ROSETTA STONE INC
Form S-1/A
April 01, 2009

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As filed with the Securities and Exchange Commission on March 31, 2009

Registration No. 333-153632

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 5
to
Form S-1

REGISTRATION STATEMENT
Under
THE SECURITIES ACT OF 1933

Rosetta Stone Inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**7372**	**043837082**
(State or Other Jurisdiction of Incorporation or Organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification Number)

1919 North Lynn Street
7th Floor
Arlington, Virginia 22209
Telephone: 800-788-0822

(Address, Including Zip Code, and Telephone Number, Including Area Code, of Registrant's Principal Executive Offices)

Michael C. Wu
General Counsel
1919 North Lynn Street
7th Floor
Arlington, Virginia 22209
Telephone: 800-788-0822

(Name, Address, Including Zip Code, and Telephone Number, Including Area Code, of Agent for Service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

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

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

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The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

PROSPECTUS (Subject to Completion)
Issued March 31, 2009

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting offers to buy these securities in any state where the offer or sale is not permitted.

6,250,000 Shares

Rosetta Stone Inc.

COMMON STOCK

Rosetta Stone Inc. is offering 3,125,000 shares of its common stock and the selling stockholders are offering 3,125,000 shares of common stock. We will not receive any proceeds from the sale of shares by the selling stockholders. This is our initial public offering and no public market currently exists for our shares. We anticipate that the public offering price will be between $15.00 and $17.00 per share.

Our common stock has been approved for listing on the New York Stock Exchange under the symbol "RST."

Investing in our common stock involves risks. See "Risk Factors" beginning on page 14.

PRICE $ A SHARE

	Price to Public	***Underwriting Discounts and Commissions***	***Proceeds to Company***	***Proceeds to Selling Stockholders***
Per Share	*$*	*$*	*$*	*$*
Total	*$*	*$*	*$*	*$*

The selling stockholders have granted the underwriters the right to purchase up to an additional 937,500 shares of common stock to cover over-allotments.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Morgan Stanley & Co. Incorporated expects to deliver the shares of common stock to purchasers on , 2009.

MORGAN STANLEY *WILLIAM BLAIR & COMPANY*

JEFFERIES & COMPANY

PIPER JAFFRAY

ROBERT W. BAIRD & CO.

, 2009

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You should rely only on the information contained in this prospectus or in any free-writing prospectus we may specifically authorize to be delivered or made available to you. We have not, the selling stockholders have not and the underwriters have not authorized anyone to provide you with additional or different information. We and the selling stockholders are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers and sales are permitted. The information in this prospectus or a free-writing prospectus is accurate only as of its date, regardless of its time of delivery or of any sale of shares of our common stock. Our business, financial condition, results of operations and prospects may have changed since that date.

Until , 2009 (25 days after the commencement of this offering), all dealers that buy, sell or trade shares of our common stock, whether or not participating in this offering, may be required to deliver a prospectus. This delivery requirement is in addition to the obligation of dealers to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

For investors outside the United States: We have not, the selling stockholders have not and the underwriters have not done anything that would permit this offering or possession or distribution of this prospectus in any jurisdiction where action for that purpose is required, other than in the United States. Persons outside the United States who come into possession of this prospectus must inform themselves about, and observe any restrictions relating to, the offering of the shares of common stock and the distribution of this prospectus outside of the United States.

PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus and does not contain all of the information that you should consider in making your investment decision. Before investing in our common stock, you should carefully read this entire prospectus, including our consolidated financial statements and the related notes and the information set forth under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations," in each case included elsewhere in this prospectus.

ROSETTA STONE INC.

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 31 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. This has 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 83% of our revenue in 2008 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, Apple, Barnes & Noble and Borders. According to an August 2008 survey we commissioned from Global Market Insite Inc., or GMI, a market research services firm, *Rosetta Stone* is the most recognized language learning brand in the United States. The unaided awareness of our brand was over 40%, which was more than seven times that of any other language learning company in the United States.

We grew our revenue from our predecessor's $25.4 million in 2004 to $209.4 million in 2008, representing a 69% compound annual growth rate. This growth has been entirely organic.

Approaches to Language Learning

The human brain has a natural capacity to learn languages. Children learn their native language without using rote memorization or adult analytical abilities for grammatical understanding. They learn at their own pace through their immersion in the language spoken around them and using trial and error. They do not rely on translation.

Traditional language instruction has ignored this natural human experience and ability, and has focused on rote memorization, grammar explanation and word translation, often in a classroom setting. Students in this environment may learn a new language sufficiently to pass examinations but often do not achieve conversational fluency. Many students view this method as ineffective and boring. While self-study alternatives are generally more affordable and convenient than classroom instruction, many of them rely on this grammar-translation method, often using passive media such as audio and books, which are not interactive and do not provide feedback.

In contrast, immersion instruction, in which only the target language is spoken, leverages the natural human ability to learn languages. Immersion learning has historically been provided through classroom courses, private lessons and in-country immersion programs. These options, however, are often expensive and require students to commute to classrooms or travel to other countries to obtain the immersion experience.

Our Industry

According to a December 2007 industry analysis we commissioned from The Nielsen Company, a market research firm, the worldwide language learning industry represented more than $83 billion in consumer spending in 2007, of which more than $32 billion was for self-study. According to the Nielsen survey, the language learning industry in the United States, where we generated 95% of our revenue in 2008, represented more than $5 billion in consumer spending in 2007, of which more than $2 billion was for self-study.

The demand for language learning is driven in part by:

- individuals seeking the enjoyment and enrichment brought by learning a language;
- professionals conducting business in a global economy;
- schools seeking to educate their students in local and foreign languages;
- companies training their employees;
- leisure travelers seeking language proficiency for independent international travel;
- armed forces training soldiers to communicate in foreign languages;
- immigrants and expatriates seeking to successfully function in their new environments;
- individuals connecting with their ethnic and family roots; and
- parents supplementing their children's education.

The language learning market is highly fragmented and consists of the following primary models: classroom instruction utilizing the traditional approach of memorization, grammar and translation; immersion-based classroom instruction; self-study books, audio tapes and software that rely on grammar and translation; and free online offerings that provide basic content and opportunities to practice writing and speaking.

We believe that language learners seek a trusted name brand solution that is more convenient and affordable than classroom alternatives, and more effective, interactive and engaging than other self-study options. We believe the combination of these elements is not offered by traditional providers of language instruction.

The Rosetta Stone Solution

Our mission is to change the way people learn languages. We believe our solutions provide an effective way to learn languages in a convenient and engaging manner. Our interactive language learning solutions enable our customers to learn a language on their own schedule and for a price that is significantly lower than most classroom-based or one-on-one tutoring alternatives. Our approach, called *Dynamic Immersion*, eliminates translation and grammar explanation and is designed to leverage the innate, natural language learning ability that children use to learn their native language. Our proprietary solutions have been developed over the past 16 years by professionals with extensive linguistic, educational and instructional technology expertise. We estimate that our content library consists of more than 25,000 individual photographic images and more than 400,000 professionally recorded sound files. We design the sequencing of our content to optimize learning. The result is a rigorous and complete language learning curriculum that is also designed to be flexible, fun and convenient.

Our language learning solutions are built upon a flexible software platform that supports multiple languages and is deployable on personal computers, on local networks and online. The platform incorporates a number of proprietary technologies that are key to enabling language learning, including:

- speech recognition that is focused on the unique challenges of language learners;
- *Adaptive Recall* algorithms that repeat content at scheduled intervals to promote long-term retention;
- reporting features and curriculum options designed to enhance the effectiveness and administration of classroom, enterprise and home school learning; and
- an intuitive user interface that assists the learner's transition from listening comprehension to speaking.

Our courses are available in up to three levels of proficiency per language, with each level providing approximately 40 hours of instruction and containing multiple units, lessons and activities. We have four different editions: personal, enterprise, classroom and home school. Each edition utilizes the same core software.

Our innovative solutions have received numerous awards and recognitions, including the 2008 CODiE awards for best corporate learning solution and best instructional solution in other curriculum areas sponsored by the Software & Information Industry Association, the 2008 education product of the year awarded by MacWorld, the 2008 BESSIE multilevel foreign language award for Spanish Levels 1, 2, and 3 awarded by *ComputED Gazette* in 2008, the 2008 EDDIE Award for our classroom edition as the best foreign language website awarded by *ComputED Gazette*, the 2007 EDDIE multilevel foreign language award for Chinese levels 1 and 2 and a 2007 multilevel English-as-a-second-language, or ESL, award for English levels 1, 2, and 3 awarded by *ComputED Gazette.* The CODiE awards are chosen based upon a peer-review of the nominated software solutions and voted on by member entities of the Software & Information Industry Association and independent judges selected by the association. The other awards were determined by the editorial staffs of the various publications.

We also provide an online peer-to-peer practice environment called *SharedTalk*, at *www.sharedtalk.com*, where registered language learners meet for language exchange to practice their foreign language skills. During 2008, we had more than 100,000 active *SharedTalk* users.

Competitive Strengths

We believe our competitive strengths include:

Advanced Technology-Enabled Language Learning System. Our proprietary solutions combine effective immersion learning with the benefits of flexibility and interactivity to provide for an efficient and engaging language learning experience. We intend to remain at the forefront of technological and pedagogical advances in language learning.

Scalable and Adaptable Platform and Content. Our solutions are designed to be efficiently delivered across multiple languages, systems and geographic markets. For example, we deploy many of the same images and image combinations across multiple languages, which accelerates our ability to add new languages. Because our solutions do not rely upon translation from the target language into the learner's native language, they require only modest localization to be used by learners from other native language backgrounds. This facilitates our ability to sell our existing language courses in new international markets. In addition, our software platform is engineered to work in the same way both online and locally installed, allowing for multiple delivery methods. We also use the same platform for all four editions of our solutions.

Effective Multi-Channel Marketing and Distribution Model. Our marketing, sales and distribution efforts are highly integrated and focused on direct interaction with consumers. As a result, we are able to present a tightly controlled and unified message to the marketplace. Our advertising includes a call to action that drives customers directly to our websites and call centers. Our marketing tools and techniques allow us to directly attribute sales results to specific marketing initiatives. We utilize this data to continuously improve the efficiency of our websites, call centers, advertising and media planning and buying. We also operate kiosks, which extend our direct interaction with customers and allow them to experience our solutions with the guidance of one of our product specialists. We operated 150 kiosks as of December 31, 2008. In our institutional markets, our sales efforts are led by our direct sales force. We augment our direct distribution network with select retailers, including Amazon.com, Apple, Barnes & Noble and Borders. We have also recently begun offering our products in a limited number of ZoomShop unmanned automated kiosks.

Leading and Trusted Brand, with a Differentiated, High-Quality Positioning. According to the GMI survey, *Rosetta Stone* is the most recognized brand of language learning solutions in the United States. Additionally, of those surveyed who had an opinion of the brand, over 80% associated the brand with high-quality and effective products and services for teaching foreign languages. We believe we have positioned *Rosetta Stone* as a premium brand and as a trusted choice for language learning.

Enthusiastic and Loyal Customer Base. Our customers exhibit loyalty and enthusiasm for our solutions and many promote sales of our products through word-of-mouth referrals. Our latest survey of our individual customers in the United States, completed in February 2009, revealed that 92% of respondents expressed satisfaction with our solutions, with a satisfaction rating of 6 or higher on a 10-point scale, and 76% have recommended our solutions to one or more individuals. Our latest survey of our institutional customers in the United States, completed in February 2009, revealed that 87% of respondents expressed satisfaction with our solutions, with a satisfaction rating of 6 or higher on a 10-point scale, and 70% have recommended our solutions to other organizations.

Effective Products. We believe our solutions are effective. According to a January 2009 study we commissioned from Roumen Vesselinov, Ph.D, visiting assistant professor, Queens College, City University of New York, after 55 hours of study with our Spanish program the average WebCAPE score will be at a level sufficient to fulfill the requirements for one semester of study in a college that offers six semesters of Spanish. Statistically, the study concluded that such an outcome would occur with 95%

confidence. WebCAPE, which stands for Web-based Computer Adaptive Placement Exam, is a standardized test which, according to their website, is used by over 500 colleges and universities for placement. In addition, approximately 64% of the students participating in the study increased their oral proficiency by at least one level on a seven-level scale based on the American Council on the Teaching of Foreign Languages OPIc test, which is used worldwide by academic institutions, government agencies, and private corporations for evaluating oral language proficiency.

Our Strategy

Our goal is to strengthen our position as a leading provider of language learning solutions through the following strategies:

Extend Our Technological and Product Leadership. We intend to apply new technologies to maintain our product leadership. We currently are working on a variety of product development initiatives. For example, we are developing a new web-based service that extends our existing language learning solutions by offering opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. We expect to provide this web-based service primarily as a bundle with our software and audio offerings. In addition, we are evaluating opportunities to extend our learning solutions to hand-held devices and we also intend to continue to advance our proprietary software platform and our speech recognition technology.

Expand Our Core Product Portfolio. We plan to expand our product portfolio by adding more advanced course levels for our existing languages, new languages and new skill development and remediation courses for advanced language learners. In addition, we believe that there may be opportunities for us to introduce additional language learning solutions containing industry-specific content.

Increase U.S. Market Share. To increase our penetration of the U.S. market and expand our brand awareness, we intend to increase our marketing campaigns through the purchase of additional television, print, radio and online advertising, and to explore new media channels. We also intend to continue to add select retail relationships and kiosks. For example, a selection of our solutions has recently become available in Apple stores and at *www.Apple.com*. For our institutional business, we expect to expand our direct sales force along with our institutional marketing activities.

Increase Our Focus on Sizeable Non-U.S. Markets. We generated approximately 5% of our revenue in 2008 from sales outside the United States. According to the Nielsen survey, over 90% of the $83 billion spent in 2007 on consumer language learning products and services worldwide was spent outside the United States. We therefore believe that there is a significant opportunity for us to expand our business internationally utilizing many of the successful marketing and distribution strategies we have used in the United States.

Risks Associated with Our Business

Our business is subject to numerous risks, as discussed more fully in the section entitled "Risk Factors" immediately following this prospectus summary. A decline in demand for our language learning solutions or language learning in general could impair our ability to generate revenue and compromise our profitability, as could the growth of free language learning software and online services and intense competition in our industry. Because approximately 80% of our revenue was generated from consumer sales in 2008, adverse trends in general economic conditions, including retail shopping patterns, may also adversely affect our sales. If we do not keep pace with technological developments and consumer preferences, demand for our products and services could decline.

Corporate Information

We were incorporated in Delaware in December 2005 and acquired our predecessor, Fairfield & Sons, Ltd., in January 2006. Our principal executive offices are located at 1919 North Lynn Street, 7th Floor, Arlington, Virginia 22209 and our telephone number is 800-788-0822. Our corporate website address is *www.RosettaStone.com*. We do not incorporate the information contained on, or accessible through, our corporate website into this prospectus, and you should not consider it part of this prospectus.

For convenience in this prospectus, "Rosetta Stone," "we," "us," "our" and "Successor" refer to Rosetta Stone Inc. and its subsidiaries, taken as a whole, unless otherwise noted. "Predecessor" refers to Fairfield & Sons, Ltd.

We have a number of registered marks, including *Rosetta Stone*®, *Rosetta World*®, *Rosetta Stone Language Learning Success*® and design, *Dynamic Immersion*®, *The Fastest Way to Learn a Language. Guaranteed.*®, *Adaptive Recall*®, *Contextual Formation*®, the Rosetta Stone blue stone logo and design and *Rosettastone.com*®. We have applied to register our *Audio Companion*, *rWorld*, *Rosetta*, the Rosetta Stone blue stone logo and design/*Language Learning Success* and *SharedTalk* trademarks. This prospectus also contains trademarks and trade names of other companies. All trademarks and trade names appearing in this prospectus are the property of their respective holders.

THE OFFERING

Common stock offered by Rosetta Stone	3,125,000 shares
Common stock offered by the selling stockholders	3,125,000 shares
Total common stock offered	6,250,000 shares
Total common stock to be outstanding after this offering	20,314,531 shares
Use of proceeds	We intend to use the net proceeds from this offering as follows: Approximately $9.9 million to repay the outstanding balance under our credit facility. Approximately $7.0 million, based upon an assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, to satisfy the federal, state and local withholding tax obligations associated with the "net issuance" of stock grants we intend to make to 10 of our key employees, including executive officers, prior to the completion of this offering. See "Use of Proceeds," "Capitalization" and "Executive Compensation Stock Grants" for a description of these stock grants and tax payments. We will withhold from each recipient's award a number of shares of our common stock equal to the dollar value of the recipient's federal, state and local withholding tax obligations relating to the "net issuance" of the stock grant and we will use a portion of the proceeds of this offering to pay to the appropriate taxing authorities an equivalent value in cash based upon the initial public offering price per share in this offering. The remaining proceeds will be used for working capital and other general corporate purposes, which may include the acquisition of other businesses, products or technologies. We do not, however, have agreements or commitments for any specific acquisitions at this time. We will not receive any proceeds from the sale of shares by the selling stockholders. See "Use of Proceeds."
Risk factors	See "Risk Factors" for a discussion of factors that you should consider carefully before deciding whether to purchase shares of our common stock.
New York Stock Exchange symbol	"RST"

The number of shares of our common stock to be outstanding after this offering is based on the number of shares outstanding as of December 31, 2008. Such number of shares excludes:

- 1,657,799 shares of common stock issuable upon the exercise of options outstanding as of December 31, 2008 with a weighted average exercise price of $6.48 per share;
- 342,214 shares of common stock issuable upon the exercise of options we expect to grant to our employees prior to the completion of this offering, which options will have an exercise price per share equal to the initial public offering price per share in this offering and are described under the caption "Executive Compensation IPO Option and Restricted Stock Grants;"
- 137,160 shares of common stock reserved for future issuance under our 2006 Stock Option Plan; and
- 2,437,744 shares of common stock, based upon an assumed public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, reserved for future issuance under our 2009 Omnibus Incentive Plan, which plan provides for the issuance of a number of shares of our common stock equal to 12% of the number of shares of our common stock outstanding as of the completion of this offering on a fully diluted basis.

Unless otherwise indicated, the information in this prospectus reflects and assumes:

- the conversion of all outstanding shares of our preferred stock into 14,507,714 shares of our common stock, which will occur automatically immediately prior to the closing of the offering;
- our issuance of 591,491 shares of common stock, net of shares withheld to satisfy tax withholding obligations, in connection with the "net issuance" of the stock grants we intend to make to 10 of our key employees, including those executive officers named in the summary compensation table on page 112, whom we refer to as our named executive officers, prior to the completion of this offering, which are described in more detail under the captions "Capitalization" and "Executive Compensation Stock Grants;"
- our issuance of 154,672 shares of restricted common stock we intend to make to our employees prior to the completion of this offering, which are described in more detail under the caption "Executive Compensation IPO Option and Restricted Stock Grants;"
- the 1.3-to-one split of our common stock completed by means of a stock dividend on March 23, 2009;
- the filing of our second amended and restated certificate of incorporation and adoption of our second amended and restated bylaws immediately prior to the closing of the offering; and
- no exercise by the underwriters of their option to purchase up to an additional 937,500 shares of our common stock from the selling stockholders to cover over-allotments.

SUMMARY CONSOLIDATED FINANCIAL DATA

The following table sets forth a summary of our consolidated statement of operations, balance sheet and other data for the periods indicated. The summary consolidated statement of operations data for the period from January 4, 2006 through December 31, 2006 and the years ended December 31, 2007 and 2008 have been derived from Rosetta Stone Inc., or the Successor, audited consolidated financial statements included elsewhere in this prospectus. The summary consolidated financial data for the period from January 1, 2006 through January 4, 2006 represents the operations of Fairfield & Sons, Ltd., or the Predecessor, all of the outstanding stock of which was acquired by Rosetta Stone Inc. on January 4, 2006, and have been derived from Predecessor audited consolidated financial statements included elsewhere in this prospectus. You should read this information together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements contained elsewhere in this prospectus.

