SECOND QUARTER 2012 INVESTOR WEBCAST

August 8, 2012

Prepared Remarks

Steve Somers, Investor Relations: Good afternoon and let me welcome you to Rosetta Stone's second quarter 2012 earnings call. I am Steve Somers, Vice President of Investor Relations and I am joined today by Steve Swad, Rosetta Stone's President and CEO, and Tom Pierno, CFO, to discuss the operations and financial results for the second quarter and our outlook.

In addition to our commentary, we have made our 2Q12 Earnings Results press release, supplemental financial information, and a slide deck supporting this webcast available on our IR website at investors.rosettastone.com. Please review them to find important additional information.

[Safe Harbor]

There are or will be forward-looking statements in our press release, slides and conversation today. We offer these statements under the Safe Harbor provided by U.S. law. Of course, risks and uncertainties attach to any forward-looking statement. A detailed discussion of such risks and uncertainties is contained in our Form 10-K filed with the SEC in March 2012, which is available in the Investor Relations section of our website. We ask that you review those risk factors before making any investment decision. Please note these forward-looking statements reflect our opinions only as of the date of this presentation and we undertake no obligation to provide or publicly release the results of any revision to the forward-looking statements in light of new information or future events.

We also use non-GAAP numbers in our presentation. The definition of those numbers, and their reconciliation to GAAP numbers, is available in today's press release on our website and as filed with the SEC today on Form 8-K.

Now here's Steve.

Steve Swad, Chief Executive Officer:

Thanks Steve and welcome everyone.

[Second Quarter Overview]

Overall, I think the quarter came in largely as expected. If you recall, in May I said my strategic focus for the company is based on three pillars: Leveraging the Brand, Innovating the Platform and Expanding Distribution. In pursuing these priorities, I committed to you that we would do it in a fashion that balances margins with growth. Since we last spoke, we have made progress internally along each of these three priorities. As it relates to 2Q, however, the best evidence of our progress was in the improvement in margins, which makes sense because it takes time to meaningfully drive these other priorities.

Adjusted EBITDA came in at a positive $1.1 million versus a negative $1.3 million a year ago, which represents a positive margin of 2%. This performance fits into the 2-3% margin range that I outlined for full year 2012 and compares favorably to a negative margin of 2% a year ago.

To drive margins, we took a number of actions.

50 • For example, we reduced global headcount by about 5%,
51 • we closed over 100 low-yielding kiosks since 2Q last year,
52 • we removed low performing SKUs,
53 • we pulled back on lower-yielding media,
54 • we reduced our cost structure in Europe by streamlining our operations in the
55 UK and Germany, and
56 • we closed low-yielding retail locations in Japan.
57
58 These actions clearly made the company more efficient, however, some of these
59 actions, particularly around media and kiosks, also resulted in lower revenues year over
60 year.
61 Overall, revenues for the second quarter declined 9%, with our Global Consumer
62 business off 11% and our Institutional business off 2%.
63 In North America, our Consumer business faced somewhat weaker consumer
64 demand, which we managed through some promotions that lasted longer than originally
65 planned. Revenues in the quarter were 4% lower than last year and were influenced by
66 several factors. The first is that revenues from our kiosks were down as we operated an
67 average of 74 fewer kiosks this year compared with last year. While this impacted
68 revenues by over $2 million, revenues per kiosk continued to increase year-over-year,
69 as we have made progress in optimizing this channel. Despite an overall decline that
70 was mainly driven by our reduced kiosk footprint, our direct-to-consumer channel was
71 up nearly 10%, as a solid lift in website traffic offset a slightly lower conversion rate.

72 On the International Consumer side, revenues declined primarily from our operations
73 in Asia. Previously, I have indicated that our challenges in Asia were not likely to be
74 resolved in the near term and that perspective was not changed in the second quarter.
75 Because our international challenges are not universal, but rather more country-specific,
76 let me touch on each geography.

77 Results in Japan were down because of declines in our kiosk, retail, and DTC
78 channels. Part of the decline was due to our efforts to reduce poor performing kiosks
79 and retail locations. In addition, our important DTC channel has not yet stabilized.
80 While our Japanese business continues to struggle and we are still searching for the
81 right pricing and marketing mix to return to growth, we still think Japan, and Asia in
82 general, is a very attractive market for language learning. To reinforce this point, I have
83 dispatched Prag Shah, our head of Consumer, to oversee our Global Consumer
84 operations from Asia. Prag will work towards addressing our challenges in Japan and
85 Korea and I feel that having a senior management presence there will help lead to
86 improvements.

