VONAGE HOLDINGS CORP
Form 10-Q
May 05, 2011
Table of Contents

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 March 31, 2011

OR

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

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 ¨ No ¨

* The registrant has not yet been phased into the interactive data requirements

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ 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 April 30, 2011**
Common Stock, par value $0.001	223,560,018 shares

Table of Contents

VONAGE HOLDINGS CORP.

INDEX

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.

Table of Contents

Part I Financial Information

Item 1. Financial Statements

VONAGE HOLDINGS CORP.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

Assets	March 31, 2011 (unaudited)	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 79,655	$ 78,934
Accounts receivable, net of allowance of $330 and $588, respectively	15,922	15,207
Inventory, net of allowance of $416 and $763, respectively	5,704	6,143
Deferred customer acquisition costs, current	5,227	6,481
Prepaid expenses and other current assets	17,425	17,231
Total current assets	123,933	123,996
Property and equipment, net	74,131	79,050
Software, net	34,552	35,516
Deferred customer acquisition costs, non-current	839	1,093
Debt related costs, net	4,764	5,372
Restricted cash	6,934	7,978
Intangible assets, net	3,900	4,186
Other assets	2,664	3,201
Total assets	$ 251,717	$ 260,392
Liabilities and Stockholders Deficit		
Liabilities		
Current liabilities:		
Accounts payable	$ 34,223	$ 37,128
Accrued expenses	75,115	89,407
Deferred revenue, current portion	41,897	43,397
Current maturities of capital lease obligations	1,859	1,783
Current portion of notes payables	10,000	20,000
Total current liabilities	163,094	191,715
Notes payable, net of discount and current maturities	168,799	173,004
Deferred revenue, net of current portion	1,460	1,784
Capital lease obligations, net of current maturities	17,170	17,665
Other liabilities, net of current portion in accrued expenses	3,155	5,871
Total liabilities	353,678	390,039
Commitments and Contingencies		
Stockholders Deficit		
	225	223

Common stock, par value $0.001 per share; 596,950 shares authorized at March 31, 2011 and December 31, 2010; 225,191 and 223,454 shares issued at March 31, 2011 and December 31, 2010, respectively; 223,205 and 221,566 shares outstanding at March 31, 2011 and December 31, 2010, respectively		
Additional paid-in capital	1,059,837	1,053,805
Accumulated deficit	(1,150,788)	(1,171,901)
Treasury stock, at cost, 1,986 shares at March 31, 2011 and 1,888 shares at December 31, 2010	(13,332)	(13,139)
Accumulated other comprehensive income	2,097	1,365
Total stockholders deficit	(101,961)	(129,647)
Total liabilities and stockholders' deficit	$ 251,717	$ 260,392

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

3

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Operating Revenues:		
Telephony services	$ 218,230	$ 224,527
Customer equipment and shipping	1,611	3,424
	219,841	227,951
Operating Expenses:		
Direct cost of telephony services (excluding depreciation and amortization of $4,124 and $4,981, respectively)	60,189	62,495
Direct cost of goods sold	11,055	16,647
Selling, general and administrative	58,243	60,787
Marketing	49,404	49,240
Depreciation and amortization	11,066	13,768
	189,957	202,937
Income from operations	29,884	25,014
Other Income (Expense):		
Interest income	42	53
Interest expense	(6,602)	(13,211)
Change in fair value of embedded features within notes payable and stock warrant	(950)	835
(Loss) gain on extinguishment of notes	(593)	1,038
Other (expense) income, net	(2)	103
	(8,105)	(11,182)
Income before income tax (expense) benefit	21,779	13,832
Income tax (expense) benefit	(666)	136
Net Income	$ 21,113	$ 13,968
Net Income per common share:		
Basic	$ 0.10	$ 0.07
Diluted	$ 0.09	$ 0.06
Weighted-average common shares outstanding:		
Basic	222,162	201,324

Diluted	240,340	221,947

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

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Cash flows from operating activities:		
Net Income	$ 21,113	$ 13,968
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization and impairment charges	10,780	13,482
Amortization of intangibles	286	286
Change in fair value of embedded features in notes payable and stock warrant	950	(835)
Loss on extinguishment of notes	593	(1,038)
Amortization of discount on notes	460	1,370
Accrued interest paid in-kind		3,920
Allowance for doubtful accounts	(251)	(623)
Allowance for obsolete inventory	79	667
Amortization of debt related costs	350	403
Share-based expense	2,475	1,018
Changes in operating assets and liabilities:		
Accounts receivable	(448)	305
Inventory	383	(5,389)
Prepaid expenses and other current assets	(184)	13,803
Deferred customer acquisition costs	1,527	6,702
Other assets	537	(8)
Accounts payable	(2,920)	4,558
Accrued expenses	(14,555)	9,245
Deferred revenue	(1,899)	(8,972)
Other liabilities	(1,819)	(1,614)
Net cash provided by operating activities	17,457	51,248
Cash flows from investing activities:		
Capital expenditures	(1,298)	(1,959)
Acquisition and development of software assets	(3,593)	(2,041)
Decrease (increase) in restricted cash	1,047	(27,098)
Net cash used in investing activities	(3,844)	(31,098)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(419)	(352)
Principal payments on notes	(15,000)	(326)
Proceeds from exercise of stock options and stock warrant	1,712	30
Net cash used in financing activities	(13,707)	(648)
Effect of exchange rate changes on cash	815	340