The Predecessor incurred transaction-related expenses during the period from January 1, 2006 to January 4, 2006 relating to the acquisition by Rosetta Stone Inc. on January 4, 2006. Included in these expenses were $5.9 million related to restricted common stock, $3.1 million in cash bonuses and $1.2 million in acquisition-related bank fees.

Unaudited pro forma net income per common share and unaudited pro forma common shares and equivalents outstanding reflect the conversion of all outstanding shares of our convertible preferred stock into an aggregate of 14,507,714 shares of our common stock, which will occur automatically immediately prior to the closing of this offering, and the issuance of 591,491 shares of common stock, net of shares withheld to satisfy tax withholding obligations associated with the "net issuance" of stock grants we intend to make to 10 of our key employees, including our named executive officers, prior to completion of this offering, and, in the case of diluted unaudited pro forma net income per share and unaudited pro forma common shares and equivalents outstanding, also reflects the issuance of 154,672 shares of restricted common stock to our employees prior to completion of this offering. Diluted unaudited pro forma net income per common share and unaudited pro forma common shares and equivalents outstanding exclude the grant of options to purchase 342,214 shares of our common stock to our employees prior to the completion of this offering as such options are antidilutive. For the purposes of this calculation we have assumed that such transactions occurred as of January 1, 2008.

We have presented the summary balance sheet data as of December 31, 2008:

- on an actual basis;
- on a pro forma basis to give effect to the conversion of all outstanding shares of our convertible preferred stock into an aggregate of 14,507,714 shares of our common stock, which will occur automatically immediately prior to the closing of this offering, the issuance of 591,491 shares of common stock, net of shares withheld to satisfy tax withholding obligations in connection with the "net issuance" of the stock grant to 10 of our key employees, including our named executive officers, and 154,672 shares of restricted common stock we intend to make to our employees prior to completion of this offering; and
- on a pro forma as adjusted basis to give further effect to our sale of 3,125,000 shares of common stock in this offering at an assumed initial public offering price of $16.00 per share, which is the midpoint of the range set forth on the cover page of this prospectus, after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us, and our use of a portion of the proceeds from that sale to repay debt and federal, state and local tax withholding obligations in connection with the "net issuance" of the stock grants we intend to make to our key employees, including our named executive officers, prior to the completion of this offering.

Each $1.00 increase or decrease in the assumed initial public offering price of $16.00 per share, which is the midpoint of the range set forth on the cover page of this prospectus, would increase or decrease each of cash and cash equivalents, total assets and total stockholders' equity on a pro forma as adjusted basis by approximately $2.9 million, which will be partially offset by a corresponding approximately $0.4 million increase or decrease in the tax withholding obligation relating to the "net issuance" of the stock grants we intend to make to 10 of our key employees, including our named executive officers, prior to the completion of this offering, assuming that the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same after deducting the estimated underwriting discounts and commissions and estimated expenses payable by us. The pro forma as adjusted information presented in the summary balance sheet data is illustrative only and will change based on the actual initial public offering price and other terms of this offering determined at pricing.

	Predecessor	Successor		
	Period from January 1, through January 4, 2006	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
	(in thousands, except per share data)			
Statement of Operations Data:				
Revenue:				
Product	$ 178	$ 80,604	$ 119,897	$ 184,182
Subscription and service	94	10,694	17,424	25,198
Total revenue	272	91,298	137,321	209,380
Cost of revenue:				
Cost of product revenue	199	11,549	19,055	26,539
Cost of subscription and service revenue	4	992	1,632	2,137
Total cost of revenue	203	12,541	20,687	28,676
Gross profit	69	78,757	116,634	180,704
Operating expenses:				
Sales and marketing	695	45,854	65,437	93,384
Research and development	41	8,117	12,893	18,387
Acquired in-process research and development		12,597		
General and administrative	142	16,590	29,786	39,577
Lease abandonment				1,831
Transaction-related expenses	10,315			
Total operating expenses	11,193	83,158	108,116	153,179
Income (loss) from operations	(11,124)	(4,401)	8,518	27,525
Other income and expense:				
Interest income		613	673	454
Interest expense		(1,560)	(1,331)	(891)
Other income	3	60	154	239
Total other income (expense)	3	(887)	(504)	(198)
Income (loss) before income taxes	(11,121)	(5,288)	8,014	27,327
Income tax expense (benefit)		(1,240)	5,435	13,435
Net income (loss)	(11,121)	(4,048)	2,579	13,892
Preferred stock accretion		(159)	(80)	
Net income (loss) attributable to common stockholders	$ (11,121)	$ (4,207)	$ 2,499	$ 13,892
Income (loss) per share attributable to common stockholders:				
Basic	$ (37,194)	$ (2.63)	$ 1.47	$ 7.29
Diluted	$ (37,194)	$ (2.63)	$ 0.15	$ 0.82
Unaudited pro forma net income per common share:				
Basic				$ 0.82
Diluted				$ 0.79
Unaudited pro forma common shares and equivalents outstanding:				
Basic weighted average shares				17,004

Diluted weighted average shares								17,521
Other Data:								
Adjusted EBITDA	$	(5,181)	$	15,332	$	17,768	$	36,429
Stock-based compensation expense included in:								
Cost of revenue	$		$	1	$	2	$	2
Sales and marketing				59		189		153
Research and development				128		360		482
General and administrative				373		776		953
Transaction-related expenses		5,930						
Total stock-based compensation expense	$	5,930	$	561	$	1,327	$	1,590
Intangible amortization expense included in:								
Cost of revenue	$		$	1,213	$	1,227	$	13
Sales and marketing				4,113		3,596		3,003
Total intangible amortization expense	$		$	5,326	$	4,823	$	3,016

	As of December 31, 2008		
	Actual	Pro Forma	Pro Forma As Adjusted
	(in thousands)		
Balance Sheet Data:			
Cash and cash equivalents	$ 30,626	$ 30,626	$ 56,721
Total assets	138,818	138,818	164,913
Deferred revenue	15,744	15,744	15,744
Long-term debt	9,910	9,910	
Total stockholders' equity	79,071	78,650	121,666

We define adjusted EBITDA as net income (loss) plus net interest expense, income tax expense (benefit), depreciation and amortization, stock-based compensation expense and acquired in-process research and development. Adjusted EBITDA is a financial measure that is not calculated in accordance with generally accepted accounting principles, or GAAP. The table below provides a reconciliation of this non-GAAP financial measure to net income (loss), the most directly comparable financial measure calculated and presented in accordance with GAAP. Adjusted EBITDA should not be considered as an alternative to net income (loss), operating income (loss) or any other measure of financial performance calculated and presented in accordance with GAAP. Our adjusted EBITDA may not be comparable to similarly titled measures of other companies because other companies may not calculate adjusted EBITDA or similarly titled measures in the same manner as we do. We prepare adjusted EBITDA to eliminate the impact of items that we do not consider indicative of our core operating performance. We encourage you to evaluate these adjustments and the reasons we consider them appropriate.

We believe adjusted EBITDA is useful to investors in evaluating our operating performance for the following reasons:

securities analysts use adjusted EBITDA as a supplemental measure to evaluate the overall operating performance of companies and we anticipate that our investor and analyst presentations after we are public will include adjusted EBITDA; and

we adopted SFAS No. 123(R), *Share-Based Payment*, on January 1, 2006 and recorded stock-based compensation expense of approximately $0.6 million for the period from January 4, 2006 through December 31, 2006, $1.3 million for the year ended December 31, 2007 and $1.6 million for the year ended December 31, 2008. By comparing our adjusted EBITDA in different periods, our investors can evaluate our operating results without the additional variations caused by stock-based compensation expense, which is not comparable from year to year due to changes in accounting treatment and is a non-cash expense that is not a key measure of our operations.

Our management uses adjusted EBITDA:

as a measure of operating performance;

to determine a significant portion of management's incentive compensation;

for planning purposes, including the preparation of our annual operating budget;

to allocate resources to enhance the financial performance of our business;

to evaluate the effectiveness of our business strategies; and

in communications with our board of directors concerning our financial performance.

Although adjusted EBITDA is frequently used by investors and securities analysts in their evaluations of companies, adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results of operations as reported under GAAP. Some of these limitations are:

- adjusted EBITDA does not reflect our cash expenditures or future requirements for capital expenditures or other contractual commitments;
- adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- adjusted EBITDA does not reflect interest expense or interest income;
- adjusted EBITDA does not reflect cash requirements for income taxes;
- adjusted EBITDA does not reflect a non-cash component of employee compensation;
- although depreciation and amortization are non-cash charges, the assets being depreciated or amortized will often have to be replaced in the future, and adjusted EBITDA does not reflect any cash requirements for these replacements;
- adjusted EBITDA does not reflect acquired in-process research and development charges; and
- other companies in our industry may calculate adjusted EBITDA or similarly titled measures differently than we do, limiting its usefulness as a comparative measure.

The following table presents a reconciliation of adjusted EBITDA to net income (loss), the most comparable GAAP measure, for each of the periods indicated:

	Predecessor	Successor		
	Period from January 1, through January 4, 2006	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
	(in thousands)			
Reconciliation of adjusted EBITDA to net income (loss):				
Net income (loss)	$ (11,121)	$ (4,048)	$ 2,579	$ 13,892
Interest expense (income), net		947	658	437
Income tax expense (benefit)		(1,240)	5,435	13,435
Depreciation and amortization	10	6,515	7,769	7,075
Stock-based compensation	5,930	561	1,327	1,590
Acquired in-process research and development		12,597		
Adjusted EBITDA	$ (5,181)	$ 15,332	$ 17,768	$ 36,429

RISK FACTORS

An investment in our common stock involves a high degree of risk. You should carefully consider the risks described below before deciding to invest in shares of our common stock. Our business, prospects, financial condition or operating results could be materially adversely affected by any of these risks, as well as other risks not currently known to us or that we currently consider immaterial. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. In assessing the risks described below, you should also refer to the other information contained in this prospectus, including our consolidated financial statements and the related notes, before deciding to purchase any shares of our common stock.

Risks Related to Our Business

Because we generate all of our revenue from language learning solutions, a decline in demand for our language learning solutions or for language learning solutions in general could cause our revenue to decline.

In the period from January 4, 2006 through December 31, 2006 and the years ended December 31, 2007 and 2008, we generated substantially all of our revenue from our language learning solutions, and we expect that we will continue to depend upon language learning solutions for substantially all of our revenue in the foreseeable future. Because we are dependent on our language learning solutions, factors such as changes in consumer preferences for these products may have a disproportionately greater impact on us than if we offered multiple product categories. If consumer interest in our language learning software products declines, or if consumer interest in learning foreign languages in general declines, we would likely experience a significant loss of sales. Some of the potential developments that could negatively affect interest in and demand for language learning software products include:

- a decline in international travel;
- changes in U.S. laws or policies making it more difficult for foreign persons to visit or take up residence in the United States; and
- a reduction in the roles of the U.S. armed forces or other governmental agencies in foreign countries.

Because a substantial portion of our revenue is generated from our consumer business, if we fail to accurately forecast consumer demand and trends in consumer preferences, our Rosetta Stone brand, sales and customer relationships may be harmed.

Demand for our language learning software products and related services, and for consumer products and services in general, is subject to rapidly changing consumer demand and trends in consumer preferences. Therefore, our success depends upon our ability to:

- identify, anticipate, understand and respond to these trends in a timely manner;
- introduce appealing new products and performance features on a timely basis;
- anticipate and meet consumer demand for additional languages and learning levels;
- effectively position and market our products and services;
- identify and secure cost-effective means of marketing our products to reach the appropriate consumers;

- identify cost-effective sales distribution channels, kiosk locations and other sales outlets where interested consumers will buy our products;
- anticipate and respond to consumer price sensitivity and pricing changes of competitive products; and
- identify and successfully implement ways of building brand loyalty and reputation.

A decline in consumer demand for our solutions, or any failure on our part to satisfy changing consumer preferences, could harm our business and profitability.

We depend on discretionary consumer spending in the consumer segment of our business. Continued adverse trends in general economic conditions, including retail shopping patterns, airport traffic or consumer confidence, may compromise our ability to generate revenue.

The success of our business depends to a significant extent upon discretionary consumer spending, which is subject to a number of factors, including general economic conditions, consumer confidence, employment levels, business conditions, interest rates, availability of credit, inflation and taxation. The United States has entered into an economic downturn. Continued weak economic conditions and further adverse trends in any of these economic indicators may cause consumer spending to decline further, which could hurt our sales and profitability. We depend on the continued popularity of malls as shopping destinations and the ability of mall anchor tenants and other attractions to generate customer traffic for our retail mall-based kiosks. We also depend on continued airline travel to generate traffic for our retail kiosks located in airports. Any decrease in mall or airport traffic could adversely affect the sales from our kiosks and our profitability and financial condition. In addition, an increase in the taxation of online sales could result in reduced online purchases or reduced margins on such sales. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors.

Intense competition in our industry may hinder our ability to generate revenue and may hurt our margins.

The market for foreign language learning solutions is rapidly evolving, highly fragmented and intensely competitive, and we expect both product and pricing competition to persist and intensify. Increased competition could cause reduced revenue, price reductions, reduced gross margins and loss of market share. Our competitors include Berlitz International Inc., Simon & Schuster, Inc. (Pimsleur), a subsidiary of CBS Corporation, Random House Ventures LLC (Living Language), Disney Publishing Worldwide, a subsidiary of Walt Disney Company, and McGraw-Hill Education, a subsidiary of The McGraw-Hill Companies. Many of our current and potential competitors have longer operating histories and substantially greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition worldwide. The resources of these competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements, reduce prices to win new customers and offer free language learning software or online services. We may not be able to compete successfully against current or future competitors.

As the market for foreign language solutions continues to develop, a number of other companies with greater resources than ours could attempt to enter the market or increase their presence by acquiring or forming strategic alliances with our competitors or our distributors or by introducing their own competing products. These companies and their products may be superior to any of our current competition. We may not have the financial resources, technical expertise, marketing, distribution or support capabilities to compete effectively with any of these new entrants to the market.

As we expand into foreign markets, we expect that we will experience competition from local foreign language learning companies that have strong brand recognition and more experience in selling to local consumers and a better understanding of local marketing, sales channels and consumer preferences.

Our success will depend on our ability to adapt to these competitive forces, to adapt to technological advances, to develop more advanced products more rapidly and less expensively than our competitors, to continue to develop an international sales network, to adapt to changing consumer preferences and to educate potential customers about the benefits of using our solutions rather than our competitors' products and services. Existing or new competitors could introduce new products and services with superior features and functionality at lower prices. This could impair our ability to sell our products and services.

Demand for paid language learning solutions such as ours could decline if effective language learning solutions become available for free.

Presently there are a number of free online language websites offering limited vocabulary lists and grammar explanations and tips. In addition, there are some online services offering limited free lessons and learning tools, including one sponsored by the U.S. Department of Education to help immigrants learn English. Many of these websites offer free language practice opportunities with other language learners. If these free products become more sophisticated and competitive or gain widespread acceptance by the public, demand for our solutions could decline.

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

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

- create greater awareness of our brands and our language learning solutions;
- select the right market, media and specific media vehicle in which to advertise;
- identify the most effective and efficient level of spending in each market, media and specific media vehicle;
- determine the appropriate creative message and media mix for advertising, marketing and promotional expenditures;
- effectively manage marketing costs, including creative and media expenses, in order to maintain acceptable customer acquisition costs;
- drive traffic to our websites, call centers, kiosks and distribution channels; and
- convert customer inquiries into actual orders.

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

Much of our radio, television and print advertising has been through the purchase of "remnant" advertising segments. These segments are random time slots and publication dates that have remained unsold and are offered at discounts to advertisers who are willing to be flexible with respect to time slots. There is a limited supply of this type of advertising and the availability of such advertising may decline or the cost of such advertising may increase. In addition, if we increase our marketing budget we cannot assure you that we can increase the amount of remnant advertising at the discounted prices we have obtained in the past. If any of these events occur, we may be forced to purchase time slots and publication dates at higher prices, which will increase our costs.

Our business depends on our Rosetta Stone brand, and if we are not able to maintain and enhance our brand, our business and operating results may be harmed.

We believe that market awareness of our *Rosetta Stone* brand in the United States has contributed significantly to the success of our business. We also believe that maintaining and enhancing the *Rosetta Stone* brand is critical to maintaining our competitive advantage. As we continue to grow in size, expand our products and services and extend our geographic reach, maintaining the quality and consistency of our language learning solutions, and thus the quality of our brand, may be more difficult. In addition, software piracy and trademark infringement may harm our *Rosetta Stone* brand by undermining our reputation for quality software programs.

We depend on search engines and other online sources to attract visitors to our websites, and if we are unable to attract these visitors and convert them into customers in a cost-effective manner, our business and financial results may be harmed.

Our success depends on our ability to attract online consumers to our websites and convert them into customers in a cost-effective manner. We depend, in part, on search engines and other online sources for our website traffic. We are included in search results as a result of both paid search listings, where we purchase specific search terms that will result in the inclusion of our listing, and algorithmic searches that depend upon the searchable content on our sites. Search engines and other online sources revise their algorithms from time to time in an attempt to optimize their search results.

If one or more of the search engines or other online sources on which we rely for website traffic were to modify its general methodology for how it displays our websites, resulting in fewer consumers clicking through to our websites, our sales could suffer. If any free search engine on which we rely begins charging fees for listing or placement, or if one or more of the search engines or other online sources on which we rely for purchased listings, modifies or terminates its relationship with us, our expenses could rise, we could lose customers and traffic to our websites could decrease.

Our expansion into international markets may not succeed and imposes special risks.

International sales accounted for approximately 5% of our revenue for the years ended December 31, 2007 and 2008, respectively. Our business strategy contemplates continued expansion into international markets. We are currently expanding our direct sales channels in Europe and Asia through our offices in London and Tokyo. In addition, we are expanding our indirect sales channels in Europe, Asia and Latin America through retailer and distributor arrangements with third parties. If we are unable to expand our international operations successfully and in a timely manner, our ability to pursue our growth strategy will be impaired. Such expansion may be more difficult or take longer than we anticipate, and we may not be able to successfully market, sell, deliver and support our products and services internationally.

Our international operations and our efforts to increase sales in international markets are subject to a number of risks that are in addition to or different than those affecting our U.S. operations, including:

- difficulty in staffing and managing geographically dispersed operations and culturally diverse work forces and increased travel, infrastructure and legal compliance costs associated with multiple international locations;

competition from local foreign language software providers and preferences for local products in some regions;

expenses associated with customizing products, support services and websites for foreign countries;

inability to identify an effective and efficient level of advertising, marketing and promotional expenditures in order to maintain acceptable customer acquisition costs;

difficulties with providing appropriate and appealing products to suit consumer preferences and capabilities in these markets, such as the potential need to customize English language software solutions for local markets;

difficulties with establishing successful kiosk sales channels;

inability to successfully develop relationships with significant retailers and distributors;

potential political and economic instability in some regions;

potential unpredictable changes in foreign government regulations;

legal and cultural differences in the conduct of business;

import and export license requirements, tariffs, taxes and other trade barriers;

inflation and fluctuations in currency exchange rates;

potentially adverse tax consequences;

difficulties in enforcing contracts and collecting accounts receivable, and longer payment cycles, especially in emerging markets;

the burden and difficulties in complying with a wide variety of U.S. and foreign laws, regulations, trade standards, treaties and technical standards, including the Foreign Corrupt Practices Act;

difficulty in protecting our intellectual property and the high incidence of software piracy in some regions;

costs and delays in downsizing foreign work forces as a result of differing employment and other laws;

protectionist laws and business practices that favor local competitors; and

uncertainty regarding liability for information retrieved and replicated in foreign countries.

The effects of any of the risks described above could reduce our future revenue from our international operations and could harm our overall business, revenue and financial results.

Our expansion into new web-based services may not succeed and may harm our business, financial results and reputation.

