

VONAGE HOLDINGS CORP

Form 10-Q

November 04, 2011

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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, 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)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**23 Main Street,**  
**Holmdel, NJ**  
(Address of principal executive offices)

**11-3547680**  
(IRS Employer  
Identification No.)

**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  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.

| Class                           | Outstanding at October 31, 2011 |
|---------------------------------|---------------------------------|
| Common Stock, par value \$0.001 | 225,557,501 shares              |

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**VONAGE HOLDINGS CORP.**

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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,<br>2011<br>(unaudited) | December 31,<br>2010 |
|--|--------------------------------------|----------------------|
| <b>Assets</b>  |                                      |                      |
| <b>Assets</b>  |                                      |                      |
| Current assets:  |                                      |                      |
| Cash and cash equivalents  | \$ 55,590                            | \$ 78,934            |
| Accounts receivable, net of allowance of \$667 and \$588, respectively | 17,747                               | 15,207               |
| Inventory, net of allowance of \$253 and \$763, respectively           | 7,161                                | 6,143                |
| Deferred customer acquisition costs, current                           | 4,988                                | 6,481                |
| Prepaid expenses and other current assets                              | 18,242                               | 17,231               |
| <b>Total current assets</b>  | <b>103,728</b>                       | <b>123,996</b>       |
| Property and equipment, net  | 69,970                               | 79,050               |
| Software, net  | 42,374                               | 35,516               |
| Deferred customer acquisition costs, non-current                       | 786                                  | 1,093                |
| Debt related costs, net  | 2,404                                | 5,372                |
| Restricted cash  | 6,930                                | 7,978                |
| Intangible assets, net   | 3,328                                | 4,186                |
| Other assets   | 3,035                                | 3,201                |
| <b>Total assets</b>  | <b>\$ 232,555</b>                    | <b>\$ 260,392</b>    |
| <b>Liabilities and Stockholders Deficit</b>                            |                                      |                      |
| <b>Liabilities</b>   |                                      |                      |
| Current liabilities:   |                                      |                      |
| Accounts payable   | \$ 48,162                            | \$ 37,128            |
| Accrued expenses   | 85,893                               | 89,407               |
| Deferred revenue, current portion                                      | 40,891                               | 43,397               |
| Current maturities of capital lease obligations                        | 2,019                                | 1,783                |
| Indebtedness under revolving credit facility                           | 15,000                               | 0                    |
| Current portion of notes payables                                      | 28,333                               | 20,000               |
| <b>Total current liabilities</b>                                       | <b>220,298</b>                       | <b>191,715</b>       |
| Notes payable, net of discount and current maturities                  | 49,583                               | 173,004              |
| Deferred revenue, net of current portion                               | 1,308                                | 1,784                |
| Capital lease obligations, net of current maturities                   | 16,126                               | 17,665               |
| Other liabilities, net of current portion in accrued expenses          | 0                                    | 5,871                |
| <b>Total liabilities</b>   | <b>287,315</b>                       | <b>390,039</b>       |

**Commitments and Contingencies****Stockholders' Deficit**

|   |                |                |
|---|----------------|----------------|
| Common stock, par value \$0.001 per share; 596,950 shares authorized at September 30, 2011 and December 31, 2010; 227,788 and 223,454 shares issued at September 30, 2011 and December 31, 2010, respectively; 225,517 and 221,566 shares outstanding at September 30, 2011 and December 31, 2010, respectively | 228            | 223            |
| Additional paid-in capital  | 1,070,628      | 1,053,805      |
| Accumulated deficit   | (1,113,003)    | (1,171,901)    |
| Treasury stock, at cost, 2,271 shares at September 30, 2011 and 1,888 shares at December 31, 2010   | (14,526)       | (13,139)       |
| Accumulated other comprehensive income  | 1,913          | 1,365          |
| <br>Total stockholders' deficit   | <br>(54,760)   | <br>(129,647)  |
| <br>Total liabilities and stockholders' deficit   | <br>\$ 232,555 | <br>\$ 260,392 |

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

**Table of Contents****VONAGE HOLDINGS CORP.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)****(Unaudited)**

|  | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2011</b>                                 | <b>2010</b> | <b>2011</b>                                | <b>2010</b> |
| <b>Operating Revenues:</b>   |   |             |  |             |
| Telephony services   | \$ 215,824                                  | \$ 212,135  | \$ 651,342                                 | \$ 658,366  |
| Customer equipment and shipping  | 683   | 1,991       | 3,291                                      | 9,052       |
|  | 216,507                                     | 214,126     | 654,633                                    | 667,418     |
| <b>Operating Expenses:</b>   |   |             |  |             |
| Direct cost of telephony services (excluding depreciation and amortization of \$3,864, \$4,357, \$11,855 and \$14,297, respectively) | 59,230                                      | 60,263      | 177,302                                    | 185,727     |
| Direct cost of goods sold  | 10,711                                      | 13,214      | 31,631                                     | 43,914      |
| Selling, general and administrative  | 59,451                                      | 58,908      | 176,175                                    | 180,463     |
| Marketing  | 51,044                                      | 49,254      | 152,659                                    | 147,818     |
| Depreciation and amortization  | 8,683                                       | 12,649      | 28,413                                     | 40,346      |
|  | 189,119                                     | 194,288     | 566,180                                    | 598,268     |
| Income from operations   | 27,388                                      | 19,838      | 88,453                                     | 69,150      |
| <b>Other Income (Expense):</b>   |   |             |  |             |
| Interest income  | 33  | 154         | 112  | 380         |
| Interest expense   | (2,926)                                     | (11,569)    | (15,116)                                   | (37,203)    |
| Change in fair value of embedded features within notes payable and stock warrant   | 0   | (62,150)    | (950)                                      | (69,556)    |
| Loss on extinguishment of notes  | (7,985)                                     | (1,545)     | (11,806)                                   | (4,492)     |
| Other income (expense), net  | (47)  | (19)        | (5)  | 41          |
|  | (10,925)                                    | (75,129)    | (27,765)                                   | (110,830)   |
| Income (loss) before income tax expense  | 16,463                                      | (55,291)    | 60,688                                     | (41,680)    |
| Income tax expense   | (426)                                       | (91)        | (1,790)                                    | (296)       |
| Net income (loss)  | \$ 16,037                                   | \$ (55,382) | \$ 58,898                                  | \$ (41,976) |
| <b>Net income (loss) per common share:</b>   |   |             |  |             |
| Basic  | \$ 0.07                                     | \$ (0.26)   | \$ 0.26                                    | \$ (0.20)   |
| Diluted  | \$ 0.07                                     | \$ (0.26)   | \$ 0.24                                    | \$ (0.20)   |
| <b>Weighted-average common shares outstanding:</b>   |   |             |  |             |
| Basic  | 225,281                                     | 212,086     | 223,903                                    | 208,278     |
| Diluted  | 241,189                                     | 212,086     | 242,295                                    | 208,278     |

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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)**

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2011</b>                                | <b>2010</b> |
| <b>Cash flows from operating activities:</b>                                    |  |             |
| Net income  | \$ 58,898                                  | \$ (41,976) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |  |             |
| Depreciation and amortization and impairment charges                            | 27,555                                     | 39,487      |
| Amortization of intangibles   | 858  | 859         |
| Change in fair value of embedded features in notes payable and stock warrant    | 950  | 69,556      |
| Loss on extinguishment of notes   | 11,806                                     | 4,492       |
| Amortization of discount on notes   | 914  | 3,723       |
| Accrued interest paid in-kind   | 0  | 13,471      |
| Allowance for doubtful accounts   | 72   | (438)       |
| Allowance for obsolete inventory  | 355  | 1,848       |
| Amortization of debt related costs  | 994  | 1,080       |
| Share-based expense   | 10,460                                     | 5,831       |
| Changes in operating assets and liabilities:                                    |  |             |
| Accounts receivable   | (2,634)                                    | (3,503)     |
| Inventory   | (1,400)                                    | 1,667       |
| Prepaid expenses and other current assets                                       | (1,023)                                    | 18,739      |
| Deferred customer acquisition costs   | 1,800                                      | 13,660      |
| Other assets  | 166  | 9,069       |
| Accounts payable  | 11,046                                     | 24,414      |
| Accrued expenses  | (4,785)                                    | 33,950      |
| Deferred revenue  | (2,917)                                    | (15,584)    |
| Other liabilities   | (4,974)                                    | (4,991)     |
| Net cash provided by operating activities                                       | 108,141                                    | 175,354     |
| <b>Cash flows from investing activities:</b>                                    |  |             |
| Capital expenditures  | (8,853)                                    | (11,346)    |
| Acquisition and development of software assets                                  | (16,550)                                   | (13,266)    |
| Decrease (increase) in restricted cash  | 1,048                                      | (4,809)     |
| Net cash used in investing activities   | (24,355)                                   | (29,421)    |
| <b>Cash flows from financing activities:</b>                                    |  |             |
| Principal payments on capital lease obligations                                 | (1,303)                                    | (1,095)     |
| Principal payments on notes   | (207,083)                                  | (41,792)    |
| Proceeds from issuance of notes payable   | 100,000                                    | 0           |
| Extinguishment of notes   | (1,054)                                    | 0           |
| Debt related costs  | (2,697)                                    | 0           |
| Proceeds from exercise of stock options and stock warrant                       | 4,521                                      | 797         |
| Net cash used in financing activities   | (107,616)                                  | (42,090)    |



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|  |           |            |
|--|-----------|------------|
| Effect of exchange rate changes on cash                              | 486       | 195        |
| Net change in cash and cash equivalents                              | (23,344)  | 104,038    |
| Cash and cash equivalents, beginning of period                       | 78,934    | 32,213     |
| Cash and cash equivalents, end of period                             | \$ 55,590 | \$ 136,251 |
| <b>Supplemental disclosures of cash flow information:</b>            |           |            |
| Cash paid during the periods for:                                    |           |            |
| Interest   | \$ 14,079 | \$ 22,677  |
| Income taxes   | \$ 1,215  | \$ 93      |
| 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 | \$ 0      | \$ 2,562   |
| Embedded conversion option within third lien convertible notes       | \$ 0      | \$ 14,563  |

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)**

|   | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Accumulated<br/>Deficit</b> | <b>Treasury<br/>Stock</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Total</b> |
|---|-------------------------|---|--------------------------------|---------------------------|---|--------------|
| Balance at December 31, 2010            | \$ 223                  | \$ 1,053,805                              | \$ (1,171,901)                 | \$ (13,139)               | \$ 1,365  | \$ (129,647) |
| Stock option exercises                  | 5                       | 4,218                                     |                                |                           |   | 4,223        |
| Share-based expense                     |                         | 10,460                                    |                                |                           |   | 10,460       |
| Share-based award activity              |                         |   |                                | (1,387)                   |   | (1,387)      |
| Warrant exercise                        |                         | 2,145                                     |                                |                           |   | 2,145        |
| Comprehensive income:                   |                         |   |                                |                           |   |              |
| Foreign currency translation adjustment |                         |   |                                |                           | 548   | 548          |
| Net income                              |                         |   | 58,898                         |                           |   | 58,898       |
| Total comprehensive income              | 0                       | 0   | 58,898                         | 0                         | 548   | 59,446       |
| Balance at September 30, 2011           | \$ 228                  | \$ 1,070,628                              | \$ (1,113,003)                 | \$ (14,526)               | \$ 1,913  | \$ (54,760)  |

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 leading provider of communications services connecting people through broadband devices worldwide. While customers in the United States represented 94% of our subscriber lines at September 30, 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 and nine month periods ended September 30, 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 Annual Report on Form 10-K for the year ended December 31, 2010 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;

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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 in determining the need for, and amount of, a valuation allowance on net deferred tax assets;

assumptions used to determine the fair value of the embedded conversion option within our prior 20% senior secured third lien notes ( 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.

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**(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, if any, 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, including 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 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.

From time to time we have generated revenue by charging a fee for activating service, although we do not currently or expect to charge an activation fee to 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.

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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, historically, we charged a disconnect fee for customers who terminated 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

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**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

customers. Revenues were 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. In addition, historically, we charged an equipment recovery fee for customers who terminated 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 are 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

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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 re-issued to new customers or returned to the manufacturer for credit.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

*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 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,

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we were 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 have changed 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 prior 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.

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**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

*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 have recorded a full valuation allowance against our net deferred tax assets because we have not concluded that it is more likely than not that we will generate sufficient taxable income in the future to utilize the future income tax benefit from our net deferred tax assets (namely, NOLs) prior to expiration. We periodically review this conclusion, which requires significant management judgment. If we are able to conclude positively 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 will in that period reduce the related valuation allowance (which was \$415,903 at December 31, 2010) with a corresponding decrease in income tax expense. This will result in a significant, one-time non-cash benefit to our net income in the period of the determination. In subsequent periods, until the net deferred tax assets are fully offset by future taxable income, we would expect to recognize income tax expense equal to our pre-tax income multiplied by our effective income tax rate, an expense that is not currently recognized each quarter as a result of the valuation allowance.

