VONAGE HOLDINGS CORP
Form 10-Q
August 06, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended June 30, 2009

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Transition Period From to

Commission File Number 001-32887

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

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

Registrant s telephone number, including area code: (732) 528-2600

(Former name, former address and former fiscal year, if changed since last report): Not Applicable

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. Check one:

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

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

Class	**Outstanding at July 31, 2009**
Common Stock, par value $0.001	**157,004,974 shares**

VONAGE HOLDINGS CORP.

INDEX

		Page
Part I. Financial Information		
Item 1.	Financial Statements	
	A) Consolidated Balance Sheets as of June 30, 2009 (Unaudited) and December 31, 2008	2
	B) Unaudited Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2009 and 2008	3
	C) Unaudited Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2009 and 2008	4
	D) Unaudited Consolidated Statement of Stockholders Equity (Deficit) for the Six Months Ended June 30, 2009	5
	E) Notes to Unaudited Consolidated Financial Statements for the Six Months Ended June 30, 2009	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	30
Item 4	Controls and Procedures	31
Part II. Other Information		
Item 1.	Legal Proceedings	32
Item 1A.	Risk Factors	32
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	32
Item 3.	Defaults Upon Senior Securities	32
Item 4.	Submission of Matters to a Vote of Security Holders	32
Item 5.	Other Information	32
Item 6.	Exhibits	33
	Signature	34

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)

	June 30, 2009 (unaudited)	December 31, 2008
Assets		
Assets		
Current assets:		
Cash and cash equivalents	$ 56,000	$ 46,134
Accounts receivable, net of allowance of $2,625 and $2,045, respectively	23,115	17,696
Inventory, net of allowance of $1,452 and $1,405, respectively	14,390	10,360
Deferred customer acquisition costs, current	21,490	24,002
Prepaid expenses and other current assets	20,964	18,325
Total current assets	135,959	116,517
Property and equipment, net of accumulated depreciation	87,086	98,292
Software, net of accumulated depreciation	33,798	34,368
Deferred customer acquisition costs, non-current	11,980	20,393
Debt related costs, net	10,277	11,541
Restricted cash	40,133	39,585
Intangible assets, net	4,529	5,400
Other assets	9,794	10,809
Total assets	$ 333,556	$ 336,905
Liabilities and Stockholders Equity (Deficit)		
Liabilities		
Current liabilities:		
Accounts payable	$ 23,515	$ 33,978
Accrued expenses	83,144	73,482
Deferred revenue, current portion	63,267	63,155
Current maturities of capital lease obligations	1,372	1,252
Current portion of long-term debt	1,303	1,303
Total current liabilities	172,601	173,170
Notes payable, net of discount	201,782	192,747
Derivative embedded within convertible note, at fair value	18,600	
Deferred revenue, net of current portion	13,845	23,058
Capital lease obligations, net of current maturities	20,234	20,947
Other liabilities, net of current portion in accrued expenses	14,981	17,725
Total liabilities	442,043	427,647

Commitments and Contingencies		
Stockholders Equity (Deficit)		
Common stock, par value $0.001 per share; 596,950 shares authorized at June 30, 2009 and December 31, 2008; 158,542 and 158,201 shares issued at June 30, 2009 and December 31, 2008, respectively; 156,936 and 156,648 shares outstanding at June 30, 2009 and December 31, 2008, respectively	159	158
Additional paid-in capital	947,719	980,768
Stock subscription receivable	(5,195)	(5,195)
Accumulated deficit	(1,038,082)	(1,052,861)
Treasury stock, at cost, 1,606 shares at June 30, 2009 and 1,553 at December 31, 2008	(12,727)	(12,704)
Accumulated other comprehensive income (loss)	(361)	(908)
Total stockholders equity (deficit)	(108,487)	(90,742)
Total liabilities and stockholders equity (deficit)	$ 333,556	$ 336,905

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)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Operating Revenues:				
Telephony services	$ 214,709	$ 218,738	$ 430,352	$ 435,718
Customer equipment and shipping	5,319	8,786	13,681	16,423
	220,028	227,524	444,033	452,141
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of $4,872, $4,728, $9,629 and $9,429, respectively)	51,480	56,586	103,231	113,084
Direct cost of goods sold	16,179	18,533	36,691	40,605
Selling, general and administrative	71,327	77,931	139,378	157,323
Marketing	52,144	65,300	117,839	126,199
Depreciation and amortization	13,848	11,114	26,744	21,323
	204,978	229,464	423,883	458,534
Income (loss) from operations	15,050	(1,940)	20,150	(6,393)
Other Income (Expense):				
Interest income	60	1,021	170	2,421
Interest expense	(13,679)	(5,535)	(27,221)	(11,106)
Change in fair value of embedded derivative	1,150		14,120	
Other, net	5	52	806	(112)
	(12,464)	(4,462)	(12,125)	(8,797)
Income (loss) before income tax benefit (expense)	2,586	(6,402)	8,025	(15,190)
Income tax benefit (expense)	(301)	(480)	(469)	(653)
Net income (loss)	$ 2,285	$ (6,882)	$ 7,556	$ (15,843)
Net income (loss) per common share:				
Basic	$ 0.01	$ (0.04)	$ 0.05	$ (0.10)
Diluted	$ 0.01	$ (0.04)	$ 0.05	$ (0.10)
Weighted-average common shares outstanding:				