We are developing new web-based services that extend our existing language learning solutions with opportunities for practice including with dedicated language conversation coaches and other language learners to increase language socialization. We expect to provide these web-based services primarily as a bundle with our software and audio offerings. At the same time, we expect to provide augmented, free peer-to-peer language practice, building on our existing success with *www.sharedtalk.com.* We will devote capital, personnel and management attention to developing these new services. These services will present new management and marketing challenges that differ from the challenges we face in our existing business. We cannot assure you that these services will be successful or that they will be profitable, or if they are profitable, that they will provide an adequate return on capital expended. If we are not successful in developing these new services, our business, financial results and reputation may be harmed.

Product returns could exceed our estimates, which would diminish our reported revenue.

We offer consumers who purchase our packaged software and audio practice products directly from us an unconditional full money-back six-month guarantee. We also permit some of our retailers and distributors to return packaged products, subject to limitations. For the year ended December 31, 2008, sales returns were approximately 6.1% of total revenue. We establish revenue reserves for packaged product returns based on historical experience, estimated channel inventory levels and the timing of new product introductions and other factors. If packaged product returns exceed our reserve estimates, the excess would offset reported revenue, which could hurt our reported financial results.

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

Our success depends in part upon the continued adoption by institutions and potential customers of technology-based education initiatives. Some academics and educators oppose online education in principle and have expressed concerns regarding the perceived loss of control over the education process that can result from offering courses online. If the acceptance of technology-based education does not grow our ability to continue to grow our institutional business could be impaired.

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

Many of our institutional customers are colleges, universities, primary and secondary schools, other education providers, armed forces and government agencies who depend substantially on government funding. Accordingly, any general decrease, delay or change in federal, state or local funding for colleges, universities, primary and secondary schools, or other education providers or for armed forces or government agencies that use our products and services could cause our current and potential customers to reduce their purchases of our products and services, to exercise their right to terminate licenses, or to decide not to renew licenses, any of which could cause us to lose revenue. In addition, a specific reduction in governmental funding support for products such as ours would also cause us to lose revenue and could hurt our overall gross margins.

Some of our institutional business faces a lengthy and unpredictable sales cycle for our solutions, which could delay new sales.

We face a lengthy sales cycle between our initial contact with some potential institutional customers and the signing of license agreements with these customers. As a result of this lengthy sales cycle, we have only a limited ability to forecast the timing of such institutional sales. A delay in or failure to complete license transactions could cause us to lose revenue, and could cause our financial results to vary significantly from quarter to quarter. Our sales cycle varies widely, reflecting differences in our potential institutional customers' decision-making processes, procurement requirements and budget cycles, and is subject to significant risks over which we have little or no control, including:

- customers' budgetary constraints and priorities;

- the timing of our customers' budget cycles;
- the need by some customers for lengthy evaluations that often include both their administrators and faculties; and
- the length and timing of customers' approval processes.

If we are unable to continually enhance our products and services and adapt them to technological changes and customer needs, including the emergence of new computing devices and more sophisticated online services, we may lose market share and revenue and our business could suffer.

We need to anticipate, develop and introduce new products, services and applications on a timely and cost-effective basis that keeps pace with technological developments and changing customer needs. For example, the number of individuals who access the internet through devices other than a personal computer, such as personal digital assistants, mobile telephones, televisions and set-top box devices, has increased dramatically, and this trend is likely to continue. Our products and services were designed for rich, graphical environments such as those available on desktop and laptop computers. The lower resolution, functionality and memory associated with alternative devices currently available may make the use of our products and services through such devices difficult. Because each manufacturer or distributor may establish unique technical standards for its devices, our products and services may not work or be viewable on these devices. We have no experience to date in operating versions of our products and services developed or optimized for users of alternative devices, and new devices and new platforms are continually being released. Accordingly, it is difficult to predict the problems we may encounter in developing versions of our products and services for use on these alternative devices, and we may need to devote significant resources to the creation, support and maintenance of such versions. If we fail to develop or sell products and services that respond to these or other technological developments and changing customer needs cost effectively, we may lose market share and revenue and our business could suffer.

If we fail to manage our growth effectively, we may experience difficulty in filling purchase orders, declines in product and service quality and customer satisfaction, increased costs or disruption in our operations.

We have experienced rapid growth in our business in recent periods, which has strained our managerial, operational, financial and other resources. Our total revenue increased from $91.3 million for the period from January 4, 2006 through December 31, 2006 to $209.4 million for the year ended December 31, 2008. From December 31, 2006 to December 31, 2008, we increased the number of our employees from 662 to 1,218, and increased the number of kiosks selling our products from 81 to 150.

We anticipate that continued growth of our operations will be required to satisfy increasing consumer and institutional demand and to avail ourselves of new market opportunities. The expanding scope of our business and growth in the number of our employees, customers and sales locations will continue to place a significant strain on our management team, information technology systems and other resources. To properly manage our growth, we need to hire and retain personnel, upgrade our existing operational, management and financial and reporting systems, including warehouse management and inventory control, improve our business processes and controls and identify and develop relationships with additional retailers and distributors. We may also be required to expand our distribution facilities and our operational facilities or add new facilities, which could require significant capital expenditures. Failure to effectively manage our growth in a cost-effective manner could result in difficulty in filling purchase orders, declines in product and service quality and customer satisfaction, increased costs or disruption of our operations.

Our rapid growth also makes it difficult for us to adequately predict the expenditures we will need to make in the future. If we do not make the necessary overhead expenditures to accommodate our future growth, we may not be successful in executing our growth strategy.

Our revenue is subject to seasonal and quarterly variations, which could cause our financial results to fluctuate significantly.

We have experienced, and we believe we will continue to experience, substantial seasonal and quarterly variations in our revenue and net income. These variations are primarily related to increased sales of our products and services to consumers in the fourth quarter during the holiday selling season as well as higher sales to governmental and educational institutions in the second and third quarters. We sell to a significant number of our retailers, distributors and institutional customers on a purchase order basis and we receive orders when these customers need products and services. As a result, their orders are typically not evenly distributed throughout the year. Our quarterly results of operations also may fluctuate significantly as a result of a variety of other factors, including the timing of holidays and advertising initiatives, changes in our products, services and advertising initiatives and changes in those of our competitors. Budgetary constraints of our institutional customers may also cause our quarterly results to fluctuate.

As a result of these seasonal and quarterly fluctuations, we believe that comparisons of our results of operations between different quarters are not necessarily meaningful and that these comparisons are not reliable as indicators of our future performance. In addition, these fluctuations could result in volatility and adversely affect our cash flows. As our business grows, these seasonal fluctuations may become more pronounced. Any seasonal or quarterly fluctuations that we report in the future may differ from the expectations of market analysts and investors. This could cause the price of our common stock to fluctuate significantly.

Because a significant portion of our sales are made to or through retailers and distributors, none of which have any obligation to sell our products, the failure or inability of these parties to sell our products effectively could hurt our revenue growth and profitability.

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers are highly concentrated on a small group, including Amazon.com, Apple, Barnes & Noble and Borders. We expect that our arrangements with these retailers and distributors will continue to generate significant revenue for us. Sales to or through our retailers and distributors accounted for approximately 11% of our revenue for the period from January 4, 2006 through December 31, 2006, 15% of our revenue for the year ended December 31, 2007, and 17% of our revenue for the year ended December 31, 2008.

We have no control over the amount of products that these retailers purchase from us or sell on our behalf, we do not have long-term contracts with any of them, and they have no obligation to offer or sell our products or to give us any particular shelf space or product placement within their stores. Thus, there is no guarantee that this source of revenue will continue at the same level as it has in the past or that these retailers will not promote competitors' products over our products or enter into exclusive relationships with competitors. Any material adverse change in the principal commercial terms, material decrease in the volume of sales generated by our larger retailers or distributors or major disruption or termination of a relationship with these retailers and distributors could result in a potentially significant decline in our revenue and profitability. Furthermore, product display locations and promotional activities that retailers undertake can affect the sales of our products. The fact that we also sell our products directly could cause retailers or distributors to reduce their efforts to promote our products or stop selling our products altogether. In addition, if one or more of such retailers or distributors were unable to meet their obligations with respect to accounts payable to us, we could be forced to write off such accounts.

Substantially all of our inventory is located in one warehouse facility. Any damage or disruption at this facility could cause significant financial loss, cause us to lose revenue and harm our reputation.

Substantially all of our inventory is located in one warehouse facility. We could experience significant interruption in the operation of this facility or damage or destruction of our inventory due to natural disasters, accidents, failures of the inventory locator or automated packing and shipping systems or other events. If a material portion of our inventory were to be damaged or destroyed, we might be unable to meet our contractual obligations which could cause us significant financial loss, cause us to lose revenue and harm our reputation.

The loss of key personnel or the failure to attract and retain highly qualified personnel could compromise our ability to effectively manage our business and pursue our growth strategy.

Our future performance depends on the continued service of our key technical, development, sales, services and management personnel. We rely on our executive officers and senior management to execute our existing business plans and to identify and pursue new opportunities. We rely on our technical and development personnel for product innovation. We generally do not have employment agreements with our personnel and, therefore, they could terminate their employment with us at any time. The loss of key employees could result in significant disruptions to our business, and the integration of replacement personnel could be costly and time consuming, could cause additional disruptions to our business, and could be unsuccessful. We do not carry key person life insurance covering any of our employees.

Our future success also depends on our continued ability to attract and retain highly qualified technical, development, sales, services and management personnel. Competition for such personnel is intense, and we may fail to retain our key employees or attract or retain other highly qualified personnel in the future. Many of our employees are located in Harrisonburg, Virginia, a city that does not have a large pool of qualified replacement personnel. The lack of qualified local replacement personnel may make it more difficult to quickly find replacement personnel and may increase the costs of identifying and relocating replacement personnel to Harrisonburg.

In addition, wage inflation and the cost of retaining our key personnel in the face of competition for such personnel may increase our costs faster than we can offset these costs with increased prices or increased sales volume.

If we are unable to hire, train, motivate and retain sales personnel to staff our kiosks, or to identify suitable locations and negotiate site licenses on acceptable terms, we could lose revenue, our costs could increase and profitability could decline.

As of December 31, 2006, we had 81 kiosks selling our products directly to consumers. As of December 31, 2008, we had increased the number of kiosks selling our products to 150. In order to successfully grow this sales channel we must be able to hire, train, motivate and retain sales personnel to staff these kiosks. These kiosks are small and widely dispersed, and, as such, are operated without substantial hands-on management or oversight by us. As a result, we depend on our kiosk sales personnel to effectively manage sales, customer issues and reporting of financial transactions from these kiosks. The opening and success of new kiosks will depend upon various additional factors, including our ability to identify suitable locations and our ability to negotiate site licenses on acceptable terms and labor costs. Specifically, we must identify and negotiate cost-effective site licenses for kiosk locations that will generate sufficient consumer demand. Many of these site licenses contain terms and conditions that are highly favorable to licensors including allowing licensors to cancel them on short notice, sometimes as little as thirty days, and broad indemnification terms in favor of licensors. If competition for kiosk space increases, license rates may increase and other terms may become even less favorable to us, resulting in lower profitability. Our failure to properly manage the expansion of this sales channel could cause us to lose revenue and increase our expenses.

Failure to maintain the availability of the systems, networks, databases and software required to operate and deliver our internet-based products and services could damage our reputation and cause us to lose revenue.

We rely on internal systems and external systems, networks and databases maintained by us and third-party providers to process customer orders, handle customer service requests, and host and deliver our internet-based language learning solutions and our *SharedTalk* online peer-to-peer collaborative and interactive community. Any damage, interruption or failure of our systems, networks and databases could prevent us from processing customer orders and result in degradation or interruptions in delivery of our products and services. Notwithstanding our efforts to protect against interruptions in the availability of our e-commerce websites and internet-based products and services, we do occasionally experience unplanned outages or technical difficulties. In addition, we do not have complete redundancy for all of our systems. We do not maintain real-time back-up of all of our data, and in the event of system disruptions, we could experience loss of data which could cause us to lose customers and could harm our reputation and cause us to face unexpected liabilities and expenses. If we continue to expand our business, we will put additional strains on these systems. We may also need to grow, reconfigure or relocate our data centers in response to changing business needs, which may be costly and lead to unplanned disruptions of service.

Our possession and use of personal information presents risks and expenses that could harm our business. Unauthorized disclosure or manipulation of such data, whether through breach of our network security or otherwise, could expose us to costly litigation and damage our reputation.

Maintaining our network security is of critical importance because our online e-commerce systems and our online administration tools for our institutional business store proprietary and confidential customer, employee and other sensitive data, such as names, addresses, other personal information and credit card numbers. We and our vendors use commercially available encryption technology to transmit personal information when taking orders. We use security and business controls to limit access and use of personal information. However, third parties may be able to circumvent these security and business measures by developing and deploying viruses, worms and other malicious software programs that are designed to attack or attempt to infiltrate our systems and networks. In addition, employee error, malfeasance or other errors in the storage, use or transmission of personal information could result in a breach of customer or employee privacy. We employ contractors and temporary and part-time employees who may have access to the personal information of customers and employees. It is possible such individuals could circumvent our controls, which could result in a breach of customer or employee privacy.

Possession and use of personal information in conducting our business subjects us to legislative and regulatory burdens that could require notification of data breach, restrict our use of personal information and hinder our ability to acquire new customers or market to existing customers. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.

If third parties improperly obtain and use the personal information of our customers or employees, we may be required to expend significant resources to resolve these problems. A major breach of our network security and systems could have serious negative consequences for our businesses, including possible fines, penalties and damages, reduced customer demand for our products and services, harm to our reputation and brand and loss of our ability to accept and process customer credit card orders.

We are exposed to risks associated with credit card and payment fraud and with credit card processing, which could cause us to lose revenue.

Many of our customers use credit cards or automated payment systems to pay for our products and services. We have suffered losses, and may continue to suffer losses, as a result of orders placed with fraudulent credit cards or other fraudulent payment data. For example, under current credit card practices, we may be liable for fraudulent credit card transactions if we do not obtain a cardholder's signature, a frequent practice in internet sales. We employ technology solutions to help us detect fraudulent transactions. However, the failure to detect or control payment fraud could cause us to lose sales and revenue.

Any significant interruptions in the operations of our call center or third-party call centers could cause us to lose sales and disrupt our ability to process orders and deliver our solutions in a timely manner.

We rely on both an in-house call center and third-party call centers to sell our solutions, respond to customer service and technical support requests and process orders. Any significant interruption in the operation of these facilities, including an interruption caused by our failure to successfully expand or upgrade our systems or to manage these expansions or upgrades, could reduce our ability to receive and process orders and provide products and services, which could result in lost and cancelled sales and damage to our brand and reputation.

As we grow, we will need more capacity from those existing call centers or we will need to identify and contract with new call centers. We may not be able to continue to locate and contract for call center capacity on favorable terms, or at all. Additionally, the rates those call centers charge us may increase or those call centers may not continue to provide service at the current levels.

We structure our marketing and advertising to drive potential customers to our call centers and websites to purchase our solutions. If our call center operators do not convert inquiries into sales at expected rates, our ability to generate revenue could be impaired. Training and retaining qualified call center operators is challenging due to the expansion of our product and service offerings and the seasonality of our business. If we do not adequately train our call center operators, they will not convert inquiries into sales at an acceptable rate.

Our call center employs a large number of personnel and historically has been subject to a high turnover rate among employees. We may have to terminate employees from time to time as our business changes and labor demands shift among our facilities. Any significant increase in labor costs, deterioration of employee relations, slowdowns or work stoppages at any of our locations, employee turnover or otherwise, could harm our business and profitability. In addition, high employee turnover could increase our exposure to employee-related litigation. Likewise, the third-party call centers we utilize face similar issues.

If any of our products contain defects or errors or if new product releases or services are delayed, our reputation could be harmed, resulting in significant costs to us and impairing our ability to sell our solutions.

If our products contain defects, errors or security vulnerabilities, our reputation could be harmed, which could result in significant costs to us and impair our ability to sell our products in the future. In the past, we have encountered product development delays due to errors or defects. We would expect that, despite our testing, errors will be found in new products and product enhancements in the future. Significant errors in our products or services could lead to, among other things:

- delays in or loss of market acceptance of our products and services;

- diversion of our resources;
- a lower rate of license renewals or upgrades for consumer and institutional customers;
- injury to our reputation; or
- increased service expenses or payment of damages.

In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products and services. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms, or at all, we could face significant financial losses.

Our sales to U.S. government agencies and armed forces subject us to special risks that could adversely affect our business.

In 2008, we derived approximately 4% of our revenue from sales to U.S. government agencies and armed forces. Government sales entail a variety of risks including:

- government contracts are subject to the approval of appropriations by the United States Congress to fund the expenditures by the agencies under these contracts. Congress often appropriates funds for government agencies on a yearly basis, even though their contracts may call for performance over a number of years;
- our products and services are included on a General Services Administration, or GSA, schedule. The loss of the GSA schedule covering our software products and related services could cause us to lose our ability to sell our products and services to U.S. government customers;
- we must comply with complex federal procurement laws and regulations in connection with government contracts, which may impose added costs on our business; and
- federal government contracts contain provisions and are subject to laws and regulations that provide government customers with rights and remedies not typically found in commercial contracts. These rights and remedies allow government clients, among other things, to terminate existing contracts, with short notice, for convenience without cause, reduce or modify contracts or subcontracts, and claim rights in products, systems, and technology produced by us.

If we fail to effectively upgrade our information technology systems, we may not be able to accurately report our financial results or prevent fraud.

As part of our efforts to continue improving our internal control over financial reporting, we plan to continue to upgrade our existing financial information technology systems in order to automate several controls that are currently performed manually. We may experience difficulties in transitioning to these upgraded systems, including loss of data and decreases in productivity, as personnel become familiar with these new systems. In addition, our management information systems will require modification and refinement as we grow and as our business needs change, which could prolong difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems or respond to changes in our business needs, we may not be able to effectively manage our business and we may fail to meet our reporting obligations. In addition, as a result of the automation of these manual processes, the data produced may cause us to question the accuracy of previously reported financial results.

Our software products must interoperate with computer operating systems of our institutional customers. If we are unable to ensure that our products interoperate properly with institutional customer systems, our business could be harmed.

Our products must interoperate with our institutional customers' computer systems, including student learning management systems. As a result, we must continually ensure that our products interoperate properly with these systems. Changes in operating systems, the technologies we incorporate into our products or the computer systems our institutional customers use may damage our business.

As our product and service offerings become more complex our reported revenue may become less predictable.

Our planned expansion of products and services will generate more varied sources of revenue than our existing business. The accounting policies that apply to these sources of revenue may be more complex than those that apply to our traditional products and services. In addition, we may change the manner in which we sell our software licenses, and such change could cause delays in revenue recognition in accordance with accounting standards. Under these accounting standards, even if we deliver products and services to, and collect cash from, a customer in a given fiscal period, we may be required to defer recognizing revenue from the sale of such product or service until a future period when all the conditions necessary for revenue recognition have been satisfied. Conditions that can cause delays in revenue recognition include software arrangements that have undelivered elements for which we have not yet established vendor specific objective evidence of fair value, requirements that we deliver services for significant enhancements or modifications to customize our software for a particular customer or material customer acceptance criteria.

Many of our expenses are fixed and many are based, in significant part, on our expectations of our future revenue and incurred prior to the sale of our products and services. Therefore, any significant decline in revenue for any period could have an immediate impact on our margins, net income and financial results for the period.

Our expense levels are based, in significant part, on our estimates of future revenue and many of these expenses are fixed in the short term. As a result, we may be unable to adjust our spending in a timely manner if our revenue falls short of our expectations. Accordingly, any significant shortfall of revenue in relation to our estimates could have an immediate effect on our profitability. In addition, as our business grows, we anticipate increasing our operating expenses to expand our product development, technical support, sales and marketing and administrative organizations. Any such expansion could cause material losses to the extent we do not generate additional revenue sufficient to cover the additional expenses.

We may need to raise additional funds to pursue our growth strategy or continue our operations, and we may be unable to raise capital when needed.

