the three months ended September 30, 2011 compared to the prior year period, resulting in a $7.4 million decrease in revenue, which was partially offset by an increase in units sold of 28% during the three months ended September 30, 2011, compared to the prior year period, resulting in a $3.5 million increase in revenue. The decrease in

average selling price per unit was the result of the company decreasing prices across all channels in the U.S. market. There was a $3.1 million decrease in retail deferred revenue during the three months ended September 30, 2011 compared to the prior year period, which was primarily related to revenue recognized for Version 4 *TOTALe* online services.

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

The majority of our sales in our Korean subsidiary are generated by sales on home shopping television networks. During the quarter, sales of most educational products on home shopping networks were down, including our products. We are working on changes to our go to market strategy, including changes in price and messaging to improve sales in this important channel, but it is too early to tell whether these changes will improve sales performance.

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Home School

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

Home school revenue was $1.5 million for the three months ended September 30, 2011, a decrease of $0.4 million or 19% from the three months ended September 30, 2010. The average selling price per unit decreased 31% as a result of changes to the pricing of our products in the U.S. market during the three months ended September 30, 2011 compared to the prior year period, resulting in a $0.7 million decrease in revenue, which was partially offset by a 19% increase in units sold during the three months ended September 30, 2011, compared to the prior year period, resulting in a $0.3 million increase in revenue.

Institutional Segment

Institutional revenue was $15.5 million for the three months ended September 30, 2011, an increase of $1.2 million, or 8%, compared to the three months ended September 30, 2010. The increase in institutional revenue was primarily due to the expansion of our direct sales force and a shift from sales of perpetual licenses to sales of renewing online subscriptions. As a result, we had a $1.1 million increase in education revenue and a $0.7 million increase in corporate and non-profit revenue in 2011, compared to the prior year period. These increases were partially offset by a $0.6 million decrease in governmental revenues, primarily as a result of government budget cuts including the non-renewal of the U.S. Army and U.S. Marines Corps contracts.

Institutional bookings, calculated as revenue plus the change in deferred revenue, decreased to $18.6 million for the three months ended September 30, 2011 from $22.3 million for the three months ended September 30, 2010. The decrease in bookings was due to a $5.0 million decrease in government bookings as a result of the non-renewal of the U.S. Army & U.S. Marines Corps contracts, partially offset by a $1.2 million increase in education bookings and a $0.1 million increase in corporate and non-profit bookings in 2011 compared to the prior year period. We expect weakness in government bookings to continue, and our qualified pipeline for corporate bookings in Q4 was not as strong as it was last year.

Product revenue represented 24% of total institutional revenue for the three months ended September 30, 2011, and subscription and service revenue represented 76% for the same period.

Revenue by Product Revenue and Subscription and Service Revenue

We categorize and report our revenue in two categories product revenue and subscription and service revenue. The following table sets forth revenue for products and subscription and services for the three months ended September 30, 2011 and 2010:

	Three months ended September 30,				2011 versus 2010	
	2011		2010		Change	% Change
	(in thousands, except percentages)					
Product revenue	$ 44,183	68.8%	$ 49,407	81.1%	$ (5,224)	-10.6%
Subscription and service revenue	20,019	31.2%	11,519	18.9%	8,500	73.8%
Total revenue	64,202	100.0%	60,926	100.0%	3,276	5.4%

Product Revenue

Product revenue decreased $5.2 million, to $44.2 million during the three months ended September 30, 2011 from $49.4 million during the three months ended September 30, 2010. Consumer product revenue decreased $4.4 million, primarily as a result of the allocation of revenue to the online services component of our software. At the launch of Rosetta Stone Version 4 *TOTALe* in the U.S. consumer market during the third quarter of 2010, we began bundling time-based subscription licenses of our web-based *TOTALe Studio and Rosetta World* services with perpetual licenses of the *Course*, which previously comprised our Rosetta Stone Version 3 language learning solutions. Approximately 10% - 25% of each of these bundled sales is allocated to online services. Institutional product revenues decreased $0.8 million as a result of a shift from sales of perpetual licenses to sales of renewing online subscriptions.

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Service and Support Revenue

Subscription and service revenue increased approximately 74%, or $8.5 million, to $20.0 million for the three months ended September 30, 2011, from $11.5 million during the three months ended September 30, 2010. The increase in subscription and service revenues was due to a $6.5 million increase in consumer online service revenue related to Version 4 *TOTALe* and a $2.0 million increase in institutional subscription and service revenue related to growth in the institutional customer base with renewing online subscriptions.

