VONAGE HOLDINGS CORP
Form 10-Q
November 05, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2014
or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period From __________ to __________
Commission File Number 001-32887
VONAGE HOLDINGS CORP.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	11-3547680 (IRS Employer Identification No.)
23 Main Street, Holmdel, NJ (Address of principal executive offices)	07733 (Zip Code)

Registrant's telephone number, including area code: (732) 528-2600
(Former name, former address and former fiscal year, if changed since last report): Not Applicable

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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 x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. Check one:

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at	October 31, 2014	
Common Stock, par value $0.001		205,486,007	shares

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Financial Information Presentation

For the financial information discussed in this Quarterly Report on Form 10-Q, other than per share and per line amounts, dollar amounts are presented in thousands, except where noted.

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Part I – Financial Information

Item 1. Financial Statements
VONAGE HOLDINGS CORP.
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

Assets	September 30, 2014 (unaudited)	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$59,368	$84,663
Marketable securities	4,622	—
Accounts receivable, net of allowance of $769 and $683, respectively	22,048	19,649
Inventory, net of allowance of $104 and $229, respectively	7,651	10,584
Deferred customer acquisition costs, current	4,324	4,991
Deferred tax assets, current	18,361	18,361
Prepaid expenses and other current assets	16,350	16,892
Total current assets	132,724	155,140
Property and equipment, net	43,771	52,243
Goodwill	83,627	83,627
Software, net	21,749	20,557
Deferred customer acquisition costs, non-current	112	193
Debt related costs, net	2,403	1,313
Restricted cash	3,407	4,405
Intangible assets, net	64,057	76,850
Deferred tax assets, non-current	232,849	246,539
Other assets	7,938	1,882
Total assets	$592,637	$642,749
Liabilities and Stockholders' Equity		
Liabilities		
Current liabilities:		
Accounts payable	$43,164	$49,867
Accrued expenses	74,255	81,127
Deferred revenue, current portion	35,392	36,899
Current maturities of capital lease obligations	3,240	2,889
Current portion of notes payables	20,000	23,333
Total current liabilities	176,051	194,115
Indebtedness under revolving credit facility	—	75,000
Notes payable, net of current portion	75,000	23,333
Deferred revenue, net of current portion	837	436
Capital lease obligations, net of current maturities	7,732	10,201
Other liabilities, net of current portion in accrued expenses	1,676	1,628
Total liabilities	261,296	304,713
Commitments and Contingencies	—	—
Redeemable noncontrolling interest	—	(38)
Stockholders' Equity		
Common stock, par value $0.001 per share; 596,950 shares authorized at September 30, 2014	253	247

and December 31, 2013; 251,612 and 246,741 shares issued at September 30, 2014 and December 31, 2013, respectively; 206,797 and 212,339 shares outstanding at September 30, 2014 and December 31, 2013, respectively		
Additional paid-in capital	1,157,473	1,136,289
Accumulated deficit	(683,279)	(697,941)
Treasury stock, at cost, 44,815 shares at September 30, 2014 and 34,402 shares at December 31, 2013	(140,140)	(101,040)
Accumulated other comprehensive (loss) income	(2,226)	519
Noncontrolling interest	(740)	—
Total stockholders' equity	331,341	338,074
Total liabilities, redeemable noncontrolling interest, and stockholders' equity	$592,637	$642,749

The accompanying notes are an integral part of the consolidated financial statements.

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VONAGE HOLDINGS CORP.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues	$214,737	$203,984	$654,352	$617,847
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of $4,704, $3,522, $14,956, and $10,484, respectively)	49,830	52,882	154,832	161,590
Direct cost of goods sold	9,205	9,535	28,394	27,630
Selling, general and administrative	73,414	64,752	225,436	189,143
Marketing	58,305	59,133	174,572	169,132
Depreciation and amortization	12,346	8,459	37,143	24,639
	203,100	194,761	620,377	572,134
Income from operations	11,637	9,223	33,975	45,713
Other Income (Expense):				
Interest income	37	97	159	208
Interest expense	(1,680)	(1,509)	(5,191)	(4,698)
Other income (expense), net	(2)	(15)	21	(71)
	(1,645)	(1,427)	(5,011)	(4,561)
Income before income tax expense	9,992	7,796	28,964	41,152
Income tax expense	(5,627)	(3,811)	(15,011)	(16,673)
Net income	$4,365	$3,985	$13,953	$24,479
Plus: Net loss attributable to noncontrolling interest	191	222	709	222
Net income attributable to Vonage	$4,556	$4,207	$14,662	$24,701
Net income attributable to Vonage per common share:				
Basic	$0.02	$0.02	$0.07	$0.12
Diluted	$0.02	$0.02	$0.07	$0.11
Weighted-average common shares outstanding:				
Basic	208,580	209,589	210,714	212,124
Diluted	217,176	217,059	220,923	222,321

The accompanying notes are an integral part of the consolidated financial statements.