From time to time, in addition to this offering, we may seek additional equity or debt financing to provide for the capital expenditures required to finance working capital requirements, continue our expansion, develop new products and services or make acquisitions or other investments. In addition, if our business plans change, general economic, financial or political conditions in our markets change, or other circumstances arise that have a material effect on our cash flow, the anticipated cash needs of our business as well as our conclusions as to the adequacy of our available sources of capital could change significantly. Any of these events or circumstances could result in significant additional funding needs, requiring us to raise additional capital. We cannot predict the timing or amount of any such capital requirements at this time. If financing is not available on satisfactory terms, or at all, we may be unable to expand our business or to develop new business at the rate desired and our results of operations may suffer.

Risks Related to Intellectual Property Rights

Protection of our intellectual property is limited, and any misuse of our intellectual property by others, including software piracy, could harm our business, reputation and competitive position.

Our intellectual property is important to our success. We believe our trademarks, copyrights, trade secrets, pending patents, trade dress and designs are valuable and integral to our success and competitive position. To protect our proprietary rights, we rely on a combination of copyrights, trademarks, trade secret laws, confidentiality procedures, contractual provisions and technical measures.

We have several patent applications on file. However, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims. Even if patents are issued from our patent applications, which is not certain, they may be contested, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, we have not emphasized patents as a source of significant competitive advantage and have instead sought to primarily protect our proprietary rights under laws affording protection for trade secrets, copyright and trademark protection of our products, brands, trademarks and other intellectual property where available and appropriate. However, all of these measures afford only limited protection and may be challenged, invalidated or circumvented by third parties. In addition, these protections may not be adequate to prevent our competitors or customers from copying or reverse-engineering our products. Third parties could copy all or portions of our products or otherwise obtain, use, distribute and sell our proprietary information without authorization. Third parties may also develop similar or superior technology independently by designing around our intellectual property, which would decrease demand for our products. In addition, our patents may not provide us with any competitive advantages and the patents of others may seriously impede our ability to conduct our business.

We protect our products, trade secrets and proprietary information, in part, by requiring all of our employees to enter into agreements providing for the maintenance of confidentiality and the assignment of rights to inventions made by them while employed by us. We also enter into non-disclosure agreements with our technical consultants, customers, vendors and resellers to protect our confidential and proprietary information. We cannot assure you that our confidentiality agreements with our employees, consultants and other third parties will not be breached, that we will be able to effectively enforce these agreements, that we will have adequate remedies for any breach, or that our trade secrets and other proprietary information will not be disclosed or will otherwise be protected.

We rely on contractual and license agreements with third parties in connection with their use of our products and technology. There is no guarantee that such parties will abide by the terms of such agreements or that we will be able to adequately enforce our rights, in part because we rely, in many instances, on "click-wrap" and "shrink-wrap" licenses, which are not negotiated or signed by individual licensees. Accordingly, some provisions of our licenses, including provisions protecting against unauthorized use, copying, transfer, resale and disclosure of the licensed software program, may be unenforceable under the laws of several jurisdictions.

Protection of trade secret and other intellectual property rights in the markets in which we operate and compete is highly uncertain and may involve complex legal questions. The laws of countries in which we operate may afford little or no protection to our trade secrets and other intellectual property rights. Although we defend our intellectual property rights and combat unlicensed copying and use of software and intellectual property rights through a variety of techniques, preventing unauthorized use or infringement of our intellectual property rights is inherently difficult. Despite our enforcement efforts against software piracy, we lose significant revenue due to illegal use of our software. If piracy activities increase, it may further harm our business.

We also expect that the more successful we are, the more likely that competitors will try to illegally use our proprietary information and develop products that are similar to ours, which may infringe on our proprietary rights. In addition, we could potentially lose future trade secret protection for our source code if any unauthorized disclosure of such code occurs. The loss of future trade secret protection could make it easier for third parties to compete with our products by copying functionality. In addition, any changes in, or unexpected interpretations of, the trade secret and other intellectual property laws in any country in which we operate may compromise our ability to enforce our trade secret and intellectual property rights. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our confidential information and trade secret protection. If we are unable to protect our proprietary rights or if third parties independently develop or gain access to our or similar technologies, our business, revenue, reputation and competitive position could be harmed.

Third-party use of our trademarks as keywords in internet search engine advertising programs may direct potential customers to competitors' websites, which could harm our reputation and cause us to lose sales.

Competitors and other third parties purchase our trademarks and confusingly similar terms as keywords in internet search engine advertising programs and in the header and text of the resulting sponsored link advertisements in order to divert potential customers to their websites. Preventing such unauthorized use is inherently difficult. In addition, the judicial precedent on whether such activity constitutes infringement varies significantly within the United States and in other countries. If we are unable to protect our trademarks and confusingly similar terms from such unauthorized use, competitors and other third parties will continue to drive potential online customers away from our websites to competing websites, which could harm our reputation and cause us to lose sales.

Our trademarks are limited in scope and geographic coverage and may not significantly distinguish us from the competition.

We own several federal trademark registrations, including the *Rosetta Stone* mark, hold common law trademark rights and have federal trademark applications pending in the United States and abroad for additional trademarks. Even if federal registrations are granted to us, our trademark rights may be challenged. It is also possible that our competitors will adopt trademarks similar to ours, thus impeding our ability to build brand identity and possibly leading to customer confusion. In fact, various third parties have registered trademarks that are similar to ours in the United States and overseas. We could incur substantial costs in prosecuting or defending trademark infringement suits. If we fail to effectively enforce our trademark rights, our competitive position and brand recognition may be diminished.

We have registered *Rosetta Stone* as a trademark for language learning in several countries. However, we have been precluded from registering this trademark in some Asian countries because third parties have previously registered the trademark or have registered similar trademarks. As a result, we have been marketing our products and services under our *Rosetta World* brand in some Asian countries, thus compromising our ability to build a cohesive worldwide brand identity and possibly leading to customer confusion.

We have not registered copyrights for all our products, which may limit our ability to enforce them.

We have not registered our copyrights in all of our software, written materials, website information, designs or other copyrightable works. The United States Copyright Act automatically protects all of our copyrightable works, but without a registration we cannot enforce those copyrights against infringers or seek certain statutory remedies for any such infringement. Preventing others from copying our products, written materials and other copyrightable works is important to our overall success in the marketplace. In the event we decide to enforce any of our copyrights against infringers, we will first be required to register the relevant copyrights, and we cannot be sure that all of the material for which we seek copyright registration would be registrable in whole or in part, or that once registered, we would be successful in bringing a copyright claim against any such infringers.

We must monitor and protect our internet domain names to preserve their value. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe on or otherwise decrease the value of our trademarks.

We own several domain names that include the terms Rosetta Stone and Rosetta World. Third parties may acquire substantially similar domain names that decrease the value of our domain names and trademarks and other proprietary rights which may hurt our business. Moreover, the regulation of domain names in the United States and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars or modify the requirements for holding domain names. Governing bodies could also establish additional "top-level" domains, which are the portion of the Web address that appears to the right of the "dot," such as "com," "gov" or "org." As a result, we may not maintain exclusive rights to all potentially relevant domain names in the United States or in other countries in which we conduct business, which could harm our business or reputation.

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

We may become subject to material claims of infringement by competitors and other third parties with respect to current or future products, e-commerce and other web-related technologies, online business methods, trademarks or other proprietary rights. Our competitors, some of which may have substantially greater resources than us and have made significant investments in competing products and technologies, may have, or seek to apply for and obtain, patents, copyrights or trademarks that will prevent, limit or interfere with our ability to make, use and sell our current and future products and technologies, and we may not be successful in defending allegations of infringement of these patents, copyrights or trademarks. Further, we may not be aware of all of the patents and other intellectual property rights owned by third parties that may be potentially adverse to our interests. We may need to resort to litigation to enforce our proprietary rights or to determine the scope and validity of a third-party's patents or other proprietary rights, including whether any of our products, technologies or processes infringe the patents or other proprietary rights of third parties. We may incur substantial expenses in defending against third-party infringement claims regardless of the merit of such claims. The outcome of any such proceedings is uncertain and, if unfavorable, could force us to discontinue sales of the affected products or impose significant penalties or restrictions on our business. We do not conduct comprehensive patent searches to determine whether the technologies used in our products infringe upon patents held by others. In addition, product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies.

We do not own all of the software, other technologies and content used in our products and services.

Some of our products and services include intellectual property owned by third parties, including software that is integrated with internally developed software and a portion of our voice recognition software, which we license from the University of Colorado. From time to time we may be required to renegotiate with these third parties or negotiate with new third parties to include their technology or content in our existing products, in new versions of our existing products or in wholly new products. We may not be able to negotiate or renegotiate licenses on commercially reasonable terms, or at all, and the third-party software may not be appropriately supported, maintained or enhanced by the licensors. If we are unable to obtain the rights necessary to use or continue to use third-party technology or content in our products and services or the inability to support, maintain and enhance any software could result in increased costs, or in delays or reductions in product shipments until equivalent software could be developed, identified, licensed and integrated.

Our use of open source software could impose limitations on our ability to commercialize our products.

We incorporate open source software into our products and may use more open source software in the future. The use of open source software is governed by license agreements. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that these licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, make generally available, in source code form, proprietary code that links to certain open source modules, re-engineer our products, discontinue the sale of our products if re-engineering could not be accomplished on a cost-effective and timely basis, or become subject to other consequences. In addition, open source licenses generally do not provide warranties or other contractual protections regarding infringement claims or the quality of the code. Thus, we may have little or no recourse if we become subject to infringement claims relating to the open source software or if the open source software is defective in any manner.

Risks Related to This Offering

Some of our stockholders could together exert control over our company after completion of this offering.

As of December 31, 2008, funds affiliated with ABS Capital Partners beneficially owned in the aggregate shares representing approximately 44% of our outstanding voting power. Two managing members of the general partner of ABS Capital Partners currently serve on our board of directors. After the completion of this offering, funds affiliated with ABS Capital Partners will beneficially own in the aggregate shares representing approximately 28% of our outstanding voting power, or approximately 25% if the underwriters exercise their over-allotment option in full. Additionally, as of December 31, 2008, Norwest Equity Partners VIII, LP, or Norwest, beneficially owned in the aggregate shares representing approximately 29% of our outstanding voting power. One managing member of the general partner of Norwest currently serves on our board of directors. After completion of this offering, affiliates of Norwest will beneficially own in the aggregate shares representing approximately 18% of our outstanding voting power, or approximately 16% if the underwriters exercise their over-allotment option in full. As a result, these stockholders could together control all matters presented to our stockholders for approval, including election and removal of our directors and change of control transactions. The interests of these stockholders may not always coincide with the interests of the other holders of our common stock.

As a public company we will incur additional cost and face increased demands on our management and key employees.

We have never operated as a public company. As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act of 2002, as well as rules implemented by the Securities and Exchange Commission, or SEC, and the New York Stock Exchange, impose various requirements on public companies. Our management and other personnel will devote substantial amounts of time to these requirements. We expect these requirements to significantly increase our legal and financial compliance costs and to make some activities more time-consuming and costly. In addition, we will incur additional costs associated with our public company reporting requirements. These rules and regulations also make it more difficult and more expensive for us to obtain director and officer liability insurance. We cannot predict or estimate the amount of additional costs we may incur or the timing of such costs. If our profitability is harmed by these additional costs, it could have a negative effect on the trading price of our common stock.

We have identified material weaknesses in our internal controls for the period from January 4, 2006 through December 31, 2006 and the year ended December 31, 2007 that, if not properly remediated, could result in material misstatements in our financial statements in future periods and impair our ability to comply with the accounting and reporting requirements applicable to public companies.

In relation to our consolidated financial statements for the period from January 4, 2006 through December 31, 2006 and the year ended December 31, 2007, we identified material weaknesses in our internal controls over financial reporting in accounting for inventory, income taxes and stock-based compensation, our general computer controls and controls within our enterprise resources planning system. In addition, we identified a significant deficiency in our financial closing process. No material weaknesses or significant deficiencies in our internal controls were identified in relation to our consolidated financial statements for the year ended December 31, 2008. A material weakness is defined as a significant deficiency or combination of significant deficiencies, that results in a reasonable possibility that a material misstatement of our financial statements will not be prevented by our internal control over financial reporting. A significant deficiency means a control deficiency, or combination of control deficiencies, that adversely affects our ability to initiate, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of our financial statements that is more than inconsequential will not be prevented or detected by our internal control over financial reporting.

Our independent registered public accounting firm's audit for the period from January 4, 2006 through December 31, 2006 and the years ended December 31, 2007 and 2008 included consideration of internal control over financial reporting as a basis for designing their audit procedures, but not for the purpose of expressing an opinion on the effectiveness of our internal controls over financial reporting. If such an evaluation had been performed or when we are required to perform such an evaluation after we become public, additional material weaknesses, significant deficiencies and other control deficiencies may have been or may be identified. Ensuring that we have adequate internal financial and accounting controls and procedures in place to help produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be evaluated frequently. We will incur increased costs and demands upon management as a result of complying with the laws and regulations affecting public companies relating to internal controls, which could materially adversely affect our results of operations.

Because of these material weaknesses, there is heightened risk that a material misstatement of our annual or quarterly financial statements relating to the periods that these material weaknesses existed was not prevented or detected. We have taken steps to remediate our material weaknesses, including hiring additional accounting and finance personnel and engaging consultants. Although we believe we have remediated these material weaknesses and significant deficiencies and did not identify any new material weaknesses or significant deficiencies in relation to our consolidated financial statements for the year ended December 31, 2008, we cannot assure you that our efforts to remediate these internal control weaknesses were successful or that similar material weaknesses will not recur. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Internal Control over Financial Reporting" for a discussion of the material weaknesses in our internal controls during the period January 4, 2006 through December 31, 2006 and the year ended December 31, 2007 and our efforts to remediate those material weaknesses.

Our internal growth plans will also put additional strains on our internal controls if we do not augment our resources and adapt our procedures in response to this growth. Once we become a public company, we will be required to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 regarding internal controls. In the event that we have not adequately remedied these material weaknesses, and if we fail to maintain proper and effective internal controls in future periods, we could become subject to potential review by the New York Stock Exchange, the SEC or other regulatory authorities, which could require additional financial and management resources, could result in our delisting by the New York Stock Exchange, could compromise our ability to run our business effectively and could cause investors to lose confidence in our financial reporting.

We will retain broad discretion in using the net proceeds from this offering and may spend a substantial portion in ways with which you do not agree.

Our management will retain broad discretion to allocate the net proceeds of this offering. The net proceeds may be applied in ways with which you and other investors in the offering may not agree, or which do not increase the value of your investment. We intend to use a portion of our net proceeds from this offering to repay the outstanding balance under our existing credit facility with Wells Fargo Bank N.A., or Wells Fargo, which was approximately $9.9 million as of February 28, 2009. We also intend to use a portion of the net proceeds of this offering equal to approximately $7.0 million, based on an assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, to satisfy the federal, state and local withholding tax obligations associated with the "net issuance" of stock grants we intend to make to 10 of our key employees, including our named executive officers, prior to the completion of this offering. We anticipate that we will use the remainder of the net proceeds for working capital and other general corporate purposes, which may include the acquisition of other businesses, products or technologies. We have not allocated these remaining net proceeds for any specific purposes. Our management might not be able to yield a significant return, if any, on any investment of these net proceeds. We will not receive any of the proceeds from the sale of the shares of our common stock by the selling stockholders.

We do not know whether a market will develop for our common stock or what the market price of our common stock will be and as a result it may be difficult for you to sell your shares of our common stock.

Before this offering, there was no public trading market for our common stock. If a market for our common stock does not develop or is not sustained, it may be difficult for you to sell your shares of common stock at an attractive price or at all. We cannot predict the prices at which our common stock will trade. The initial public offering price for our common stock will be determined through negotiations with the underwriters and may not bear any relationship to the market price at which the common stock will trade after this offering or to any other established criteria regarding our value. It is possible that in one or more future periods our results of operations may be below the expectations of public market analysts and investors and, as a result of these and other factors, the price of our common stock may fall.

If securities analysts do not publish research or reports about our business or if they publish negative evaluations of our stock, the price of our stock could decline.

The trading market for our common stock will rely in part on the research and reports that industry or financial analysts publish about us or our business. We do not currently have and may never obtain research coverage by industry or financial analysts. If no or few analysts commence coverage of us, the trading price of our stock would likely decrease. Even if we do obtain analyst coverage, if one or more of the analysts covering our business downgrade their evaluations of our stock, the price of our stock could decline. If one or more of these analysts cease to cover our stock, we could lose visibility in the market for our stock, which in turn could cause our stock price to decline.

Sales of outstanding shares of our common stock into the market in the future could cause the market price of our common stock to drop significantly, even if our business is doing well.

If our existing stockholders sell, or indicate an intention to sell, substantial amounts of our common stock in the public market, the trading price of our common stock could decline substantially. After this offering, approximately 20.3 million shares of our common stock will be outstanding. Of these shares, the 6.25 million shares of our common stock sold in this offering will be freely tradable, without restriction, in the public market and more than 99% of the remaining shares are subject to 180-day contractual lockup agreements with our underwriters. Morgan Stanley & Co. Incorporated may, in its discretion, permit our directors, officers, employees and current stockholders who are subject to these contractual lockups to sell shares prior to the expiration of the lockup agreements. The lockup is subject to extension for an additional 34 days under some circumstances. See "Shares Eligible for Future Sale Lock-Up Agreements."

After the lockup agreements pertaining to this offering expire, up to an additional approximately 14.1 million shares will be eligible for sale in the public market, approximately 13.3 million of which are held by directors, executive officers and other affiliates and will be subject to volume limitations under Rule 144 under the Securities Act of 1933, as amended, or the Securities Act. In addition, the approximately 4.3 million shares underlying options and restricted stock grants that are either subject to the terms of our equity compensation plans or reserved for future issuance under our equity compensation plans will become eligible for sale in the public market to the extent permitted by the provisions of various option agreements, the lock-up agreements and Rules 144 and 701 under the Securities Act. The approximately 0.6 million shares of common stock we intend to grant to 10 of our key employees, including our named executive officers, net of the shares withheld to satisfy the federal, state and local tax withholding obligations as a result of the "net issuance" of these stock grants, are subject to contractual restrictions on resale of six, twelve and eighteen months for each one-third of such shares. If these additional shares are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline. For additional information, see "Shares Eligible for Future Sale."

You will experience immediate and substantial dilution in your investment.

The offering price of the common stock is substantially higher than the net tangible book value per share of our common stock, which on a pro forma basis was $1.97 as of December 31, 2008. As a result, you will experience immediate and substantial dilution in pro forma net tangible book value when you buy shares of common stock in this offering. This means that you will pay a higher price per share than the amount of our total assets, minus our total liabilities, divided by the number of outstanding shares. Holders of our common stock will experience further dilution if options or other rights to purchase our common stock that are outstanding or that we may issue in the future are exercised or converted, or if we issue additional shares of our common stock, at prices lower than our net tangible book value at such time.

Provisions in our organizational documents and in the Delaware General Corporation Law may prevent takeover attempts that could be beneficial to our stockholders.