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

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the three months ended September 30, 2011 and 2010:

	Three months ended September 30,		2011 versus 2010	
	2011	2010	Change	% Change
	(in thousands, except percentages)			
Revenue				
Product	$ 44,183	$ 49,407	$ (5,224)	-10.6%
Subscription and service	20,019	11,519	8,500	73.8%
Total revenue	64,202	60,926	3,276	5.4%
Cost of revenue				
Cost of product revenue	7,862	8,749	(887)	-10.1%
Cost of subscription and service revenue	3,447	1,680	1,767	105.2%
Total cost of revenue	11,309	10,429	880	8.4%
Gross profit	$ 52,893	$ 50,497	$ 2,396	4.7%
Gross margin percentages	82.4%	82.9%	-0.5%	

Cost of Product Revenue

Cost of product revenue for the three months ended September 30, 2011 was $7.9 million, a decrease of $0.9 million, or 10%, from the three months ended September 30, 2010. As a percentage of product revenue, cost of product revenue remained flat at 18% for the three months ended September 30, 2011 and September 30, 2010, respectively. The dollar decrease in cost was primarily attributable to a $1.3 million decrease in expense for inventory obsolescence and scrap associated with the U.S. Version 4 *TOTALe* launch in the third quarter of 2010. We are exploring the possibility of moving more of our business on-line, which should reduce the cost of product revenue as the cost of producing and shipping CD s would decline. However, we could experience a temporary increase in the cost of our product revenue as we scrap existing packaging.

Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the three months ended September 30, 2011 was $3.4 million, an increase of $1.8 million, or 105% from the three months ended September 30, 2010. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 17% for the three months ended September 30, 2011 compared to 15% for the three months ended September 30, 2010. The increase in cost was primarily attributable to a $1.2 million increase in personnel-related expenses as a result of our web-based service offerings in our Version 4 *TOTALe* and *ReFLEX* products that include a component of dedicated online language conversation coaching and higher direct costs to deliver to customers than our previous software solutions. We expect our cost of

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subscription and service revenue will increase in future periods, as a percent of revenue, associated with the launch of our Version 4 *TOTALe* solutions in our international markets.

Operating Expenses

	Three months ended September 30,				2011 versus 2010		
		2011		2010		Change	% Change
	(in thousands, except percentages)						
Sales and marketing		39,821	$	34,093	$	5,728	16.8%
Research and development		4,991		6,030		(1,039)	-17.2%
General and administrative		14,115		12,048		2,067	17.2%
Total operating expenses	$	58,927	$	52,171	$	6,756	12.9%

Sales and Marketing Expenses

Sales and marketing expenses for the three months ended September 30, 2011 were $39.8 million, an increase of $5.7 million, or 17%, from the three months ended September 30, 2010. As a percentage of total revenue, sales and marketing expenses were 62% for the three months ended September 30, 2011, compared to 56% for the three months ended September 30, 2010. The dollar and percentage increase in sales and marketing expenses were primarily attributable to the continued expansion of our direct marketing activities in the U.S. and international markets. Media and marketing activities grew by $3.5 million, primarily outside of the U.S., including increased media associated with the launch of Version 4 *TOTALe* and *ReFLEX*, our English remediation solution for our Asian markets, in Korea, and increased internet marketing due to increased spending in online social media networks. Personnel-related costs as a result of growth in our institutional sales channel, non-kiosk consumer, and marketing and sales support activities increased by $1.5 million over the prior year period. Additionally, professional service related expenses increased by $1.1 million over the prior period as a result of increased consulting and clerical service expenses related to institutional and international retail sales. These costs were partially offset by a decrease of $1.1 million in kiosk related expenses as the number of worldwide kiosks decreased from 257 as of September 30, 2010 to 197 as of September 30, 2011. We plan to continually evaluate our kiosk performance balancing the positive branding with the profitability of the kiosk, potentially closing additional underperforming kiosk locations.

Research and Development Expenses

Research and development expenses for the three months ended September 30, 2011 were $5.0 million, a decrease of $1.0 million, or 17%, from the three months ended September 30, 2010. As a percentage of total revenue, research and development expenses were 8% for the three months ended September 30, 2011, compared to 10% for the three months ended September 30, 2010. The dollar decrease was primarily attributable to a decrease in consulting and personnel related costs of $0.7 million and a decrease in hosting communication costs of $0.2 million. We expect research and development expenses to increase in future periods as we continue to develop *ReFLEX,* our English remediation solution for our Asian markets, invest in new platforms such as the iPad, continue to roll out our Version 4 *TOTALe* product in our international markets, and support institutional development initiatives.

General and Administrative Expenses

General and administrative expenses for the three months ended September 30, 2011 were $14.1 million, an increase of $2.1 million, or 17%, from the three months ended September 30, 2010. As a percentage of total revenue, general and administrative expenses were 22% for the three months ended September 30, 2011, compared to 20% for the three months ended September 30, 2010. The dollar increase was primarily attributable to increased investment in our IT and infrastructure and other administrative functions which enable continued support for our international expansion. Consulting expenses increased $1.5 million, primarily related to investment in our IT infrastructure and legal. IT and infrastructure expenses increased $0.7 million related to hardware and software upgrades, hosting, and telephone expenses. There was also an increase in sales and use tax of $0.4 million related to a New York State tax credit in Q3 of 2010, $0.3 million increase in

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personnel-related expenses, and $0.4 million increase in capitalized project expenses as a result of allocating project expenses based on the nature of the project. These increases were partially offset by a $1.1 million decrease in legal fees associated with our trademark infringement lawsuit against Google, Inc., other intellectual property enforcement actions, and a $0.5 million decrease in lease abandonment. In 2011, there have been and we expect there will continue to be increases to certain general and administrative expenses to support expansion into new international markets. However, we also are taking steps to reduce certain general and administrative expenses as we realign our resources with our business priorities.