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VONAGE HOLDINGS CORP.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$4,365	$3,985	$13,953	$24,479
Other comprehensive income (loss):				
Foreign currency translation adjustment	(1,643)	885	(2,732)	(802)
Unrealized loss on available-for-sale securities	(6)	—	(6)	—
Total other comprehensive income (loss)	(1,649)	885	(2,738)	(802)
Comprehensive income	2,716	4,870	11,215	23,677
Comprehensive loss attributable to noncontrolling interest:				
Add: Net loss	(191)	(222)	(709)	(222)
Foreign currency translation adjustment	38	—	7	—
Total comprehensive loss attributable to noncontrolling interest	(153)	(222)	(702)	(222)
Comprehensive income attributable to Vonage	$2,869	$5,092	$11,917	$23,899

The accompanying notes are an integral part of the consolidated financial statements.

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VONAGE HOLDINGS CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$13,953	$24,479
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization and impairment charges	24,350	22,859
Amortization of intangibles	12,793	1,780
Deferred tax expense	13,454	15,751
Allowance for doubtful accounts	(183)	(135)
Allowance for obsolete inventory	306	520
Amortization of debt related costs	820	1,190
Share-based expense	16,899	13,085
Changes in operating assets and liabilities:		
Accounts receivable	(2,237)	(1,401)
Inventory	2,559	(6,575)
Prepaid expenses and other current assets	256	(3,877)
Deferred customer acquisition costs	742	(437)
Other assets	(6,056)	1,856
Accounts payable	(6,658)	(34,516)
Accrued expenses	(8,793)	18,467
Deferred revenue	(1,020)	(939)
Other liabilities	48	47
Net cash provided by operating activities	61,233	52,154
Cash flows from investing activities:		
Capital expenditures	(7,236)	(7,008)
Purchase of marketable securities	(4,628)	—
Acquisition and development of software assets	(9,969)	(8,750)
Decrease in restricted cash	996	1,254
Net cash used in investing activities	(20,837)	(14,504)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(2,118)	(1,810)
Principal payments on notes and revolving credit facility	(36,666)	(17,500)
Proceeds received from issuance of notes payable	10,000	27,500
Debt related costs	(1,910)	(2,056)
Common stock repurchases	(36,747)	(44,370)
Acquisition of redeemable noncontrolling interest	—	455
Proceeds from exercise of stock options, net of stock cancellation payment	4,262	3,568
Net cash used in financing activities	(63,179)	(34,213)
Effect of exchange rate changes on cash	(2,512)	(632)
Net change in cash and cash equivalents	(25,295)	2,805
Cash and cash equivalents, beginning of period	84,663	97,110
Cash and cash equivalents, end of period	$59,368	$99,915
Supplemental disclosures of cash flow information:		

Cash paid during the periods for:		
Interest	$3,987	$3,156
Income taxes	$1,871	$1,902
Non-cash financing transactions during the periods for:		
Common stock repurchases	$635	$1,099

The accompanying notes are an integral part of the consolidated financial statements.

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VONAGE HOLDINGS CORP.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND REDEEMABLE NONCONTROLLING INTEREST
(In thousands)
(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Non-controlling interest	Total	Redeemable non-controlling interest	Net Income
Balance at December 31, 2013	$247	$1,136,289	$(697,941)	$(101,040)	$519	$—	$338,074	$(38)	
Stock option exercises	6	4,256					4,262		
Share-based expense		16,899					16,899		
Share-based award activity				(2,220)			(2,220)		
Common stock repurchases				(36,646)			(36,646)		
Other		29		(234)			(205)		
Foreign currency translation adjustment					(2,739)	7	(2,732)		
Unrealized loss on available-for-sale securities					(6)		(6)		
Transfer of noncontrolling interest						(706)	(706)	706	
Net income (loss)			14,662			(41)	14,621	(668)	$13,953
Balance at September 30, 2014	$253	$1,157,473	$(683,279)	$(140,140)	$(2,226)	$(740)	$331,341	$—	

The accompanying notes are an integral part of the consolidated financial statements.

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VONAGE HOLDINGS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

Note 1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Vonage Holdings Corp. ("Vonage", "Company", "we", "our", "us") is incorporated as a Delaware corporation. We are a leadin provider of communications services connecting consumers and businesses through cloud-connected devices worldwide. Customers in the United States represented 93% of our subscriber lines for our broadband telephone replacement services at September 30, 2014, with the balance primarily in Canada and the United Kingdom.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows, and statement of stockholders' equity for the periods presented. The results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for the full year.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission on February 13, 2014.

Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Vonage and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. We also consolidate a majority-owned entity in Brazil where we have the ability to exercise controlling influence. The ownership interest of the noncontrolling party is presented as noncontrolling interest.

Use of Estimates

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported and disclosed in the consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

On an ongoing basis, we evaluate our estimates, including the following:

- the useful lives of property and equipment, software costs, and intangible assets;
- assumptions used for the purpose of determining share-based compensation using the Black-Scholes option pricing model and Monte Carlo simulation model ("Models"), and various other assumptions that we believe to be reasonable; the key inputs for these Models include our stock price at valuation date, exercise price, the dividend yield, risk-free interest rate, life in years, and historical volatility of our common stock; and
- assumptions used in determining the need for, and amount of, a valuation allowance on net deferred tax assets.