Provisions in our second amended and restated certificate of incorporation and second amended and restated bylaws, both of which will be effective upon the closing of this offering, and in the Delaware General Corporation Law, may make it difficult and expensive for a third-party to pursue a takeover attempt we oppose even if a change in control of our company would be beneficial to the interests of our stockholders. Any provision of our second amended and restated certificate of incorporation or second amended and restated bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our board of directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner. However, because funds affiliated with ABS Capital Partners and Norwest acquired their shares prior to this offering, Section 203 is currently inapplicable to any business combination or transaction with them or their affiliates. In addition, our second amended and restated certificate of incorporation includes a classified board of directors and requires that any action to be taken by stockholders must be taken at a duly called meeting of stockholders and may not be taken be written consent. Our second amended and restated bylaws require that any stockholder proposals or nominations for election to our board of directors must meet specific advance notice requirements and procedures, which make it more difficult for our stockholders to make proposals or director nominations.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus, including the sections entitled "Prospectus Summary," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and "Business," contains forward-looking statements. We may, in some cases, use words such as "project," "believe," "anticipate," "plan," "expect," "estimate," "intend," "should," "would," "could," "potentially," "will," or "may," or other words that convey uncertainty of future events or outcomes to identify these forward-looking statements. Forward-looking statements in this prospectus include statements about:

- demand for language learning software;
- the advantages of our products, technology, brand and business model as compared to others;
- our ability to maintain effective internal controls or to remediate material weaknesses;
- our spending of the proceeds from this offering;
- our cash needs and expectations regarding cash flow from operations;
- our product development plans, including our plans to develop new web-based services and expansion of our product portfolio;
- our plans regarding expansion of our marketing initiatives and sales force;
- our international expansion plans;
- our plans to increase our kiosks and retail relationships;
- our ability to manage and grow our business and execution of our business strategy;
- our financial performance; and
- the costs associated with being a public company.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. There are a number of important factors that could cause actual results to differ materially from the results anticipated by these forward-looking statements, which statements apply only as of the date of this prospectus. These important factors include those that we discuss in this prospectus under the caption "Risk Factors" and elsewhere. You should read these factors and the other cautionary statements made in this prospectus as being applicable to all related forward-looking statements wherever they appear in this prospectus. If one or more of these factors materialize, or if any underlying assumptions prove incorrect, our actual results, performance or achievements may vary materially from any future results, performance or achievements expressed or implied by these forward-looking statements. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

USE OF PROCEEDS

We estimate that the net proceeds we will receive from this offering will be approximately $43.0 million, based on the assumed initial public offering price of $16.00 per share, which is the midpoint of the range included on the cover page of this prospectus, and after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us. If the underwriters' option to purchase additional shares in this offering is exercised, our net proceeds will not change as the entire option will be comprised of shares from the selling stockholders. We will not receive any proceeds from the sale of shares of our common stock by the selling stockholders. A $1.00 increase or decrease in the assumed initial public offering price of $16.00 per share would increase or decrease the net proceeds we receive from this offering by approximately $2.9 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriter discounts and commissions and estimated offering expenses payable by us.

We expect to use a portion of the net proceeds we will receive from this offering to repay all amounts outstanding under our credit agreement with Wells Fargo, which has a maturity date of January 15, 2011 and had an outstanding balance of $9.9 million and an interest rate of approximately 3.0% as of February 28, 2009.

We expect to use approximately $7.0 million, based upon an assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, to satisfy the federal, state and local withholding tax obligations of 10 of our key employees, including our named executive officers, relating to the "net issuance" of the stock grants we intend to make to them prior to the completion of this offering. See "Capitalization" and "Executive Compensation Stock Grants" for a description of these stock grants and tax payments. We will withhold from each recipient's award a number of shares of our common stock equal to the dollar value of the recipient's federal, state and local withholding tax obligations relating to the "net issuance" of the stock grant and we will use a portion of the proceeds of this offering to pay to the appropriate taxing authorities an equivalent value in cash based upon the actual initial public offering price per share in this offering.

A $1.00 increase or decrease in the assumed initial public offering price of $16.00 per share, which is the midpoint of the range set forth on the cover page of this prospectus, would increase or decrease the amount of cash we would pay to satisfy the federal, state and local withholding tax obligations relating to recipient's "net issuance" of the stock grants by an aggregate of $0.4 million.

We expect to use the remainder of the net proceeds for working capital and general corporate purposes. We may also use a portion of the proceeds to expand our current business through acquisitions or investments in other complementary businesses, products or technologies. We have no agreements or commitments with respect to any acquisitions at this time. We will have broad discretion in the way we use the net proceeds.

Pending use of the net proceeds from this offering described above, we intend to invest the net proceeds in short- and intermediate-term interest-bearing obligations, investment-grade instruments, certificates of deposit or direct or guaranteed obligations of the U.S. government.

The primary purposes of this offering are to raise additional capital, create a public market for our common stock, allow us easier and quicker access to the public markets should we need more capital in the future, increase the profile and prestige of our company with existing and possible future customers, vendors and strategic partners, and make our stock more valuable and attractive to our employees and potential employees for compensation purposes.

DIVIDEND POLICY

The Successor has never declared or paid cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings to support the operation of and to finance the growth and development of our business. We do not anticipate paying any cash dividends in the foreseeable future.

CAPITALIZATION

The following table sets forth our cash and cash equivalents, our current maturities of long-term debt and our capitalization as of December 31, 2008 on:

an actual basis;

a pro forma basis after giving effect to (i) the conversion of all outstanding shares of preferred stock into 14,507,714 shares of our common stock, which will occur automatically immediately prior to the closing of this offering, (ii) the issuance of 154,672 shares of restricted common stock we intend to make prior to completion of this offering to some of our employees, and (iii) the issuance of 591,491 shares of our common stock we intend to make prior to the completion of this offering to 10 of our key employees, including our named executive officers, which number of shares is net of the shares withheld by us to satisfy the tax withholding obligations relating to the "net issuance" of the stock grants; and

a pro forma as adjusted basis to give further effect to (i) our filing of a second amended and restated certificate of incorporation, (ii) the sale by us of 3,125,000 shares of common stock in this offering at an assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, and our receipt of the estimated net proceeds from that sale after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us, and (iii) our use of a portion of the net proceeds to repay the outstanding balance under our credit facilities, which was approximately $9.9 million at February 28, 2009, and to pay approximately $7.0 million after the completion of this offering to federal, state and local taxing authorities to satisfy the tax withholding obligations associated with the stock grants relating to the "net issuance" of the stock grants we intend to make to 10 of our key employees prior to the completion of the offering.

You should read the following table in conjunction with the sections titled "Selected Consolidated Financial Data," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and related notes included elsewhere in this prospectus.

	As of December 31, 2008		
	Actual	Pro Forma	Pro Forma as Adjusted
	(in thousands, except per share data)		
Cash and cash equivalents	$ 30,626	$ 30,626	$ 56,721
Current maturities of long-term debt	$ 4,250	$ 4,250	$
Long-term debt	$ 5,660	$ 5,660	$
Class A, Series A-1 Convertible Preferred Stock, $0.001 par value; 269,000, zero and zero shares authorized, issued and outstanding actual, pro forma, and pro forma as adjusted	26,876		
Class A, Series A-2 Convertible Preferred Stock, $0.001 par value; 178,000, zero and zero shares authorized, issued and outstanding actual, pro forma, and pro forma as adjusted	17,820		
Class B Convertible Preferred Stock, $0.001 par value; 115,000, zero and zero shares authorized actual, pro forma, and pro forma as adjusted; 111,000, zero and zero shares, issued and outstanding actual, pro forma, and pro forma as adjusted	11,341		
Preferred Stock, $0.001 par value; zero, zero and 10,000,000 shares authorized actual, pro forma, and pro forma as adjusted; zero, zero, and zero shares issued and outstanding actual, pro forma, and pro forma as adjusted			
Common stock, $0.00005 par value; 39,100,000, 39,100,000 and 190,000,000 shares authorized actual, pro forma, and pro forma as adjusted; 1,935,654, 17,189,531 and 20,314,531 shares issued and outstanding actual, pro forma, and pro forma as adjusted	1	2	2
Additional paid-in capital	10,814	76,315	119,331
Accumulated other comprehensive loss	(203)	(203)	(203)
Accumulated income	12,422	2,536	2,536
Total stockholders' equity	79,071	78,650	121,666
Total capitalization	$ 84,731	$ 84,310	$ 121,666

Each $1.00 increase or decrease in the assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, would increase or decrease the amount of cash and cash equivalents, additional paid-in capital, total stockholders' equity and total capitalization by approximately $2.9 million, which will be partially offset by a corresponding approximately $0.4 million increase or decrease in the tax withholding obligation relating to the "net issuance" of the stock grants we intend to make to 10 of our key employees, including our named executive officers, prior to the completion of this offering, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated expenses payable by us.

This table excludes the following shares:

- 1,657,799 shares of our common stock issuable upon the exercise of options outstanding as of December 31, 2008 with a weighted average exercise price of $6.48 per share;

- 342,214 shares of common stock issuable upon the exercise of options we expect to grant to our employees prior to the completion of this offering, which options will have an exercise price per

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share equal to the initial public offering price per share in this offering and are described under the caption "Executive Compensation IPO Option and Restricted Stock Grants;"

137,160 shares of common stock reserved for future issuance under our 2006 Stock Option Plan; and

2,437,744 shares of common stock, based upon an assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, reserved for future issuance under our 2009 Omnibus Incentive Plan, which plan provides for the issuance of a number of shares of our common stock equal to 12% of the number of shares of our common stock outstanding as of the completion of this offering on a fully diluted basis.

DILUTION

If you invest in our common stock, your interest will be diluted immediately to the extent of the difference between the initial public offering price per share of our common stock in this offering and the pro forma as adjusted net tangible book value per share of our common stock after this offering.

Our net tangible book value as of December 31, 2008 was $34.2 million, or $17.68 per share of common stock. Net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the number of shares of our common stock outstanding. On a pro forma basis, after giving effect to the automatic conversion of all outstanding shares of our preferred stock into an aggregate of 14,507,714 shares of common stock immediately prior to the closing of this offering, our intended issuance of 154,672 shares of restricted common stock to some of our employees prior to the completion of this offering, our intended issuance of 591,491 shares of common stock prior to the completion of this offering to 10 of our key employees, including our executive officers, which number is net of the shares withheld by us to satisfy the tax withholding obligations as a result of the "net issuance" of these stock grants, our net tangible book value as of December 31, 2008 was $33.8 million, or $1.97 per share of common stock.

After giving further effect to our issuance and sale of 3,125,000 shares of common stock in this offering, less the estimated underwriting discounts and commissions and estimated offering expenses payable by us, and the application of approximately $9.9 million of the proceeds of the offering to repay debt and of approximately $7.0 million to pay the federal, state and local tax withholding obligations relating to the "net issuance" of the stock grants we intend to make to 10 of our key employees, including our named executive officers, prior to completion of this offering, based upon an assumed initial public offering price of $16.00 per share, the midpoint of the range set forth on the cover page of this prospectus, our pro forma as adjusted net tangible book value as of December 31, 2008 would have been $76.8 million, or $3.78 per share of common stock. This represents an immediate increase in net tangible book value per share of $1.81 to existing stockholders and an immediate dilution of $12.22 per share to new investors. Dilution per share to new investors is determined by subtracting pro forma as adjusted net tangible book value per share after this offering from the initial public offering price per share paid by a new investor. The following table illustrates the per share dilution:

Initial public offering price per share of common stock		$16.00
Actual net tangible book value per share as of December 31, 2008	$ 17.68	
Decrease per share attributable to conversion of preferred stock and the intended issuance of restricted stock grants and stock grants	(15.72)	
Pro forma net tangible book value per share as of December 31, 2008	1.97	
Increase per share attributable to new investors	1.81	
Pro forma as adjusted net tangible book value per share after this offering		3.78
Dilution per share to new investors		$12.22

If the underwriters exercise their option to purchase additional shares of our common stock in full in this offering, the pro forma as adjusted net tangible book value per share after the offering would not change since the shares for this option are all being provided by our selling stockholders and we will not receive any of the proceeds from the sale of these shares.

A $1.00 increase or decrease in the assumed initial public offering price of $16.00 per share, which is the midpoint of the range set forth on the cover page of this prospectus, would increase or decrease our pro forma as adjusted net tangible book value as of December 31, 2008 by approximately $2.9 million, the pro forma as adjusted net tangible book value per share after this offering by $0.14 per share and the dilution in pro forma as adjusted net tangible book value per share to new investors in this offering by $0.86 per share, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The following table summarizes, as of December 31, 2008, on the pro forma as adjusted basis described above, the number of shares of our common stock purchased from us, the total consideration paid to us, and the average price per share paid to us by existing stockholders and to be paid by new investors purchasing shares of our common stock in this offering.

	Shares Purchased		Total Consideration		Average Price
	Number	Percent	Amount	Percent	Per Share
Existing stockholders	17,189,531	85%	$ 63,929,930	56%	$ 3.72
New investors	3,125,000	15	50,000,000	44	16.00
Total	20,314,531	100%	$113,929,930	100%	

A $1.00 increase or decrease in the assumed initial public offering price of $16.00 per share, which is the midpoint of the range set forth on the cover page of this prospectus, would increase or decrease total consideration paid to us by investors participating in this offering by approximately $2.9 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The sale of 3,125,000 shares of common stock to be sold by the selling stockholders in this offering will reduce the number of shares held by existing stockholders to 14,064,531 shares, or 69% of the total shares outstanding, and will increase the number of shares held by investors participating in this offering to 6,250,000 shares, or 31% of the total shares outstanding. In addition, if the underwriters exercise their over-allotment option in full, the number of shares held by existing stockholders will be further reduced to 13,127,031 shares, or 65% of the total shares outstanding, and the number of shares held by investors participating in this offering will be further increased to 7,187,500 shares, or 35% of the total shares outstanding.

As of December 31, 2008, there were options outstanding to purchase a total of 1,657,799 shares of common stock at a weighted average exercise price of $6.48 per share. In addition, we expect to grant additional options to our employees prior to completion of this offering to purchase an aggregate of 342,214 shares of common stock, which options will have an exercise price per share equal to the initial public offering price per share in this offering. The above discussion and table assumes no exercise of stock options outstanding as of December 31, 2008 or the new options. If all of these options were exercised, our existing stockholders, including the holders of these options, would own 86% of the total number of shares of our common stock outstanding upon the closing of this offering and our new investors would own 14% of the total number of shares of our common stock upon the closing of this offering.

SELECTED CONSOLIDATED FINANCIAL DATA

The following table sets forth our selected consolidated statement of operations, balance sheet and other data for the periods indicated. The selected consolidated statement of operations data for the period from January 4, 2006 through December 31, 2006 and the years ended December 31, 2007 and 2008, and the consolidated balance sheet data as of December 31, 2007 and 2008 have been derived from Rosetta Stone Inc., or the Successor, audited consolidated financial statements included elsewhere in this prospectus. The selected consolidated statement of operations data for the period from January 1, 2006 through January 4, 2006, represents the operations of Fairfield & Sons, Ltd., or the Predecessor, which was acquired by Rosetta Stone Inc. on January 4, 2006 and have been derived from Predecessor audited consolidated financial statements included elsewhere in this prospectus. The selected consolidated financial data as of December 31, 2006 has been derived from Successor audited financial statements, which are not included in this prospectus. The selected consolidated financial data for the Predecessor as of December 31, 2004 and 2005, and for the years ended December 31, 2004 and 2005, have been derived from Predecessor audited financial statements, which are not included in this prospectus. This information should be read in conjunction with "Capitalization," "Selected Consolidated Financial Data," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements contained elsewhere in this prospectus. Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

The Predecessor incurred transaction-related expenses during the period from January 1, 2006 through January 4, 2006 relating to the acquisition by Rosetta Stone Inc. on January 4, 2006. Included in the expenses were $5.9 million related to restricted common stock, $3.1 million in cash bonuses and $1.2 million in acquisition-related bank fees.

Unaudited pro forma net income per common share and unaudited pro forma common shares and equivalents outstanding reflect conversion of all outstanding shares of our convertible preferred stock into an aggregate of 14,507,714 shares of our common stock, which will occur automatically immediately prior to the closing of this offering, and the issuance of 591,491 shares of common stock, net of shares withheld to satisfy tax withholding obligations associated with the "net issuance" of stock grants we intend to make to 10 of our key employees, including our named executive officers, prior to completion of this offering, and, in the case of diluted unaudited pro forma net income per share and unaudited pro forma common shares and equivalents outstanding, also reflects the issuance of 154,672 shares of restricted common stock we intend to make to our employees prior to completion of this offering. Diluted unaudited pro forma net income per common share and unaudited pro forma common shares and equivalents outstanding exclude the grant of options to purchase 342,214 shares of our common stock to our employees prior to the completion of this offering as such options are antidilutive. For the purpose of this calculation we have assumed that such transactions occurred as of January 1, 2008.

The Predecessor declared cash dividends of $6,716 and $14,324 per share in the years ended December 31, 2004 and 2005, respectively.

	Predecessor			Successor		
	Year Ended December 31,		Period from January 1, through January 4,	Period from January 4, through December 31,	Year Ended December 31,	
	2004	2005	2006	2006	2007	2008
	(in thousands, except per share data)					
Statement of Operations Data:						
Revenue	$25,373	$48,402	$ 272	$ 91,298	$ 137,321	$ 209,380
Cost of revenue	3,968	8,242	203	12,541	20,687	28,676
Gross profit	21,405	40,160	69	78,757	116,634	180,704
Operating expenses:						
Sales and marketing	11,303	22,432	695	45,854	65,437	93,384
Research and development	1,833	2,819	41	8,117	12,893	18,387
Acquired in-process research and development				12,597		
General and administrative	6,484	8,157	142	16,590	29,786	39,577
Lease abandonment						1,831
Transaction-related expenses			10,315			
Total operating expenses	19,620	33,408	11,193	83,158	108,116	153,179
Income (loss) from operations	1,785	6,752	(11,124)	(4,401)	8,518	27,525
Other income and expense:						
Interest income	84	38		613	673	454
Interest expense				(1,560)	(1,331)	(891)
Other (expense) income	120	134	3	60	154	239
Interest and other income (expense), net	204	172	3	(887)	(504)	(198)
Income (loss) before income taxes	1,989	6,924	(11,121)	(5,288)	8,014	27,327
Income tax expense (benefit)	66	143		(1,240)	5,435	13,435
Net income (loss)	1,923	6,781	(11,121)	(4,048)	2,579	13,892
Preferred stock accretion				(159)	(80)	
Net income (loss) attributable to common stockholders	$ 1,923	$ 6,781	$ (11,121)	$ (4,207)	$ 2,499	$ 13,892
Income (loss) per share attributable to common stockholders:						
Basic	$ 6,993	$24,658	$ (37,194)	$ (2.63)	$ 1.47	$ 7.29
Diluted	$ 6,993	$24,658	$ (37,194)	$ (2.63)	$ 0.15	$ 0.82
Common shares and equivalents outstanding:						
Basic weighted average shares	0.275	0.275	0.299	1,598	1,702	1,905
Diluted weighted average shares	0.275	0.275	0.299	1,598	16,533	16,924
Unaudited pro forma net income per common share:						
Basic						$ 0.82
Diluted						$ 0.79
Unaudited pro forma common shares and equivalents outstanding:						
Basic weighted average shares						17,004
Diluted weighted average shares						17,521

Other Data:						
Adjusted EBITDA	$ 2,380	$ 7,615	$ (5,181)	$ 15,332	$ 17,768	$ 36,429
Stock-based compensation included in:						
Cost of revenue	$	$	$	$ 1	$ 2	$ 2
Sales and marketing				59	189	153
Research and development				128	360	482
General and administrative	2			373	776	953
Transaction-related expenses			5,930			
Total stock-based compensation expense	$ 2	$	$ 5,930	$ 561	$ 1,327	$ 1,590
Intangible amortization included in:						
Cost of revenue	$	$	$	$ 1,213	$ 1,227	$ 13
Sales and marketing				4,113	3,596	3,003
Total intangible amortization expense	$	$	$	$ 5,326	$ 4,823	$ 3,016

	Predecessor As of December 31,		Successor As of December 31,		
	2004	2005	2006	2007	2008
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	$ 1,767	$ 11,738	$ 16,917	$ 21,691	$ 30,626
Total assets	10,752	25,620	96,754	110,376	138,818
Deferred revenue	1,653	6,231	8,105	12,939	15,744
Notes payable and capital lease obligation	741	63	15,917	13,324	9,910
Redeemable convertible preferred stock			4,920	5,000	
Total stockholders' equity	6,187	8,985	53,548	58,125	79,071

The following table presents a reconciliation of adjusted EBITDA to net income (loss), the most comparable GAAP measure, for each of the periods identified.

