

VONAGE HOLDINGS CORP
Form 10-Q
November 04, 2015
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the Quarterly Period Ended September 30, 2015

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, 07733
Holmdel, NJ (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 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

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
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

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

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Class	Outstanding at	October 31, 2015	shares
Common Stock, par value \$0.001		213,564,220	

Table of Contents

VONAGE HOLDINGS CORP.
INDEX

Part I. Financial Information

	Page
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets as of September 30, 2015 (Unaudited) and December 31, 2014</u>	<u>3</u>
<u>Unaudited Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2015 and 2014</u>	<u>4</u>
<u>Unaudited Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2015 and 2014</u>	<u>5</u>
<u>Unaudited Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2015 and 2014</u>	<u>6</u>
<u>Unaudited Consolidated Statement of Stockholders' Equity for the Nine Months Ended September 30, 2015</u>	<u>7</u>
<u>Notes to Unaudited Consolidated Financial Statements</u>	<u>8</u>

Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>39</u>
--	-----------

Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>56</u>
---	-----------

Item 4. <u>Controls and Procedures</u>	<u>57</u>
--	-----------

Part II. Other Information

Item 1. <u>Legal Proceedings</u>	<u>58</u>
----------------------------------	-----------

Item 1A. <u>Risk Factors</u>	<u>58</u>
------------------------------	-----------

Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>58</u>
--	-----------

Item 3. <u>Defaults Upon Senior Securities</u>	<u>58</u>
--	-----------

Item 4. <u>Mine Safety Disclosures</u>	<u>59</u>
--	-----------

Item 5. <u>Other Information</u>	<u>59</u>
----------------------------------	-----------

Item 6. <u>Exhibits</u>	<u>60</u>
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<u>Signature</u>	<u>61</u>
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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.

Table of Contents

Part I – Financial Information

Item 1. Financial Statements

VONAGE HOLDINGS CORP.
CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	September 30, 2015 (unaudited)	December 31, 2014 (revised) (1)
Assets		
Assets		
Current assets:		
Cash and cash equivalents	\$59,777	\$40,797
Marketable securities	9,537	7,162
Accounts receivable, net of allowance of \$945 and \$607, respectively	22,669	17,832
Inventory, net of allowance of \$198 and \$181, respectively	7,828	10,081
Deferred customer acquisition costs, current	4,112	4,854
Deferred tax assets, current	21,849	21,849
Prepaid expenses and other current assets	18,363	12,665
Total current assets	144,135	115,240
Property and equipment, net	48,063	49,630
Goodwill	250,702	142,544
Software, net	17,531	18,624
Deferred customer acquisition costs, non-current	137	87
Debt related costs, net	2,196	1,183
Restricted cash	2,588	3,405
Intangible assets, net	108,716	110,832
Deferred tax assets, non-current	212,293	225,167
Other assets	9,300	7,748
Total assets	\$795,661	\$674,460
Liabilities and Stockholders' Equity		
Liabilities		
Current liabilities:		
Accounts payable	\$37,944	\$42,564
Accrued expenses	86,564	84,322
Deferred revenue, current portion	34,330	35,570
Current maturities of capital lease obligations	4,311	3,365
Current portion of notes payables	15,000	20,000
Total current liabilities	178,149	185,821
Indebtedness under revolving credit facility	149,000	67,000
Notes payable, net of debt related costs and current portion	80,031	69,032
Deferred revenue, net of current portion	791	855
Capital lease obligations, net of current maturities	4,484	6,836
Other liabilities, net of current portion in accrued expenses	4,809	1,419
Total liabilities	417,264	330,963
Commitments and Contingencies	—	—
Stockholders' Equity		
Common stock, par value \$0.001 per share; 596,950 shares authorized at September 30, 2015 and December 31, 2014; 267,823 and 262,423 shares issued at September 30, 2015	269	264

and
 December 31, 2014, respectively; 213,439 and 211,994 shares outstanding at
 September 30,
 2015 and December 31, 2014, respectively

Additional paid-in capital	1,216,326	1,184,662	
Accumulated deficit	(658,426)	(677,675))
Treasury stock, at cost, 54,384 shares at September 30, 2015 and 50,429 shares at December 31, 2014	(177,979)	(159,775))
Accumulated other comprehensive loss	(1,793)	(3,131))
Noncontrolling interest	—	(848))
Total stockholders' equity	378,397	343,497	
Total liabilities and stockholders' equity	\$795,661	\$674,460	

(1) See Note 4 Long-Term Debt and Revolving Credit Facility and Note 9 Acquisition of Business.