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 September 30, 2011 and \$897 as of December 31, 2010 was included as a Level 2 liability.

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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. Level 3 liabilities were \$0 as of September 30, 2011 and \$79,520 as of September 30, 2010, which included the embedded derivative within our prior Convertible Notes with a value of \$19,520 and the make-whole premium provisions within our prior First Lien Senior Facility and our prior Second Lien Senior Facility with a value of \$60,000, respectively.

The following table sets forth the changes in the fair value of our Level 3 liabilities for the nine months ended September 30, 2010:

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

|   | <b>Nine Months Ended<br/>September 30,<br/>2010</b> |
|---|---|
| <b>Liabilities:</b>                       |   |
| Beginning balance                         | \$ 25,050   |
| Increase in value for notes converted     | 70  |
| Fair value adjustment for notes converted | (14,563)  |
| Total unrealized loss in earnings         | \$ 68,963   |
| <br>Ending balance                        | <br>\$ 79,520                                       |

*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, 2011 and December 31, 2010. We believe the fair value of our debt at September 30, 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 July 29, 2011 for a similar debt instrument.

*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 our prior 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 was reflected in diluted earnings per share using the if-converted method.

The following table sets forth the computation for basic and diluted net income (loss) per share for the three and nine months ended September 30, 2011 and 2010:

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

|  | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2011</b>                                 | <b>2010</b> | <b>2011</b>                                | <b>2010</b> |
| <b>Numerator</b>   |   |             |  |             |
| Numerator for basic earnings per share-net income (loss)     | \$ 16,037                                   | \$ (55,382) | \$ 58,898                                  | \$ (41,976) |
| Numerator for diluted earnings per share - net income (loss) | \$ 16,037                                   | \$ (55,382) | \$ 58,898                                  | \$ (41,976) |
| <b>Denominator</b>   |   |             |  |             |
| Basic weighted average common shares outstanding             | 225,281                                     | 212,086     | 223,903                                    | 208,278     |
| Dilutive effect of stock options and restricted stock units  | 15,908                                      | 0           | 18,392                                     | 0           |
| Diluted weighted average common shares outstanding           | 241,189                                     | 212,086     | 242,295                                    | 208,278     |
| <b>Basic net income per share</b>                            |   |             |  |             |
| Basic net income (loss) per share                            | \$ 0.07                                     | \$ (0.26)   | \$ 0.26                                    | \$ (0.20)   |
| <b>Diluted net income per share</b>                          |   |             |  |             |
| Diluted net income (loss) per share                          | \$ 0.07                                     | \$ (0.26)   | \$ 0.24                                    | \$ (0.20)   |

For the three and nine months ended September 30, 2011 and 2010, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

|                        | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|------------------------|---|-------------|--|-------------|
|                        | <b>2011</b>                                 | <b>2010</b> | <b>2011</b>                                | <b>2010</b> |
| Common stock warrant   | 0   | 514         | 85   | 514         |
| Convertible notes      | 0   | 8,276       | 0  | 8,276       |
| Restricted stock units | 1,052                                       | 2,385       | 631  | 2,385       |
| Stock options          | 22,442                                      | 36,121      | 20,379                                     | 36,121      |
|                        | 23,494                                      | 47,296      | 21,095                                     | 47,296      |

*Comprehensive Income (Loss)*

Comprehensive income (loss) consists of net income (loss) and other comprehensive items. Other comprehensive items include foreign currency translation adjustments. 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).

*Foreign Currency*

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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.

### *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.

In May 2011, the FASB issued Accounting Standards Update No. 2011-04 (ASU 2011-04) *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This ASU changes several aspects of the fair measurement guidance in FASB ASC 820. In addition, ASU 2011-04 includes several new fair value disclosure requirements, including, among other things, information about valuation techniques and unobservable inputs used in Level 3 fair value measurements and a narrative description of Level 3 measurements' sensitivity to changes in unobservable inputs. It is effective during interim and annual periods beginning after December 15, 2011. We do not expect a material effect upon adoption.

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**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

In June 2011, the FASB issued Accounting Standards Update No. 2011-05 ( ASU 2011-05 ) *Comprehensive Income (Topic 220), Presentation of Comprehensive Income* . The objective of ASU 2011-05 is to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The amendments in ASU 2011-05 should be applied retrospectively. It is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. We are currently evaluating the timing of adopting ASU 2011-05.

*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*

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| Nontrade receivables                             | \$ 6,276              | \$ 6,526             |
| Services   | 7,195                 | 5,955                |
| Telecommunications                               | 1,819                 | 2,792                |
| Insurance  | 1,297                 | 960                  |
| Marketing  | 1,189                 | 603                  |
| Other prepaids                                   | 466                   | 395                  |
| <b>Prepaid expenses and other current assets</b> | <b>\$ 18,242</b>      | <b>\$ 17,231</b>     |

*Property and equipment, net*

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Building (under capital lease)                  | \$ 25,709             | \$ 25,709            |
| Network equipment and computer hardware         | 134,607               | 131,263              |
| Leasehold improvements                          | 42,995                | 42,078               |
| Furniture                                       | 1,879                 | 9,721                |
| Vehicles  | 258                   | 260                  |
|   | 205,448               | 209,031              |
| Less: accumulated depreciation and amortization | (135,478)             | (129,981)            |
| <b>Property and equipment, net</b>              | <b>\$ 69,970</b>      | <b>\$ 79,050</b>     |

*Software, net*

|                      | September 30,<br>2011 | December 31,<br>2010 |
|----------------------|-----------------------|----------------------|
| Purchased            | \$ 71,981             | \$ 55,808            |
| Licensed             | 909                   | 909                  |
| Internally developed | 37,696                | 37,696               |

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|                                |           |           |
|--------------------------------|-----------|-----------|
|                                | 110,586   | 94,413    |
| Less: accumulated amortization | (68,212)  | (58,897)  |
| Software, net                  | \$ 42,374 | \$ 35,516 |

*Debt related costs, net*

|                                | September 30,<br>2011 | December 31,<br>2010 |
|--------------------------------|-----------------------|----------------------|
| Senior secured term loan       | \$ 2,697              | \$ 5,430             |
| Senior secured lien notes      | 0                     | 12,271               |
|                                | 2,697                 | 17,701               |
| Less: accumulated amortization | (293)                 | (4,588)              |
| accelerated amortization       | 0                     | (7,741)              |
| Debt related costs, net        | \$ 2,404              | \$ 5,372             |

*Restricted cash*

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Letter of credit-lease deposits             | \$ 6,300              | \$ 7,350             |
| Letter of credit-energy curtailment program | 536                   | 535                  |
|   | 6,836                 | 7,885                |
| Cash reserves                               | 94                    | 93                   |
| Restricted cash                             | \$ 6,930              | \$ 7,978             |

**Table of Contents****VONAGE HOLDINGS CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts)****(Unaudited)***Intangible assets, net*

|                                | September 30,<br>2011 | December 31,<br>2010 |
|--------------------------------|-----------------------|----------------------|
| Patents and patent licenses    | \$ 12,018             | \$ 12,018            |
| Trademark                      | 560                   | 560                  |
|                                | 12,578                | 12,578               |
| Less: accumulated amortization | (9,250)               | (8,392)              |
| Intangible assets, net         | \$ 3,328              | \$ 4,186             |

*Accrued expenses*

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| Compensation and related taxes and temporary labor | \$ 14,700             | \$ 19,709            |
| Marketing  | 19,323                | 18,886               |
| Taxes and fees                                     | 20,133                | 15,973               |
| Litigation   | 6,828                 | 11,717               |
| Telecommunications                                 | 10,389                | 10,636               |
| Other accruals                                     | 8,106                 | 6,295                |
| Customer credits                                   | 2,659                 | 2,138                |
| Professional fees                                  | 2,099                 | 1,864                |
| Accrued interest                                   | 100                   | 975                  |
| Inventory  | 1,247                 | 957                  |
| Credit card fees                                   | 309                   | 257                  |
| Accrued expenses                                   | \$ 85,893             | \$ 89,407            |

**Note 3. Supplemental Income Statement Account Information***Amounts included in telephony services revenue*

|          | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|----------|-------------------------------------|-----------|------------------------------------|-----------|
|          | 2011                                | 2010      | 2011                               | 2010      |
| USF fees | \$ 17,301                           | \$ 14,688 | \$ 52,362                          | \$ 51,383 |

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|                         |          |          |          |           |
|-------------------------|----------|----------|----------|-----------|
| Disconnect fee          | \$ 133   | \$ 2,242 | \$ 1,233 | \$ 8,230  |
| Initial activation fees | \$ 1,097 | \$ 3,330 | \$ 4,515 | \$ 15,018 |

*Amounts included in customer equipment and shipping revenue*

|                           | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |          |
|---------------------------|-------------------------------------|--------|------------------------------------|----------|
|                           | 2011                                | 2010   | 2011                               | 2010     |
| Equipment recovery fee    | \$ 132                              | \$ 745 | \$ 1,538                           | \$ 5,526 |
| Shipping and handling fee | \$ 378                              | \$ 704 | \$ 1,295                           | \$ 1,338 |

*Amount included in direct cost of telephony services*

|           | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|-----------|-------------------------------------|-----------|------------------------------------|-----------|
|           | 2011                                | 2010      | 2011                               | 2010      |
| USF costs | \$ 17,301                           | \$ 14,688 | \$ 52,362                          | \$ 51,383 |

*Amount included in direct cost of goods sold*

|                            | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|----------------------------|-------------------------------------|----------|------------------------------------|----------|
|                            | 2011                                | 2010     | 2011                               | 2010     |
| Shipping and handling cost | \$ 2,090                            | \$ 2,104 | \$ 5,859                           | \$ 6,454 |

*Amount included in marketing*

|                   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|-------------------|-------------------------------------|-----------|------------------------------------|------------|
|                   | 2011                                | 2010      | 2011                               | 2010       |
| Advertising costs | \$ 31,692                           | \$ 35,997 | \$ 98,019                          | \$ 107,759 |

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

*Depreciation and amortization expense*

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2011                                | 2010      | 2011                               | 2010      |
| Network equipment and computer hardware | \$ 4,129                            | \$ 4,863  | \$ 12,813                          | \$ 16,045 |
| Software                                | 2,621                               | 5,493     | 9,691                              | 16,864    |
| Capital leases                          | 550                                 | 550       | 1,650                              | 1,649     |
| Other leasehold improvements            | 961                                 | 914       | 2,912                              | 2,741     |
| Furniture                               | 59                                  | 485       | 231                                | 1,462     |
| Vehicles                                | 5                                   | 5         | 15                                 | 10        |
| Patents                                 | 286                                 | 286       | 858                                | 858       |
|   | 8,611                               | 12,596    | 28,170                             | 39,629    |
| Property and equipment impairments      | 72                                  | 53        | 243                                | 582       |
| Software impairments                    | 0                                   | 0         | 0                                  | 135       |
| Depreciation and amortization expense   | \$ 8,683                            | \$ 12,649 | \$ 28,413                          | \$ 40,346 |

*Amount included in interest expense*

|                                 | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |          |
|---------------------------------|-------------------------------------|--------|------------------------------------|----------|
|                                 | 2011                                | 2010   | 2011                               | 2010     |
| Debt related costs amortization | \$ 364                              | \$ 321 | \$ 994                             | \$ 1,080 |

*Amount included in other income (expense), net*

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |       |
|---|-------------------------------------|---------|------------------------------------|-------|
|   | 2011                                | 2010    | 2011                               | 2010  |
| Net (losses) gains resulting from foreign exchange transactions | \$ (47)                             | \$ (20) | \$ (60)                            | \$ 40 |

**Note 4. Long-Term Debt and Revolving Credit Facility**

A schedule of long-term debt at September 30, 2011 and December 31, 2010 is as follows:

| September 30,<br>2011 | December 31,<br>2010 |
|-----------------------|----------------------|
|-----------------------|----------------------|

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|  |    |        |    |         |
|--|----|--------|----|---------|
| 3.25-3.75% Credit Facility - due 2014  | \$ | 49,583 | \$ |         |
| 9.75% Credit Facility, net of discount |    |        |    | 173,004 |
|  | \$ | 49,583 | \$ | 173,004 |

At September 30, 2011, future payments under long-term debt obligations over each of the next five years and thereafter were as follows:

|   | <b>Credit Facility</b> |
|---|------------------------|
| 2011  | \$ 7,083               |
| 2012  | 28,333                 |
| 2013  | 28,333                 |
| 2014  | 14,167                 |
| <b>Minimum future payments of principal</b> | <b>77,916</b>          |
| Less: current portion                       | 28,333                 |
| <b>Long-term portion</b>                    | <b>\$ 49,583</b>       |

*December 2010 Financing*

On December 14, 2010, we entered into a credit agreement (the 2010 Credit Facility ) consisting of a \$200,000 senior secured term loan. The co-borrowers under the 2010 Credit Facility were us and Vonage America Inc., our wholly owned subsidiary. Obligations under the 2010 Credit Facility were guaranteed, fully and unconditionally, by our other United States subsidiaries and are secured by substantially all of the assets of each borrower and each of the guarantors. An affiliate of the chairman of our board of directors and one of our principal stockholders was a lender under the 2010 Credit Facility.