	Predecessor			Successor		
	Year Ended December 31,		Period from January 1, through January 4,	Period from January 4, through December 31,	Year Ended December 31,	
	2004	2005	2006	2006	2007	2008
	(in thousands)					
Reconciliation of adjusted EBITDA to net income (loss):						
Net income (loss)	$ 1,923	$ 6,781	$ (11,121)	$ (4,048)	$ 2,579	$ 13,892
Interest expense (income), net	(84)	(38)		947	658	437
Income tax expense (benefit)	66	143		(1,240)	5,435	13,435
Depreciation and amortization	473	729	10	6,515	7,769	7,075
Stock-based compensation	2		5,930	561	1,327	1,590
Acquired in-process research and development				12,597		
Adjusted EBITDA	$ 2,380	$ 7,615	$ (5,181)	$ 15,332	$ 17,768	$ 36,429

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion together with our consolidated financial statements and the related notes included elsewhere in this prospectus. This discussion contains forward-looking statements about our business and operations. Our actual results may differ materially from those we currently anticipate as a result of the factors we describe under "Risk Factors" and elsewhere in this prospectus.

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 31 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 has 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 83% of our revenue in 2008 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, Apple, Barnes & Noble and Borders.

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;
- 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.

Fairfield Acquisition

On January 4, 2006, Rosetta Stone Inc., or the Successor, acquired all of the outstanding stock of Fairfield & Sons, Ltd., along with its wholly owned United Kingdom subsidiary, Fairfield & Sons, Limited, or collectively the Predecessor. After the acquisition, we changed the names of Fairfield & Sons, Ltd. and Fairfield & Sons, Limited to Rosetta Stone Ltd. and Rosetta Stone (UK) Limited, respectively. The results of acquired operations are included in our consolidated results of operations subsequent to the closing of the Predecessor's accounting records on January 4, 2006. Rosetta Stone Inc. had no operations prior to that acquisition.

Fairfield & Sons, Ltd. developed, marketed and sold a suite of language learning software products under the *Rosetta Stone* brand name. As a result of the acquisition of all of the stock of Fairfield & Sons, Ltd., we acquired all of the assets and assumed all of the liabilities of the Predecessor. Those assets included intellectual property, trade receivables, inventory, contracts, equipment and other tangible personal property and those liabilities included trade payables, accrued expenses and future customer support and services. We paid a total purchase price of approximately $79.1 million for the net assets acquired.

We recorded amortizable intangibles associated with the acquisition related to acquired software technology, as well as existing trade names and trademarks, core technology and customer relationships. The estimated lives of the acquired technology and customer relationships was between 18 and 36 months. The intangible assets associated with the trade names and trademarks have an indefinite useful life. We compute amortization of intangible assets that do not have an indefinite life on a straight-line basis over the estimated useful life of the assets. We test goodwill and intangible assets that have an indefinite life annually for impairment.

A summary of the fair value of assets acquired and liabilities assumed in the acquisition is as follows (in thousands):

Tangible assets:	
Assets current	$ 21,874
Assets non-current	4,742
Intangible assets:	
Intangible assets	36,396
Goodwill	34,199
Total assets acquired	97,211
Liabilities assumed	(18,106)
Net assets acquired	$ 79,105

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.

Product revenue consists of revenue from sales of our packaged software and audio products. Subscription and service revenue consists primarily of revenue from our online software subscriptions. 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 sell our solutions directly to individuals, educational institutions, armed forces, government agencies and corporations. 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. 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. We anticipate that revenue growth in future periods will be less significant than we have experienced historically.

Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2008 accounted for 32% of our annual revenue in 2008. Our institutional revenue is seasonally stronger in the second and third quarters of the calendar year due to education, home school and government purchasing cycles. We expect these trends to continue.

Cost of 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 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. In the period from January 4, 2006 to December 31, 2006 and the years ended December 31, 2007 and 2008, cost of product revenue and subscription and service revenue included intangible amortization related to core technology associated with the acquisition of Fairfield & Sons, Ltd., which was fully amortized by June 2008. We expect our cost of revenue to increase in absolute dollars in future periods as our unit sales continue to grow. Cost of revenue may also increase as a percentage of revenue in future periods as we are planning to release service offerings that will have higher direct costs to deliver to customers.

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 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. We established local sales offices and call centers, added employees and launched marketing and public relations campaigns within each 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 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. We expect general and administrative expenses to increase in future periods as we expect to continue to invest in corporate infrastructure and incur additional expenses associated with being a public company, including increased legal and accounting costs, investor relations costs, higher insurance premiums and compliance costs in connection with Section 404 of the Sarbanes-Oxley Act of 2002. We also intend to increase administrative expenses as a result of our planned international expansion.

Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Interest expense is related to our long-term debt, the outstanding balance of which was $9.9 million as of December 31, 2008. We expect interest expense to decrease in future periods as we will pay down the balance of our outstanding long-term debt with proceeds from this offering. Interest income represents interest received on our cash and cash equivalents.

Income Tax Expense

Income tax expense consists of federal and state income taxes in the United States. In 2008, our effective tax rate in the United States was approximately 37%, although operating losses of our international subsidiaries raised our worldwide effective tax rate to 49%. We expect this rate should be lower in 2009 and beyond as results improve in international operations and as we implement new tax planning strategies, assuming no general increase in U.S. federal or state income tax rates applicable to companies such as ours. However, we expect our income tax expense to increase in absolute dollars as our income continues to grow.

Critical Accounting Policies and Estimates

In presenting our financial statements in conformity with accounting principles generally accepted in the United States, or GAAP, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, 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. Actual results may differ significantly from these estimates. Future results may differ from our estimates under different assumptions or conditions.

We believe that the critical accounting policies listed below involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements. In addition, we believe that a discussion of these policies is necessary to understand and evaluate the consolidated financial statements contained in this prospectus.

For further information on our critical and other significant accounting policies, see Note 2, Summary of Significant Accounting Policies, of our consolidated financial statements contained elsewhere in this prospectus.

Revenue Recognition

We derive revenue primarily from the sale of packaged software and audio practice products and online software subscriptions. We recognize revenue for software products and online software subscriptions in accordance with the Statement of Position, or SOP, No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, and the SEC Staff Accounting Bulletin, or SAB, No. 101, *Revenue Recognition in Financial Statements*, as amended by SAB No. 104, *Revenue Recognition, Corrected Copy*.

We recognize revenue 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. We recognize revenue from packaged software and audio practice products and online software subscriptions net of discounts. We recognize revenue related to professional services, which represented less than 1% of total revenue for the year ended December 31, 2008, as the services are performed.

We recognize revenue 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 is recognized as the products are shipped and title passes. We also sell a limited amount of packaged software products to resellers on a consignment basis. We recognize revenue for these consignment transactions once the end-user sale has occurred, assuming the remaining revenue recognition criteria have been met. We allow some customers to make payments for packaged software products 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 then 12 months and a successful collection history has been established, we recognize revenue at the time of sale, assuming the remaining revenue recognition criteria have been met. We provide customers who purchase our packaged software products directly from us with a six-month right of return. We also allow our retailers to return unsold products, subject to some limitations. In accordance with Statement of Financial Accounting Standards, or SFAS, No. 48, *Revenue Recognition When Right of Return Exists*, we reduce product revenue for estimated returns, which are based on historical return rates.

We recognize revenue for software license agreements sold via online software subscriptions as hosting agreements in accordance with Emerging Issue Task Force, or EITF, No. 00-3: *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*. We recognize revenue for online software subscriptions ratably over the term of the subscription period, which typically ranges between three and 12 months, assuming all revenue recognition criteria have been met. Some online licensing arrangements include a specified number of licenses that can be activated over a period of time, which typically ranges between 12 and 24 months. We recognize revenue for these arrangements on a per license basis ratably over the term of the individual license subscription period, which typically ranges between three and 12 months, assuming all revenue recognition criteria have been met. We recognize revenue for set-up fees related to online licensing arrangements ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. We record accounts receivable and deferred revenue at the time a customer enters into a binding subscription agreement and the subscription services are made available to the customer. We classify amounts received in advance of revenue recognition as deferred revenue.

In connection with packaged software product sales and online software subscriptions, we provide technical support to customers, including customers of resellers, at no additional charge. Because we include the fee for technical support in the initial product cost or licensing fee, as applicable, we generally provide the technical support and services within one year, we deem the estimated cost of providing such support insignificant and we offer no unspecified upgrades or enhancements, we recognize technical support revenue together with the software product and license revenue. We accrue costs associated with the technical support at the time of sale.

In connection with packaged software product sales and online software subscriptions, we provide accessory products, such as headsets, to customers at no additional charge. In accordance with SOP 97-2, *Software Revenue Recognition,* and EITF No. 00-21, *Revenue Arrangements with Multiple Deliverables*, we account for the accessory products, such as headsets, and the software as separate elements or units of accounting. We recognize revenue upon the delivery of both the software and accessory products.

We recognize revenue from the sale of packaged software products with specific upgrade rights in accordance with SOP 97-2, *Software Revenue Recognition*. We defer revenue recognition for these sales until the earlier of the point at which sufficient vendor-specific objective evidence, or VSOE, exists for the specific upgrade right or we have delivered all elements of the arrangement. As of December 31, 2007, we had not delivered specified upgrade rights and had not yet established VSOE for these upgrade rights. As of December 31, 2008, the specific upgrade rights under all our arrangements expired and there were no undelivered elements for these arrangements. Deferred revenue related to these arrangements as of December 31, 2007 and 2008 was $2.4 million and zero, respectively.

In accordance with EITF No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Product*, we account for cash sales incentives to resellers as a reduction of revenue unless a specific benefit is identified and the fair value is reasonably determinable.

We have developed language learning solutions for some endangered languages under fixed fee arrangements. These arrangements also include contractual periods of post-contract support, or PCS, and online hosting services ranging from one to ten years. We recognize revenue for these arrangements ratably over the longer of the PCS or online hosting period, once the PCS or online hosting period begins. When the current estimates of total contract revenue and contract cost indicate a loss for a fixed fee arrangement, we record the entire loss on the contract.

Stock-Based Compensation

We record all stock-based awards, including employee stock option grants, at fair value as of the grant date and recognize these awards as expenses in our statement of operations on a straight-line basis over the vesting period of the award in accordance with SFAS No. 123(R), *Share-Based Payments*.

As of December 31, 2007 and 2008, there were approximately $3.8 million and $4.4 million of unrecognized stock-based compensation expense related to non-vested stock option awards that we expect to be recognized over a weighted average period of 2.61 and 2.21 years, respectively. For the period from January 1, 2006 through January 4, 2006, the Predecessor recognized $5.9 million in stock-based compensation expense in its net loss related to change-of-control stock agreements issued in connection with our acquisition of the Predecessor.

The following table sets forth the stock-based compensation expense included in the related financial statement line items:

	Predecessor	Successor		
	Period From January 1, through January 4, 2006	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
		(in thousands)		
Cost of revenue	$	$ 1	$ 2	$ 2
Sales and marketing		59	189	153
Research and development		128	360	482
General and administrative		373	776	953
Transaction-related expenses	5,930			
Total	$ 5,930	$ 561	$ 1,327	$ 1,590

We estimate the fair value of each option grant on the date of grant using the Black Scholes option pricing model. For the period from January 4, 2006 through December 31, 2006 and the years ended

December 31, 2007 and 2008, we calculated the fair value of options granted using the following assumptions:

	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
Expected stock price volatility	61% - 67%	62% - 70%	57% - 62%
Expected term of options	5 years	6 years	6 years
Expected dividend yield			
Risk-free interest rate	4.53% - 4.94%	3.50% - 4.96%	2.08% - 3.36%

Since our common stock is not publicly quoted and we have a limited history of stock option activity, we established a peer group of comparable publicly traded education and technology-enabled learning companies and high growth consumer companies for which historical information was available. As of each stock option grant date, we utilized the peer group data to calculate our expected volatility, the average expected stock option term and expected forfeitures. We will continue to use our peer group until sufficient historical data is available. The risk-free interest rate was determined by reference to the United States Treasury rates with the remaining term approximating the expected life assumed at the date of grant.

The following table sets forth all stock option grants since January 4, 2006, the date of plan inception, through the date of this prospectus:

Grant Date	Number of Options Granted	Exercise Price	Common Stock Fair Value Per Share at Grant Date
May 22, 2006	1,366,456	$ 3.85	$ 4.57
August 16, 2006	29,861	3.85	5.10
August 21, 2006	149,500	3.85	5.14
September 5, 2006	130,000	3.85	5.25
December 8, 2006	29,133	3.85	5.92
February 2, 2007(1)	20,423	3.85	6.35
March 21, 2007	221,559	6.08	6.73
April 20, 2007(1)	31,330	6.08	6.98
June 5, 2007	59,800	7.31	7.31
August 3, 2007(1)	18,824	7.31	9.60
August 22, 2007	27,911	10.60	10.60
November 28, 2007	34,229	11.19	11.19
December 17, 2007(1)	22,178	10.60	11.30
February 8, 2008(1)	57,447	11.19	11.64
April 29, 2008(1)	99,346	11.64	10.36
May 28, 2008	110,916	10.36	10.36
August 19, 2008	36,075	14.22	14.22
November 19, 2008	99,021	17.49	17.49

(1) The exercise price for these stock options was established at the fair value of our common stock on the date of grant approval by the board of directors. However, in accordance with SFAS No. 123(R), because all of the key terms of the stock option grants were not communicated to employees on a timely basis, we established the option grant date, the interpolated common stock fair value and stock option fair value as of the date on which all key option terms were communicated to the employees, which is the date reflected above.

Given the absence of an active market for our common stock, our board of directors estimated the fair value of our common stock. These estimates of the fair value of our common stock were made as of the following dates:

Valuation Date	Fair Value Per Share
January 4, 2006	$ 3.85
June 30, 2006	4.77
December 31, 2006	6.08
May 31, 2007	7.31
August 31, 2007	10.60
November 30, 2007	11.19
January 31, 2008	11.64
April 30, 2008	10.36
July 31, 2008	14.22
October 31, 2008	17.49

On January 4, 2006, we acquired our Predecessor for a price of $3.85 per share. The board of directors utilized this value as the exercise price for all stock option grants approved in 2006. Subsequent to December 31, 2006, we performed retrospective valuations of our common stock as of June 30, 2006 and December 31, 2006. The board of directors utilized the December 31, 2006 common stock valuation to establish the exercise price for stock option grants approved on March 21, 2007, as it was the most recent valuation of our common stock. Our board of directors performed the next common stock valuation on May 31, 2007 and continued performing valuations at regular intervals that did not exceed three months.

In order to determine the fair value of our common stock on the date of grant for purposes of calculating the fair value of our stock option grants under SFAS No. 123(R), we utilized the valuation closest to the grant date if there was a valuation done within 30 days of the grant date. If a valuation was not performed within 30 days of the grant date, we utilized the valuations performed immediately prior to and after the option grant dates and interpolated the grant date values on a straight-line basis between the two valuation dates.

Assuming an initial public offering price of $16.00 per share, the midpoint of the price range set forth on the cover page of this prospectus, the intrinsic value of the options outstanding at December 31, 2008, was $15.8 million, of which $6.3 million related to options that were vested and $9.5 million related to options that were not vested.

Valuation Methodology

We considered numerous objective and subjective factors in valuing our common stock at each valuation date in accordance with the guidance in the AICPA Practice Aid *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*. For each common stock valuation that we performed, we determined the fair value of our common stock by taking the average value calculated under the discounted cash flow method, the guideline company method and the comparative transaction method. We weighted each method equally.

The significant variables utilized in the discounted cash flow method are:

- our expected revenue, operating performance, cash flow and EBITDA for the current and future years, determined as of the valuation date based on our estimates;

- a discount rate, which is applied to discretely forecasted future cash flows in order to calculate the present value of those cash flows; and

- a terminal value multiple, which is applied to our last year of discretely forecasted EBITDA to calculate the residual value of our future cash flows.

The guideline company method is based on the following factors:

- our historical revenue and EBITDA for the twelve months prior to the valuation date;

- in later valuations, our expected revenue and EBITDA for the following fiscal year, determined as of the valuation date based on our estimates;

- multiples of market value to trailing twelve months revenue and EBITDA, determined as of the valuation date, based on a group of comparable public companies we identified; and

- multiples of market value to expected revenue and EBITDA for the following fiscal year, determined as of the valuation date, based on the group of comparable public companies that we identified.

The comparative transaction method is based on the following factors:

- our historical revenue and EBITDA for the twelve months prior to the valuation date; and

- multiples of the final transaction values, for comparable companies that were sold, to their revenue and EBITDA for the twelve months prior to the acquisition date.

Our analysis of comparable transactions for valuations performed from January 4, 2006 through May 31, 2007 was focused on the sale of three technology-enabled education companies that were sold between March 2004 and October 2005. The average revenue and EBITDA of this group was $12.2 million and $1.0 million, respectively. The revenue multiples for the group ranged from 0.8 to 1.7 times the trailing twelve month revenue. The EBITDA multiple for the group ranged from 6.3 to 19.2 times the trailing twelve months EBITDA. We felt that these companies were comparable to us as they operated in our industry, were relatively comparable in terms of our revenue at that time and occurred within a reasonable time of the valuation.

Beginning with the August 31, 2007 valuation and for all subsequent valuations, our analysis of comparative transactions focused on the sales of four privately held technology-enabled education companies that were sold between April 2003 and April 2007. These transactions were different than those utilized in our comparative transaction method in prior valuations. We adjusted the comparable companies because we had experienced significant growth and we felt the previous companies were not representative of us. The average revenue and EBITDA for the new group in the twelve months before their respective sale dates was $92.7 million and $11.7 million, respectively. The revenue multiple for the group ranged from 1.0 to 14.2 with a median of 1.4 times the trailing twelve months revenue. We also examined adjusted revenue multiples at each valuation date due to differences in EBITDA margin between us and the comparable companies. The adjusted revenue multiples ranged from 0.69 to 3.20 between August 31, 2007 and October 31, 2008. The EBITDA multiple for the group ranged from 9.5 to 18.9 times trailing twelve months EBITDA and were not adjusted. We felt that these companies were comparable to us as they operated in our industry, were, on average, comparable in size in terms of revenue and EBITDA and the transactions occurred within a reasonable time of the valuation date.

Our valuations also considered the lack of marketability of our common stock and the liquidation rights and preferences of our preferred stock. In allocating the total equity value between preferred and common stock, we assumed that the preferred stock would convert to common stock because the preferred stock was in-the-money based on the concluded common stock value on each valuation date. This assumption remained consistent for all valuations through the May 31, 2007 valuation, after which we began to utilize the probability-weighted method and the option- pricing method for allocating the total equity value between preferred and common stock.

Valuation at January 4, 2006

On January 4, 2006, we sold 446,958 shares of series A convertible preferred stock and 1,291,212 shares of common stock to outside investors at a price of $100.00 per preferred share and $3.85 per common share. Each share of preferred stock is convertible into 26 shares of common stock. All of the stock was purchased by ABS Capital Partners, Norwest, Madison Capital Funding LLC and our chief executive officer, Tom Adams, all of whom purchased shares on the same date for the same price. We performed a valuation of our common and preferred stock contemporaneously with the stock sale to outside investors, which supported the price paid for the stock by the outside investors. This valuation utilized the valuation methodology described above. For purposes of the guideline company method, we utilized a group of three comparable technology-enabled education companies to compute our implied multiples of market value to revenue and EBITDA. Based on the stock sale and the corroborating valuation, we determined the fair value of our common stock to be $3.85 on January 4, 2006.

Valuation at June 30, 2006

In May 2007, the board of directors performed a retrospective valuation of our common stock as of June 30, 2006. Under the discounted cash flow method, we utilized a discount rate of 25% and a terminal value multiple of 4.8, which we believed best reflected our growth rate and other attributes of our business at that time. Our forecasted future revenue and EBITDA for 2008 through 2010 increased by 9% and 8%, respectively, from our forecast on the previous valuation date. Under the guideline company method, we expanded our peer group of comparable publicly traded companies to include six technology-enabled education companies. The implied multiples of trailing twelve months revenue and EBITDA for the peer group were 1.4 and 9.1, respectively. Under the comparative transaction method, we utilized average trailing twelve months revenue and EBITDA multiples of 1.5 and 9.5, respectively. Our trailing twelve months revenue increased by 39% and EBITDA increased by 99% from the previous valuation. We applied a 20% discount for the lack of marketability of our common stock. Based on these factors, the fair value of our common stock as of June 30, 2006 increased to $4.77 per share.