We base our estimates on historical experience, available market information, appropriate valuation methodologies, and on various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Revenue Recognition

Operating revenues consist of telephony services revenues and customer equipment (which enables our telephony services) and shipping revenues. The point in time at which revenues are recognized is determined in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, Revenue Recognition, and Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 605, Revenue Recognition.

VONAGE HOLDINGS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

At the time a customer signs up for our telephony services, there are the following deliverables:

- Providing equipment, if any, to the customer that enables our telephony services; and
- Providing telephony services.

The equipment is generally provided free of charge to our customers and in most instances there are no fees collected at sign-up. We record the fees collected for shipping the equipment to the customer, if any, as shipping and handling revenue at the time of shipment.

Telephony Services Revenue

Substantially all of our revenues are telephony services revenues, which are derived primarily from monthly subscription fees that customers are charged under our service plans. We also derive telephony services revenues from per minute fees for international calls if not covered under a plan, including calls made via applications for mobile devices and other stand-alone products, and for any calling minutes in excess of a customer’s monthly plan limits. Monthly subscription fees are automatically charged to customers’ credit cards, debit cards or electronic check payments ("ECP"), in advance and are recognized over the following month when services are provided. Revenues generated from international calls and from customers exceeding allocated call minutes under limited minute plans are recognized as services are provided, that is, as minutes are used, and are billed to a customer's credit cards, debit cards or ECP in arrears. As a result of multiple billing cycles each month, we estimate the amount of revenues earned from international calls and from customers exceeding allocated call minutes under limited minute plans but not billed from the end of each billing cycle to the end of each reporting period and record these amounts as accounts receivable. These estimates are based primarily upon historical minutes and have been consistent with our actual results.

We also provide rebates to customers who purchase their customer equipment from retailers and satisfy minimum service period requirements. These rebates in excess of activation fees are recorded as a reduction of revenues over the service period based upon the estimated number of customers that will ultimately earn and claim the rebates.

In the United States, we charge regulatory, compliance, E-911, and intellectual property-related fees on a monthly basis to defray costs, and to cover taxes that we are charged by the suppliers of telecommunications services. In addition, we charge customers Federal Universal Service Fund (“USF”) fees. We recognize revenue on a gross basis for USF and related fees. We record these fees as revenue when billed. All other taxes are recorded on a net basis.

Customer Equipment and Shipping Revenue

Customer equipment and shipping revenues consist of revenues from sales of customer equipment to wholesalers or directly to customers for replacement devices, or for upgrading their device at the time of customer sign-up for which we charge an additional fee. In addition, customer equipment and shipping revenues include revenues from the sale of VoIP telephones in order to access our small and medium business services on a net basis rather than a gross basis. Customer equipment and shipping revenues also include the fees that customers are charged for shipping their customer equipment to them. Customer equipment and shipping revenues include sales to our retailers, who subsequently resell this customer equipment to customers. Revenues are reduced for payments to retailers and rebates to customers, who purchased their customer equipment through these retailers, to the extent of customer equipment and shipping revenues.

Direct Cost of Telephony Services

Direct cost of telephony services consists primarily of direct costs that we pay to third parties in order to provide telephony services. These costs include access and interconnection charges that we pay to other telephone companies to terminate domestic and international phone calls on the public switched telephone network. In addition, these costs

include the cost to lease phone numbers, to co-locate in other telephone companies' facilities, to provide enhanced emergency dialing capabilities to transmit 911 calls, and to provide local number portability. These costs also include taxes that we pay on telecommunications services from our suppliers or are imposed by government agencies such as Federal USF and royalties for use of third parties' intellectual property. These costs do not include indirect costs such as depreciation and amortization, payroll, and facilities costs. Our presentation of direct cost of telephony services may not be comparable to other similar companies.

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VONAGE HOLDINGS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

Direct Cost of Goods Sold
Direct cost of goods sold consists primarily of costs that we incur when a customer signs up for our service. These costs include the cost of customer equipment for customers who subscribe through the direct sales channel in excess of activation fees. In addition, these costs include the amortization of deferred customer equipment, the cost of shipping and handling for customer equipment, the installation manual that accompanies the customer equipment, and the cost of certain promotions.
Development Expenses
Costs for research, including predevelopment efforts prior to establishing technological feasibility of software expected to be marketed, are expensed as incurred. Development costs are capitalized when technological feasibility has been established and anticipated future revenues support the recoverability of the capitalized amounts. Capitalization stops when the product is available for general release to customers. Due to the short time period between achieving technological feasibility and product release and the insignificant amount of costs incurred during such periods, we have not capitalized any software development, and have expensed these costs as incurred. These costs are included in selling, general and administrative expense.
Cash, Cash Equivalents and Marketable Securities
We maintain cash with several investment grade financial institutions. Highly liquid investments, which are readily convertible into cash, with original maturities of three months or less, are recorded as cash equivalents. Management determines the appropriate classification of our investments in debt and marketable equity securities at the time of purchase and reevaluates such designation at each balance sheet date. Our debt and marketable equity securities have been classified and accounted for as available for sale. We may or may not hold securities with stated maturities until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, we may sell these securities prior to their stated maturities. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss). Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of other income or expense.
Certain Risks and Concentrations
Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents, marketable securities, and accounts receivable. They are subject to fluctuations in both market value and yield based upon changes in market conditions, including interest rates, liquidity, general economic conditions, and conditions specific to the issuers. Accounts receivable are typically unsecured and are derived from revenues earned from customers primarily located in the United States. A portion of our accounts receivable represents the timing difference between when a customer’s credit card is billed and the subsequent settlement of that transaction with our credit card processors. This timing difference is generally three days for substantially all of our credit card receivables. We have never experienced any accounts receivable write-offs due to this timing difference. In addition, we collect subscription fees in advance, minimizing our accounts receivable and bad debt exposure. If a customer’s credit card, debit card or ECP is declined, we generally suspend international calling capabilities as well as their ability to incur domestic usage charges in excess of their plan minutes. If the customer’s credit card, debit card or ECP could not be successfully processed during three billing cycles (i.e., the current and two subsequent monthly billing cycles), we terminate the account. In addition, we automatically charge any per minute fees to our customers’ credit card, debit card or ECP monthly in arrears. To further mitigate our bad debt exposure, a customer’s credit card, debit card or ECP will be charged in advance of their monthly billing if their international calling or overage charges exceed a certain dollar threshold.
Inventory