Net change in cash and cash equivalents	721	19,842
Cash and cash equivalents, beginning of period	78,934	32,213
Cash and cash equivalents, end of period	$ 79,655	$ 52,055
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	$ 5,955	$ 7,375
Income taxes	$ 123	$ 33
Non-cash financing transactions during the periods for:		
Conversion of convertible notes into common stock:		
Third lien convertible notes, net of discount and debt related costs	$	$ 2,406
Embedded conversion option within third lien convertible notes	$	$ 13,394

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

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIT

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2010	$ 223	$ 1,053,805	$ (1,171,901)	$ (13,139)	$ 1,365	$ (129,647)
Stock option exercises	2	1,412				1,414
Share-based expense		2,475				2,475
Share-based award activity				(193)		(193)
Warrant exercise		2,145				2,145
Comprehensive income:						
Foreign currency translation adjustment					732	732
Net Income			21,113			21,113
Total comprehensive income			21,113		732	21,845
Balance at March 31, 2011	$ 225	$ 1,059,837	$ (1,150,788)	$ (13,332)	$ 2,097	$ (101,961)

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

6

Table of Contents

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 leading provider of low-cost communications services connecting people through broadband devices worldwide. While customers in the United States represented 94% of our subscriber lines at March 31, 2011, we also bill customers 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 deficit for the periods presented. The results for the three month period ended March 31, 2011 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 2010 Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 17, 2011.

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.

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:

- those related to the average period of service to a customer (the customer life) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation;
- the useful lives of property and equipment, software costs, and intangible assets;

assumptions used for the purpose of determining share-based compensation and the fair value of our prior stock warrant using the Black-Scholes option pricing model (Model), and various other assumptions that we believe to be reasonable. The key inputs for this Model are 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;

assumptions used to determine the fair value of the embedded conversion option within our prior 20% senior secured third lien notes due 2015 (Convertible Notes) using the Monte Carlo simulation model. The key inputs are maturity date, risk-free interest rate, our stock price at valuation date, and historical volatility of our common stock; and

assumptions used to determine the fair value of the embedded make-whole premium feature within our prior senior secured first lien credit facility (the First Lien Senior Facility) and our prior senior secured second lien credit facility (the Second Lien Senior Facility).

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.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Revenue Recognition

The point in time at which revenues are recognized is determined in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition, and Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 605, Revenue Recognition.

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

- Providing equipment to the customer that enables our telephony services and
- Providing telephony services.

The equipment is 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.

A further description of our revenues is as follows:

Telephony Services Revenue

Substantially all of our operating 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 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 if not covered under a plan 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 our multiple billing cycles each month, we estimate the amount of revenues earned from international calls if not covered under a plan 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.

We also generate revenue by charging a fee for activating service but from time to time we may forgo collecting this fee. For example, since May 2009 we have waived activation fees for almost all new customers. In these instances when no activation fee is being collected, no customer acquisition costs are deferred. Customer activation fees when collected, along with the related incremental direct customer acquisition amounts for customer equipment in the direct channel and for rebates and retailer commissions in the retail channel, up to but not exceeding the activation fee, are deferred and amortized over the estimated average customer life. The amortization of deferred customer equipment is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction of telephony services revenues. The amortization of deferred retailer commissions is recorded as marketing expense. We estimate customer life by analyzing historical trends and applying those trends to future periods. This customer life is solely used to amortize deferred activation fees collected, along with the related incremental customer acquisition costs. The customer life was 38 months for 2010 and remains at 38 months for 2011 based on consistent historical trends.

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.

In addition, we charge a disconnect fee for customers who terminate their service plan within the first twelve months of service. Disconnect fees are recorded as revenue and are recognized at the time the customer terminates service. Beginning in September 2010, we eliminated the disconnect fee for new customers.

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 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 were reduced for payments to retailers and rebates to customers, who purchased their customer equipment through

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

these retailers, to the extent of customer equipment and shipping revenues. In addition, we charge an equipment recovery fee for customers who terminate their service plan within the first twelve months of service. Equipment recovery fees are recorded as revenue and are recognized at the time the customer terminates service. Beginning in September 2010, we eliminated the equipment recovery fees for new customers.

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.

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 would be included in selling, general and administrative expense.

Cash and Cash Equivalents

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.

Certain Risks and Concentrations

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents 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, which minimizes 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 re-issued 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

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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 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 three years.

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.