Valuation at December 31, 2006

In April 2007, the board of directors performed a retrospective valuation of our common stock as of December 31, 2006. Under the discounted cash flow method, our discount rate was unchanged from the previous valuation, and our terminal value multiple was 4.7. Our forecasted revenue and EBITDA for 2008 through 2010 increased by 9% and 15%, respectively, from the forecast at our previous valuation. Under the guideline company method, the peer group was also unchanged and the market multiples remained consistent with the previous valuation. Under the comparative transaction method, we utilized average trailing twelve months revenue and EBITDA multiples of 1.4 and 9.0, respectively. Our trailing twelve months revenue increased by 36% and our trailing twelve months EBITDA decreased by 3% from the previous valuation. As a result, the fair value of our common stock as of December 31, 2006 increased to $6.08 per share.

Valuation at May 31, 2007

On May 31, 2007, the board of directors performed a contemporaneous valuation of our common stock. Under the discounted cash flow method, we utilized a discount rate of 24% and the terminal value multiple was 5.0. Our forecasted future revenue and EBITDA was unchanged from our forecast on our previous valuation date. Under the guideline company method, the peer group was unchanged and the market multiples derived from our peer group for trailing twelve months revenue and EBITDA increased to 1.9 and 10.7, respectively. Under the comparative transaction method, we did not change revenue and EBITDA multiples from the previous valuation. Our trailing twelve months revenue increased by 17% and our trailing twelve months EBITDA decreased by 4% from the previous valuation. We reduced the discount for the lack of marketability to 15%, as we began more seriously evaluating the timing of a potential initial public offering. Based on these factors, the fair value of our common stock as of May 31, 2007 increased to $7.31 per share.

Valuation at August 31, 2007

On August 31, 2007, the board of directors performed a contemporaneous valuation of our common stock. At this time, the board of directors expanded and refined the valuation methodologies utilized in its common stock valuations with a view to providing what they believed would be a more comprehensive valuation analysis.

For example, although the preferred stock was still in-the-money based on the concluded value of the common stock, we began utilizing the option-pricing method and the probability-weighted expected return method to determine the equity allocation between common and preferred stock and thereby estimate the fair value of our common stock. We made this change because we had begun to consider a possible future initial public offering of our common stock. Both methods were weighted equally and the fair value of our common stock was calculated by taking the average value calculated under each method. This adjustment in our methodology did not have a significant effect on the estimated fair value of our common stock. We continued to use this method of allocating value between preferred and common stock for all subsequent valuations.

Under the probability-weighted model, we estimated three potential outcomes for our company, which were an initial public offering, a sale of the company or continuing to operate as a private company. The weighted-probabilities we associated with these scenarios were 70%, 20% and 10%, respectively.

Under the option-pricing method, the primary assumptions are the volatility of the total equity value of the company and the time to an expected liquidity event. We utilized a volatility of 60%, which was based on the volatilities of the stock prices of the peer group, in our August 31, 2007 valuation and for all subsequent valuations. The time to a liquidity event at each valuation was based on our expectations with respect to the timing of an initial public offering or sale of the company.

Under the discounted cash flow method, we utilized a discount rate of 21% and our terminal value multiple was increased to 10.0. We determined to use a higher terminal value at this time because we believed it more closely reflected the EBITDA multiples of the comparable public companies in our peer group, which we significantly expanded for this valuation. Under the guideline company method, we expanded our peer group of comparable public companies to include a total of seven technology-enabled learning companies and seven high-growth consumer companies. The addition of these high-growth consumer companies to our peer group reflected our views at that time about our company, its growth potential and its positioning. The addition of these high-growth consumer companies resulted in an increase in our average trailing twelve months EBITDA multiple to 17.5, while the average trailing twelve months revenue multiple decreased slightly to 1.8. In this valuation, we also began to consider market multiples on expected future revenue and EBITDA in our guideline company analysis. The multiples on expected future revenue and EBITDA for the following fiscal year were 1.4 and 11.5, respectively, as of the valuation date. Under the comparative transaction method, we utilized average trailing twelve months revenue and EBITDA multiples of 1.8 and 17.0, respectively. Our trailing twelve months revenue increased by 9%, while our trailing twelve months EBITDA decreased by 20%, from the previous valuation. Our forecasted revenue and EBITDA for 2008 through 2010 was cumulatively reduced by 4% and 41%, respectively, from our forecast at the previous valuation date due to lower than expected growth in 2007. We also began to determine the discount for lack of liquidity based on a Black-Scholes put option model, and we continued to use this model for all subsequent valuations. The discount for lack of marketability was increased to 22% from the prior valuation based on this analysis and reflecting an extension of our expected timing of our potential future initial public offering. Based upon these factors, the fair value of our common stock per share as of August 31, 2007 increased to $10.60 per share. The increase was primarily driven by the significant increase in market-based EBITDA multiples of our comparable peer group as well as the increase in our discounted cash flow analysis, which was primarily due to the increase in the terminal value multiple.

Valuation at November 30, 2007

On November 30, 2007, the board of directors performed a contemporaneous valuation of our common stock. Under the discounted cash flow method, we reduced the discount rate to 20%, while the terminal value factor was unchanged from the previous valuation. Under the guideline company method, the peer group was unchanged and the average implied multiple for revenue remained consistent with the previous value, although the average implied multiple of EBITDA increased to 20.5, and the average multiples of expected revenue and EBITDA were 1.4 and 12.5, respectively. Under the comparative transaction method, we did not change the revenue and EBITDA multiples from the previous valuation. Our trailing twelve months revenue increased by 7% and trailing twelve months EBITDA decreased by 19%, while our forecasted revenue and EBITDA for 2008 through 2010 was unchanged from our forecast at the prior valuation date. We reduced the discount for the lack of marketability of our common stock to 20%, as we felt that we were closer to an initial public offering. The scenarios and probability weighting in our probability-weighted expected return model and the assumptions in our option-pricing model were unchanged from the previous valuation. Based on these factors, the fair value of our common stock increased to $11.19 per share.

Valuation at January 31, 2008

On January 31, 2008, the board of directors performed a contemporaneous valuation of our common stock. Under the discounted cash flow method, our discount rate and terminal value multiple was unchanged from the previous valuation. Under the guideline company method, the peer group was unchanged and our average implied multiples for trailing twelve months revenue and EBITDA decreased to 1.5 and 12.5, respectively, and the average multiples of expected revenue and EBITDA were 1.3 and 11.5, respectively. Under the comparative transaction method, our average trailing twelve months revenue was unchanged, however, we reduced our EBITDA multiple to 12.5, based on changes in market conditions. Our trailing twelve months revenue and EBITDA increased by 10% and 83%, respectively. Our forecasted revenue for 2008 through 2010 was unchanged and our forecasted EBITDA for 2008 through 2010 declined by 1% from our forecast on the previous valuation date. We increased the discount for the lack of marketability of our common stock to 24% as our estimated date for an initial public offering was extended. The scenarios and probability weighting in our probability-weighted expected return model and the assumptions in our option-pricing model were unchanged from the previous valuation, except that the estimated timing of the potential initial public offering was extended. Based on these factors, the fair value of our common stock per share increased to $11.64 per share.

Valuation at April 30, 2008

On April 30, 2008, the board of directors performed a contemporaneous valuation of our common stock. Under the discounted cash flow method, we utilized a discount rate to 21%, while the terminal value multiple was unchanged from the previous valuation. Under the guideline company method, the peer group was unchanged. Our average implied multiples for trailing twelve months revenue and EBITDA were 1.2 and 12.5, respectively, and the average multiples for expected revenue and EBITDA were 1.1 and 9.5, respectively. Under the comparative transaction method, based on continuing changes in market conditions, we utilized average trailing twelve months revenue and EBITDA multiples of 1.4 and 14.5, respectively. Our trailing twelve months revenue increased by 5%, while our trailing twelve months EBITDA decreased by 19%. Our forecasted revenue for 2008 through 2010 was unchanged from our estimate on the prior valuation date, although our cumulative forecasted EBITDA for the same period was reduced by 8%. We reduced the discount for the lack of marketability of our common stock to 22%, as we felt that were closer to an initial public offering. The scenarios and probability weighting in our probability-weighted expected return model and the assumptions in our option-pricing model were unchanged from the previous valuation. As a result of these factors, the fair value of our common stock decreased to $10.36 per share.

Valuation at July 31, 2008

On July 31, 2008, the board of directors performed a contemporaneous valuation of our common stock. Under the discounted cash flow method, we reduced the discount rate to 18%, while the terminal value multiple was unchanged from the previous valuation. Under the guideline company method, the peer group was unchanged and our average implied multiples for trailing twelve months revenue and EBITDA were 1.7 and 11.5, respectively, and the average multiples for expected revenue and EBITDA were to 1.3 and 9.0, respectively. Under the comparative transaction method, based on continuing changes in market conditions, we utilized average trailing twelve months revenue and EBITDA multiples of 1.75 and 12.5, respectively. Our trailing twelve months revenue increased by 12% and EBITDA increased by 67% from the previous valuation. We also increased our revenue and EBITDA forecast for 2008 through 2010 by 4% and 18%, respectively. The discount for the lack of marketability of our common stock declined from the prior valuation to 19%. The scenarios and probability weighting in our probability-weighted expected return model and the assumptions in our option-pricing model were unchanged from the previous valuation. Based on these factors, the fair value of our common stock per share increased to $14.22. The increase in the fair value of our common stock was primarily due to the significant increase in our trailing twelve months and future expected EBITDA.

Valuation at October 31, 2008

On October 31, 2008, the board of directors performed a contemporaneous valuation of our common stock. Under the discounted cash flow method, our discount rate and terminal value multiple were unchanged from the previous valuation. Under the guideline company method, we added two additional technology-enabled learning public companies and eliminated the consumer companies from our peer group. We eliminated the consumer companies from our peer group because we felt that they no longer were representative comparables for our company, particularly in light of their generally slowing growth rates. Our average implied multiples, based on the modified peer group, for trailing twelve months revenue and EBITDA were 1.7 and 9.5, respectively, and the average multiples for future expected revenue and EBITDA were 1.2 and 7.5, respectively. Under the comparative transaction method, we did not change the revenue and EBITDA multiples from the previous valuation. Our trailing twelve months revenue increased by 16% and EBITDA increased by 42% from the previous valuation. We also increased our revenue and EBITDA forecast for 2008 through 2010 by 9% and 21%, respectively. The discount for the lack of marketability of our common stock remained at 19%. The scenarios and probability weighting in our probability-weighted expected return model and the assumptions in our option-pricing model were unchanged from the previous valuation, except that the estimated timing of the potential initial public offering was extended again. Based on these factors, the fair value of our common stock per share increased to $17.49. The increase in the fair value of our common stock was primarily due to the continued increase in our trailing twelve months and future expected EBITDA.

Stock-based Compensation Expense in Connection with Executive Stock Grants and IPO Option and Restricted Stock Grants

We intend to make stock grants, restricted stock grants and stock option grants to our employees prior to the completion of this offering. These stock and option grants are described in more detail under the captions "Executive Compensation Stock Grants" and "Executive Compensation IPO Option and Restricted Stock Grants." In connection with these grants, we expect to record an aggregate expense of approximately $16.5 million in the second quarter of 2009, and an additional $5.6 million that will be recorded over the four-year vesting period of the stock options and restricted stock grants, assuming an initial public offering price of $16.00, the midpoint of the range set forth on the cover page of this prospectus.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due to us from our normal business activities, which include credit card receivables and amounts due from our institutional customers and retailers. We provide an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified.

Inventories

We state inventories at the lower of cost, determined on a first-in first-out basis, or market. We review inventory for excess quantities and obsolescence based on our best estimates of future demand, product lifecycle status and product development plans. We use historical information along with these future estimates to reserve for obsolete and potentially obsolete inventory.

Intangible Assets

Intangible assets consist of acquired technology, including developed and core technology, customer related assets, trade names and trademarks and other intangible assets. We record intangible assets at cost and amortize them on a straight line basis over their expected lives in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. We review our indefinite-lived intangible assets for impairment on an annual basis based on the fair value of indefinite-lived intangible assets compared to the carrying value in accordance with SFAS No. 142. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, we write down the assets to their net realizable values. Based on our analysis, we believe our intangible assets have not been impaired during any of the periods presented.

Goodwill

In accordance with SFAS No. 142, goodwill is not amortized and is tested for impairment annually on June 30th and whenever events and circumstances occur indicating goodwill might be impaired. As of June 30, 2006, 2007 and 2008, we reviewed the goodwill for impairment and determined that no impairment of goodwill had occurred during any of the periods presented.

Valuation of Long-Lived Assets

We evaluate the recoverability of our long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*. SFAS No. 144 requires recognition of impairment of long-lived assets in the event that the net book value of such assets exceeds the future undiscounted net cash flows attributable to such assets. In accordance with SFAS No. 144, we recognize impairment, if any, in the period of identification to the extent the carrying amount of an asset exceeds the fair value of such asset. Based on our analysis, we believe that no impairment of our long-lived assets was indicated as of December 31, 2007 and 2008.

Income Taxes

For the period from January 1, 2006 through January 4, 2006, the Predecessor made no provision for federal income taxes because it was treated as an S corporation for purposes of federal income taxes. It was also treated as an S corporation for most state income taxes, but some states do not recognize S corporation status and tax S corporations the same as C corporations. Federal and most state income taxes were the responsibility of the Predecessor's stockholders, who were responsible for reporting their allocable shares of the Predecessor's income and deductions in their respective income tax returns. Income tax expense for the period from January 1, 2006 through January 4, 2006 was related to state income taxes from states that do not recognize the S corporation status.

For the period from January 4, 2006 through December 31, 2006, the years ended December 31, 2007 and 2008, we accounted for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, 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, we recognize deferred tax assets for deductible temporary differences, and operating loss and tax credit carryforwards. We recognize deferred liabilities for taxable temporary differences. We reduce deferred tax assets by a valuation allowance when, in the opinion of our management, it is more likely than not that we will not realize some portion or all of the deferred tax assets. We recognize the impact of tax rate changes on deferred tax assets and liabilities in the year that the change is enacted.

In June 2006, the Financial Accounting Standards Board, or FASB, issued FIN No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN No. 48 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. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 did not have a material impact on our financial condition, results of operations or cash flows.

Internal Control over Financial Reporting

Effective internal control over financial reporting is necessary for us to provide reliable annual and interim financial reports and to prevent fraud. If we cannot provide reliable financial reports or prevent fraud, our operating results and financial condition could be materially misstated and our reputation could be significantly harmed. As a private company, we were not subject to the same standards applicable to a public company. As a public company, we will be subject to requirements and standards set by the SEC.

In relation to our consolidated financial statements for the period from January 4, 2006 through December 31, 2006 and the year ended December 31, 2007, we identified material weaknesses in our internal controls. As of December 31, 2008, we believe we have remediated all material weaknesses that we identified in previous years and we have not identified any new outstanding material weaknesses as of December 31, 2008. A material weakness is defined as a significant deficiency or combination of significant deficiencies, that results in a reasonable possibility that a material misstatement of our financial statements will not be prevented by our internal control over financial reporting. A significant deficiency means a control deficiency, or combination of control deficiencies, that adversely affects our ability to initiate, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of our financial statements that is more than inconsequential will not be prevented or detected by our internal control over financial reporting.

We identified the following material weaknesses as of December 31, 2007, which we believe have been remediated as of December 31, 2008:

- our accounting for inventory, which included our application of overhead costs, our physical inventory system and our valuation of inventory held by our U.K. subsidiary;

- our calculation of our income tax provision, which included our calculation of a tax deduction, our tax provision for U.K. and Japanese subsidiaries and our identification and documentation of uncertain tax positions;

- our general computer controls, which included our user account, user password, user access review and audit log practices and our change management policy;

- our accounting for stock-based compensation, which included our recently implemented equity reporting system, our option documentation and option modifications; and

- controls within our enterprise resources planning system.

In addition, we had a significant deficiency in our financial closing process at December 31, 2007, which had been classified as a material weakness at December 31, 2006. We believe this significant deficiency has also been remediated as of December 31, 2008. The material weaknesses over accounting for inventory, income taxes and stock-based compensation were identified during 2007 and were not outstanding at December 31, 2006.

Remediation Efforts

We began our initial evaluation of our system of internal control over financial reporting with the assistance of independent third-party consultants in late 2006 and have continued these efforts through December 31, 2008. This evaluation consists of a detailed review of current processes and controls, and the identification and evaluation of the deficiencies affecting our financial statements.

We have taken steps to remediate material weaknesses in the areas of accounting for inventory, income taxes and stock-based compensation and general computer controls, including:

- In April 2007, we began expanding our accounting and finance organization by hiring additional senior-level accounting personnel, many of whom are certified public accountants and possess experience with publicly traded companies.

- In July 2007, we implemented stock option administration software to enhance compliance with the reporting requirements of SFAS No. 123(R). We established procedures for communicating significant terms of stock option grants to employees for the purpose of grant date determination, and we implemented controls surrounding modification of stock option exercise terms.

In July 2007, we engaged an independent consultant to assist us in the evaluation, design and remediation of the business cycles included in our internal control structure.

In December 2007, we engaged an information technology consultant to assess the design and effectiveness of our general computer controls and assist us in the remediation of the gaps identified.

During 2008, we focused our remediation efforts on the design and implementation and testing the effectiveness of our general computer controls and enterprise resource planning system controls.

The process of improving our internal controls has required and will continue to require us to expend significant resources to design, implement and maintain a system of internal controls that is adequate to satisfy our reporting obligations as a public company. As a private company, we were not subject to the same internal control standards applicable to a public company. Upon completion of this offering, we will become subject to the requirements of the Sarbanes-Oxley Act of 2002, Section 404, which will require our management to assess the effectiveness of our internal controls over financial reporting after a phase-in period applicable to all companies after filing an initial public offering. There can be no assurance that the remediation efforts we have taken during 2008 have been successful in meeting this standard. Material weaknesses and other deficiencies in our internal controls could cause investors to lose confidence in our financial reporting, particularly as a result of inaccurate financial reporting, and also cause our stock price to decline. Material weaknesses in our internal controls may impede our ability to produce timely and accurate financial statements, which could cause us to fail to file our periodic reports timely, result in inaccurate financial reporting or restatements of our financial statements, subject our stock to delisting and materially harm our business reputation and our stock price. We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal controls over financial reporting on an ongoing basis.

Results of Operations

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

	Predecessor	Successor		
	Period from January 1, through January 4, 2006	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
	(in thousands)			
Revenue:				
Product	$ 178	$ 80,604	$ 119,897	$ 184,182
Subscription and service	94	10,694	17,424	25,198
Total revenue	272	91,298	137,321	209,380
Cost of revenue:				
Cost of product revenue	199	11,549	19,055	26,539
Cost of subscription and service revenue	4	992	1,632	2,137
Total cost of revenue	203	12,541	20,687	28,676
Gross profit	69	78,757	116,634	180,704
Operating expenses:				
Sales and marketing	695	45,854	65,437	93,384
Research and development	41	8,117	12,893	18,387
Acquired in-process research and development		12,597		
General and administrative	142	16,590	29,786	39,577
Lease abandonment				1,831
Transaction-related expenses	10,315			
Total operating expenses	11,193	83,158	108,116	153,179
Income (loss) from operations	(11,124)	(4,401)	8,518	27,525
Other income and expense:				
Interest income		613	673	454
Interest expense		(1,560)	(1,331)	(891)
Other (expense) income	3	60	154	239
Total interest and other income (expense), net	3	(887)	(504)	(198)
Income (loss) before income taxes	(11,121)	(5,288)	8,014	27,327
Income tax expense (benefit)		(1,240)	5,435	13,435
Net income (loss)	$ (11,121)	$ (4,048)	$ 2,579	$ 13,892
Stock-based compensation expense included in:				
Cost of revenue	$	$ 1	$ 2	$ 2
Sales and marketing		59	189	153
Research and development		128	360	482
General and administrative		373	776	953
Transaction-related expenses	5,930			
Total stock-based compensation expense	$ 5,930	$ 561	$ 1,327	$ 1,590
Intangible amortization expense included in:				
Cost of revenue				

	$	$	1,213	$	1,227	$	13
Sales and marketing			4,113		3,596		3,003
Total intangible amortization expense	$	$	5,326	$	4,823	$	3,016

The following table sets forth our consolidated statement of operations data expressed as a percentage of total revenue for the periods indicated.