Inventory consists of the cost of customer equipment and is stated at the lower of cost or market, with cost determined using the average cost method. We provide an inventory allowance for customer equipment that has been returned by customers but may not be able to be reissued to new customers or returned to the manufacturer for credit.

Property and Equipment

Property and equipment includes acquired assets and those accounted for under capital leases and consist principally of network equipment and computer hardware, furniture, software, and leasehold improvements. In addition, the lease of our corporate headquarters has been accounted for as a capital lease and is included in property and equipment. Network equipment and computer hardware and furniture are stated at cost with depreciation provided using the straight-line method over the estimated useful lives

VONAGE HOLDINGS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

of the related assets, which range from three to five years. Leasehold improvements are amortized over their estimated useful life of the related assets or the life of the lease, whichever is shorter. The cost of renewals and substantial improvements is capitalized while the cost of maintenance and repairs is charged to operating expenses as incurred. Our network equipment and computer hardware, which consists of routers, gateways, and servers that enable our telephony services, is subject to technological risks and rapid market changes due to new products and services and changing customer demand. These changes may result in future adjustments to the estimated useful lives or the carrying value of these assets, or both.

Software Costs

We capitalize certain costs, such as purchased software and internally developed software that we use for customer acquisition and customer care automation tools, in accordance with FASB ASC 350-40, “Internal-Use Software”. Computer software is stated at cost less accumulated amortization and the estimated useful life is two to five years.

Goodwill and Purchased-Intangible Assets

Goodwill acquired in acquisition of a business is accounted for based upon the excess fair value of consideration transferred over the fair value of net assets acquired in the business combination. Goodwill is tested for impairment on an annual basis on October 1st and, when specific circumstances dictate, between annual tests. When impaired, the carrying value of goodwill is written down to fair value. The goodwill impairment test involves a two-step process. The first step, identifying a potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. If the carrying value of the reporting unit exceeds its fair value, the second step would need to be conducted; otherwise, no further steps are necessary as no potential impairment exists. The second step, measuring the impairment loss, compares the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill. Any excess of the reporting unit goodwill carrying value over the respective implied fair value is recognized as an impairment loss.

Purchased-intangible assets are accounted for based upon the fair value of assets received. Purchased-intangible assets are amortized on a straight-line or accelerated basis over the periods of benefit, ranging from two to ten years. We perform a review of purchased-intangible assets whenever events or changes in circumstances indicate that the useful life is shorter than we had originally estimated or that the carrying amount of assets may not be recoverable. If such facts and circumstances exist, we assess the recoverability of purchased-intangible assets by comparing the projected undiscounted net cash flows associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairments, if any, are based on the excess of the carrying amount over the fair value of those assets. If the useful life of the asset is shorter than originally estimated, we accelerate the rate of amortization and amortize the remaining carrying value over the new shorter useful life. There was no impairment of purchased-intangible assets identified for the three and nine months ended September 30, 2014.

Intangible Assets

Intangible assets acquired in the settlement of litigation or by direct purchase are accounted for based upon the fair value of assets received.

Patents and Patent Licenses

Patent rights acquired in the settlement of litigation or by direct purchase are accounted for based upon the fair value of assets received.

Long-Lived Assets

We evaluate impairment losses on long-lived assets used in operations when events and changes in circumstances indicate that the assets might be impaired. If our review indicates that the carrying value of an asset will not be recoverable, based on a comparison of the carrying value of the asset to the undiscounted future cash flows, the impairment will be measured by comparing the carrying value of the asset to its fair value. Fair value will be

determined based on quoted market values, discounted cash flows or appraisals. Impairments are recorded in the statement of operations as part of depreciation expense.

Debt Related Costs

Costs incurred in raising debt are deferred and amortized as interest expense using the effective interest method over the life of the debt.