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

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Total revenues	\$223,360	\$214,710	\$664,948	\$654,321
Operating Expenses:				
Cost of service (excluding depreciation and amortization of \$6,415 and \$4,704, \$18,144, and \$14,956, respectively)	67,193	56,475	193,255	174,837
Cost of goods sold	8,206	9,205	25,613	28,394
Sales and marketing	88,028	93,000	257,977	286,553
Engineering and development	6,830	4,992	20,299	14,483
General and administrative	28,860	24,160	79,256	73,286
Depreciation and amortization	15,446	12,275	43,854	37,046
	214,563	200,107	620,254	614,599
Income from operations	8,797	14,603	44,694	39,722
Other Income (Expense):				
Interest income	24	37	65	159
Interest expense	(2,222)	(1,680)	(6,245)	(5,191)
Other income (expense), net	(50)	(2)	(595)	21
	(2,248)	(1,645)	(6,775)	(5,011)
Income from continuing operations before income tax expense	6,549	12,958	37,919	34,711
Income tax expense	(3,116)	(5,631)	(16,290)	(15,010)
Income from continuing operations	3,433	7,327	21,629	19,701
Loss from discontinued operations	—	(2,962)	(1,615)	(5,748)
Loss on disposal, net of taxes	—	—	(824)	—
Discontinued operations	—	(2,962)	(2,439)	(5,748)
Net income	3,433	4,365	19,190	13,953
Plus: Net loss from discontinued operations attributable to noncontrolling interest	—	191	59	709
Net income attributable to Vonage	\$3,433	\$4,556	\$19,249	\$14,662
Net income per common share - continuing operations:				
Basic	\$0.02	\$0.04	\$0.10	\$0.09
Diluted	\$0.02	\$0.03	\$0.10	\$0.09
Net loss per common share - discontinued operations attributable to Vonage:				
Basic	\$—	\$(0.01)	\$(0.01)	\$(0.02)
Diluted	\$—	\$(0.01)	\$(0.01)	\$(0.02)
Net income attributable to Vonage per common share:				
Basic	\$0.02	\$0.02	\$0.09	\$0.07
Diluted	\$0.02	\$0.02	\$0.09	\$0.07
Weighted-average common shares outstanding:				
Basic	213,291	208,580	212,907	210,714
Diluted	225,182	217,176	222,820	220,923

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

4

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Net income	\$3,433	\$4,365	\$19,190	\$13,953
Other comprehensive income (loss):				
Foreign currency translation adjustment	56	(1,643)	369	(2,732)
Discontinued operations cumulative translation adjustment	—	—	974	—
Unrealized loss on available-for-sale securities	1	(6)	(5)	(6)
Total other comprehensive income (loss)	57	(1,649)	1,338	(2,738)
Comprehensive income	3,490	2,716	20,528	11,215
Comprehensive loss attributable to noncontrolling interest:				
Comprehensive loss	—	191	59	709
Comprehensive loss from discontinued operations	—	(38)	—	(7)
Total comprehensive loss attributable to non-controlling interest	—	153	59	702
Comprehensive income attributable to Vonage	\$3,490	\$2,869	\$20,587	\$11,917

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)

	Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net income	\$ 19,190	\$ 13,953
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization and impairment charges	26,222	24,350
Amortization of intangibles	17,823	12,793
Deferred tax expense	13,478	13,454
Loss on foreign currency	1,358	—
Allowance for doubtful accounts	(8	) (183
Allowance for obsolete inventory	1,362	306
Amortization of debt related costs	743	820
Share-based expense	20,081	16,899
Non-controlling interest	907	—
Changes in operating assets and liabilities:		
Accounts receivable	(1,991	) (2,237
Inventory	1,076	2,559
Prepaid expenses and other current assets	(4,567	) 256
Deferred customer acquisition costs	677	742
Other assets	(1,357	) (6,056
Accounts payable	(8,700	) (6,658
Accrued expenses	(1,492	) (8,793
Deferred revenue	(2,066	) (1,020
Other liabilities	890	48
Net cash provided by operating activities	83,626	61,233
Cash flows from investing activities:		
Capital expenditures	(9,578	) (7,236
Purchase of intangible assets	(2,500) —
Purchase of marketable securities	(7,255	) (4,628
Maturities and sales of marketable securities	4,875	—
Acquisition and development of software assets	(7,932	) (9,969
Acquisition of businesses, net of cash acquired	(116,890) —
Decrease in restricted cash	997	996
Net cash used in investing activities	(138,283	) (20,837
Cash flows from financing activities:		
Principal payments on capital lease obligations	(2,515	) (2,118
Principal payments on notes and revolving credit facility	(13,750	) (36,666
Proceeds received from draw down of revolving credit facility and issuance of notes payable	102,000	10,000
Debt related costs	(2,007	) (1,910
Common stock repurchases	(15,911	) (36,747
Proceeds from exercise of stock options	6,010	4,262
Net cash provided by (used in) financing activities	73,827	(63,179

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Effect of exchange rate changes on cash	(190) (2,512)
Net change in cash and cash equivalents	18,980	(25,295)
Cash and cash equivalents, beginning of period	40,797	84,663	
Cash and cash equivalents, end of period	\$59,777	\$59,368	
Supplemental disclosures of cash flow information:			
Cash paid during the periods for:			
Interest	\$5,426	\$3,987	
Income taxes	\$2,104	\$1,871	
Non-cash transactions during the periods for:			
Common stock repurchases	\$—	\$635	
Issuance of Common Stock in connection with acquisition of business	\$5,578	\$—	
Purchase of intangible assets	\$5,000	\$—	

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

Table of Contents

VONAGE HOLDINGS CORP.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(In thousands)
(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Non-controlling interest	Total
Balance at December 31, 2014	\$ 264	\$ 1,184,662	\$ (677,675)	\$(159,775)	\$ (3,131)	\$ (848)	\$ 343,497
Stock option exercises	4	6,006					6,010
Share-based expense		20,081					20,081
Share-based award activity				(2,954)			(2,954)
Common stock repurchases				(15,250)			(15,250)
Acquisition of business	1	5,577					5,578
Foreign currency translation adjustment					1,343		1,343
Unrealized loss on available-for-sale securities					(5)		(5)
Net income			19,249			848	20,097
Balance at September 30, 2015	\$ 269	\$ 1,216,326	\$ (658,426)	\$(177,979)	\$ (1,793)	\$ —	\$ 378,397

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

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 communications services connecting people through cloud-connected devices worldwide. Customers in the United States represented 93% of our combined subscriber lines and seats at September 30, 2015, with the balance 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, 2015 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, 2014 filed with the Securities and Exchange Commission on February 13, 2015.

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 had the ability to exercise controlling influence. The ownership interest of the noncontrolling party is presented as noncontrolling interest. On March 31, 2015, the Company completed its previously announced exit from the Brazilian market for consumer telephony services and the associated wind down of its joint venture operations in the country. The results of Brazilian operations are presented as discontinued operations for all periods presented. The results of companies acquired or disposed of are included in the consolidated financial statements from the effective date of the acquisition or up to the date of disposal.

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 services revenue and customer equipment (which enables our services) and shipping revenue. The point in time at which revenues are recognized is determined in accordance with Securities and Exchange Commission Staff

8

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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 services, there are the following deliverables:

• Providing equipment, if any, to the customer that enables our services; and

• Providing 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.

Services Revenue

Substantially all of our revenues are services revenues, which are derived primarily from monthly subscription fees that customers are charged under our service plans. We also derive 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. 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.

Cost of Service

Cost of service consists of costs that we pay to third parties in order to provide services. These costs include access and interconnection charges that we pay to other 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 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 universal service fund (“USF”) contributions and royalties for use of third parties’ intellectual property. In addition, these costs include certain personnel and related costs for network operations and technical support that are attributable to revenue generating activities.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Cost of Goods Sold

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.