*Use of Proceeds*

We used the net proceeds of the 2010 Credit Facility of \$194,000 (\$200,000 principal amount less original discount of \$6,000), plus \$102,090 of cash on hand, to (i) exercise our existing right to retire debt under our First Lien Senior Facility, for 100% of the

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**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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contractual make-whole price, (ii) retire debt under our Second Lien Senior Facility at a more than 25% discount to the contractual make-whole price, and (iii) cause the conversion of all outstanding Convertible Notes into 8,276 shares of our common stock (the Convertible Notes together with the First Lien Senior Facility and the Second Lien Senior Facility, the Prior Financing ). We also incurred \$11,444 of fees in connection with the Credit Facility and repayment of the Prior Financing. We agreed to make an additional cash payment to the holders of our Second Lien Senior Facility in an aggregate amount of \$9,000 if we engaged in Qualifying Discussions (as defined in the Master Agreement) prior to June 30, 2011 that result in a merger or acquisition transaction (as defined in the Master Agreement) that is consummated prior to June 30, 2012. No such discussions occurred prior to June 30, 2011.

In accordance with FASB ASC 470 *Debt Modification and Extinguishment* , substantially all of the repayment of the Prior Financing was treated as an extinguishment of notes resulting in a loss on early extinguishment of notes of \$26,531. For the portion of the repayment of the Prior Financing treated as a debt modification, we carried forward \$1,072 of unamortized discount, which will be amortized to interest expense over the life of the debt using the effective interest method in addition to the \$6,000 of original issue discount in connection with the 2010 Credit Facility. The accumulated amortization as of September 30, 2011 and December 31, 2010 was \$7,072 and \$76, respectively, including acceleration of \$6,081 and \$0, respectively. The amortization for the three and nine months ended September 30, 2011 was \$93 and \$915, respectively.

*Repayments*

For the three months ended September 30, 2011, using the net available proceeds from a credit agreement consisting of an \$85,000 senior secured term loan and a \$35,000 revolving credit facility (the 2011 Credit Facility ) financing and cash on hand, we made repayments of \$130,000 which represented the outstanding principal balance under the 2010 Credit Facility. A loss on extinguishment of \$7,985, representing a \$1,000 prepayment fee to holders of the 2010 Credit Facility, professional fees of \$54, and acceleration of unamortized debt discount and debt related costs of \$3,920 and \$3,011, respectively, was recorded for the three months ended September 30, 2011 as a result of the repayments.

For the nine months ended September 30, 2011, we made repayments of the entire \$200,000 under the 2010 Credit Facility, with \$20,000 designated to cover our 2011 mandatory amortization, \$50,000 designated to cover our 2011 annual excess cash flow mandatory repayment, if any, and \$130,000 designated to cover the outstanding principal balance under the 2010 Credit Facility at the time of the 2011 Credit Facility financing. A loss on extinguishment of \$11,806, representing a \$1,000 prepayment fee to holders of the 2010 Credit Facility, professional fees of \$54, and acceleration of unamortized debt discount and debt related costs of \$6,081 and \$4,671, respectively, was recorded for the nine months ended September 30, 2011 as a result of the repayments.

*July 2011 Financing*

On July 29, 2011, we entered into the 2011 Credit Facility. The co-borrowers under the 2011 Credit Facility are us and Vonage America Inc., our wholly owned subsidiary. Obligations under the 2011 Credit Facility are guaranteed, fully and unconditionally, by our other United States subsidiaries and are secured by substantially all of the assets of each borrower and each of the guarantors.

*Use of Proceeds*

We used \$100,000 of the net available proceeds of the 2011 Credit Facility, plus \$31,000 of cash on hand, to retire all of the debt under our 2010 Credit Facility, including a \$1,000 prepayment fee to holders of the 2010 Credit Facility. We also incurred \$2,697 of fees in connection with the 2011 Credit Facility, which is amortized to interest expense over the life of the debt using the effective interest method. The amortization for the three and nine months ended September 30, 2011 was \$293.

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In accordance with FASB ASC 470 *Debt Modification and Extinguishment*, the repayment of the 2010 Credit Facility was treated as an extinguishment of notes resulting in a loss on early extinguishment of notes of \$7,985, which was recorded in the third quarter of 2011.

### *2011 Credit Facility Terms*

The following description summarizes the material terms of the 2011 Credit Facility:

The loans under the 2011 Credit Facility mature in July 2014. Principal amounts under the 2011 Credit Facility are repayable in quarterly installments of \$7,083 per quarter for the senior secured term loan. The unused portion of our revolving credit facility incurs a 0.50% commitment fee.

Outstanding amounts under each of the senior secured term loan and the revolving credit facility, at our option, will bear interest at:

LIBOR (applicable to one-, two-, three- or six-month periods) plus an applicable margin equal to 3.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.5% 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 3.75% 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



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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 LIBOR rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 2.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.5% 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 2.75% 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 2011 Credit Facility.

We may prepay the 2011 Credit Facility at our option at any time without premium or penalty. The 2011 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 transaction, including insurance proceeds not otherwise applied to the relevant insurance loss.

Subject to certain restrictions and exceptions, the 2011 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, without the consent of the existing lenders under the 2011 Credit Facility. The 2011 Credit Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition, the 2011 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 2.00 to 1.00;

a consolidated fixed coverage charge ratio of no less than 1.75 to 1.00;

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, plus a portion of annual excess cash flow up to \$8,000.

The 2011 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.

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*Conversion of Convertible Notes in 2010.* At the time of conversion of the \$3,295 principal amount of Convertible Notes during the nine months ended September 30, 2010, which converted into 11,362 shares of our common stock, we determined that the aggregate fair value of the conversion feature of those Convertible Notes was \$14,563, which was a increase in value of \$70 from the fair value of the conversion feature as of December 31, 2009. This change in fair value was recorded as income within other income (expense), net for the nine months ended September 30, 2010. The aggregate fair value of the common stock issued by us in the conversion was \$16,038 at the time of conversion, which was recorded as common stock and additional paid-in capital. In addition, in connection with the extinguishment of the converted Convertible Notes, we recorded a gain on extinguishment of \$0 and \$1,087 for the three and nine months ended September 30, 2010, respectively, which represented the difference in the carrying value of those Convertible Notes including the fair value of the conversion feature, which was reduced by the discount of \$0 and \$316 and debt related costs of \$0 and \$416 for the three and nine months ended September 30, 2010, respectively, associated with those Convertible Notes, and the fair value of the common stock issued at the time of conversion.

### **Note 5. Common Stock**

#### *Common Stock Warrant*

On April 17, 2002, Vonage's principal stockholder and Chairman received a warrant to purchase 514 shares of Common Stock at an exercise price of \$0.70 per share that would have expired on June 20, 2012. As a result of the issuance of our prior Convertible Notes, the exercise price was reduced to \$0.58. At the time the warrant was exercised during the first quarter of 2011, we determined that the aggregate fair value of the warrant was \$1,847, which was an increase in value of \$950 from the fair value of the warrant as of December 31, 2010. This change in fair value was recorded as expense within other income (expense), net for the three and nine months ended September 30, 2011. The aggregate fair value of the warrant was reclassified to additional paid-in capital at the time of exercise. In addition, we received proceeds of \$298 in connection with the exercise of the warrant.

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**Note 6. Commitments and Contingencies**

*Litigation*

*IP Matters*

*Alcatel-Lucent.* On November 4, 2008, we received a letter from Alcatel-Lucent initiating an opportunity for us to obtain a non-exclusive license to certain of its patents that may be relevant to our business. We have met with Alcatel-Lucent on a number of occasions to discuss this licensing opportunity. If we determine that these patents are applicable to our business and valid, we may incur an expense in licensing them. If we determine that these patents are inapplicable to our business, invalid and/or unenforceable, we may incur expense and damages if there is litigation.

*Hitachi.* On January 27, 2011, we met with Hitachi, Ltd. to discuss an opportunity for us to obtain a non-exclusive license to certain Hitachi patents that Hitachi believes may be relevant to our business. We are currently analyzing the applicability of such patents to our business. If we determine that these patents are applicable to our business and valid, we may incur an expense in licensing them. If we determine that these patents are inapplicable to our business, invalid or unenforceable, we may incur expense and damages if there is litigation.

*Bear Creek Technologies, Inc.* On February 22, 2011, Bear Creek Technologies, Inc. ( Bear Creek ) filed a lawsuit against Vonage Holdings Corp., Vonage America, Inc., and Vonage Marketing LLC in the United States District Court for the Eastern District of Virginia (Norfolk Division) alleging that Vonage's products and services are covered by United States Patent No. 7,899,722, entitled System for Interconnecting Standard Telephony Communications Equipment to Internet Protocol Networks (the 722 Patent ). The suit also named numerous other defendants, including Verizon Communications, Inc., Comcast Corporation, Time-Warner Cable, Inc., AT&T, Inc., and T-Mobile USA Inc. On April 26, 2011, Bear Creek amended its complaint adding several defendants, dropping Vonage Communications (a non-existent entity) from the suit, and adding allegations of induced infringement and willful infringement. On May 9, 2011, Vonage filed a Motion to Sever Plaintiff's Claims against the Vonage entities and transfer them to New Jersey. On May 27, 2011, Vonage filed a Motion to Dismiss Bear Creek's claims of induced and willful infringement. Subsequently, other defendants filed similar motions to dismiss and sever and transfer. A hearing on the motions was held on August 12, 2011. On August 17, 2011 the judge in the Eastern District of Virginia dismissed Bear Creek's case against the Vonage entities, as well as all the other defendants, except for one defendant. Later, on August 17, 2011, Bear Creek re-filed its complaint concerning the 722 Patent in the United States District Court for the District of Delaware against the same Vonage entities. In its Delaware complaint, Bear Creek alleges that Vonage is infringing and contributing and inducing infringement of one or more claims of the 722 Patent. On September 28, 2011, Vonage filed a motion to dismiss Bear Creek's claims for induced, contributory, and willful inducement. The motion is now fully briefed.

*GZTM Technology Ventures Ltd.* On September 8, 2011, GZTM Technology Ventures Ltd. ( GZTM ) filed a lawsuit against Vonage Holdings Corp., Vonage America Inc. and Vonage Marketing LLC in the United States District Court for the District of Delaware alleging that Vonage's products and services are covered by United States Patent No. 5,455,859, entitled Telephone Handset Interface for Device Having Audio Input . The suit also named numerous other defendants, including Comcast Corporation, Cox Communications, Inc. and Time Warner Cable. On October 25, 2011, Vonage filed a Motion to Sever GTZM's claims against Vonage entities from GTZM's claims against the other defendants. GTZM filed a First Amended Complaint on November 2, 2011.

From time to time, in addition to those identified above, we are subject to legal proceedings, claims, investigations, and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment, and other matters. From time to time we receive letters or other communications from third parties initiating an opportunity for us to obtain patent licenses that might be relevant to our business. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss or range of loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of

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legal counsel, and other information and events pertaining to a particular case. No additional reserves were recorded in the three months ended September 30, 2011. Litigation is inherently unpredictable. We believe that we have valid defenses with respect to the legal matters pending against us and are vigorously defending these matters. Given the uncertainty surrounding litigation and our inability to assess the likelihood of a favorable or unfavorable outcome in the above noted matters, it is possible that the resolution of one or more of these matters could have a material adverse effect on our consolidated financial position, cash flows or results of operations.

### *Regulation*

Telephony services are subject to a broad spectrum of state and federal regulations. Because of the uncertainty over whether Voice over Internet Protocol ( VoIP ) should be treated as a telecommunications or information service, we have been involved in a substantial amount of state and federal regulatory activity. Implementation and interpretation of the existing laws and regulations is ongoing and is subject to litigation by

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various federal and state agencies and courts. Due to the uncertainty over the regulatory classification of VoIP service, there can be no assurance that we will not be subject to new regulations or existing regulations under new interpretations, and that such change would not introduce material additional costs to our business.

*Federal CALEA*

On August 5, 2005, the Federal Communications Commission (the FCC) released an Order extending the obligations of the Communications Assistance for Law Enforcement Act (CALEA) to interconnected VoIP providers. Under CALEA, telecommunications carriers must assist law enforcement in executing electronic surveillance, which include the capability of providing call content and call-identifying information to a local enforcement agency, or LEA, pursuant to a court order or other lawful authorization.