VONAGE HOLDINGS CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

Noncontrolling Interest and Redeemable Noncontrolling Interest
We consolidate a majority-owned entity where we have the ability to exercise controlling influence. The ownership interest of the noncontrolling party is presented as noncontrolling interest in the Consolidated Balance Sheets as Stockholders' Equity. If we are required to repurchase the noncontrolling interest at fair value, subject to adjustment, under a put option or other contractual redemption requirement, we will report the noncontrolling interest as redeemable in the Consolidated Balance Sheets between liabilities and equity. We adjust the redeemable noncontrolling interest to the redemption values on each balance sheet date with changes recognized as an adjustment to retained earnings, or in the absence of retained earnings, as an adjustment to additional paid-in capital when it becomes probable the noncontrolling interest will become redeemable.
Derivatives
We do not hold or issue derivative instruments for trading purposes. However, in accordance with FASB ASC 815, “Derivatives and Hedging” (“FASB ASC 815”), we review our contractual obligations to determine whether there are terms that possess the characteristics of derivative financial instruments that must be accounted for separately from the financial instrument in which they are embedded. We recognize these features as liabilities in our consolidated balance sheet at fair value each period and recognize any change in the fair value in our statement of operations in the period of change. We estimate the fair value of these liabilities using available market information and appropriate valuation methodologies.
Income Taxes
We recognize deferred tax assets and liabilities at enacted income tax rates for the temporary differences between the financial reporting bases and the tax bases of our assets and liabilities. Any effects of changes in income tax rates or tax laws are included in the provision for income taxes in the period of enactment. Our net deferred tax assets primarily consist of net operating loss carry forwards (“NOLs”). We are required to record a valuation allowance against our net deferred tax assets if we conclude that it is more likely than not that taxable income generated in the future will be insufficient to utilize the future income tax benefit from our net deferred tax assets (namely, the NOLs) prior to expiration. We periodically review this conclusion, which requires significant management judgment. If we are able to conclude in a future period that a future income tax benefit from our net deferred tax assets has a greater than 50 percent likelihood of being realized, we are required in that period to reduce the related valuation allowance with a corresponding decrease in income tax expense. This would result in a non-cash benefit to our net income in the period of the determination. In the fourth quarter of 2011, we released $325,601 of valuation allowance. In subsequent periods, we would expect to recognize income tax expense equal to our pre-tax income multiplied by our effective income tax rate, an expense that was not recognized prior to the reduction of the valuation allowance. Our effective rate may differ from the federal statutory rate due, in part, to our foreign operations and certain discrete period items. The 2014 estimated annual effective tax rate is expected to approximate 51%, but may fluctuate due to the timing of other discrete period transactions.
We file income tax returns in the U.S. on a federal basis and in U.S. state and foreign jurisdictions. Our federal tax return remains subject to examination by the Internal Revenue Service from 2010 to present, our New Jersey tax returns remain open from 2008 to present, our Canada tax return remains open from 2009 to present, and other domestic and foreign tax returns remain open for all periods to which those filings relate. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate resolution.

We have not had any unrecognized tax benefits. We recognize interest and penalties accrued related to unrecognized tax benefits as components of our income tax provision. We have not had any interest and penalties accrued related to unrecognized tax benefits.

Business Combinations

We account for business combinations using the acquisition method of accounting. The acquisition method of accounting requires that the purchase price, including the fair value of contingent consideration, of the acquisition be allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. Goodwill as of the acquisition date is measured as the excess of consideration transferred over the net of the acquisition date fair values of assets acquired and the liabilities assumed. While the Company uses its best estimates and assumptions as part of the purchase price allocation process to accurately value assets acquired and liabilities assumed at the acquisition date, the Company’s estimates are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the

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acquisition date, the Company records adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill to the extent the Company identifies adjustments to the preliminary purchase price allocation. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded to the consolidated statements of operations. We will include the results of all acquisitions in our Consolidated Financial Statements from the date of acquisition.

In connection with the acquisition of Vocalocity, Inc. on November 15, 2013, we recorded preliminary estimates primarily related to income, sales, excise, and ad valorem taxes. As such, the provisional measurements of fair value are subject to change.

Acquisition related transaction costs, such as banking, legal, accounting and other costs incurred in connection with an acquisition, are expensed as incurred in selling, general and administrative expense.

Acquisition related integration costs include costs associated with exit or disposal activities, which do not meet the criteria of discontinued operations, including costs for employee, lease, and contract terminations, facility closing or other exit activities. Additionally, these costs include expenses directly related to integrating and reorganizing acquired businesses and include items such as employee retention costs, recruiting costs, certain moving costs, certain duplicative costs during integration and asset impairments. These costs are expensed as incurred in selling, general and administrative expense.

Fair Value of Financial Instruments

Effective January 1, 2008, we adopted FASB ASC 820-10-25, “Fair Value Measurements and Disclosures”. This standard establishes a framework for measuring fair value and expands disclosure about fair value measurements. We did not elect fair value accounting for any assets and liabilities allowed by FASB ASC 825, “Financial Instruments”. FASB ASC 820-10 defines fair value as the amount that would be received for an asset or paid to transfer a liability (i.e., an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820-10 also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. FASB ASC 820-10 describes the following three levels of inputs that may be used:

- Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets and liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.
- Level 2: Observable prices that are based on inputs not quoted on active markets but corroborated by market data.
- Level 3: Unobservable inputs when there is little or no market data available, thereby requiring an entity to develop its own assumptions. The fair value hierarchy gives the lowest priority to Level 3 inputs.