87 Even as top line was below expectations in Japan, our focus on better managing
88 costs, including media spend, enabled us to compensate somewhat for the lower
89 revenues and come in better than we expected.

90 Elsewhere in Asia, our business in Korea recorded a top line that was down double-
91 digits compared with a year ago. As you know, over the past several quarters we have
92 been addressing issues related to a slowing in our home shopping channel, and trying
93 to ignite growth in our ReFLEX product. We made some progress in the quarter units

94 from our DTTC channel were up strong double-digits . In addition, we also experienced
95 higher year-on-year sales in our kiosk channel.
96 As I've told you on the past couple of calls, our conversational English product,
97 ReFLEX, has struggled to gain traction on the consumer side of the business. Part of
98 the challenge for this product has been the immaturity of our web channel, as well as
99 the disruptive nature of the product in what is a very traditional consumer market. While
100 we are seeing improved customer acceptance and better, more targeted marketing, we
101 have not yet generated a positive meaningful impact on business results. In light of this,
102 we are expanding our efforts to find distribution partners and have introduced ReFLEX
103 into the Institutional market. We've seen some positive initial receptivity, but are still
104 operating at sub-optimal levels. During the quarter, we managed the cost side of our
105 Korean business tightly, which allowed us to improve Adjusted EBITDA contribution
106 versus last year despite the softer revenues.
107 Our European business also experienced a decrease on the top line compared to
108 last year, but improvements on the bottom line. That being said, the revenue decrease
109 in Europe largely reflects the shift in our Germany business from box product to a 12
110 month online product. While revenues were down, we were still able to significantly
111 increase EBITDA by spending less on media as we drove improved returns on that
112 spend. Together with expense reduction associated with closing our German office, we
113 were able to improve margins in 2Q12 meaningfully.
114 As we've discussed previously, this move to all online in Germany back in late
115 February started out softer than expected. In 2Q, we still tracked below expectations,

116 but we are gaining momentum, particularly in our web channel as the market becomes
117 more familiar with our offering and we become more effective at marketing this solution.
118 While each of our markets have their own characteristics, we are, in part, using
119 Germany as a test market to think about how we can effectively offer similar solutions in
120 other markets. I am still not satisfied with where we are today in Germany, but believe
121 we are progressing toward making our business more relevant over the long term.
122 On the consumer pricing front, average revenue per unit was around $250
123 compared with roughly $360 a year ago. There were a number of factors that drove this
124 decrease, including the addition of lower ARPU monthly online subscribers in our
125 metrics. In the second quarter, we also promoted for more of the quarter than we did a
126 year ago, which impacted average pricing.
127 To help mitigate the downward trend in pricing, we are currently testing different tiers
128 or bundles to address customer preferences along various price points on the demand
129 curve. Some of our options include unbundling certain elements of our TOTALe
130 offering, like Studio, and selling some of those sessions as upsells. We expect that
131 such actions should help offset the recent down trend in our pricing.
132 Now let's move to our Institutional business. As I mentioned to you back in May, we
133 believe that we have an opportunity to grow this business. We had solid sales
134 momentum in the second quarter, inking a number of large deals. However, revenues
135 were down 2% year-over-year. Similar to what we experienced in the first quarter, our
136 K-12 market is soft versus the prior year due to sun-setting of 2011 federal stimulus
137 money that drove demand for our solution in schools. Our International business

138 continues to make nice gains and we sold more into the US corporate and Higher Ed
139 channels. During the quarter, we even grew our Government business excluding the
140 headwinds from the 2011 non-renewal of the Army & Marines contract, which will
141 persist into the third quarter. Institutional is an important segment for us and we are
142 investing in people, marketing, and systems to position us to capture this opportunity.
143 Before turning the call over to Tom to review the financials, let me make a couple of
144 comments regarding where we are today and where we are headed. We are clearly
145 making progress around operating efficiencies. What is more difficult to see however,
146 are the initiatives that we are working on to address our strategic priorities. Among
147 those is development of a product for the Kids market which will leverage our brand in
148 both the consumer and institutional segments. In addition, we are working with potential
149 partners to broaden our distribution and expand our reach, both in the U.S. and
150 internationally. We are also making investments to innovate our platform, including
151 efforts around artificial intelligence and a new learner management system for
152 institutional users. All of this is being carried out with a careful eye on costs.
153 I've used the phrase, "cutting back on empty-calorie revenues" to describe some of
154 the actions that we have, and are taking to improve the business in the short term and
155 the second quarter was a good reflection of how we are working to right the ship
156 financially setting us up for profitable growth in the future. By no means am I saying
157 that we've got it all figured out, but I believe we are making the company stronger and
158 more relevant.
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160 Now let me turn the call over to Tom, who will review our financials in detail.