In connection with the transition agreement between the Company and our chief executive officer, certain previously issued stock option grants made to our chief executive officer will continue to vest after his transition to non-employee director. This constitutes a modification of his original stock option agreement, accordingly we expect to record an additional non-cash charge of approximately $0.5 million to $1.5 million as a result of the modification at the time he becomes a non-employee director.

Additionally, in accordance with the terms of the transition agreement, our chief executive officer is eligible to receive a transition bonus in the amount of $575,000 to continue in his role until a successor is hired. The transition bonus will be paid after the transition is made to the new chief executive officer. Beginning in the fourth quarter of 2011, we expect to record the expense related to the transition bonus which will be recognized ratably over the estimated term of the transition, which we estimate to be six months.

Interest and Other Income (Expense)

	Three months ended September 30,		2011 versus 2010	
	2011	**2010**	**Change**	**% Change**
	(in thousands, except percentages)			
Interest Income	$ 62	$ 85	$ (23)	-27.1%
Interest Expense	(1)	(8)	7	-87.5%
Other Income (Expense)	34	53	(19)	35.8%
Total other income (expense)	$ 95	$ 130	$ (35)	26.9%

Interest income represents interest earned on our cash and cash equivalents. Interest income for the three months ended September 30, 2011 was $62,000, a decrease of $ 23,000, or 27%, from the three months ended September 30, 2010.

Interest expense is primarily related to our short-term investment account as well as interest related to our other operating leases. Interest expense for the three months ended September 30, 2011 was $1,000, a decrease of $7,000 or 88%, from the three months ended September 30, 2010. We expect interest expense to be minimal in future periods as we allowed the revolving line of credit with Wells Fargo to expire on January 17, 2011.

Other income for the three months ended September 30, 2011 was $34,000 a decrease of $19,000 or 36% from the three months ended September 30, 2010. The decrease was primarily due to a loss on short-term investments.

Income Tax Benefit

	Three months ended September 30,		2011 versus 2010	
	2011	2010	Change	% Change
	(in thousands, except percentages)			
Income tax expense (benefit)	$ (4,762)	$ (1,159)	$ (3,603)	310.9%

Income tax benefit for the three months ended September 30, 2011 was $4.8 million, compared to $1.2 million for the three months ended September 30, 2010. The change was the result of a decrease of $4.4 million in pre-tax income for the three months ended September 30, 2011 and an increase in our effective tax rate. Our effective tax rate was 80% for the three months ended September 30, 2011 compared to 75% for the three months ended September 30, 2010. The change in our effective tax rate was a result of changes in the geographic distribution of our income.

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Comparison of the nine months ended September 30, 2011 and the nine months ended September 30, 2010

	Nine months ended September 30, 2011	Nine months ended September 30, 2010	2011 versus 2010 Change	% Change
	(in thousands, except percentages)			
Revenue				
Product	$ 134,541	$ 154,025	$ (19,484)	-12.6%
Subscription and service	53,381	30,563	22,818	74.7%
Total revenue	187,922	184,588	3,334	1.8%
Cost of revenue				
Cost of product revenue	25,430	23,041	2,389	10.4%
Cost of subscription and service revenue	8,861	3,631	5,230	144.0%
Total cost of revenue	34,291	26,672	7,619	28.6%
Gross margin	153,631	157,916	(4,285)	-2.7%
Operating Expenses:				
Sales and marketing	118,175	91,896	26,279	28.6%
Research and development	17,829	17,600	229	1.3%
General and administrative	42,731	38,107	4,624	12.1%
Total operating expenses	178,735	147,603	31,132	21.1%
Income (loss) from operations	(25,104)	10,313	(35,417)	-343.4%
Other income and expense:				
Interest income	224	191	33	17.3%
Interest expense	(5)	(25)	20	-80.0%
Other (expense) income	83	(158)	241	152.5%
Total interest and other income (expense), net	302	8	294	-3675.0%
Income (loss) before income taxes	(24,802)	10,321	(35,123)	-340.3%
Income tax expense (benefit)	(9,794)	2,001	(11,795)	-589.5%
Net income (loss)	$ (15,008)	$ 8,320	$ (23,328)	-280.4%

Our revenue increased $3.3 million to $187.9 million for the nine months ended September 30, 2011 from $184.6 million for the nine months ended September 30, 2010. The increase in revenue was primarily due to international growth of $2.0 million over the prior year period. Bookings, calculated as revenue plus the change in deferred revenue, decreased from $198.1 million for the nine months ended September 30, 2010 to $188.4 million for the nine months ended September 30, 2011. The decrease in bookings was primarily due to a $19.3 million decrease in U.S. consumer net bookings and a $2.2 million decrease in institutional net bookings, partially offset by an $11.8 million increase in international consumer net bookings. The U.S. consumer selling price per unit decreased from $387 to $320, or 17%, during the nine months ended September 30, 2011, compared to the prior year period, resulting in a $21.3 million decrease in revenue. The decrease in average selling price per unit was the result of lower prices across all channels in the U.S. market. Our U.S. consumer units sold increased from 314,000 to 319,000, or 2%, during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $2.0 million increase in revenue.