The following table presents the assets that are measured and recognized at fair value on a recurring basis classified under the appropriate level of the fair value hierarchy as of September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Level 1 Assets		
Money market fund (1)	$5,333	$—
Level 2 Assets		
Available-for-sale securities (2)	$4,622	$—

(1) Included in cash and cash equivalents on our consolidated balance sheet.
(2) Included in marketable securities on our consolidated balance sheet.

Foreign Currency

Generally, the functional currency of our non-United States subsidiaries is the local currency. The financial statements of these subsidiaries are translated to United States dollars using month-end rates of exchange for assets and liabilities, and average rates of exchange for revenues, costs, and expenses. Translation gains and losses are deferred and recorded in accumulated other comprehensive income as a component of stockholders' equity.

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Share-Based Compensation
We account for share-based compensation in accordance with FASB ASC 718, “Compensation-Stock Compensation”. Under the fair value recognition provisions of this pronouncement, share-based compensation cost is measured at the grant date based on the fair value of the award, reduced as appropriate based on estimated forfeitures, and is recognized as expense over the applicable vesting period of the stock award using the accelerated method. The excess tax benefit associated with stock compensation deductions have not been recorded in additional paid-in capital. When evaluating whether an excess tax benefit has been realized, share based compensation deductions are not considered realized until NOLs are no longer sufficient to offset taxable income. Such excess tax benefits will be recorded when realized.
Earnings per Share
Net income per share has been computed according to FASB ASC 260, “Earnings per Share”, which requires a dual presentation of basic and diluted earnings per share (“EPS”). Basic EPS represents net income divided by the weighted average number of common shares outstanding during a reporting period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, including stock options and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, were exercised or converted into common stock. The dilutive effect of outstanding stock options and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. In applying the treasury stock method for stock-based compensation arrangements, the assumed proceeds are computed as the sum of the amount the employee must pay upon exercise and the amounts of average unrecognized compensation cost attributed to future services.
The following table sets forth the computation for basic and diluted net income per share for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator				
Numerator for basic earnings per share-net income attributable to Vonage	$4,556	$4,207	$14,662	$24,701
Numerator for diluted earnings per share-net income attributable to Vonage	$4,556	$4,207	$14,662	$24,701
Denominator				
Basic weighted average common shares outstanding	208,580	209,589	210,714	212,124
Dilutive effect of stock options and restricted stock units	8,596	7,470	10,209	10,197
Diluted weighted average common shares outstanding	217,176	217,059	220,923	222,321
Basic net income per share				
Basic net income per share	$0.02	$0.02	$0.07	$0.12
Diluted net income per share				
Diluted net income per share	$0.02	$0.02	$0.07	$0.11

For the three and nine months ended September 30, 2014 and 2013, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three Months Ended September 30,	Nine Months Ended September 30,

	2014	2013	2014	2013
Restricted stock units	5,318	2,063	5,014	2,029
Stock options	22,932	26,964	21,623	24,270
	28,250	29,027	26,637	26,299

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Comprehensive Income (Loss)
Comprehensive income (loss) consists of net income and other comprehensive items. Other comprehensive items include foreign currency translation adjustments.
Recent Accounting Pronouncements
In May 2014, Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers". This ASU is a comprehensive new revenue recognition model that requires a company to recognize revenue to depict the transfer of good or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. This ASU is effective for annual reporting periods beginning after December 15, 2016 and early adoption is not permitted. Accordingly, we will adopt this ASU on January 1, 2017. Companies may use either a full retrospective or modified retrospective approach to adopt this ASU and our management is currently evaluating which transition approach to use. We are currently evaluating the impact of adopting ASU 2014-09 on our consolidated financial statements and related disclosures.
Reclassifications
Certain reclassifications have been made to prior years’ financial statements in order to conform to the current year’s presentation. The reclassifications had no impact on net earnings previously reported.

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Note 2. Supplemental Balance Sheet Account Information

Prepaid expenses and other current assets

	September 30, 2014	December 31, 2013
Nontrade receivables	$1,930	$7,402
Services	9,710	7,084
Telecommunications	492	479
Insurance	1,177	757
Marketing	1,567	312
Other prepaids	1,474	858
Prepaid expenses and other current assets	$16,350	$16,892

Property and equipment, net

	September 30, 2014	December 31, 2013
Building (under capital lease)	$25,709	$25,709
Network equipment and computer hardware	76,083	78,312
Leasehold improvements	47,044	44,141
Furniture	1,771	812
Vehicles	92	109
	150,699	149,083
Less: accumulated depreciation and amortization	(106,928)	(96,840)
Property and equipment, net	$43,771	$52,243

Software, net

	September 30, 2014	December 31, 2013
Purchased	$53,779	$45,178
Licensed	909	909
Internally developed	36,088	36,088
	90,776	82,175
Less: accumulated amortization	(69,027)	(61,618)
Software, net	$21,749	$20,557

Debt related costs, net

	September 30, 2014	December 31, 2013
Senior secured term loan and revolver	$6,617	$4,706