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162 **Tom Pierno, CFO:**

163 [Review of results vs. guidance]

164 Thanks Steve and good afternoon everyone. As Steve noted throughout his
165 commentary, the second quarter was one that saw us take steps to improve the
166 profitability of the company. This resulted in us generating less robust results on the top
167 line, but driving margin enhancement and strong improvement in Adjusted EBITDA
168 versus last year.

169 Total revenues in the quarter decreased 9% to $60.8 million. This reflected an 11%
170 decrease in our Consumer segment, predominantly driven by lower revenues from our
171 International markets, but also modestly lower results in North America as well.

172 Institutional revenues were off 2% due to the absence of the Army & Marines
173 contracts and softness in the K-12 vertical. Adjusting out for Army & Marines, revenues
174 would have been up nearly double-digit percent in the quarter.

175 Average revenue per unit was down in the quarter to $246 from $362 a year ago and
176 $290 last quarter. There are a few main reasons for the year-over-year decrease, some
177 of which represent lower prices for our products and some of which reflects the
178 mechanics in how we calculate the metric.

179 i. First, it reflects the blending in the calculation of our metric of hard
180 box units with the increasing number of lower-priced, online,
181 monthly subscriptions - this accounts for about half of the change

182 ii. Second, it reflects impact of lower pricing and promotions in 2Q12
183 versus last year and
184 iii. Third, it reflects a channel shift away from our owned kiosk channel
185 with higher average pricing compared with pricing that we get from
186 our retail partners.

187 As you've seen in recent quarters, our reported ARPU has been decreasing, in part
188 because of the expansion of the number of units through an increasing amount of new
189 and renewal monthly online subscribers in our unit count. Because more of our
190 business is shifting online, we are working on expanded disclosure in the coming
191 months that will include a break-out of physical box units versus subscribers and
192 related average pricing metrics. We expect that after we provide this disclosure,
193 ARPUs on our box units will change by eliminating the noise associated with monthly
194 subscriber ARPU, but still show trends similar to what we've reported, although less
195 pronounced. We look forward to discussing this with you on subsequent earnings calls.
196 Gross margin held even with the first quarter at 81% but was down from 83% in
197 2Q11. We managed down our hard product and inventory costs in the quarter, but
198 these gains were offset by increased support and coaching costs. As we've noted the
199 past few quarters, our gross margin has compressed with the introduction of live studio
200 in our v4 and ReFLEX products. Even as coaching costs in absolute dollars have
201 increased, we continue to gain leverage on our fixed infrastructure as studio sessions
202 increase, in part driving a 25% decrease in per session costs. We are also currently
203 exploring additional measures to further address coaching costs, including potentially
204 capping the number of sessions versus the current unlimited practice and offering upsell

205 coaching bundles to those who want more of them. Consistent with our theme of better
206 managing costs and focusing on margins, operating expenses decreased 10% to $54.5
207 million from $60.7 million a year ago. The improvement in operating expenses was
208 driven by a $5.4 million decrease in sales and marketing expenses to $35.1 million from
209 $40.5 million with the bulk of that coming from lower media spend across all our
210 markets and drove a 300 basis point improvement in sales and marketing to 58% as a
211 percentage of revenues. Research and development costs increased slightly to $6.5
212 million from $6.4 million versus a year-ago, while general and administrative expenses
213 decreased $900 thousand or 6% to $12.9 million. In total, Cost of goods sold and
214 operating expenses decreased 9% versus a year ago, more than offsetting the 9%
215 decline in revenues.

216 During the quarter, we implemented modest cost savings measures, which included
217 some headcount reduction. While we expect that these actions will improve margins
218 going forward, there were expenses associated with these actions of almost $1 million
219 that are in 2Q. Excluding these and other similar costs, Adjusted EBITDA for the
220 quarter was a positive $1.1 million compared with a negative $1.3 million a year ago.
221 Adjusted EBITDA margin improved 400 basis points to a positive 2% from a negative
222 2% a year ago.