We reported an operating loss of $25.1 million during the nine months ended September 30, 2011 compared to operating income of $10.3 million in the nine months ended September 30, 2010. The operating loss was due to a decrease in gross profit of $4.3 million, from $ 157.9 million to $153.6 million, and an increase in operating expenses of $31.1 million. The decrease in gross profit was primarily due to higher direct

costs associated with our web-based services offering Version 4

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TOTALe that include higher direct costs to deliver to customers than our previous software solutions. The increase in operating expenses was primarily due to $8.7 million in personnel-related costs, $16.4 million in increased media and marketing activities, primarily outside of the U.S., $0.7 million increase in professional services and $1.6 million increase in depreciation and amortization expenses incurred to support the business expansion outside of the U.S., and $0.6 million increase in lease abandonment due to the reversal of the lease abandonment expenses in Q310.

Revenue by Operating Segment

The following table sets forth revenue for each of our two operating segments for the nine months ended September 30, 2011 and 2010:

	Nine months ended September 30,				2011 versus 2010	
	2011		2010		Change	% Change
	(in thousands, except percentages)					
Consumer:						
Direct-to-Consumer	$ 94,016	50.0%	$ 83,667	45.3%	$ 10,349	12.4%
Kiosk	21,668	11.5%	25,467	13.8%	(3,799)	-14.9%
Retail	22,352	11.9%	30,640	16.6%	(8,288)	-27.0%
Homeschool	3,958	2.1%	4,456	2.4%	(498)	-11.2%
Total consumer revenue	141,994	75.6%	144,230	78.1%	(2,236)	-1.6%
Institutional	45,928	24.4%	40,358	21.9%	5,570	13.8%
Total Revenue	$ 187,922	100.0%	$ 184,588	100.0%	$ 3,334	1.8%

Consumer Segment

Consumer revenue was $142.0 million for the nine months ended September 30, 2011, a decrease of $2.2 million, or 2%, from the nine months ended September 30, 2010. Consumer bookings, calculated as revenue plus the change in deferred revenue, decreased from $149.6 million for the nine months ended September 30, 2010 to $142.1 million for the nine months ended September 30, 2011. The decrease in bookings was due to a $19.3 million decrease in U.S. consumer net bookings, partially offset by an $11.8 million increase in international consumer net bookings. The worldwide average selling price per unit decreased from $393 to $355, resulting in a $15.1 million decrease in revenue, which was partially offset by an increase in the consumer units sold from 380,000 to 400,000 or 5% during the nine months ended September 30, 2011, compared to the prior year period, resulting in a $7.6 million increase in revenue. There was a $5.3 million decrease in deferred revenue during the nine months ended September 30, 2011 compared to the prior year period, which was primarily deferred revenue for Version 4 *TOTALe* online services.

Product revenue represented 13% of total consumer revenue for the nine months ended September 30, 2011, with the balance attributable to subscription and service revenue. We began bundling time-based subscription licenses of our web-based *TOTALe Studio and Rosetta World* services with perpetual licenses of the *Course,* which previously comprised our Rosetta Stone Version 3 language learning solutions, in the U.S. consumer market during the third quarter of 2010 with the launch of Rosetta Stone Version 4 *TOTALe*. As a result, we defer approximately 10% - 25% of each of these bundled sales. We will recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition.*

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

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Direct-to-Consumer

Direct-to-consumer revenue was $94.0 million for the nine months ended September 30, 2011, an increase of $10.3 million or 12%, from the nine months ended September 30, 2010. The increase in direct-to-consumer revenue was driven by $8.5 million in growth in our international direct-to-consumer markets and a $1.8 million increase in our U.S. direct-to-consumer business. The worldwide average selling price per unit increased 8% during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $6.8 million increase in revenue. Units sold increased 4% during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $3.4 million increase in revenue. There was a $0.1 million decrease in deferred revenue during the nine months ended September 30, 2011 compared to the prior year period, which was primarily related to revenue recognition for Version 4 *TOTALe* online services.

Kiosk

Kiosk revenue was $21.7 million for the nine months ended September 30, 2011, a decrease of $3.8 million, or 15%, from the nine months ended September 30, 2010. The number of worldwide kiosks decreased from 257 as of September 30, 2010 to 197 as of September 30, 2011. The worldwide average selling price per unit decreased 18% during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $4.7 million decrease in revenue. The number of units sold decreased 3% during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $0.9 million decrease in revenue, primarily due to the decrease in the number of kiosks. We plan to continually review kiosk performance for the remainder of 2011 and we may continue to close our underperforming kiosk locations. There was a $1.8 million decrease in deferred revenue during the nine months ended September 30, 2011 compared to the prior year period, which was primarily related to revenue recognition for Version 4 *TOTALe* online services.