	Predecessor	Successor		
	Period from January 1, through January 4, 2006	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
Revenue:				
Product	65%	88%	87%	88%
Subscription and service	35	12	13	12
Total revenue	100	100	100	100
Cost of revenue:				
Cost of product revenue	73	13	14	13
Cost of subscription and service revenue	1	1	1	1
Total cost of revenue	75	14	15	14
Gross profit	25	86	85	86
Operating expenses:				
Sales and marketing	256	50	48	45
Research and development	15	9	9	9
Acquired in-process research and development		14		
General and administrative	52	18	22	19
Lease abandonment				1
Transaction-related expenses	3,792			
Total operating expenses	4,115	91	79	73
Income (loss) from operations	(4,090)	(5)	6	13
Other income and expense:				
Interest income		1	1	0
Interest expense		(2)	(1)	0
Other income	1	0	0	0
Total interest and other (expense) income, net	1	(1)	0	0
Income (loss) before income taxes	(4,089)	(6)	6	13
Income tax expense (benefit)		(1)	4	6
Net income (loss)	(4,089)%	(4)%	2%	7%

Comparison of the Year Ended December 31, 2008 and the Year Ended December 31, 2007

	Year Ended December 31,					
	2007		2008		Change	% Change
	(dollars in thousands)					
Product revenue	$119,897	87.3%	$184,182	88.0%	$64,285	53.6%
Subscription and service revenue	17,424	12.7	25,198	12.0	7,774	44.6
Total revenue	$137,321	100.0%	$209,380	100.0%	$72,059	52.5
Revenue by sales channel:						
Direct-to-consumer	$ 61,950	45.1%	$ 96,702	46.2%	$34,752	56.1
Kiosk	23,947	17.4	36,314	17.3	12,367	51.6
Retail	21,206	15.4	34,638	16.5	13,432	63.3
Total consumer	107,103	78.0	167,654	80.1	60,551	56.5
Institutional	30,218	22.0	41,726	19.9	11,508	38.1
Total revenue	$137,321	100.0%	$209,380	100.0%	$72,059	52.5

Revenue

Total revenue for the year ended December 31, 2008 was $209.4 million, an increase of $72.1 million, or 53%, from the year ended December 31, 2007.

Consumer

Consumer revenue was $167.7 million for the year ended December 31, 2008, an increase of $60.6 million, or 57%, from the year ended December 31, 2007. The increase in consumer revenue was attributable to a 22% increase in unit sales, which resulted in a $23.7 million increase in revenue, combined with a 28% increase in the average selling price of each unit, which accounted for a $36.9 million increase in revenue. Unit growth was driven by the expansion of our direct advertising campaign as well as growth in our retail distribution network. Direct advertising expenses increased 38% to $33.9 million during the year ended December 31, 2008, while the number of kiosks increased from 86 to 150 from December 31, 2007 to December 31, 2008. We also received a $2.6 million initial stocking order from Barnes & Noble in June 2008 to support their expansion of our product line to over 650 of their stores nationally.

In August 2007, we released our Version 3 solution for ten of our best selling languages. All Version 3 solutions include three course levels, while our Version 2 solutions only include one or two course levels. Upon the release of a language in Version 3, we discontinue selling that language in Version 2 and, as a result, sales of Version 3 products replace sales of Version 2 products for that language. Our solutions are often purchased in sets including all available course levels for a language. The additional levels included in Version 3 enabled us to offer additional languages with three course levels, resulting in a greater number of available products at our highest price point for a complete set. In March 2008, we released Version 3 in four additional languages and, in June 2008, we released seven additional Version 3 languages. Also in June 2008, we released our *Audio Companion* practice tool product for all 14 then-available Version 3 languages. In September 2008, we released Version 3 and our *Audio Companion* in seven additional languages. This expansion of our product portfolio with higher price point options has resulted in the 28% increase in average selling price per unit for the year ended December 31, 2008.

Product revenue represented 94% of total consumer revenue for the year ended December 31, 2008, with the balance attributable to subscription and service revenue.

Institutional

Institutional revenue was $41.7 million for the year ended December 31, 2008, an increase of $11.5 million, or 38%, compared to the year ended December 31, 2007. The increase in institutional revenue was primarily due to the expansion of our direct sales force. As a result, we had a $9.4 million increase in education and home school revenue and a $1.6 million increase in corporate revenue.

Product revenue represented 65% of total institutional revenue for the year ended December 31, 2008, and subscription and service revenue represented 35% for the same period.

Cost of Revenue and Gross Profit

	Year Ended December 31,			
	2007	2008	Change	% Change
	(dollars in thousands)			
Revenue:				
Product	$119,897	$184,182	$64,285	53.6%
Subscription and service	17,424	25,198	7,774	44.6
Total revenue	137,321	209,380	72,059	52.5
Cost of revenue:				
Cost of product revenue	19,055	26,539	7,484	39.3
Cost of subscription and service revenue	1,632	2,137	505	30.9
Total cost of revenue	20,687	28,676	7,989	38.6
Gross profit	$116,634	$180,704	$64,070	
Gross margin percentages	84.9%	86.3%	1.4%	

Cost of revenue for the year ended December 31, 2008 was $28.7 million, an increase of $8.0 million, or 38.6%, from the year ended December 31, 2007. As a percentage of total revenue, cost of revenue was 14% for the year ended December 31, 2008 compared to 15% for the year ended December 31, 2007. The dollar increase in cost of revenue was attributable to growth in unit sales. The increase in gross margin percentage was due to a $0.9 million write down of inventory in the 2007 period associated with the transition from Version 2 to Version 3 product and packaging.

Operating Expenses

	Year Ended December 31,			
	2007	2008	Change	% Change
	(dollars in thousands)			
Sales and marketing	$ 65,437	$ 93,384	$27,947	42.7%
Research and development	12,893	18,387	5,494	42.6
General and administrative	29,786	39,577	9,791	32.9
Lease abandonment		1,831	1,831	100.0
Total operating expenses	$108,116	$153,179	$45,063	41.7

Sales and Marketing Expenses

Sales and marketing expenses for the year ended December 31, 2008 were $93.4 million, an increase of $27.9 million, or 43%, from the year ended December 31, 2007. As a percentage of total revenue, sales and marketing expenses were 45% for the year ended December 31, 2008, compared to 48% for the year ended December 31, 2007. The dollar increase in sales and marketing expenses was primarily attributable to the continued expansion of our direct marketing activities. Advertising expenses grew by $9.3 million and were primarily related to the purchase of additional television media. We also expanded the number of our kiosks from 86 as of December 31, 2007 to 150 as of December 31, 2008, which resulted in $7.9 million of additional kiosk operating expenses, including sales compensation related expenses. Personnel costs related to growth in our institutional sales channel and marketing and sales support activities also increased by $7.7 million.

Research and Development Expenses

Research and development expenses were $18.4 million for the year ended December 31, 2008, an increase of $5.5 million, or 43%, from the year ended December 31, 2007. As a percentage of total revenue, research and development expenses were 9% for the years ended December 31, 2008 and 2007. The dollar increase was primarily attributable to additional personnel and contract development costs associated with the transition of Version 2 languages to Version 3, as well as the development of new products and services that are complementary to our existing solutions.

General and Administrative Expenses

General and administrative expenses for the year ended December 31, 2008 were $39.6 million, an increase of $9.8 million, or 33%, from the year ended December 31, 2007. As a percentage of revenue, general and administrative expenses decreased to 19% for the year ended December 31, 2008 compared to 22% for the year ended December 31, 2007. The dollar increase was primarily attributable to a $4.3 million increase in personnel-related costs as we expanded our finance, information technology and other administrative functions to support the overall growth in our business, and a corresponding increase in communications, travel and other support costs of $4.4 million. Depreciation expense also increased $0.9 million and bad debt expense increased $0.8 million during the year ended December 31, 2008 as a result of greater capital expenditures and credit sales. We also incurred an additional $1.0 million in legal fees related to trademark protection matters. This increase was partially offset by decreased professional service expenses of $0.2 million as we replaced contract staff with employees.

Lease Abandonment Expenses

Lease abandonment expense associated with the relocation of our headquarters was $1.8 million for the year ended December 31, 2008, consisting of accrued exit costs and liabilities under operating lease agreements.

Interest and Other Income (Expense)

	Year Ended December 31,			
	2007	2008	Change	% Change
	(dollars in thousands)			
Interest income	$ 673	$ 454	$ (219)	(32.5)%
Interest expense	(1,331)	(891)	440	(33.1)
Other income	154	239	85	55.2
Total	$ (504)	$ (198)	$ 306	(60.7)

Interest expense for the year ended December 31, 2008 was $0.9 million, a decrease of $0.4 million, or 33%, from the year ended December 31, 2007. The decrease was due to a reduction in the outstanding balance of our long-term debt as a result of $3.4 million in principal payments during the period.

Income Tax Expense

	Year Ended December 31,			
	2007	2008	Change	% Change
	(dollars in thousands)			
Income tax expense	$5,435	$13,435	$8,000	147.2%

Income tax expense for the year ended December 31, 2008 was $13.4 million, an increase of $8.0 million, or 147%, compared to the year ended December 31, 2007. The increase was the result of an increase of $19.3 million in pre-tax income for the year ended December 31, 2008, compared to the year ended December 31, 2007. Our effective tax rate decreased to 49.2% for the year ended December 31, 2008 compared to 67.8% for the year ended December 31, 2007 as a result of a decline in the percentage of foreign losses relative to total consolidated income before tax. We do not currently recognize income tax benefits on losses in our foreign subsidiaries.

Comparison of the Year Ended December 31, 2007 and the Period from January 4, 2006 through December 31, 2006

Revenue

	Period from January 4, through December 31,		Year Ended December 31,			
	2006		2007		Change	% Change
	(dollars in thousands)					
Revenue:						
Product	$80,604	88.3%	$119,897	87.3%	$39,293	48.7%
Subscription and service	10,694	11.7	17,424	12.7	6,730	62.9
Total revenue	$91,298	100.0%	$137,321	100.0%	$46,023	50.4
Revenue by sales channel:						
Direct-to-consumer	$41,134	45.1%	$ 61,950	45.1%	$20,816	50.6
Kiosk	17,055	18.7	23,947	17.4	6,892	40.4
Retail	9,694	10.6	21,206	15.4	11,512	118.8
Total consumer	67,883	74.4	107,103	78.0	39,220	57.8
Institutional	23,415	25.6	30,218	22.0	6,803	29.1
Total revenue	$91,298	100.0%	$137,321	100.0%	$46,023	50.4

Total revenue was $137.3 million, an increase of $46.0 million, or 50%, from the period from January 4, 2006 through December 31, 2006.

Consumer

Consumer revenue in 2007 was $107.1 million, an increase of $39.2 million, or 58%, from the period from January 4, 2006 through December 31, 2006. The increase in consumer revenue was due to a 37% increase in unit sales, which resulted in a $25.4 million increase in revenue, combined with a 15% increase in the average selling price per unit, which accounted for a $13.8 million increase in revenue. Our unit growth was driven by the expansion of our direct advertising campaigns as advertising expenses increased by 51% to $24.5 million in 2007. Kiosk locations grew slightly from 81 at December 31, 2006 to 86 at December 31, 2007. Sales through our retailer partners increased 119% due to the expansion of our retail presence, increased advertising and brand awareness and increased sales by our existing retailers and distributors.

The increase in our average selling price per unit was attributable to the release of Version 3 in August 2007. Upon the release of a language in Version 3, we discontinue selling that language in Version 2, and as a result, sales of Version 3 products replace sales of Version 2 products for that language. Version 3 includes three course levels for all languages, while our Version 2 languages were only available in one or two course levels. We often sell our solutions in a set comprising all course levels for a specific language, so increasing the available course levels to three also increased the price of a complete set of courses for a Version 3 language and resulted in higher average dollar value per sale.

Product revenue represented 95% of total consumer revenue for the years ended December 31, 2007 and 2006 with the balance attributable to subscription and service revenue.

Institutional

Institutional revenue in 2007 was $30.2 million, an increase of $6.8 million, or 29%, from the period from January 4, 2006 through December 31, 2006. The increase in institutional revenue was primarily attributed to the expansion of our direct sales force. As a result, government revenue increased by $2.2 million, education and home school revenue increased by $3.1 million and corporate revenue increased by $1.5 million. Although directed at the consumer markets, we believe our consumer marketing campaigns continue to positively impact our brand recognition, which also contributes to increased sales in our institutional markets.

Product revenue represented 60% and 68% of total institutional revenue for the years ended December 31, 2007 and 2006, respectively, and subscription and service revenue represented 40% and 32% for the same periods. The increase in subscription and service revenue as a percentage of total institutional revenue was attributable to growth in the government and corporate customer bases.

Cost of Revenue and Gross Profit

	Period from January 4, through December 31, 2006	Year Ended December 31, 2007	Change	% Change
	(dollars in thousands)			
Revenue:				
Product	$ 80,604	$ 119,897	$ 39,293	48.7%
Subscription and service	10,694	17,424	6,730	62.9
Total revenue	91,298	137,321	46,023	50.4
Cost of revenue:				
Cost of product revenue	11,549	19,055	7,506	65.0
Cost of subscription and service revenue	992	1,632	640	64.5
Total cost of revenue	12,541	20,687	8,146	65.0
Gross profit	$ 78,757	$ 116,634	$ 37,877	
Gross margin percentage	86.3%	84.9%	(1.4)%	

Cost of revenue in 2007 was $20.7 million, an increase of $8.1 million, or 65%, from the period from January 4, 2006 through December 31, 2006 to December 31, 2007. As a percentage of total revenue, cost of revenue for the year ended December 31, 2007 increased to 15% from 14% for the period from January 4, 2006 through December 31, 2006. The dollar increase in cost of revenue in 2007 compared to the 2006 period was primarily attributable to increased unit sales. The reduction of gross profit in 2007 was primarily due to slightly higher per-unit costs related to the inclusion of an audio headset with the Version 3 software product. We released Version 3 in ten of our best selling languages in August 2007. We also incurred a write-down of inventory of $0.9 million associated with the transition from Version 2 to Version 3 product and product packaging.

Operating Expenses

	Period from January 4 through December 31, 2006	Year Ended December 31, 2007	Change	% Change
	(dollars in thousands)			
Sales and marketing	$ 45,854	$ 65,437	$ 19,583	42.7%
Acquired in-process research and development	12,597		(12,597)	(100.0)
Research and development	8,117	12,893	4,776	58.8
General and administrative	16,590	29,786	13,196	79.5
Total operating expenses	$ 83,158	$ 108,116	$ 24,958	30.0

Sales and Marketing Expenses

Sales and marketing expenses in 2007 were $65.4 million, an increase of $19.6 million, or 43%, from the period from January 4, 2006 through December 31, 2006. As a percentage of total revenue, sales and marketing expenses decreased to 48% in 2007 as compared to 50% for the period from January 4, 2006 through December 31, 2006. The dollar increase was primarily attributable to an increase in advertising expenses of $8.3 million, or 51%, resulting from continued expansion of our television, print, radio and online advertising as well as an increase in personnel related costs of $4.6 million as we continued to add new personnel to manage our expanded sales and marketing activities, which included the opening of our Tokyo office in May 2007 and growth in our London office. In connection with our international expansion, we also incurred $3.7 million of expenses to establish local sales and support call centers within each geographic region. Finally, we increased our marketing and public relations expenses by $1.5 million related to a rebranding of our products in association with the launch of Version 3 in August 2007.

Acquired In-Process Research and Development Expenses

On January 4, 2006, we acquired all of the outstanding stock of Fairfield & Sons, Ltd., along with its wholly owned subsidiary Fairfield & Sons, Limited. As a result of the acquisition, we allocated $12.6 million to acquired in-process research and development, which we expensed during the period from January 4, 2006 through December 31, 2006.

Research and Development Expenses

Research and development expenses in 2007 were $12.9 million, an increase of $4.8 million, or 59%, as compared to the period from January 4, 2006 through December 31, 2006. As a percentage of total revenue, research and development expenses remained unchanged at 9% for the 2006 period and for 2007. The dollar increase was primarily attributable to additional personnel and contract development costs of $3.6 million, both of which were related to the development of Version 3. We initially released Version 3 in ten languages in August 2007 and continued development of additional Version 3 languages throughout the remainder of 2007.

General and Administrative Expenses

General and administrative expenses in 2007 increased $13.2 million, or 80%, to $29.8 million as compared to the period from January 4, 2006 through December 31, 2006. As a percentage of revenue, general and administrative expenses increased to 22% in 2007 as compared to 18% for the period from January 4, 2006 to December 31, 2006. The increase was primarily attributable to increased personnel and recruiting costs of $4.7 million and increased professional service expenses of $4.4 million in order to build our finance, information technology and other administrative functions to support the overall growth in our business and to enhance processes and controls.

Interest and Other Income (Expense)

	Period from January 4 through December 31, 2006	Year Ended December 31, 2007	Change	% Change
	(dollars in thousands)			
Interest income	$ 613	$ 673	$ 60	9.8%
Interest expense	(1,560)	(1,331)	229	(14.7)
Other income (expense)	60	154	94	156.7
Total	$ (887)	$ (504)	$ 383	43.2

Interest expense decreased $0.2 million, or 15%, for the year ended December 31, 2007 as compared to the period from January 4, 2006 to December 31, 2006 due to a reduction in the outstanding balance of our long-term debt, as a result of $2.6 million in principal payments during 2007.

Income Tax Expense

	Period from January 4 through December 31, 2006	Year Ended December 31, 2007	Change	% Change
	(dollars in thousands)			
Income tax expense (benefit)	$ (1,240)	$ 5,435	$ 6,675	538.3%

Income tax expense for the year ended December 31, 2007 was $5.4 million, an increase of $6.7 million, or 538%, compared to the period from January 4, 2006 through December 31, 2006. The increase was the result of an increase of $13.3 million in pre-tax income for the year ended December 31, 2007 compared to the period from January 4, 2006 through December 31, 2006. Our effective tax rate was 67.8% for the year ended December 31, 2007 compared to 23.4% for the period from January 4, 2006 through December 31, 2006. The increase in our effective tax rate was due to an increase in foreign losses, for which no income tax benefits are recognized, relative to total consolidated income before tax.

Period from January 1, 2006 through January 4, 2006

Activity for the period from January 1, 2006 through January 4, 2006 represents the results of operations for our Predecessor in 2006 prior to its acquisition by Rosetta Stone Inc. on January 4, 2006. During this period, our Predecessor incurred transaction-related expenses relating to the acquisition. Included in the expenses were $5.9 million related to restricted common stock, $3.1 million in cash bonuses and $1.2 million in acquisition-related bank fees.

Quarterly Results of Operations

The following tables set forth unaudited quarterly consolidated statement of operations data for the four quarters of 2007 and 2008, as well as the percentage that each line item represented of our revenue. We have prepared the statement of operations data for each of these quarters on the same basis as the audited consolidated financial statements included elsewhere in this prospectus and, in the opinion of the management, the statement of operations data includes all adjustments, consisting solely of normal recurring adjustments, necessary for the fair statement of the results of operations for these periods. This information should be read in conjunction with the audited consolidated financial statements and related notes included elsewhere in this prospectus. These quarterly results of operations are not necessarily indicative of our operating results for any future period.

	Three Months Ended							
	March 31, 2007	June 30, 2007	September 30, 2007	December 31, 2007	March 31, 2008	June 30, 2008	September 30, 2008	December 31, 2008
	(in thousands, except per share data)							
Statement of Operations Data:								
Revenue:								
Product	$ 25,192	$ 26,319	$ 30,323	$ 38,063	$ 30,218	$ 41,630	$ 53,139	$ 59,195
Subscription and service	3,894	4,099	4,486	4,945	5,367	6,112	6,664	7,055
Total revenue	29,086	30,418	34,809	43,008	35,585	47,742	&n	