Less: accumulated amortization	(4,214)	(3,393)
Debt related costs, net	$2,403	$1,313

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Restricted cash

	September 30, 2014	December 31, 2013
Letter of credit-lease deposits	$3,310	$4,306
Cash reserves	97	99
Restricted cash	$3,407	$4,405

Intangible assets, net

	September 30, 2014	December 31, 2013
Customer relationships	$39,100	$39,100
Developed technology	35,200	35,200
Patents and patent licenses	12,764	18,264
Trademark	560	560
Trade names	500	500
Non-compete agreements	200	200
	88,324	93,824
Less: accumulated amortization	(24,267)	(16,974)
Intangible assets, net	$64,057	$76,850

Other assets

	September 30, 2014	December 31, 2013
Long term non-trade receivable	6,623	—
Others	1,315	1,882
Other assets	$7,938	$1,882

Accrued expenses

	September 30, 2014	December 31, 2013
Compensation and related taxes and temporary labor	$19,508	$20,276
Marketing	20,648	23,277
Taxes and fees	15,770	18,207
Litigation and settlements	89	89
Telecommunications	7,961	7,942
Other accruals	4,108	6,063
Customer credits	1,849	1,719
Professional fees	3,842	2,490
Accrued interest	11	12

Inventory	172	769
Credit card fees	297	283
Accrued expenses	$74,255	$81,127

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Note 3. Supplemental Income Statement Account Information

Amounts included in revenues

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
USF fees	$16,785	$17,148	$53,817	$52,378
Disconnect fees	$776	$1,002	$2,455	$3,308
Initial activation fees	$252	$291	$839	$964
Customer equipment fees	$75	$101	$660	$271
Equipment recovery fees	$19	$24	$58	$79
Shipping and handling fees	$765	$248	$1,689	$938

Amount included in direct cost of telephony services

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
USF costs	$16,785	$17,148	$53,874	$52,378

Amount included in direct cost of goods sold

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Shipping and handling cost	$1,482	$1,164	$4,619	$4,008

Amount included in selling, general and administrative expense

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Advertising costs	$(18)	$299	$307	$487
Acquisition related costs	$—	$680	$20	$680
Acquisition integration cost	$2	$—	$100	$—

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Amount included in marketing

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Advertising costs	$36,826	$38,997	$108,522	$106,963

Depreciation and amortization expense

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Network equipment and computer hardware	$3,363	$3,382	$10,574	$10,029
Software	3,056	2,826	8,604	7,975
Capital leases	550	549	1,650	1,647
Other leasehold improvements	1,083	1,064	3,237	3,100
Furniture	36	32	105	88
Vehicles	8	1	15	9
Patents	368	576	1,449	1,728
Trademarks	18	18	54	54
Customer relationship	2,136	—	6,404	—
Developed technology	1,574	—	4,722	—
Trade names	50	—	150	—
Non-compete agreements	4	—	12	—
	12,246	8,448	36,976	24,630
Property and equipment impairments	99	11	101	9
Software impairments	1	—	66	—
Depreciation and amortization expense	$12,346	$8,459	$37,143	$24,639

Amount included in interest expense

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Debt related costs amortization	$276	$407	$820	$1,190

Amount included in other income (expense), net

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income (loss) resulting from foreign exchange transactions	$(1)	$(15)	$21	$(77)

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Note 4. Long-Term Debt and Revolving Credit Facility

A schedule of long-term debt at September 30, 2014 and December 31, 2013 is as follows:

	September 30, 2014	December 31, 2013
2.875-3.375% Credit Facility - due 2018	$75,000	$—
3.125-3.625% Credit Facility - due 2016	$—	$23,333
3.125-3.625% Revolving Credit Facility - due 2016	—	75,000

At September 30, 2014, future payments under long-term debt obligations over each of the next five years and thereafter were as follows:

	Credit Facility
2014	$5,000
2015	20,000
2016	20,000
2017	20,000
2018	30,000
Minimum future payments of principal	95,000
Less: current portion	20,000
Long-term portion	$75,000

2014 Financing

On August 13, 2014, we entered into a credit agreement (the “2014 Credit Facility”) consisting of a $100,000 senior secured term loan and a $125,000 revolving credit facility. The co-borrowers under the 2014 Credit Facility are us and Vonage America Inc., our wholly owned subsidiary. Obligations under the 2014 Credit Facility are guaranteed, fully and unconditionally, by our other material United States subsidiaries and are secured by substantially all of the assets of each borrower and each guarantor. The lenders under the 2014 Credit Facility are JPMorgan Chase Bank, N.A., Citizens Bank, N.A., Silicon Valley Bank, SunTrust Bank, Fifth Third Bank, Keybank National Association, and MUFG Union Bank, N.A. JPMorgan Chase Bank, N.A. is a party to the agreement as administrative agent, Citizens Bank, N.A. as syndication agent, and Silicon Valley Bank and SunTrust Bank as documentation agents. J.P. Morgan Securities LLC and Citizens Bank, N.A. acted as joint lead bookrunners, and J.P. Morgan Securities LLC, Citizens Bank, N.A., Silicon Valley Bank, and SunTrust Robinson Humphrey Inc. acted as joint lead arrangers.