Sales and Marketing Expenses

Sales and marketing expenses consist primarily of personnel and related costs for employees and contractors directly associated with our sales and marketing activities, internet advertising fees, radio and billboard advertising, public relations, commissions paid to employees, resellers and other third parties, trade shows, marketing and promotional activities, customer support, credit card fees, collections, and systems and information technology support.

Engineering and Development Expenses

Engineering and development expenses primarily include personnel and related costs for developers responsible for new products, and software engineers maintaining and enhancing existing products. These costs have been reclassified from selling, general and administrative expenses. Research and development costs related to new product development included in engineering and development were \$4,706 and \$3,353 for three months ended September 30, 2015 and 2014 and \$13,405 and \$9,504 for the nine months ended September 30, 2015 and 2014, respectively.

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.

General and Administrative Expenses

General and administrative expenses primarily relate to our executive, finance, human resources, legal, and information technology organizations. General and administrative expenses primarily consist of personnel costs, stock compensation, board of directors' costs, professional fees for legal, accounting, tax, compliance and information systems, travel, recruiting expense and, rent and related expenses.

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

10

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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. Generally, 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, software, furniture, and leasehold improvements. Company-owned equipment in use at customer premises is also included in property and equipment. 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 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. Company-owned customer premises equipment is depreciated on a straight-line basis over three years.

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

Goodwill acquired in the 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 evaluating qualitative information to determine if it is more than 50% likely that the fair value of a reporting unit is less than its carrying value. If such a determination is made, then the traditional two-step goodwill impairment test described below must be applied. 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. There was no impairment of goodwill for the three and nine months ended September 30, 2015.

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.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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, 2015.

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 of property and equipment are recorded in the statement of income 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. A portion of these costs are netted against the underlying notes payable in accordance with ASU 2015-15, "Interest-Imputation of Interest".

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

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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. We periodically review this conclusion, which requires significant management judgment. In the future, if available evidence changes our conclusion that it is more likely than not that we will utilize our net deferred tax assets prior to their expiration, we will make an adjustment to the related valuation allowance and income tax expense at that time. 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 2015 estimated annual effective tax rate is expected to approximate 44%, 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 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 include the results of all acquisitions in our Consolidated Financial Statements from the date of acquisition.

Acquisition related transaction costs, such as banking, legal, accounting and other costs incurred in connection with an acquisition, are expensed as incurred in 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 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:

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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.

Although management believes its valuation methods were appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could have resulted in a different fair value measurement at the reporting date.

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, 2015 and December 31, 2014:

	September 30, 2015	December 31, 2014
Level 1 Assets		
Money market fund (1)	\$428	\$2,786
Level 2 Assets		
Available-for-sale securities (2)	\$9,537	\$7,162

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

(2) Included in marketable securities on our consolidated balance sheet.

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 September 30, 2015 and December 31, 2014. We believe the fair value of our debt at September 30, 2015 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 July 27, 2015 for a similar debt instrument.

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.

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

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

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 months ended September 30, 2015 and 2014:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Numerator				
Income from continuing operations	\$3,433	\$7,327	\$21,629	\$19,701
Discontinued operations	—	(2,962)	\$(2,439)	\$(5,748)
Plus: Net loss from discontinued operations attributable to noncontrolling interest	\$—	\$191	\$59	\$709
Loss from discontinued operations attributable to Vonage	\$—	\$(2,771)	\$(2,380)	\$(5,039)
Net income attributable to Vonage	\$3,433	\$4,556	\$19,249	\$14,662
Denominator				
Basic weighted average common shares outstanding	213,291	208,580	212,907	210,714
Dilutive effect of stock options and restricted stock units	11,891	8,596	9,913	10,209
Diluted weighted average common shares outstanding	225,182	217,176	222,820	220,923
Basic net income per share				
Basic net income per share-from continuing operations	\$0.02	\$0.04	\$0.10	\$0.09
Basic net loss per share-from discontinued operations attributable to Vonage	\$—	\$(0.01)	\$(0.01)	\$(0.02)