223 Net loss for the quarter was $4.5 million or $0.22 per share which was flat with a net
224 loss of $4.5 million or $0.22 per share, a year ago. Share count in the quarter was 21.0
225 million versus 20.7 million a year ago.

226 [Consumer Channel Review]

227 From a channel perspective, our worldwide direct-to-consumer channel was flat with
228 last year with revenues of $31 million. The reduction of our kiosk footprint over the past
229 year to 99 global locations at quarter end resulted in lower sales of $4.6 million from this
230 channel compared with $7.4 million a year ago. While the reduction of locations has
231 impacted top line, sales efficiency in this channel improved sharply as average
232 revenues per kiosk were up over 30% versus a year ago. As has been our plan, we are
233 shifting resources from less efficient channels like kiosk to more effective ones like our
234 web channel. The global retail channel produced revenues of $8.1 million, down from
235 $10.8 million. Part of this decrease reflects our more careful management of retail
236 partners, and the timing of purchases by retailers also impacts our quarter to quarter
237 results. More telling was the low double-digit increase in U.S. retail sell-through to the
238 end consumer in the quarter. This reflected strong results from our larger partners as
239 well as a full quarter of selling through Best Buy and an increase in Canadian retail
240 sales.
241
242 [Balance Sheet and Cash Flow Review]
243 Turning to our financial position, the company's balance sheet remained very
244 healthy with $120.4 million of total cash, cash equivalents and short-term investments,
245 which was up from $118.5 million at the end of the first quarter and up $5.2 million from
246 $115.2 million a year ago. This represents approximately $5.75 of cash per share. We
247 also better managed our working capital with our A/R days outstanding and our

248 inventory levels both lower than a year ago, reflecting both the modest shift towards
249 online offerings but also a reduction of SKUs in our system.
250 Capex in the quarter was $1.0 million and we generated $2.4 million of free cash
251 flow compared with negative $5.8 million in 2Q of last year. This represents the third
252 consecutive quarter of positive free cash flow. For the first half of the year, free cash
253 flow was $4.1 million versus negative $7.5 million for the comparable period last year,
254 largely reflecting the improved operating results.
255 [Guidance]
256 In May, we provided full year 2012 guidance for revenues of $270-285 million and
257 Adjusted EBITDA of $5-8 million. We also indicated that the quarterly pattern of
258 Adjusted EBITDA would directionally follow that of 2011 with most of our EBITDA
259 coming in the fourth quarter. Today, we are slightly modifying our guidance to increase
260 the bottom end of our Adjusted EBITDA range to now be $6 million, so our full year
261 2012 range is now $6 million to $8 million. Given the measures we've taken to address
262 margins and costs, we believe that we can achieve this level. However, given that
263 revenues in 2Q were down, in part, as a result of our focus on improving margins and
264 yields, we are keeping our revenue guidance unchanged at this point. Since we last
265 spoke to you, we have determined that we plan to proceed with further litigation in our
266 trademark infringement case against Google, Inc. We anticipate that second half 2012
267 legal expenses related to this matter could be in the low single-digit million range, which
268 are not included in our Adjusted EBITDA or net income and EPS guidance. In addition,

269 as a reminder, we previously indicated that we expected third quarter margins to be
270 tighter due to a more competitive advertising market.

271 I'd also like to reiterate that starting with today's release we are no longer going to
272 be providing 'Bookings' as a metric. While this metric is useful for internal management
273 purposes, it can create confusion from an external reporting perspective and we want to
274 be consistent in our discussion of results. In addition, given our GAAP losses in 2011,
275 most notably in our US operations, the Company is required to evaluate the potential for
276 a non-cash valuation allowance against its deferred tax balances. Our evaluation of our
277 Korea subsidiary's recent losses combined with forecasted performance led us to
278 conclude a full valuation allowance was needed to reduce the deferred tax assets of the
279 Korea subsidiary. As a result, a non-cash charge of $0.4 million was recorded during
280 the three months ended June 30, 2012. While we have not taken a valuation allowance
281 against any other deferred tax assets currently, it is possible that we may have to take a
282 non-cash valuation allowance in the future of up to $17.3 million. Given the fact that
283 through June 30, 2012, the Company is ahead of forecast and new leadership has
284 taken steps to enhance profitability by cutting costs, management believes that it is
285 more likely than not that the net deferred tax asset will be realized through future
286 taxable earnings, but we will be evaluating this each quarter.

287 With that, operator, we are ready to take questions.

288