Retail

Retail revenue was $22.4 million for the nine months ended September 30, 2011, a decrease of $8.3 million or 27% from the nine months ended September 30, 2010. The worldwide average selling price per unit decreased 40% during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $14.8 million decrease in revenue, partially offset by an 9% increase in units sold during the nine months ended September 30, 2011 compared to the prior year period, resulting in a $3.1 million increase in revenue. There was a $3.4 million decrease in deferred revenue during the nine months ended September 30, 2011 compared to the prior year period, which was primarily related to revenue recognized for Version 4 *TOTALe* online services.

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

Home School

For the nine months ended September 30, 2011, we reclassified our home school sales vertical from Institutional to Consumer. We believe the drivers of acquiring a home school customer are more aligned with a typical sale in our consumer sales vertical. Prior year information has been modified to conform to current year presentation.

Home school revenue was $4.0 million for the nine months ended September 30, 2011, a decrease of $0.5 million, or 11%, from the nine months ended September 30, 2010. In 2009, we began offering home school edition products through other sales channels, including direct-to-consumer call centers and our retail channels. As the availability of home school products in other sales channels increased during 2010, consumers began utilizing these new channels to make purchases.

Institutional Segment

Institutional revenue was $45.9 million for the nine months ended September 30, 2011, an increase of $5.6 million, or 14%, compared to the nine months ended September 30, 2010. The increase in institutional revenue was primarily due to the expansion of our direct sales force and a shift from sales of perpetual licenses to sales of renewing online subscriptions. As a

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result, we had a $4.1 million increase in education revenue and a $1.8 million increase in corporate and non-profit revenue in 2011, compared to the prior year period. Government revenue decreased $0.3 million primarily as a result of government budget cuts, including the non-renewal of the U.S. Army & U.S. Marines Corps contracts.

Product revenue represented 25% of total institutional revenue for the nine months ended September 30, 2011, and subscription and service revenue represented 75% for the same period.

Revenue by Product Revenue and Subscription and Service Revenue

We categorize and report our revenue in two categories product revenue and subscription and service revenue. The following table sets forth revenue for products and subscription and services for the nine months ended September 30, 2011 and 2010:

	Nine months ended September 30,				2011 versus 2010	
	2011		2010		Change	% Change
	(in thousands, except percentages)					
Product revenue	$ 134,541	71.6%	$ 154,025	83.4%	$ (19,484)	-12.6%
Subscription and service revenue	53,381	28.4%	30,563	16.6%	22,818	74.7%
Total revenue	187,922	100.0%	184,588	100.0%	3,334	1.8%

Product Revenue

Product revenue decreased $19.5 million, to $134.5 million during the nine months ended September 30, 2011 from $154.0 million during the nine months ended September 30, 2010. Consumer product revenue decreased $16.7 million, or 12%, primarily as a result of the allocation of revenue to the online services component of our software. In conjunction with the launch of Rosetta Stone Version 4 *TOTALe* in the U.S. consumer market during the third quarter of 2010, we began bundling time-based subscription licenses of our web-based *TOTALe* services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions. Approximately 10% - 25% of the revenues from each of these bundled sales is allocated to online services and recognized over the life of these services. Institutional product revenues decreased $2.8 million, or 20%, as a result of a shift from sales of perpetual licenses to sales of renewing online subscriptions.

Service and Support Revenue

Subscription and service revenue increased approximately 75 %, or $22.8 million, to $53.4 million for the nine months ended September 30, 2011, from $30.6 million during the nine months ended September 30, 2010. The increase in subscription and service revenues was due to a $14.5 million increase in consumer online service revenue related to Version 4 *TOTALe* and an $8.3 million increase in institutional subscription and service revenue related to growth in the institutional customer base with renewing online subscriptions.

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

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the nine months ended September 30, 2011 and 2010:

	Nine months ended September 30,		2011 versus 2010	
	2011	2010	Change	% Change
	(in thousands, except percentages)			
Revenue				
Product	$ 134,541	$ 154,025	$ (19,484)	-12.6%
Subscription and service	53,381	30,563	22,818	74.7%
Total revenue	187,922	184,588	3,334	1.8%
Cost of revenue				
Cost of product revenue	25,430	23,041	2,389	10.4%
Cost of subscription and service revenue	8,861	3,631	5,230	144.0%
Total cost of revenue	34,291	26,672	7,619	28.6%
Gross profit	$ 153,631	$ 157,916	$ (4,285)	-2.7%
Gross margin percentages	81.8%	85.6%	-3.8%	

Cost of Product Revenue

Cost of product revenue for the nine months ended September 30, 2011 was $25.4 million, an increase of $2.4 million, or 10%, from the nine months ended September 30, 2010. As a percentage of product revenue, cost of product revenue increased to 19% for the nine months ended September 30, 2011 compared to 15% for the nine months ended September 30, 2010. The increase in cost was primarily attributable to a $2.1 million increase in expense associated with product support activities, a $0.4 million increase in freight, and a $0.4 million increase in commission expenses associated with our partners and affiliates. This increase was slightly offset by a $0.4 million decrease in inventory scrap related primarily to the V4 launch in the US in Q310. We are exploring the possibility of moving more of our business online, which should reduce the cost of product revenue as the cost of producing and shipping CD s would decline. However, we could experience a temporary increase in the cost of our product revenue as we scrap existing packaging.

Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the nine months ended September 30, 2011 was $8.9 million, an increase of $5.2 million, or 144%, from the nine months ended September 30, 2010. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 17% for the nine months ended September 30, 2011 compared to 12% for the nine months ended September 30, 2010. The increase in cost was primarily attributable to our web-based service

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offering in our Version 4 *TOTALe* product that includes a component of dedicated online language conversation coaching and higher direct costs to deliver to customers than our previous software solutions. We expect cost of subscription and service revenue will increase in future periods, as a percent of revenue, associated with the launch of the Version 4 *TOTALe* solution in our international markets.

Operating Expenses

	Nine months ended September 30,		2011 versus 2010	
	2011	2010	Change	% Change
	(in thousands, except percentages)			
Sales and marketing	118,175	$ 91,896	$ 26,279	28.6%
Research and development	17,829	17,600	229	1.3%
General and administrative	42,731	38,107	4,624	12.1%
Total operating expenses	$ 178,735	$ 147,603	$ 31,132	21.1%

Sales and Marketing Expenses

Sales and marketing expenses for the nine months ended September 30, 2011 were $118.2 million, an increase of $26.3 million, or 29%, from the nine months ended September 30, 2010. As a percentage of total revenue, sales and marketing expenses were 63% for the nine months ended September 30, 2011, compared to 50% for the nine months ended September 30, 2010. The dollar and percentage increase in sales and marketing expenses were primarily attributable to the continued expansion of our direct marketing activities in the U.S. and international markets. Media and marketing activities grew by $16.4 million, primarily outside of the U.S., including the launch of our new advertising campaign focused on promoting language learning and our brand, increased media associated with the launch of Version 4 *TOTALe* in the U.K., Japan and Korea and *ReFLEX* in Korea, and increased internet marketing due to increased spending in online social media networks. Personnel-related costs as a result of growth in our institutional sales channel, non-kiosk consumer, and marketing and sales support activities increased by $5.5 million over the prior year period. Additionally, travel and training expense increased by $0.7 million over the prior period as a result of increased travel in our institutional sales channel and global initiatives. These costs were partially offset by a decrease of $1.7 million in kiosk related expenses as the number of worldwide kiosks decreased from 257 as of September 30, 2010 to 197 as of September 30, 2011. We plan to continually evaluate our kiosk performance as we balance the positive branding with the profitability of the kiosk, potentially closing additional underperforming kiosk locations.

Research and Development Expenses

Research and development expenses were $17.8 million for the nine months ended September 30, 2011, an increase of $0.2 million, or 1%, from the nine months ended September 30, 2010. As a percentage of revenue, research and development expenses remained flat at 10% for the nine months ended September 30, 2011 and September 30, 2010 respectively. The dollar increases were primarily attributable to personnel-related increases in development personnel of $1.3 million, offset by a $0.8 million decrease in consulting-related costs associated with the development of new products and services that are complementary to our existing solutions.

General and Administrative Expenses

General and administrative expenses for the nine months ended September 30, 2011 were $42.7 million, an increase of $4.6 million, or 12%, from the nine months ended September 30, 2010. As a percentage of revenue, general and administrative expenses increased to 23% for the nine months ended September 30, 2011 compared to 21% for the nine months ended September 30, 2010. The dollar and percentage increases were primarily attributable to a $4.0 million increase in personnel-related costs due to our investment in finance, legal, human resources, information technology and other administrative functions which enable continued support for our international expansion. IT and infrastructure expenses increased $2.7 million related to hardware and software upgrades, hosting, and telephone. Additionally, consulting expenses

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increased $3.2 million primarily related to investment in our IT infrastructure and cost realignment initiatives. These increases were partially offset by a $5.8 million decrease in legal fees associated with our trademark infringement lawsuit against Google, Inc. and other intellectual property enforcement actions. For the remainder of 2011, we expect there will be increases to certain general and administrative expenses to support expansion into new international markets. However, we also are taking steps to reduce certain general and administrative expenses as we realign our resources with our business priorities.

Interest and Other Income (Expense)

	Nine months ended September 30,		2011 versus 2010	
	2011	2010	Change	% Change
	(in thousands, except percentages)			
Interest Income	224	$ 191	$ 33	17.3%
Interest Expense	(5)	(25)	20	-80.0%
Other Income (Expense)	83	(158)	241	152.5%
Total other income/(expense)	$ 302	$ 8	$ 294	-3675.0%

Interest income represents interest earned on our cash and cash equivalents. Interest income for the nine months ended September 30, 2011 was $0.2 million, an increase of $33,000, or 17%, from the nine months ended September 30, 2010.