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. Based upon this review, we are required to value the following features separately for accounting purposes:

- certain features within a common stock warrant to purchase 514 shares of common stock at an exercise price of $0.58 that was exercised in the first quarter of 2011 because the number of shares to be received by the holder could change under certain conditions;

- certain features within our prior Convertible Notes because the number of shares to be received by the holder could have changed under certain conditions; and

- the make-whole premium provisions within our prior First Lien Senior Facility and our Second Lien Senior Facility because upon prepayment under certain circumstances we may have been required to settle the debt for more than its face amount.

We recognized these features as liabilities in our consolidated balance sheet at fair value each period and recognized any change in the fair value in our statement of operations in the period of change. We estimated the fair value of these liabilities using available market information and appropriate valuation methodologies.

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

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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.

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. We record a valuation allowance to reduce the deferred tax assets to the amount that we estimate is more likely than not to be realized. 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.

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. Our common stock warrant with a value of $0 as of March 31, 2011 and $897 as of December 31, 2010 was included as a Level 2 liability.
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 embedded derivative within our Convertible Notes with a value of $10,860 as of March 31, 2010 was included as a Level 3 liability. In addition, the make-whole premium provisions within our prior First Lien Senior Facility and our Second Lien Senior Facility with a nominal value as March 31, 2010 were included as Level 3 liabilities.

The following table sets forth a summary of changes in the fair value of our Level 3 liabilities for the three months ended March 31, 2010:

Liabilities:		Three Months Ended March 31, 2010
Beginning balance	$	25,050
Increase in value for notes converted		(220)
Fair value adjustment for notes converted		(13,394)
Total unrealized loss in earnings	$	(576)
Ending balance	$	10,860

Fair Value of Other Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, accounts receivable, and accounts payable, approximate fair value because of their short maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management s best estimates of interest rates that would be available for similar debt obligations at March 31, 2011 and December 31, 2010. We believe the fair value of our debt at March 31, 2011 was approximately the same as its carrying amount as market conditions, including available interest rates, credit spread relative to our credit rating, and illiquidity, remain relatively unchanged from the issuance date of our debt on December 14, 2010.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Earnings per Share

Net income (loss) 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 (loss) 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 warrants, stock options, and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, and the Convertible Notes, were exercised or converted into common stock. The dilutive effect of outstanding warrants, 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 dilutive effect of the Convertible Notes is reflected in diluted earnings per share using the if-converted method.

The following table sets forth the computation for basic and diluted net income per share for the three months ended March 31, 2011 and 2010.

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Numerator		
Numerator for basic earnings per share-net income	$ 21,113	$ 13,968
Add: interest savings on assumed conversion of Convertible Notes		394
Less: gain on extinguishment of debt		(1,038)
Less: change in fair value of embedded features within notes payable and stock warrant		(835)
Numerator for diluted earnings per share	$ 21,113	$ 12,489
Denominator		
Basic weighted average common shares outstanding	222,162	201,324
Dilutive effect of stock options and restricted stock units	18,178	2,000
Dilutive effect of stock warrant		315
Dilutive effect of Convertible Notes		18,308
Diluted weighted average common shares outstanding	240,340	221,947
Basic net income per share		
Basic net income per share	$ 0.10	$ 0.07
Diluted net income per share		
Diluted net income per share	$ 0.09	$ 0.06

For the quarters ended March 31, 2011 and 2010, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three Months Ended March 31, 2011	2010
Common stock warrant	256	
Restricted stock units	87	1,178
Employee stock options	17,589	26,867
	17,932	28,045

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive items. Other comprehensive items include foreign currency translation adjustments and unrealized gains (losses) on available for sale investments. Assets and liabilities of foreign operations are translated at the period-end exchange rate and revenue and expense amounts are translated at the average rates of exchange prevailing during the period and represents the balance in accumulated other comprehensive income (loss).

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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.

Recent Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update No. 2009-13 (ASU 2009-13) *Revenue Recognition (Topic 605), Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force (EITF).* This ASU provides amendments to the criteria in FASB ASC 605-25 for separating consideration in multiple-deliverable arrangements. ASU 2009-13 changes existing rules regarding recognition of revenue in multiple deliverable arrangements and expands ongoing disclosures about the significant judgments used in applying its guidance. It was effective for revenue arrangements entered into or materially modified in the fiscal year beginning on or after June 15, 2010. The adoption of ASU 2009-13 did not have an impact on our financial statements.

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.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 2. Supplemental Balance Sheet Account Information

Prepaid expenses and other current assets

	March 31, 2011	December 31, 2010
Nontrade receivables	$ 6,478	$ 6,526
Services	6,972	5,955
Telecommunications	2,256	2,792
Insurance	360	960
Marketing	985	603
Other prepaids	374	395
Prepaid expenses and other current assets	$ 17,425	$ 17,231

Property and equipment, net

	March 31, 2011	December 31, 2010
Building (under capital lease)	$ 25,709	$ 25,709
Network equipment and computer hardware	131,241	131,263
Leasehold improvements	42,489	42,078
Furniture	9,303	9,721
Vehicles	258	260
	209,000	