The FCC required all interconnected VoIP providers to become fully CALEA compliant by May 14, 2007. To date, we have taken significant steps towards CALEA compliance, which include testing a CALEA solution with the Federal Bureau of Investigation and delivering lawful CALEA requests. We have also implemented alternative solutions that allow CALEA access to call content and call-identifying information. The FCC and law enforcement officials have been advised as to our CALEA progress and our efforts at implementing alternative solutions. We could be subject to an enforcement action by the FCC if our CALEA solution is deemed not fully operational.

*Federal Local Number Portability*

On May 13, 2009, the FCC adopted an order that reduced to one business day the amount of time that an interconnected VoIP provider such as us have to port a telephone number to another provider. If we, or third parties we rely upon for porting, have difficulty executing the new one-day porting requirement, we could be subject to FCC enforcement action.

*Federal Net Neutrality*

Clear and enforceable net neutrality rules would make it more difficult for broadband Internet service providers to block or discriminate against Vonage service. Also explicitly applying net neutrality rules to wireless broadband Internet service could create greater opportunities for VoIP applications that run on wireless broadband Internet service. In October 2009, the FCC proposed the adoption of enforceable net neutrality rules for both wired and wireless broadband Internet service providers. The proposed rules would prohibit wired and wireless broadband Internet service providers from blocking or hindering lawful content, applications, or services and from unreasonably discriminating when transmitting lawful network traffic. In addition, broadband Internet service providers would have to publicly disclose certain information about their network management practices. In December 2010, the FCC adopted enforceable net neutrality rules based on its October 2009 proposal. All of the proposed rules in the October 2009 proposal applied to wired broadband Internet providers. The FCC applied some but not all of the proposed rules to wireless broadband service. Wireless broadband Internet services providers are prohibited from blocking or hindering voice or video applications that compete with the broadband Internet service provider's voice or video services. Wireless providers are also subject to transparency requirements, but they are not subject to the prohibition on unreasonable discrimination that applies to wired broadband Internet services providers. Final rules were filed in the Federal Register in September 2011. Shortly thereafter, a number of parties filed appeals of the rules in various federal circuit courts; some alleging that the FCC lacks authority to apply net neutrality rules to broadband service providers and some alleging that the rules did not go far enough. The D.C. Circuit Court of Appeals was selected by lottery to decide the appeals.

*Federal Intercarrier Compensation*

On February 9, 2011, the FCC released a Notice of Proposed Rulemaking (NPRM) on reforming universal service and the intercarrier compensation (ICC) system that governs payments between telecommunications carriers primarily for terminating traffic. In particular, the FCC indicated that it has never determined the ICC obligations for VoIP service and sought comment on a number of proposals for how VoIP should

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be treated in the ICC system. The FCC's adoption of an ICC proposal will impact Vonage's costs for telecommunications services. On October 27, 2011, the FCC adopted an order reforming universal service and ICC. The FCC order provides that VoIP originated calls will be subject to interstate access charges for long distance calls and reciprocal compensation for local calls that terminate to the public switched telephone network (PSTN). It also subjected PSTN originated traffic directed to VoIP subscribers to similar ICC obligations. The termination charges for all traffic, including VoIP originated traffic, will transition over several years to a bill and keep arrangement (i.e., no termination charges). The text of FCC order has not been released yet.

### *State Telecommunications Regulation*

In general, the focus of interconnected VoIP telecommunications regulation is at the federal level. On November 12, 2004, the FCC issued a declaratory ruling providing that our service is subject to federal regulation and preempted the Minnesota Public Utilities Commission from imposing certain of its regulations on us. The FCC's decision was based on its conclusion that our service is interstate in nature and cannot be separated into interstate and intrastate components. On March 21, 2007, the United States Court of

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Appeals for the 8th Circuit affirmed the FCC's declaratory ruling preempting state regulation of our service. The 8th Circuit found that it is impossible for us to separate our interstate traffic from our intrastate traffic because of the nomadic nature of the service. As a result, the 8th Circuit held that it was reasonable for the FCC to preempt state regulation of our service. The 8th Circuit was clear, however, that the preemptive effect of the FCC's declaratory ruling may be reexamined if technological advances allow for the separation of interstate and intrastate components of the nomadic VoIP service. Therefore, the preemption of state authority over our service under this ruling generally hinges on the inability to separate the interstate and intrastate components of the service.

While this ruling does not exempt us from all state oversight of our service, it effectively prevents state telecommunications regulators from imposing certain burdensome and inconsistent market entry requirements and certain other state utility rules and regulations on our service. State regulators continue to probe the limits of federal preemption in their attempts to apply state telecommunications regulation to interconnected VoIP service. On July 16, 2009, the Nebraska Public Service Commission and the Kansas Corporation Commission filed a petition with the FCC seeking a declaratory ruling or, alternatively, adoption of a rule declaring that state authorities may apply universal service funding requirements to nomadic VoIP providers. We participated in the FCC proceedings on the petition. On November 5, 2010, the FCC issued a declaratory ruling that allowed states to assess state USF on nomadic VoIP providers on a going forward basis provided that the states comply with certain conditions to ensure that imposing state USF does not conflict with federal law or policy. We expect that state public utility commissions and state legislators will continue their attempts to apply state telecommunications regulations to nomadic VoIP service.

*Stand-by Letters of Credit*

We had stand-by letters of credit totaling \$6,836 as of September 30, 2011 and \$7,885 December 31, 2010, respectively.

*End-User Commitments*

We are obligated to provide telephone services to our registered end-users. The costs related to the potential utilization of minutes sold are expensed as incurred. Our obligation to provide this service is dependent on the proper functioning of systems controlled by third-party service providers. We do not have a contractual service relationship with some of these providers.

*Vendor Commitments*

We have committed to purchase carrier operation services from a vendor. We have committed to pay this vendor a minimum of approximately \$300 in 2011, \$1,200 in 2012, and \$800 in 2013, respectively.

We have committed to lease collocation facilities from a vendor. We have committed to pay this vendor a minimum of \$1,300 through 2013.

*State and Municipal Taxes*

In accordance with generally accepted accounting principles, we make a provision for a liability for taxes when it is both probable that a liability has been incurred and the amount of the liability or range of liability can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. For a period of time, we did not collect or remit state or municipal taxes (such as sales, excise, utility, use, and ad valorem taxes), fees or surcharges ( Taxes ) on the charges to our customers for our services, except that we historically complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these Taxes do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes to expressly include VoIP and we are now collecting and remitting sales taxes in

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those states. In addition, many states address how VoIP providers should contribute to support public safety agencies, and in those states we remit fees to the appropriate state agencies. We could also be contacted by state or municipal taxing and 911 agencies regarding Taxes that do explicitly apply to VoIP and these agencies could seek retroactive payment of Taxes. As such, we have a reserve of \$2,609 as of September 30, 2011 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is approximately \$5,062 as of September 30, 2011.



**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*You should read the following discussion together with our consolidated financial statements and the related notes included elsewhere in this Form 10-Q and our audited financial statements included in our Annual Report on Form 10-K. This discussion contains forward-looking statements. These forward-looking statements are based on information available at the time the statements are made and/or management's belief as of that time with respect to future events and involve risks and uncertainties that could cause actual results and outcomes to be materially different. Important factors that could cause such differences include but are not limited to: the competition we face; our ability to adapt to rapid changes in the market for voice and messaging services; our ability to retain customers and attract new customers; results of pending litigation and intellectual property and other litigation that may be brought against us; failure to protect our trademarks and internally developed software; our ability to obtain or maintain relevant intellectual property licenses; our dependence on third party facilities, equipment, systems and services; our ability to implement our new billing and ordering management system; system disruptions or flaws in our technology; fraudulent use of our name or services; our ability to maintain data security; results of regulatory inquiries into our business practices; our ability to obtain additional financing if required; restrictions in our debt agreements that may limit our operating flexibility; any reinstatement of holdbacks by our vendors; our dependence on our customers' existing broadband connections; uncertainties relating to regulation of VoIP services; increased governmental regulation, currency restrictions, and other restraints and burdensome taxes and risks incident to foreign operations; differences between our service and traditional phone services, including our 911 service; our dependence upon key personnel; our history of net losses and ability to achieve consistent profitability in the future and other factors that are set forth in the Risk Factors in our Annual Report on Form 10-K, in our Quarterly Reports on Form 10-Q and in our Current Reports on Form 8-K. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, and therefore, you should not rely on these forward-looking statements as representing our views as of any date subsequent to the date this Form 10-Q is filed with the Securities and Exchange Commission.*

**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. All trademarks are the property of their owners.

**Overview**

We are a leading provider of communications services connecting individuals through broadband devices worldwide. We rely heavily on our network, which is a flexible, scalable Session Initiation Protocol (SIP) based Voice over Internet Protocol, or VoIP, network that rides on top of the Internet. This platform enables a user via a single identity, either a number or user name, to access and utilize services and features regardless of how they are connected to the Internet, including over 3G, 4G, Cable, or DSL broadband networks. This technology enables us to offer attractively priced services that provide our customers with access to Vonage voice, messaging, and features, regardless of location, device, or their form of Internet access.

Our customers include both domestic callers and international long distance callers, which we classify as callers that make 20 or more minutes of international long distance calls per month within their plan. Our primary product offering is Vonage World, a residential plan with unlimited calling domestically and to more than 60 countries, including India, Mexico, and China, for a flat monthly rate. We believe the value and convenience provided by our Vonage World offer is particularly attractive to international long distance callers compared to offers by traditional telephone services, wireless providers, and calling card-based or PC-only services. To increase the visibility of our Vonage World offer to international callers, we have shifted an increasing portion of our marketing budget from broad national advertising as we target attractive segments of the international long distance market. We also began offering an end-to-end Spanish language experience in 2010 and subsequently added telesales and customer care centers in Costa Rica, Chile, and Mexico to support these efforts. We introduced our first mobile offering in late 2009. We anticipate leveraging our technology to offer additional applications for mobile and other connected devices to address existing markets such as our recently introduced Extensions and Time to Call products.

We serviced approximately 2.4 million subscriber lines as of September 30, 2011. Subscribers can sign-up through our direct sales channel, as represented by web-sites and toll free numbers, or purchase devices at our regional and national retailers, including Walmart, Sears, Kmart, Best Buy, and Fry's Electronics. Our primary source of revenue is subscription fees that we charge customers for our service plans, primarily on a monthly basis. We also generate revenue from call usage that is not included in customers' service plans, including stand-alone products, and for additional features that customers add to their service plans. We bill customers in the United States, Canada, and the United Kingdom. Customers in the United States represented 94% of our subscriber lines at September 30, 2011.

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**Trends and Key Operating Data** A number of trends have a significant effect on our results of operations and are important to an understanding of our financial statements. The table below includes key operating data that our management uses to measure the growth and operating performance of our business:

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2011                                | 2010      | 2011                               | 2010      |
| Gross subscriber line additions                            | 170,344                             | 163,055   | 503,736                            | 472,770   |
| Change in net subscriber lines                             | (8,939)                             | (4,846)   | (16,162)                           | (35,861)  |
| Subscriber lines (at period end)                           | 2,388,721                           | 2,399,035 | 2,388,721                          | 2,399,035 |
| Average monthly customer churn                             | 2.7%                                | 2.4%      | 2.6%                               | 2.5%      |
| Average monthly revenue per line                           | \$ 30.16                            | \$ 29.72  | \$ 30.35                           | \$ 30.68  |
| Average monthly telephony services revenue per line        | \$ 30.06                            | \$ 29.45  | \$ 30.19                           | \$ 30.27  |
| Average monthly direct cost of telephony services per line | \$ 8.25                             | \$ 8.36   | \$ 8.22                            | \$ 8.54   |
| Marketing costs per gross subscriber line addition         | \$ 299.65                           | \$ 302.07 | \$ 303.05                          | \$ 312.66 |
| Employees (excluding temporary help) (at period end)       | 1,035                               | 1,145     | 1,035                              | 1,145     |

*Broadband adoption.* The number of United States households with broadband Internet access has grown significantly. On March 16, 2010, the Federal Communications Commission (the "FCC") released its National Broadband Plan, which seeks, through supporting broadband deployment and programs, to encourage broadband adoption for the approximately 100 million United States residents who do not have broadband at home. We expect the trend of greater broadband adoption to continue. We benefit from this trend because our service requires a broadband Internet connection and our potential addressable market increases as broadband adoption increases.