Interest expense is primarily related to our short-term investment account as well as interest related to our operating leases. Interest expense for the nine months ended September 30, 2011 was $5,000, a decrease of $20,000 or 80%, from the nine months ended September 30, 2010.

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

Other income for the nine months ended September 30, 2011 was $83,000 an increase of $0.2 million, or 153%, from the nine months ended September 30, 2010. The increase was primarily due to an increase in foreign exchange gains and an increase in trademark infringement awards compared to the prior year period.

Income Tax Expense (Benefit)

Nine months ended September 30,		2011 versus 2010	
2011	2010	Change	% Change
(in thousands, except percentages)			

Income tax expense (benefit)	$	(9,794)	$	2,001	$	(11,795)	-589.5%

Income tax expense (benefit) for the nine months ended September 30, 2011 was $(9.8) million, compared to $2.0 million for the nine months ended September 30, 2010. The change was the result of a decrease of $35.1 million in pre-tax income for the nine months ended September 30, 2011 and an increase in our effective tax rate. Our effective tax rate was 39% for the nine months ended September 30, 2011 compared to 19% and for the nine months ended September 30, 2010. The change in our effective tax rate was a result of changes in the geographic distribution of our income.

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Liquidity and Capital Resources

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

On January 16, 2009, we entered into a new secured credit agreement with Wells Fargo Bank, N.A., or Wells Fargo, that provided us with a $12.5 million revolving line of credit. This revolving credit facility had a two-year term and the applicable interest rate is 2.5% above one month LIBOR. On January 17, 2011, the Company allowed its $12.5 million revolving line of credit with Wells Fargo to expire.

We expect that our future growth will continue to require additional working capital. Our future capital requirements will depend on many factors, including development of new products, market acceptance of our products, the levels of advertising and promotion required to launch additional products and improve our competitive position in the marketplace, the expansion of our sales, support and marketing organizations, the establishment of additional offices in the United States and worldwide and building the infrastructure necessary to support our growth, the response of competitors to our products and our relationships with suppliers and clients. We have experienced increases in our expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase in the future. We believe that anticipated cash flows from operations and existing cash reserves will provide sufficient liquidity to fund our business and meet our obligations for at least the next 12 months.

Cash Flow Analysis

Net Cash Provided By (Used In) Operating Activities

Net cash used in operating activities was $4.0 million for the nine months ended September 30, 2011, compared to net cash provided by operating activities of $16.6 million for the nine months ended September 30, 2010, a decrease of $20.6 million. Net cash used in operating activities was primarily the result of the net loss as adjusted for depreciation, amortization and stock compensation expense and collection of accounts receivable, offset in part by decreases in net liabilities. The net loss totaled $15.0 million for the nine months ended September 30, 2011 compared to net income of $8.3 million for the nine months ended September 30, 2010. For the nine months ended September 30, 2011, we incurred depreciation, amortization and stock compensation expense in the amount of $11.4 million, compared to $7.7 million for the nine months ended September 30, 2010. Accounts receivable decreased by $12.3 million for the nine months ended September 30, 2011, the result of continued collection efforts compared to an increase of $9.4 million for the nine months ended September 30, 2010. We have been providing customers with the option of purchasing our product over time in 3 or 5 month installments in order to increase the number of customers who purchase our product without materially increasing our bad debt exposure. However this option has extended the time for us to collect cash from our customers. Accounts Payable increased by $0.7 million for the nine months ended September 30, 2011 primarily the result of more efficient cash management and the timing of cash expenditures compared to a decrease of $0.3 million for the nine months ended September 30, 2010. This increase was partially offset by an increase in income tax receivable of $12.2 million. In the future, our cash flow management may not be successful in extending the timing of payments to vendors, which would then cause this cash flow benefit to reverse. If our efforts to reposition the U.S. consumer business are not successful, we would anticipate our cash flow from operations to decline for the remainder of 2011. The total amount of cash that was held by foreign subsidiaries as of September 30, 2011 was $12.4 million. If we were to repatriate the cash from our foreign subsidiaries, a significant tax liability may result.

Net Cash Used In Investing Activities

Net cash used in investing activities was $9.8 million for the nine months ended September 30, 2011, compared to $5.7 million for the nine months ended September 30, 2010, an increase of $4.1 million. Our investing activities during these periods primarily related to the purchase of property and equipment associated with the expansion of our information technology systems and our facilities as a result of our growth and international expansion, and the purchase of short-term investments.

Net Cash Provided By Financing Activities

Net cash provided by financing activities was $1.0 million for the nine months ended September 30, 2011 compared to net cash provided by financing activities of $3.4 million for the nine months ended September 30, 2010. Net cash provided by financing activities during the nine months ended September 30, 2011 primarily related to proceeds received from stock option exercises.