Use of Proceeds

We used $90,000 of the net available proceeds of the 2014 Credit Facility to retire all of the debt under our 2013 Credit Facility. Remaining proceeds from the senior secured term loan and the undrawn revolving credit facility under the 2014 Credit Facility will be used for general corporate purposes. We also incurred $1,910 of fees in connection with the 2014 Credit Facility, which is amortized, along with the unamortized fees of $668 in connection with the 2013 Credit Facility, to interest expense over the life of the debt using the effective interest method.

2014 Credit Facility Terms

The following description summarizes the material terms of the 2014 Credit Facility:

The loans under the 2014 Credit Facility mature in August 2018. Principal amounts under the 2014 Credit Facility are repayable in quarterly installments of $5,000 per quarter for the senior secured term loan. The unused portion of our revolving credit facility incurs a 0.40% commitment fee.

Outstanding amounts under the 2014 Credit Facility, at our option, will bear interest at:

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- LIBOR (applicable to one-, two-, three-, six-, or twelve-month periods) plus an applicable margin equal to 2.875% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.125% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 3.375% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last day of each relevant interest period or, if the interest period is longer than three months, each day that is three months after the first day of the interest period, or
- the base rate determined by reference to the highest of (a) the federal funds effective rate from time to time plus 0.50%, (b) the prime rate of JPMorgan Chase Bank, N.A., and (c) the adjusted LIBO rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 1.875% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.125% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 2.375% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last business day of each March, June, September, and December and the maturity date of the 2014 Credit Facility.

The 2014 Credit Facility provides greater flexibility to us in funding acquisitions and restricted payments, such as stock buybacks, than the 2013 Credit Facility.

We may prepay the 2014 Credit Facility at our option at any time without premium or penalty. The 2014 Credit Facility is subject to mandatory prepayments in amounts equal to:

- 100% of the net cash proceeds from any non-ordinary course sale or other disposition of our property and assets for consideration in excess of a certain amount subject to customary reinvestment provisions and certain other exceptions, and
- 100% of the net cash proceeds received in connection with other non-ordinary course transactions, including insurance proceeds not otherwise applied to the relevant insurance loss.

Subject to certain restrictions and exceptions, the 2014 Credit Facility permits us to obtain one or more incremental term loans and/or revolving credit facilities in an aggregate principal amount of up to $60,000 plus an amount equal to repayments of the senior secured term loan upon providing documentation reasonably satisfactory to the administrative agent. The 2014 Credit Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition, the 2014 Credit Facility contains customary negative covenants, including, among other things, restrictions on the ability of us and our subsidiaries to consolidate or merge, create liens, incur additional indebtedness, dispose of assets, consummate acquisitions, make investments, and pay dividends and other distributions. We must also comply with the following financial covenants:

- a consolidated leverage ratio of no greater than 2.25 to 1.00;
- a consolidated fixed coverage charge ratio of no less than 1.75 to 1.00 subject to adjustment to exclude up to $80,000 in specified restricted payments;
- minimum cash of $25,000 including the unused portion of the revolving credit facility; and
- maximum capital expenditures not to exceed $55,000 during any fiscal year, provided that the unused amount of any permitted capital expenditures in any fiscal year may be carried forward to the next following fiscal year.

In addition, annual excess cash flow up to $8,000 increases permitted capital expenditures.

As of September 30, 2014, we were in compliance with all covenants, including financial covenants, for the 2014 Credit Facility.

The 2014 Credit Facility contains customary events of default that may permit acceleration of the debt. During the continuance of a payment default, interest will accrue at a default interest rate of 2% above the interest rate which would otherwise be applicable, in the case of loans, and at a rate equal to the rate applicable to base rate loans plus 2%, in the case of all other amounts.

2013 Financing

On February 11, 2013 we entered into Amendment No. 1 to the 2011 Credit Agreement (as further amended by Amendment No. 2 to our 2011 Credit Facility, the "2013 Credit Facility"). The 2013 Credit Facility consisted of a $70,000 senior secured term loan and a $75,000 revolving credit facility. The co-borrowers under the 2013 Credit Facility were our wholly owned subsidiary, Vonage America Inc., and us. Obligations under the 2013 Credit Facility were guaranteed, fully and unconditionally, by our other United States subsidiaries and were secured by substantially all of the assets of each borrower and each of the guarantors. On July 26, 2013 we entered into Amendment No. 2 to our 2011 Credit Agreement, which amended our financial covenant related to our

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consolidated fixed charge coverage ratio by increasing the amount of restricted payments excluded from such calculation from $50,000 to $80,000.

Use of Proceeds

The net proceeds received of $27,500 from the senior secured term loan and the undrawn revolving credit facility under the 2013 Credit Facility were used for general corporate purposes. We also incurred $2,009 of fees in connection with the 2013 Credit Facility, which is amortized, along with the unamortized fees of $670 in connection with the 2011 Credit Facility, to interest expense over the life of the debt using the effective interest method. We used $75,000 from the 2013 revolving credit facility in connection with the acquisition of Vocalocity on November 15, 2013.

Note 5. Common Stock