*Competitive landscape.* We face intense competition from traditional telephone companies, wireless companies, cable companies, and alternative voice communication providers. Most traditional wire line and wireless telephone service providers and cable companies are substantially larger and better capitalized than we are and have the advantage of a large existing customer base. In addition, because our competitors provide other services, they often choose to offer VoIP services or other voice services as part of a bundle that includes other products, such as video, high speed Internet access, and wireless telephone service, which we do not offer. Further, as wireless providers offer more minutes at lower prices, better coverage, and companion landline alternative services, their services have become more attractive to households as a replacement for wire line service. We also compete against alternative voice communication providers, such as Skype, Google Voice, magicJack, and independent VoIP service providers. Some of these service providers have chosen to sacrifice telephony revenue in order to gain market share and have offered their services at low prices or for free. As we continue to introduce applications that integrate different forms of voice and messaging services over multiple devices, we are likely to face competition from emerging competitors focused on similar integration, as well as from established alternative voice communication providers. In addition, our competitors have partnered and may in the future partner with other competitors to offer products and services, leveraging their collective competitive positions. We also are subject to the risk of future disruptive technologies.

*Gross subscriber line additions.* Gross subscriber line additions for a particular period are calculated by taking the net subscriber line additions during that particular period and adding to that the number of subscriber lines that terminated during that period. This number does not include subscriber lines both added and terminated during the period, where termination occurred within the first 30 days after activation. The number does include, however, subscriber lines added during the period that are terminated within 30 days of activation but after the end of the period.

*Net subscriber line additions.* Net subscriber line additions for a particular period reflect the number of subscriber lines at the end of the period, less the number of subscriber lines at the beginning of the period.

*Subscriber lines.* Our subscriber lines include, as of a particular date, all subscriber lines from which a customer can make an outbound telephone call on that date. Our subscriber lines include fax lines and soft phones but do not include our virtual phone numbers or toll free numbers, which only allow inbound telephone calls to customers. Overall, subscriber lines decreased slightly from 2,404,883 as of December 31, 2010 to 2,388,721 as of September 30, 2011. For 2011, we continue to expect higher gross subscriber line additions than in 2010, however, we now expect that net subscriber lines are likely to be slightly negative.

*Average monthly customer churn.* Average monthly customer churn for a particular period is calculated by dividing the number of customers that terminated during that period by the simple average number of customers during the period, and dividing the result by the number of months

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in the period. The simple average number of customers during the period is the number of customers on the first day of the period, plus the number of customers on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first 30 days after activation. Our average monthly customer churn increased to 2.7% for the three months ended September 30, 2011 compared to 2.4% for the three months ended September 30, 2010. We believe the increase in churn was primarily due to higher early life churn as a result of no longer requiring a minimum service period and higher churn rates associated with some ethnic calling segments. We monitor churn on a daily basis and use it as an indicator of the level of customer satisfaction. Other companies may calculate churn differently, and their churn data

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may not be directly comparable to ours. Customers who have been with us for a year or more tend to have a lower churn rate than customers who have not. Our churn will fluctuate over time due to economic conditions, competitive pressures including wireless substitution, marketplace perception of our services, and our ability to provide high quality customer care and network quality and add future innovative products and services.

*Average monthly revenue per line.* Average monthly revenue per line for a particular period is calculated by dividing our total revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two. Our average monthly revenue per line increased to \$30.16 for the three months ended September 30, 2011 compared to \$29.72 for the three months ended September 30, 2010. This increase was primarily due to an increase in subscription fees due to changes in plan mix, lower bad debt costs due to improved customer credit quality and lower non-pay churn, and an increase in regulatory fee revenue, partially offset by the elimination of the disconnect fee and the equipment recovery fee for new customers beginning in September 2010, lower activation fees as the historical deferred activation fees are amortized and new activation fees are no longer charged and deferred, and higher rebate fees due to various promotions.

*Average monthly telephony services revenue per line.* Average monthly telephony services revenue per line for a particular period is calculated by dividing our total telephony services revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. Our average monthly telephony services revenue per line was \$30.06 for the three months ended September 30, 2011 compared with \$29.45 for the three months ended September 30, 2010.

*Average monthly direct cost of telephony services per line.* Average monthly direct cost of telephony services per line for a particular period is calculated by dividing our direct cost of telephony services for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. We use the average monthly direct cost of telephony services per line to evaluate how effective we are at managing our costs of providing service. Our average monthly direct cost of telephony services per line decreased to \$8.25 for the three months ended September 30, 2011 compared to \$8.36 for the three months ended September 30, 2010, due to more favorable rates negotiated with our service providers, the decrease in our network costs, and the decrease in E-911 costs. These decreases were offset by higher costs from higher international call volume associated with Vonage World. Direct cost of telephony services both overall and on a per line basis is expected to increase in 2011. The drivers of this increase are international calling by our growing base of Vonage World customers and potential increased regulatory termination charges in certain high volume countries.

*Marketing cost per gross subscriber line addition.* Marketing cost per gross subscriber line addition is calculated by dividing our marketing expense for a particular period by the number of gross subscriber line additions during the period. Marketing expense does not include the cost of certain customer acquisition activities, such as rebates and promotions, which are accounted for as an offset to revenues, or customer equipment subsidies, which are accounted for as direct cost of goods sold. As a result, it does not represent the full cost to us of obtaining a new customer. Our marketing cost per gross subscriber line addition was \$299.65 for the three months ended September 30, 2011 and \$302.07 for the three months ended September 30, 2010.

*Employees.* Employees represent the number of personnel that are on our payroll and exclude temporary or outsourced labor.

*Regulation.* Our business has developed in a relatively lightly regulated environment. The United States and other countries, however, are examining how VoIP services should be regulated. The November 2010 order by the FCC in response to a request by Kansas and Nebraska that permits states to impose state universal service fund obligations on VoIP service, discussed in Note 6 to our financial statements, is an example of efforts by regulators to determine how VoIP service fits into the telecommunications regulatory landscape. In addition to regulatory matters that directly address VoIP, a number of other regulatory initiatives could impact our business. One such regulatory initiative is net neutrality. In December 2010, the FCC adopted a revised set of net neutrality rules for broadband Internet service providers. These rules make it more difficult for broadband Internet service providers to block or discriminate against Vonage service. Final rules were filed in the Federal Register in September 2011. Shortly thereafter, a number of parties filed appeals of the rules in various federal circuit courts; some alleging that the FCC lacks authority to apply net neutrality rules to broadband service providers and some alleging that the rules did not go far enough. The D.C. Circuit Court of Appeals was selected by lottery to decide the appeals. In addition, the FCC's final adoption of an intercarrier compensation proposal will impact Vonage's costs for telecommunications services. See also the discussion under Regulation in Note 6 to our financial statements for a discussion of these and certain other regulatory issues that impact us.

**Operating Revenues**

Operating revenues consists of telephony services revenue and customer equipment and shipping revenue.

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*Telephony services revenue.* Substantially all of our operating revenues are telephony services revenue. In the United States, we have six residential plans, Vonage World , World Premium Unlimited , Vonage Pro , U.S. and Canada Unlimited , U.S. and Canada 300 , and U.S. and Canada 750 , two mobile plans, Vonage World Mobile and Vonage Mobile Pay per Use and two small office and home office calling plans, Small Business Premium Unlimited Minutes and Small Business Basic 1500 Minutes . Each of our unlimited plans other than Vonage World offers unlimited domestic calling as well as unlimited calling to Puerto Rico, Canada, and selected European countries, subject to certain restrictions. Each of our basic plans offers a limited number of domestic calling minutes per month. We also offer international calling plans that are bundled with our Residential Premium Unlimited plan where a customer can make calls to a chosen international region. We offer similar plans in Canada and the United Kingdom. The Vonage

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World plan, now available in the United States and Canada, offers unlimited calling across the United States and Puerto Rico, unlimited international calling to over 60 countries including India, Mexico, and Canada, subject to certain restrictions, and free voicemail to text messages with Vonage Visual Voicemail. Under our basic plans, we charge on a per minute basis when the number of domestic calling minutes included in the plan is exceeded for a particular month. International calls (except for calls to Puerto Rico, Canada and certain European countries under our unlimited plans and a variety of countries under international calling plans and Vonage World) are charged on a per minute basis. These per minute fees are not included in our monthly subscription fees. In October 2009, we launched Vonage Mobile, our first mobile calling application for smart phones. Vonage Mobile is a free downloadable application that provides seamless, low-cost pay-per-use international calling while on Wi-Fi or cellular networks, depending on the device. In December 2009, we began offering Vonage World Mobile using this mobile calling application. Bundle discounts are provided for customers who subscribe to both our residential and mobile Vonage World plans. In September 2010, we launched the Vonage World Canada plan, the first calling plan in Canada to offer unlimited international calls to landlines in over 60 countries for a flat rate. In August 2011, we announced two new products, Extensions and Time to Call. Extensions is an enhancement to our flat rate, unlimited international calling plan that extends the plan to additional phone numbers and devices including smartphones and feature phones. A customer may sign-up for up to two extensions with the first extension provided free of charge and the second extension incurring an additional fee. Time to Call provides low-cost, easy to use international calling on smartphones around the world. It is the first downloadable mobile application that allows pay-per-call international dialing to more than 190 countries. The service is available in 87 countries around the world. Time to Call provides direct payment through iTunes, requires far less effort than calling card services and other international calling plan options, and delivers substantial savings versus major mobile carriers.

We derive most of our telephony services revenue from monthly subscription fees that we charge our customers under our service plans. We also offer residential fax service, virtual phone numbers, toll free numbers and other services, and charge an additional monthly fee for each service. One business fax line is included with each of our two small office and home office plans, but we charge monthly fees for additional business fax lines. We automatically charge these fees to our customers' credit cards, debit cards, or electronic check payments ( ECP ), monthly in advance. We also automatically charge the per minute fees not included in our monthly subscription fees to our customers' credit cards, debit cards or ECP monthly in arrears unless they exceed a certain dollar threshold, in which case they are charged immediately.

By collecting monthly subscription fees in advance and certain other charges immediately after they are incurred, we are able to reduce the amount of accounts receivable that we have outstanding, thus allowing us to have lower working capital requirements. Collecting in this manner also helps us mitigate bad debt losses, which are recorded as a reduction to revenue. If a customer's credit card, debit card or ECP is declined, we generally suspend international calling capabilities as well as the customer's ability to incur domestic usage charges in excess of their plan minutes. Historically, in most cases, we are able to correct the problem with the customer within the current monthly billing cycle. 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.

From time to time we have generated revenue by charging a fee for activating service, although we do not currently or expect to charge an activation fee to 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 relationship period ( 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. This customer life is solely used to amortize deferred activation fees collected, which we have waived for almost all new customers since May 2009, including those signing up for our Vonage World plan, along with the related incremental customer acquisition costs. Customers signing up for our Vonage World plan currently churn at lower rates than other customers, and therefore appear to have a longer customer life. Because these customers have not paid an activation fee, this does not impact the customer life used in determining the amortization period. The customer life was 38 months for 2010 and will remain at 38 months for 2011 based on consistent historical trends.

In the United States, we charge regulatory, compliance, E-911, and intellectual property-related recovery 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 recognize revenue on a gross basis for contributions to the Federal Universal Service Fund ( USF ) and related fees. All other taxes are recorded on a net basis.

In addition, historically, we charged a disconnect fee for customers who terminated 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.

Telephony services revenue is offset by the cost of certain customer acquisition activities, such as rebates and promotions.

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*Customer equipment and shipping revenue.* Customer equipment and shipping revenue consists of revenue from sales of customer equipment to our wholesalers or directly to customers and retailers. In addition, customer equipment and shipping revenue includes the fees, when collected, that we charge our customers for shipping any equipment to them. In addition, historically, we charged an equipment recovery fee for customers who terminated 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 fee for new customers.

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### **Operating Expenses**

Operating expenses consist of direct cost of telephony services, royalties, direct cost of goods sold, selling, general and administrative expense, marketing expense, and depreciation and amortization.

*Total direct cost of telephony services.* Total direct cost of telephony services primarily consists of fees that we pay to third parties on an ongoing basis in order to provide our services. These fees include:

Access charges that we pay to other telephone companies to terminate domestic and international calls on the public switched telephone network. These costs represented approximately 50% and 51% of our total direct cost of telephony services for the three months ended September 30, 2011 and 2010, respectively, with a portion of these payments ultimately being made to incumbent telephone companies. When a Vonage subscriber calls another Vonage subscriber, we do not pay an access charge.

The cost of leasing Internet transit services from multiple Internet service providers. This Internet connectivity is used to carry VoIP session initiation signaling and packetized audio media between our subscribers and our regional data centers.

The cost of leasing from other telephone companies the telephone numbers that we provide to our customers. We lease these telephone numbers on a monthly basis.

The cost of co-locating our regional data connection point equipment in third-party facilities owned by other telephone companies, Internet service providers or collocation facility providers.