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

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

Off-Balance Sheet Arrangements

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

Contractual Obligations

The following table summarizes our contractual obligations at September 30, 2011 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
			(in thousands)		
Operating lease obligations	$ 15,455	$ 7,813	$ 6,885	$ 757	$
Total	$ 15,455	$ 7,813	$ 6,885	$ 757	$

We anticipate that we will experience an increase in our capital expenditures and lease commitments consistent with our anticipated growth in operations, infrastructure and personnel during the remainder of 2011.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

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

Interest Rate Sensitivity

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Principal Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2011. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), means controls and other procedures of a company that are designed to ensure that information required to be

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disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2011, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) or 15d-15(d) of the Exchange Act that occurred during the quarter ended September 30, 2011 that had materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

On or about April 28, 2010, a purported class action lawsuit was filed against us in the Superior Court of the State of California, County of Alameda for damages, injunctive relief and restitution in the matter of Michael Pierce, Patrick Gould, individually and on behalf of all others similarly situated v. Rosetta Stone Ltd. and DOES 1 to 50. The complaint alleges that plaintiffs and other persons similarly situated who are or were employed as salaried managers by us in our retail locations in California are due unpaid wages and other relief for our violations of state wage and hour laws. Plaintiffs moved to amend their complaint to include a nationwide class on January 21, 2011. On March 16, 2011, the case was removed to the United States District Court for the Northern District of California, Oakland Division. On October 27, 2011, a mediation of the case was held. In November 2011, the plaintiffs attorneys and the Company agreed to the mediator s proposed settlement terms. As of September 30, 2011, we reserved $0.6 million with respect to the proposed settlement. Approval of the proposed settlement by the court is pending. We dispute the plaintiffs claims and have not admitted any wrongdoing with respect to the case.

On or about March 24, 2011, a purported securities class action lawsuit was filed on behalf of persons who purchased our publicly traded securities between February 25, 2010 and February 28, 2011 against the Company and certain of our present and former officers in the United

States District Court for the Eastern District of Virginia alleging violations of federal securities law in connection with various public statements and alleged material omissions made by us. The complaint names as defendants Rosetta Stone Inc., Tom P.H. Adams, President and Chief Executive Officer, Brian D. Helman, former Chief Financial Officer, and Matthew C. Sysak, Vice President and Controller. On September 19, 2011, the United States District Court for the Eastern District of Virginia granted plaintiff s motion for leave to voluntarily dismiss its claims with prejudice. Although no settlement was paid, we incurred legal fees and other costs in the defense of these claims.

On June 23, 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG (Langenscheidt) in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone s use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. Langenscheidt is seeking, among other things, to enjoin Rosetta Stone GmbH from using the color yellow in Germany, a declaratory judgment that Rosetta Stone GmbH is liable for damages based on our activities in Germany, and the award of costs and attorneys fees associated with the legal proceeding. A hearing was held on October 27, 2011 and the presiding judge indicated his opinion that Rosetta Stone GmbH has infringed on Langenscheidt s German trademark. The court has encouraged the parties to enter into settlement discussions and has postponed rendering its decision until January 19, 2012. If settlement discussions are unsuccessful we intend to vigorously defend this matter including appealing of any decision by the District Court of Cologne. The outcome of the matter is currently not known, and the range of any potential loss is not reasonably estimatable at this time. Even if the plaintiff is unsuccessful in its claims against us, we will incur legal fees and other costs in the defense of these claims.

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

Item 1A. Risk Factors

There have been no material changes to our risk factors contained in our Annual Report on Form 10-K filed on March 14, 2011 with the U.S. Securities and Exchange Commission for the period ended December 31, 2010. For a further discussion of our Risk Factors, refer to the Risk Factors discussion contained in our Annual Report on Form 10-K for the period ended December 31, 2010.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibits	
3.1(1)	Second Amended and Restated Certificate of Incorporation of the Company.
3.2(1)	Second Amended and Restated Bylaws of the Company.
4.1(1)	Specimen certificate evidencing shares of Common Stock of the Company.
4.3(1)	Registration Rights Agreement dated January 4, 2006 among the Company and the Investor Shareholders and other Shareholders listed on Exhibit A thereto.
10.19+	Executive Employment Agreement between Rosetta Stone Ltd. and Michael F. Fulkerson effective as of May 31, 2011

31.1*	Certification of Chief Executive Officer (Principle Executive Officer) Pursuant to Rule 13-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer Pursuant to Rule 13-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Chief Executive Officer (Principle Executive Officer) Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document.
101.SCH**	XBRL Taxonomy Extension Schema.
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF**	XBRL Taxonomy Extension Definition Linkbase.
101.LAB**	XBRL Taxonomy Extension Label Linkbase.
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase.

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* Filed herewith

** Furnished herewith

+ Identifies management contracts and compensatory plans or arrangements.

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(1) Incorporated by reference to exhibit filed with Registrant s registration statement on Form S-1 (File No. 333-153632), as amended.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ROSETTA STONE INC.

/s/ STEPHEN M. SWAD

Stephen M. Swad

Chief Financial Officer

(Principal Financial Officer,

Principal Accounting Officer and

Duly Authorized Signatory)

Date: November 8, 2011