

ROSETTA STONE INC  
Form 10-Q  
November 06, 2018  
Table of Contents

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

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

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

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

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

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

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

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

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

(Do not check if a smaller reporting company)

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

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

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

Edgar Filing: ROSETTA STONE INC - Form 10-Q

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

---

ROSETTA STONE INC.

Table of Contents

	Page
PART I. FINANCIAL INFORMATION	
Item 1 <u>Financial Statements (unaudited)</u>	<u>3</u>
Item 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>39</u>
Item 3 <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>54</u>
Item 4 <u>Controls and Procedures</u>	<u>54</u>
PART II. OTHER INFORMATION	
Item 1 <u>Legal Proceedings</u>	<u>56</u>
Item 1A <u>Risk Factors</u>	<u>56</u>
Item 2 <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>71</u>
Item 3 <u>Defaults Upon Senior Securities</u>	<u>71</u>
Item 4 <u>Mine Safety Disclosures</u>	<u>71</u>
Item 5 <u>Other Information</u>	<u>71</u>
Item 6 <u>Exhibits</u>	<u>72</u>
<u>Signatures</u>	<u>73</u>

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## ROSETTA STONE INC.

## CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

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

Edgar Filing: ROSETTA STONE INC - Form 10-Q

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

See accompanying notes to consolidated financial statements

3

---

Table of Contents

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

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

See accompanying notes to consolidated financial statements

Table of Contents

## ROSETTA STONE INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(in thousands)

(unaudited)

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

See accompanying notes to consolidated financial statements

Table of Contents

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

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



Edgar Filing: ROSETTA STONE INC - Form 10-Q

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

6

---

Table of Contents

## ROSETTA STONE INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

(unaudited)

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

Table of Contents

## ROSETTA STONE INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

(unaudited) (Continued)

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

See accompanying notes to consolidated financial statements

Table of Contents

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

1. NATURE OF OPERATIONS

Rosetta Stone Inc. and its subsidiaries ("Rosetta Stone," or the "Company") develop, market and support a suite of language-learning and literacy solutions consisting of web-based software subscriptions, perpetual software products, online and professional services, audio practice products and mobile applications. The Company's offerings are sold on a direct basis and through select third party retailers and distributors. The Company provides its solutions to customers through the sale of web-based software subscriptions, mobile applications, and packaged software, domestically and in certain international markets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Basis of Presentation

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

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

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

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make certain estimates and assumptions. The amounts reported in the consolidated financial statements include significant estimates and assumptions that have been made, including, but not limited to, those related to revenue recognition, allowance for doubtful accounts, estimated sales returns and reserves, stock-based compensation, restructuring costs, fair value of intangibles and goodwill, disclosure of contingent assets and liabilities, disclosure of contingent litigation, allowance for valuation of deferred tax assets, and the Company's quarterly going concern assessment. The Company bases its

estimates and assumptions on historical experience and on various other judgments that are believed to be reasonable under the circumstances. The Company continuously evaluates its estimates and assumptions. Actual results may differ from these estimates and assumptions.

Table of Contents

ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Issued Accounting Standards

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

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230) Restricted Cash a consensus of the FASB Emerging Issues Task Force. Under ASU 2016-18, amounts generally described as restricted cash should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statements of cash flows. The Company retrospectively adopted ASU 2016-18 beginning January 1, 2018. The Company does not consider its restricted cash balances to be material for further disclosure or reconciliation. The adoption of this guidance did not impact the Company's consolidated financial position, results of operations, or footnote disclosures.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("ASU 2018-02").

ASU 2018-02 provided financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act of 2017 (or portion thereof) was recorded. ASU 2018-02 is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted for any interim period for which financial statements have not been issued. The Company adopted ASU 2018-02 effective January 1, 2018. Due to the presence of a full valuation allowance, adoption did not have a material impact on the Company's consolidated financial statements and the disclosure requirements under ASU 2018-02 were not applicable.

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

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

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

The most significant impact of ASC 606 to the Company related to the accounting for offerings that