The cost of providing local number portability, which allows customers to move their existing telephone numbers from another provider to our service. Only regulated telecommunications providers have access to the centralized number databases that facilitate this process. Because we are not a regulated telecommunications provider, we must pay other telecommunications providers to process our local number portability requests.

The cost of complying with the FCC regulations regarding VoIP emergency services, which require us to provide enhanced emergency dialing capabilities to transmit 911 calls for all of our customers.

Taxes that we pay on our purchase of telecommunications services from our suppliers or imposed by government agencies such as Federal USF and related fees.

Royalties for use of third-party intellectual property.

*Direct cost of goods sold.* Direct cost of goods sold primarily consists of costs that we incur when a customer first subscribes to our service. These costs include:

The cost of the equipment that we provide to customers who subscribe to our service through our direct sales channel in excess of activation fees when an activation fee is collected. The remaining cost of customer equipment is deferred up to the activation fee collected and amortized over the estimated average customer life.



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The cost of the equipment that we sell directly to retailers.

The cost of shipping and handling for customer equipment, together with the installation manual, that we ship to customers.

The cost of certain products or services that we give customers as promotions.

*Selling, general and administrative expense.* Selling, general and administrative expense includes:

Compensation and benefit costs for all employees, which is the largest component of selling, general and administrative expense and includes customer care, research and development, network engineering and operations, sales and marketing, executive, legal, finance, and human resources personnel.

Share-based expense related to share-based awards to employees, directors, and consultants.

Outsourced labor related to customer care, kiosk and events sales teams, and retail support activities.

Transaction fees paid to credit card, debit card, and ECP companies, which include a per transaction charge in addition to a percent of billings charge.

Rent and related expenses.

Professional fees for legal, accounting, tax, public relations, lobbying, and development activities.

Litigation settlements.

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*Marketing expense.* Marketing expense includes:

Advertising costs, which comprise a majority of our marketing expense and include online, television, direct mail, alternative media, promotions, sponsorships, and inbound and outbound telemarketing.

Creative and production costs.

The costs to serve and track our online advertising.

Certain amounts we pay to retailers for activation commissions.

The cost associated with our customer referral program.

*Depreciation and amortization expenses.* Depreciation and amortization expenses include:

Depreciation of our network equipment, furniture and fixtures, and employee computer equipment.

Amortization of leasehold improvements and purchased and developed software.

Amortization of intangible assets (patents and trademarks).

Loss on disposal or impairment of property and equipment.

**Other Income (Expense)**

Other Income (Expense) includes:

Interest income on cash and cash equivalents.

Interest expense on notes payable, patent litigation judgments and settlements and capital leases.

Amortization of debt related costs.

Accretion of notes.

Realized and unrealized gains (losses) on foreign currency.

Debt conversion expense relating to the conversion of notes payable to equity.

Gain (loss) on extinguishment of notes.

Change in fair value of embedded features within notes payable and stock warrant.

Life insurance proceeds.

**Table of Contents****Results of Operations**

The following table sets forth, as a percentage of consolidated operating revenues, our consolidated statement of operations for the periods indicated:

|  | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |      |
|--|-------------------------------------|-------|------------------------------------|------|
|  | 2011                                | 2010  | 2011                               | 2010 |
| <b>Operating Revenues:</b>   |                                     |       |                                    |      |
| Telephony services   | 100%                                | 99%   | 99%                                | 99%  |
| Customer equipment and shipping  | 0                                   | 1     | 1                                  | 1    |
|  | 100                                 | 100   | 100                                | 100  |
| <b>Operating Expenses:</b>   |                                     |       |                                    |      |
| Direct cost of telephony services (excluding depreciation and amortization)      | 27                                  | 28    | 27                                 | 28   |
| Direct cost of goods sold  | 5                                   | 6     | 5                                  | 7    |
| Selling, general and administrative  | 27                                  | 28    | 27                                 | 27   |
| Marketing  | 24                                  | 23    | 23                                 | 22   |
| Depreciation and amortization  | 4                                   | 6     | 5                                  | 6    |
|  | 87                                  | 91    | 87                                 | 90   |
| Income from operations   | 13                                  | 9     | 13                                 | 10   |
| <b>Other Income (Expense):</b>   |                                     |       |                                    |      |
| Interest income  | 0                                   | 0     | 0                                  | 0    |
| Interest expense   | (1)                                 | (5)   | (2)                                | (5)  |
| Change in fair value of embedded features within notes payable and stock warrant | 0                                   | (29)  | 0                                  | (10) |
| Loss on extinguishment of notes  | (4)                                 | (1)   | (2)                                | (1)  |
| Other income (expense), net  | 0                                   | 0     | 0                                  | 0    |
|  | (5)                                 | (35)  | (4)                                | (16) |
| Income (loss) before income tax expense  | 8                                   | (26)  | 9                                  | (6)  |
| Income tax expense   | 0                                   | 0     | 0                                  | 0    |
| Net income (loss)  | 8%                                  | (26)% | 9%                                 | (6)% |

**Summary of Results for the Three and Nine months ended September 30, 2011 and September 30, 2010****Telephony Services Revenue and Direct Cost of Telephony Services**

(in thousands, except percentages)

|                                      | Three Months Ended September 30, |            |                  |                   | Nine Months Ended September 30, |            |                  |                   |
|--------------------------------------|----------------------------------|------------|------------------|-------------------|---------------------------------|------------|------------------|-------------------|
|                                      | 2011                             | 2010       | Dollar<br>Change | Percent<br>Change | 2011                            | 2010       | Dollar<br>Change | Percent<br>Change |
| Telephony services                   | \$ 215,824                       | \$ 212,135 | \$ 3,689         | 2%                | \$ 651,342                      | \$ 658,366 | \$ (7,024)       | (1%)              |
| Direct cost of telephony services(1) | 59,230                           | 60,263     | (1,033)          | (2%)              | 177,302                         | 185,727    | (8,425)          | (5%)              |

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(1) Excludes depreciation and amortization of \$3,864, \$4,357, \$11,855, and \$14,297, respectively.

*Telephony services revenue.* For the three months ended September 30, 2011, telephony services revenue increased by \$3,689, or 2%, compared to the three months ended September 30, 2010. This was primarily driven by an increase in monthly subscription fees of \$6,235 due to changes in plan mix, a decrease of \$2,659 in bad debt expense due to improved customer credit quality and lower non-pay churn, an increase in our regulatory recovery and E-911 fees of \$1,778, and an increase in other revenue of \$354. These increases were offset by a decrease in activation fees of \$2,491 as the historical deferred activation fees are amortized and new activation fees are no longer charged and deferred, and an increase in credits issued to subscribers of \$1,458. There was also a reduction in international minutes of use revenue of \$391 and a decrease in additional features revenue of \$857 due primarily to customers opting for our Vonage World offering, which now includes directory assistance and voice mail to text. In addition, there was a decrease in fees that we charged for disconnecting our service of \$2,109 due to fewer disconnections and elimination of disconnect fees for new customers beginning in September 2010 and a decrease in overage in plan minutes of \$31.

For the nine months ended September 30, 2011, telephony services revenue decreased by \$7,024, or 1%, compared to the nine months ended September 30, 2010. This was primarily driven by a decrease in activation fees of \$11,359 as the historical deferred activation fees are amortized and new activation fees are no longer charged and deferred, a decrease in fees that we charged for disconnecting our service of \$6,997 due to fewer disconnections and elimination of disconnect fees for new customers beginning in

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September 2010, and a reduction in international minutes of use revenue of \$1,629. In addition, there was an increase in credits issued to subscribers of \$1,786 and a decrease in additional features revenue of \$2,704 due primarily to customers opting for our Vonage World offering, which now includes directory assistance and voice mail to text. These decreases were offset by an increase in our regulatory recovery and E-911 fees of \$6,770 that we collected from subscribers due to pricing actions in 2010, a decrease of \$9,269 in bad debt expense due to improved customer credit quality and lower non-pay churn, an increase in overage in plan minutes of \$337, an increase in other revenue of \$571, and an increase in monthly subscription fees of \$503 due to changes in plan mix.

*Direct cost of telephony services.* For the three months ended September 30, 2011 compared to 2010, the decrease in direct cost of telephony services of \$1,033, or 2%, was primarily driven by a decrease in domestic termination costs of \$4,466 due to improved termination rates, which are costs that we pay other phone companies for terminating phone calls, and fewer minutes of use and a decrease in our network costs of \$1,877, which includes costs for co-locating in other carriers' facilities, leasing phone numbers, routing calls on the Internet, E-911 costs, and transferring calls to and from the Internet to the public switched telephone network due to improved rates. There was also a decrease in other costs of \$261 and a decrease in local number portability costs of \$269 due to lower rates. These decreases were partially offset by an increased cost of \$3,227 from higher international call volume associated with Vonage World and an increase of USF and related fees imposed by government agencies of \$2,613.

For the nine months ended September 30, 2011 compared to 2010, the decrease in direct cost of telephony services of \$8,425, or 5%, was primarily driven by a decrease in domestic termination costs of \$13,660 due to improved termination rates, which are costs that we pay other phone companies for terminating phone calls, and fewer minutes of use and a decrease in our network costs of \$5,092, which includes costs for co-locating in other carriers' facilities, for leasing phone numbers, routing calls on the Internet, E-911 costs, and transferring calls to and from the Internet to the public switched telephone network due to improved rates. There was also a decrease in taxes and other cost of \$812 and a decrease in local number portability costs of \$817 due to lower rates. These decreases were partially offset by an increased cost of \$10,978 from higher international call volume associated with Vonage World and an increase of USF and related fees imposed by government agencies of \$979.

**Customer Equipment and Shipping Revenue and Direct Cost of Goods Sold**

(in thousands, except percentages)

|  | Three Months Ended September 30, |             |               |                | Nine Months Ended September 30, |             |               |                |
|--|----------------------------------|-------------|---------------|----------------|---------------------------------|-------------|---------------|----------------|
|  | 2011                             | 2010        | Dollar Change | Percent Change | 2011                            | 2010        | Dollar Change | Percent Change |
| Customer equipment and shipping revenue    | \$ 683                           | \$ 1,991    | \$ (1,308)    | (66%)          | \$ 3,291                        | \$ 9,052    | \$ (5,761)    | (64%)          |
| Direct cost of goods sold                  | 10,711                           | 13,214      | (2,503)       | (19%)          | 31,631                          | 43,914      | (12,283)      | (28%)          |
| Customer equipment and shipping gross loss | \$ (10,028)                      | \$ (11,223) | \$ 1,195      | 11%            | \$ (28,340)                     | \$ (34,862) | \$ 6,522      | 19%            |

*Customer equipment and shipping revenue.* For the three months ended September 30, 2011 compared to 2010, our customer equipment and shipping revenue decreased by \$1,308, or 66%, primarily due to a decrease in equipment sales, net of rebates, of \$983 related to lower equipment recovery fees due to fewer terminations and elimination of equipment recovery fees for new customers beginning in September 2010 and a decrease in customer shipping revenue of \$326 due to higher priority shipping in 2010, partially offset by higher customer additions in 2011.

For the nine months ended September 30, 2011 compared to 2010, our customer equipment and shipping revenue decreased by \$5,761, or 64%, primarily due to a decrease in equipment sales, net of rebates, of \$5,718 related to lower equipment recovery fees due to fewer terminations and elimination of equipment recovery fees for new customers beginning in September 2010 and a decrease in customer shipping revenue of \$43 due to higher priority shipping in 2010, partially offset by higher customer additions in 2011.

*Direct cost of goods sold.* For the three months ended September 30, 2011 compared to 2010, the decrease in direct cost of goods sold of \$2,503, or 19%, was primarily due to a decrease in customer equipment costs of \$1,179 resulting from a lower cost device introduced in September 2010 and lower promotional activity. There was also a corresponding decrease in shipping costs of \$36 and a decrease in amortization costs on deferred customer equipment of \$1,986 as the historical deferred customer equipment costs are amortized and new customer equipment costs are no longer charged and deferred. These decreases were offset by an increase in waived activation fees for new customers of \$698.

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For the nine months ended September 30, 2011 compared to 2010, the decrease in direct cost of goods sold of \$12,283, or 28%, was primarily due to a decrease in customer equipment costs of \$5,646 resulting from a lower cost device introduced in September 2010 and lower promotional activity. There was also a corresponding decrease in shipping costs of \$435 and a decrease in amortization costs on deferred customer equipment of \$9,093 as the historical deferred customer equipment costs are amortized and new customer equipment costs are no longer charged and deferred. These decreases were offset by an increase in waived activation fees for new customers of \$2,892.

### Selling, General and Administrative

*(in thousands, except percentages)*

|                                     | Three Months Ended September 30, |           |                  |                   | Nine Months Ended September 30, |            |                  |                   |
|-------------------------------------|----------------------------------|-----------|------------------|-------------------|---------------------------------|------------|------------------|-------------------|
|                                     | 2011                             | 2010      | Dollar<br>Change | Percent<br>Change | 2011                            | 2010       | Dollar<br>Change | Percent<br>Change |
| Selling, general and administrative | \$ 59,451                        | \$ 58,908 | \$ 543           | 1%                | \$ 176,175                      | \$ 180,463 | \$ (4,288)       | (2%)              |

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*Selling, general and administrative.* For the three months ended September 30, 2011 compared to 2010, there was an increase in selling, general, and administrative expenses of \$543, or 1%. This increase was primarily due to an increase in share based cost of \$1,647, higher retail kiosk costs of \$1,978 due to the expansion of event teams, an increase in facility and other costs of \$488, and an increase in professional fees of \$511. These increases were offset by a decrease in salary related expense, outsourced temporary labor and severance costs of \$2,041, a decrease in uncollected state and municipal tax expense of \$1,336, a decrease in credit card fees of \$210, and a decrease in settlement costs related to litigation and contractual disputes of \$496.

For the nine months ended September 30, 2011 compared to 2010, there was a decrease in selling, general, and administrative expenses of \$4,288, or 2%. This decrease was primarily due to a decrease in salary related expense, outsourced temporary labor and severance costs of \$5,933, a decrease in facility and other costs of \$49, and a decrease in credit card fees of \$750. Additionally, we had a decrease in settlement costs related to litigation and contractual disputes of \$2,506, a decrease in professional fees of \$1,831, and a decrease in uncollected state and municipal tax expense of \$2,248. These decreases were offset by an increase in share based cost of \$4,629 and higher retail kiosk costs of \$4,400 due to the expansion of event teams.

**Marketing**

(in thousands, except percentages)

|           | Three Months Ended September 30, |           |               |                | Nine Months Ended September 30, |            |               |                |
|-----------|----------------------------------|-----------|---------------|----------------|---------------------------------|------------|---------------|----------------|
|           | 2011                             | 2010      | Dollar Change | Percent Change | 2011                            | 2010       | Dollar Change | Percent Change |
| Marketing | \$ 51,044                        | \$ 49,254 | \$ 1,790      | 4%             | \$ 152,659                      | \$ 147,818 | \$ 4,841      | 3%             |

*Marketing.* For the three months ended September 30, 2011 compared to 2010, there was a slight increase in marketing expense of \$1,790, or 4%, primarily related to an increase in direct mail costs of \$5,636, television advertising of \$246, and retail advertising of \$911. There was also an increase in other marketing of \$1,107 and alternative media of \$35. These increases were offset by a decrease in online advertising of \$6,146.

For the nine months ended September 30, 2011 compared to 2010, there was a slight increase in marketing expense of \$4,841, or 3%, primarily related to an increase in direct mail costs of \$15,872, television advertising of \$6,721, and retail advertising of \$2,723. These increases were offset by a decrease in online advertising of \$19,506, alternative media of \$944, and other marketing of \$25.

**Depreciation and Amortization**

(in thousands, except percentages)

|                               | Three Months Ended September 30, |           |               |                | Nine Months Ended September 30, |           |               |                |
|-------------------------------|----------------------------------|-----------|---------------|----------------|---------------------------------|-----------|---------------|----------------|
|                               | 2011                             | 2010      | Dollar Change | Percent Change | 2011                            | 2010      | Dollar Change | Percent Change |
| Depreciation and amortization | \$ 8,683                         | \$ 12,649 | \$ (3,966)    | (31%)          | \$ 28,413                       | \$ 40,346 | \$ (11,933)   | (30%)          |

*Depreciation and amortization.* The decrease in depreciation and amortization of \$3,966, or 31%, for the three months ended September 30, 2011 compared to 2010, was primarily due to lower depreciation of network equipment, computer hardware, and furniture of \$1,114 and lower software amortization of \$2,872 due to certain projects being fully amortized.

The decrease in depreciation and amortization of \$11,933, or 30%, for the nine months ended September 30, 2011 compared to 2010, was primarily due to lower impairment charges of \$474, lower depreciation of network equipment, computer hardware, and furniture of \$4,286, and lower software amortization of \$7,172 due to certain projects being fully amortized.

**Other Income (Expense)**

(in thousands, except percentages)

|                  | Three Months Ended September 30, |          |               |                | Nine Months Ended September 30, |          |               |                |
|------------------|----------------------------------|----------|---------------|----------------|---------------------------------|----------|---------------|----------------|
|                  | 2011                             | 2010     | Dollar Change | Percent Change | 2011                            | 2010     | Dollar Change | Percent Change |
| Interest income  | \$ 33                            | \$ 154   | \$ (121)      | (79%)          | \$ 112                          | \$ 380   | \$ (268)      | (71%)          |
| Interest expense | (2,926)                          | (11,569) | 8,643         | 75%            | (15,116)                        | (37,203) | 22,087        | 59%            |
|                  | 0                                | (62,150) | 62,150        | 100%           | (950)                           | (69,556) | 68,606        | 99%            |



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| Change in fair value of embedded features within notes payable and stock warrant |             |             |           |        |             |              |           |        |
|--|-------------|-------------|-----------|--------|-------------|--------------|-----------|--------|
| Loss on extinguishment of notes  | (7,985)     | (1,545)     | (6,440)   | (417%) | (11,806)    | (4,492)      | (7,314)   | (163%) |
| Other income (expense), net  | (47)        | (19)        | (28)      | (147%) | (5)         | 41           | (46)      | (112%) |
|  | \$ (10,925) | \$ (75,129) | \$ 64,204 |        | \$ (27,765) | \$ (110,830) | \$ 83,065 |        |

*Interest income.* For the three and nine months ended September 30, 2011 compared to 2010, the decrease in interest income was due to lower interest rates and lower average cash balance driven by the prepayment on the credit agreement we entered into in December 2010 (the 2010 Credit Facility ).

*Interest expense.* For the three and nine months ended September 30, 2011 compared to 2010, the decrease in interest expense was due to the reduced interest rate on our 2010 Credit Facility and the credit agreement we entered into in July 2011 (the 2011 Credit Facility ) resulting from our refinancings in December 2010 and July 2011 and lower principal outstanding due to the refinancing and prepayments in 2011.

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*Change in fair value of embedded features within notes payable and stock warrant.* The change in fair value of the embedded conversion option within our prior convertible notes ( Convertible Notes ) fluctuated with changes in the price of our common stock and was \$0 during 2011 compared to loss of \$2,030 and \$9,032, respectively, for the three and nine months ended September 30, 2010 as all Convertible Notes had been converted as of December 31, 2010. The change in the fair value of our stock warrant fluctuated with changes in the price of our common stock and was an expense of \$0 and \$950 for the three and nine months ended September 30, 2011, as the stock warrant was exercised during the three months ended March 31, 2011, compared to \$120 and \$524 for the three and nine months ended September 30, 2010, respectively. An increase in our stock price resulted in expense while a decrease in our stock price resulted in income. In addition, due to the progress of our repurchase negotiations and other factors, the make-whole premiums in our Senior Secured First Lien Credit Facility and Senior Secured Second Lien Credit Facility were ascribed a value of \$60,000 as of September 30, 2010, impacting both the three and nine months ended September 30, 2010.

*Loss on extinguishment of notes.* The loss on extinguishment of notes for the three and nine months ended September 30, 2011 was due to the acceleration of unamortized debt discount and debt related costs in connection with prepayments of our 2010 Credit Facility and our refinancing of the 2010 Credit Facility in July 2011. The loss on extinguishment of notes for the three and nine months ended September 30, 2010 was due to the acceleration of unamortized debt discount, debt related costs, and administrative agent fees associated with our Senior Secured First Lien Credit Facility and Senior Secured Second Lien Credit Facility prepayments partially offset by gains associated with conversion of our convertible notes.

*Other.* For the three and nine months ended September 30, 2011 compared to 2010, net other income and expense decreased by \$28, or 147%, and \$46, or 112%, respectively.

**Income Tax Expense**

(in thousands, except percentages)

|                                   | Three Months Ended September 30, |         |               |                | Nine Months Ended September 30, |          |               |                |
|-----------------------------------|----------------------------------|---------|---------------|----------------|---------------------------------|----------|---------------|----------------|
|                                   | 2011                             | 2010    | Dollar Change | Percent Change | 2011                            | 2010     | Dollar Change | Percent Change |
| Income tax expense                | \$ (426)                         | \$ (91) | \$ (335)      | (368%)         | \$ (1,790)                      | \$ (296) | \$ (1,494)    | (505%)         |
| <i>Provision for Income Taxes</i> |                                  |         |               |                |                                 |          |               |                |

The provision represents the federal alternative minimum tax and state and local income taxes currently payable.

We participated in the State of New Jersey's corporation business tax benefit certificate transfer program, which allows certain high technology and biotechnology companies to transfer unused New Jersey net operating loss carryovers to other New Jersey corporation business taxpayers. During 2003 and 2004, we submitted an application to the New Jersey Economic Development Authority, or EDA, to participate in the program and the application was approved. The EDA then issued a certificate certifying our eligibility to participate in the program. The program requires that a purchaser pay at least 75% of the amount of the surrendered tax benefit. For the nine months ended September 30, 2011 and 2010, we sold \$0 and \$2,194, respectively, of our New Jersey State net operating loss carry forwards for a recognized benefit of \$0 in 2011 and \$168 in 2010. Collectively, all transactions represent approximately 85% of the surrendered tax benefit each year and have been recognized in the year received.

**Net Income (Loss)**

(in thousands, except percentages)

|                   | Three Months Ended September 30, |             |               |                | Nine Months Ended September 30, |             |               |                |
|-------------------|----------------------------------|-------------|---------------|----------------|---------------------------------|-------------|---------------|----------------|
|                   | 2011                             | 2010        | Dollar Change | Percent Change | 2011                            | 2010        | Dollar Change | Percent Change |
| Net income (loss) | \$ 16,037                        | \$ (55,382) | \$ 71,419     | 129%           | \$ 58,898                       | \$ (41,976) | \$ 100,874    | 240%           |

*Net income (loss).* Based on the explanations described above, our net income of \$16,037 for the three months ended September 30, 2011 increased by \$71,419, or 129%, from net loss of \$55,382 for the three months ended September 30, 2010.

Based on the explanations described above, our net income of \$58,898 for the nine months ended September 30, 2011 increased by \$100,874, or 240%, from net loss of \$41,976 for the nine months ended September 30, 2010.

**Liquidity and Capital Resources***Overview*

The following table sets forth a summary of our cash flows for the periods indicated:

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2011</b>                                | <b>2010</b> |
|   | <b>(in thousands)</b>                      |             |
| Net cash provided by operating activities | \$ 108,141                                 | \$ 175,354  |
| Net cash used in investing activities     | (24,355)                                   | (29,421)    |
| Net cash used in financing activities     | (107,616)                                  | (42,090)    |

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For the nine months ended September 30, 2011, we generated income from operations. We expect to continue to balance efforts to grow our customer base while consistently achieving operating profitability. To grow our customer base, we continue to make investments in marketing, application development as we seek to launch new services, network quality and expansion, and customer care. Although we believe we will achieve consistent profitability in the future, we ultimately may not be successful and we may never achieve consistent operating profitability. We believe that cash flow from operations and cash on hand will fund our operations for at least the next twelve months.

### *December 2010 Financing*

On December 14, 2010, we entered into the 2010 Credit Facility consisting of a \$200,000 senior secured term loan. The co-borrowers under the 2010 Credit Facility were us and Vonage America Inc., our wholly owned subsidiary. Obligations under the 2010 Credit Facility were guaranteed, fully and unconditionally, by our other United States subsidiaries and are secured by substantially all of the assets of each borrower and each of the guarantors. An affiliate of the chairman of our board of directors and one of our principal stockholders was a lender under the 2010 Credit Facility.

### *Use of Proceeds*

We used the net proceeds of the 2010 Credit Facility of \$194,000 (\$200,000 principal amount less original discount of \$6,000), plus \$102,090 of cash on hand, to (i) exercise our existing right to retire debt under our prior senior secured first lien credit facility (the First Lien Senior Facility ) for 100% of the contractual make-whole price, (ii) retire debt under our prior senior secured second lien credit facility (the Second Lien Senior Facility ) at a more than 25% discount to the contractual make-whole price, and (iii) cause the conversion of all outstanding third lien Convertible Notes into 8,276 shares of our common stock. We also incurred \$11,444 of debt related costs in connection with the 2010 Credit Facility, repayment of our First Lien Senior Facility and our Second Lien Senior Facility, and conversion of our Convertible Notes.

### *Repayments*

For the nine months ended September 30, 2011, we made repayments of the entire \$200,000 under the 2010 Credit Facility, with \$20,000 designated to cover our 2011 mandatory amortization, \$50,000 designated to cover our 2011 annual excess cash flow mandatory repayment, if any, and \$130,000 designated to cover the outstanding principal balance under the 2010 Credit Facility, at the time of the 2011 Credit Facility financing.

### *July 2011 Financing*

On July 29, 2011, we entered into the 2011 Credit Facility consisting of an \$85,000 senior secured term loan and a \$35,000 revolving credit facility. The co-borrowers under the 2011 Credit Facility are us and Vonage America Inc., our wholly owned subsidiary. Obligations under the 2011 Credit Facility are guaranteed, fully and unconditionally, by our other United States subsidiaries and are secured by substantially all of the assets of each borrower and each of the guarantors.

### *Use of Proceeds*

We used \$100,000 of the net available proceeds of the 2011 Credit Facility, plus \$31,000 of cash on hand, to retire all of the debt under our 2010 Credit Facility, including a \$1,000 prepayment fee to holders of the 2010 Credit Facility.

### *2011 Credit Facility Terms*

The following description summarizes the material terms of the 2011 Credit Facility:

The loans under the 2011 Credit Facility mature in July 2014. Principal amounts under the 2011 Credit Facility are repayable in quarterly installments of \$7,083 per quarter for the senior secured term loan. The unused portion of our revolving credit facility incurs a 0.50% commitment fee.

Outstanding amounts under each of the senior secured term loan and the revolving credit facility, at our option, will bear interest at:

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LIBOR (applicable to one-, two-, three- or six-month periods) plus an applicable margin equal to 3.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.5% 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 3.75% 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 LIBOR rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 2.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.5% 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 2.75% 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 2011 Credit Facility.

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The 2011 Credit Facility provides greater flexibility to us in funding acquisitions and restricted payments, such as stock buybacks, than the 2010 Credit Facility.

We may prepay the 2011 Credit Facility at our option at any time without premium or penalty. The 2011 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 2011 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, without the consent of the existing lenders under the 2011 Credit Facility. The 2011 Credit Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition, the 2011 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 2.00 to 1.00;

a consolidated fixed coverage charge ratio of no less than 1.75 to 1.00;

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, plus a portion of annual excess cash flow up to \$8,000.

As of September 30, 2011, we were in compliance with all covenants, including financial covenants, for the 2011 Credit Facility.

The 2011 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.

### *State and Local Sales Taxes*

We also have contingent liabilities for state and local sales taxes. As of September 30, 2011, we had a reserve of \$2,609. If our ultimate liability exceeds this amount, it could affect our liquidity unfavorably. However, we do not believe it will significantly impair our liquidity.

### *Capital Expenditures*

For the nine months ended September 30, 2011, capital expenditures were primarily for the implementation of software solutions and purchase of network equipment as we continue to expand our network. Our capital expenditures for the nine months ended September 30, 2011 were \$25,403, of which \$16,550 was for software acquisition and development. For 2011, we believe our capital expenditures will not exceed \$40,000. The majority of these expenditures are comprised of investments in information technology and systems infrastructure, including the new Amdocs billing and order management system we are in the process of implementing. We expect the platform to be operational before the

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end of the year and our intention is to begin migrating customers during the first quarter of next year.

### *Operating Activities*

Cash provided by operating activities decreased to \$108,141 for the nine months ended September 30, 2011 compared to \$175,354 for the nine months ended September 30, 2010, primarily due to the timing of payments of accounts payable and accrued expenses.

Changes in working capital requirements include changes in accounts receivable, inventory, prepaid and other assets, accounts payable, accrued and other liabilities, and deferred revenue and costs. Cash provided by working capital requirements decreased by \$82,142 during the nine months ended September 30, 2011 compared to the prior year period primarily due to timing of payments.

### *Investing Activities*

Cash used in investing activities for the nine months ended September 30, 2011 of \$24,355 was attributable to capital expenditures of \$8,853 and development of software assets of \$16,550, offset by a decrease in restricted cash of \$1,048 due primarily to the return of part of the security deposit on our leased office property in Holmdel, New Jersey.

Cash used in investing activities for the nine months ended September 30, 2010 of \$29,421 was attributable to capital expenditures of \$11,346, development of software assets of \$13,266, and an increase in restricted cash of \$4,809, primarily due to funding of a concentration account under a prior financing, partially offset by the reduction of \$23,101 of reserves held by our credit card processors as a result of improvements in our credit quality.

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### *Financing Activities*

Cash used in financing activities for the nine months ended September 30, 2011 of \$107,616 was primarily attributable to \$200,000 in 2010 Credit Facility and \$7,083 in 2011 Credit Facility principal payments, respectively, \$1,303 in capital lease payments, and \$2,697 in 2011 Credit Facility debt related cost payments, offset by \$100,000 in proceeds received from the issuance of the 2011 Credit Facility and \$4,521 in proceeds received from the exercise of stock options and a common stock warrant.

Cash used in financing activities for the nine months ended September 30, 2010 of \$42,090 was attributable to \$28,664 in First Lien Senior Facility principal payments, \$13,128 in Second Lien Senior Facility principal payments, including \$3,668 representing paid-in-kind interest payment, and \$1,095 in capital lease payments offset by \$797 in stock options exercised.

### **Summary of Critical Accounting Policies and Estimates**

Our significant accounting policies are summarized in Note 1 to our consolidated financial statements. The following describes our critical accounting policies and estimates:

#### *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 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 believed 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 in determining the need for, and amount of, a valuation allowance on net deferred tax assets;

assumptions used to determine the fair value of the embedded conversion option within our prior 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 First Lien Senior Facility and our prior Second Lien Senior Facility.

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

### ***Revenue Recognition***



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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, if any, 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:

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

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international calls if not covered under a plan, including 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, or 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 our 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. These estimates are based primarily upon historical minutes and have been consistent with our actual results.

From time to time we have generated revenue by charging a fee for activating service, although we do not currently or expect to charge an activation fee to 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 average customer life was 38 months for 2010 and remains at 38 months for 2011 based on consistent historical trends.

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.

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 these retailers, to the extent of customer equipment and shipping revenues.

***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.

***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 have recorded a full valuation allowance against our net deferred tax assets because we have not concluded that it is more likely than not that we will generate sufficient taxable income in the future to utilize the future income tax benefit from our net deferred tax assets (namely, NOLs) prior to expiration. We periodically review this conclusion, which requires significant management judgment. If we are able to conclude positively 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 will in that period reduce the related valuation allowance (which was \$415,903 at December 31, 2010) with a corresponding decrease in income tax expense. This will result in a significant, one-time non-cash benefit to our net income in the period of the determination. In subsequent periods, until the net deferred tax assets are fully offset by future taxable income, we would expect to recognize income tax expense equal to our pre-tax income multiplied by our effective income tax rate, an expense that is not currently recognized each quarter as a result of the valuation allowance.

***Net Operating Loss Carry Forwards***

As of December 31, 2010, we had NOLs for United States federal and state tax purposes of \$885,431 and \$849,567, respectively, expiring at various times from years ending 2012 through 2030. In addition, we had NOLs for Canadian tax purposes of \$42,457 expiring through 2027. We also had NOLs for United Kingdom tax purposes of \$40,335 with no expiration date.

Under Section 382 of the Internal Revenue Code, if a corporation undergoes an ownership change (generally defined as a greater than 50% change (by value) in its equity ownership over a three-year period), the corporation's ability to use its pre-change of control NOLs and other

pre-change tax attributes against its post-change income may be limited. The Section 382 limitation is applied annually so as to limit the use of our pre-change NOLs to an amount that generally equals the value of our stock immediately before the ownership change multiplied by a designated federal long-term tax-exempt rate. Due to the cumulative impact of our equity issuances over the three year period ended April 2005, a change of ownership occurred upon the issuance of our previously outstanding Series E Preferred Stock at the end of April 2005. As a result, \$171,147 of the total United States NOLs were subject to an annual base limitation of \$39,374. The ownership change is not anticipated to restrict our ability to utilize our NOLs since the carryover of the 382 limitations that were not utilized in prior years results in the NOL being fully available this year.

***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.

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### ***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 will be 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.

In May 2011, the FASB issued Accounting Standards Update No. 2011-04 ( ASU 2011-04 ) *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* . This ASU changes several aspects of the fair measurement guidance in FASB ASC 820. In addition, ASU 2011-04 includes several new fair value disclosure requirements, including, among other things, information about valuation techniques and unobservable inputs used in Level 3 fair value measurements and a narrative description of Level 3 measurements' sensitivity to changes in unobservable inputs. It is effective during interim and annual periods beginning after December 15, 2011. We do not expect a material effect upon adoption.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05 ( ASU 2011-05 ) *Comprehensive Income (Topic 220), Presentation of Comprehensive Income* . The objective of ASU 2011-05 is to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The amendments in ASU 2011-05 should be applied retrospectively. It is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. We are currently evaluating the timing of adopting ASU 2011-05.

### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to financial market risks, including changes in currency exchange rates and interest rates.

#### ***Foreign Exchange Risk***

We sell our products and services in the United States, Canada, and the United Kingdom. Changes in currency exchange rates affect the valuation in our financial statements of the assets and liabilities of these operations. We also have a portion of our sales denominated in Euros, the Canadian dollar, and the British Pound, which are also affected by changes in currency exchange rates. Our financial results could be affected by changes in foreign currency exchange rates, although foreign exchange risks have not been material to our financial position or results of operations to date.

#### ***Interest Rate and Debt Risk***

Our exposure to market risk for changes in interest rates primarily relates to our long-term debt.

On July 29, 2011, we entered into the 2011 Credit Facility. We are exposed to interest rate risk since amounts payable under the 2011 Credit Facility, at our option, bear interest at:

LIBOR plus, an applicable margin equal to 3.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.5% 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 3.75% 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

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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 LIBOR rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 2.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.5% 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 2.75% 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 Credit Facility.

If the interest rate on our variable rate debt changed by 1%, our annual debt service payment would change by approximately \$1,000.

### **Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures.* Based on the evaluation of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) required by Securities Exchange Act Rules 13a-15(b) or 15d-15(b), our Chief Executive Officer and our Chief Financial Officer have concluded that as of the end of the period covered by this report, our disclosure controls and procedures were effective.

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*Changes in Internal Controls.* There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**Part II Other Information**

**Item 1. Legal Proceedings**

We are subject to a number of lawsuits, government investigations and claims arising out of the conduct of our business. See a discussion of our litigation matters in Note 6 of Notes to our Consolidated Financial Statements, which is incorporated herein by reference.

**Item 1A. Risk Factors**

There have been no material changes from the risk factors previously disclosed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010. This information should be read in conjunction with the risk factors in such Annual Report.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 5. Other Information**

On November 1, 2011, the Compensation Committee (the Committee) of our Board of Directors unanimously approved an increase in the annual base salary of Kimberly O Loughlin, our Senior Vice President of Customer Care and Managing Director, International Markets, to \$315,000 from \$275,000. The Committee also unanimously approved the grant to Ms. O Loughlin of non-qualified stock options to purchase 100,000 shares of our Common Stock, \$0.001 par value (Common Stock). The stock option grant will be made on December 1, 2011, and will generally vest in four equal annual installments over a four-year period commencing on the first anniversary of the date of grant. The options will have a term of ten years and will have a per share exercise price equal to the closing price of our Common Stock on the New York Stock Exchange on December 1, 2011. In approving the increase in base salary and stock option grant to Ms. O Loughlin, the Committee considered her increased responsibilities beginning in June 2011 for international markets and the execution of our international growth initiatives, her leadership addressing churn, and her continuing oversight of customer care. Additional information with respect to the compensation arrangements for our executive officers will be set forth in our proxy statement for our 2012 Annual Meeting of Stockholders.

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**Item 6. Exhibits**

- 31.1 Certification of the Company's Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
- 31.2 Certification of the Company's Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
- 32.1 Certification of the Company's Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002(1)
- 101 The following financial statements from Vonage Holdings Corp.'s Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2011, filed with the Securities and Exchange Commission on November 3, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; (iv) the Consolidated Statements of Stockholders' Deficit; and (v) the Notes to Consolidated Financial Statements.

(1) Filed herewith.



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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

VONAGE HOLDINGS CORP.

Dated: November 3, 2011

By: /s/ BARRY ROWAN

Barry Rowan  
Executive Vice President, Chief Financial Officer,

Chief Administrative Officer and Treasurer  
(Principal Financial and Accounting Officer and Duly Authorized  
Officer)

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**EXHIBIT INDEX**

- 31.1 Certification of the Company's Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
- 31.2 Certification of the Company's Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
- 32.1 Certification of the Company's Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002(1)
- 101 The following financial statements from Vonage Holdings Corp.'s Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2011, filed with the Securities and Exchange Commission on November 3, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; (iv) the Consolidated Statements of Stockholders' Deficit; and (v) the Notes to Consolidated Financial Statements.

(1) Filed herewith.