Basic	156,928	156,103	156,824	156,068
Diluted	156,928	156,103	218,893	156,068

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

3

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2009	**2008**
Cash flows from operating activities:		
Net income (loss)	$ 7,556	$ (15,843)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization and impairment charges	25,873	19,924
Amortization of intangibles	871	1,399
Change in fair value of embedded derivative	(14,120)	
Beneficial conversion on interest in kind on convertible notes		46
Amortization of discount on notes	2,729	
Accrued interest paid in-kind	9,523	
Allowance for doubtful accounts	800	(92)
Allowance for obsolete inventory	1,020	679
Amortization of debt related costs	1,515	1,655
Share-based expense	4,835	5,036
Changes in operating assets and liabilities:		
Accounts receivable	(6,158)	(5,027)
Inventory	(4,993)	4,459
Prepaid expenses and other current assets	(2,597)	(4,515)
Deferred customer acquisition costs	11,037	3,958
Due from related parties		2
Other assets	1,015	(2,563)
Accounts payable	(10,570)	15,813
Accrued expenses	9,400	(972)
Deferred revenue	(9,362)	2,716
Other liabilities	(2,750)	(2,581)
Net cash provided by (used in) operating activities	25,624	24,094
Cash flows from investing activities:		
Capital expenditures	(5,272)	(5,293)
Purchase of intangible assets		(560)
Purchase of marketable securities		(21,375)
Maturities and sales of marketable securities		77,779
Acquisition and development of software assets	(8,772)	(16,504)
Increase in restricted cash	(437)	(3,268)
Net cash provided by (used in) investing activities	(14,481)	30,779
Cash flows from financing activities:		
Principal payments on capital lease obligations	(593)	(490)
Principal payments on notes	(1,158)	
Debt related costs	(251)	
Proceeds from subscription receivable, net		9

Proceeds from directed share program, net		45
Proceeds from exercise of stock options	1	48
Net cash provided by (used in) financing activities	(2,001)	(388)
Effect of exchange rate changes on cash	724	61
Net change in cash and cash equivalents	9,866	54,546
Cash and cash equivalents, beginning of period	46,134	71,542
Cash and cash equivalents, end of period	$ 56,000	$ 126,088
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	$ 13,432	$ 9,405
Income taxes	$ 835	$ 653

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

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Stock Subscription Receivable	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2008	$ 158	$ 980,768	$ (5,195)	$ (1,052,861)	$ (12,704)	$ (908)	$ (90,742)
Opening adjustment-adoption of EITF 07-5		(37,884)		7,223			(30,661)
Stock option exercises	1						1
Share-based expense		4,835					4,835
Share-based award activity					(23)		(23)
Comprehensive income (loss):							
Foreign currency translation adjustment						547	547
Net income (loss)				7,556			7,556
Total comprehensive income (loss)				7,556		547	8,103
Balance at June 30, 2009	$ 159	$ 947,719	$ (5,195)	$ (1,038,082)	$ (12,727)	$ (361)	$ (108,487)

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

5

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, pure-play provider of broadband telephone services to residential and small office and home office customers with approximately 2.5 million subscriber lines as of June 30, 2009. While customers in the United States represented 94% of our subscriber lines at June 30, 2009, we also serve customers in Canada and the United Kingdom.

We decided to shut down our Toronto, Canada customer service center. The closing of this facility is part of our company-wide rationalization of call centers designed to cut costs. The Canadian operation, which opened in 2004, mainly handled calls from Canada and recently United Kingdom customers. The customers from these two regions will still be able to buy a full range of our products, services and receive customer support through our other customer service centers. Canadian and United Kingdom markets remain important marketplaces to our business. Approximately 200 positions were eliminated due to the shut down of our Toronto facility on July 30, 2009. See Significant Accounting Policies Facility Exit and Restructuring Costs.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows and statement of stockholders equity (deficit) for the periods presented. The results for the three and six month periods ended June 30, 2009 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 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 3, 2009.

Significant Accounting Policies

Basis 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 relationship period) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation. For 2008, due to the increase in churn, the customer relationship period was reduced from 60 months to 48 months. In 2009, the customer relationship period was further reduced to 44 months. The impact of this change was not material to the consolidated results of operations;

the useful lives of property and equipment, software costs and intangible assets;

assumptions used for the purpose of determining share-based compensation using the Black-Scholes option model (Model), and various other assumptions that we believed to be reasonable. The key inputs for this Model are stock price at valuation date, strike price for the option, the dividend yield, risk-free interest rate, life of option in years and volatility; and

assumptions used to determine the fair value of the embedded derivative within our convertible notes using the Monte Carlo simulation model. The key inputs are maturity date, risk-free interest rate, current share price and historical volatility of our common stock.

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.

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Restricted Cash and Letters of Credit

Our credit card processors have established reserves to cover any exposure that they may have as we collect revenue in advance of providing services to our customers, which is a customary practice for companies that bill their customers in advance of providing services. As such, we provided our credit card processors with cash reserves of $22,133 and a cash collateralized letter of credit for $10,500 and $10,413 as of June 30, 2009 and December 31, 2008, respectively. We also had a cash collateralized letter of credit for $7,350 and $7,000 as of June 30, 2009 and December 31, 2008, respectively, related to lease deposits for our offices. The total amount of collateralized letters of credit was $18,000 and $17,562 at June 30, 2009 and December 31, 2008, respectively. In the aggregate, cash reserves and collateralized letters of credit of $40,133 and $39,585 were recorded as long-term restricted cash at June 30, 2009 and December 31, 2008, respectively.

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 Statement of Position 98-1, *Accounting for Costs of Computer Software Development or Obtained for Internal Use.* Computer software is stated at cost less accumulated amortization and the estimated useful life is three years. Total computer software was $59,651 and $53,429 at June 30, 2009 and December 31, 2008, respectively, substantially all of which were external costs. Accumulated amortization was $25,853 and $19,061 at June 30, 2009 and December 31, 2008, respectively. Amortization expense was $4,600 and $2,816, including impairment of $292 and $83, for the three months ended June 30, 2009 and 2008, respectively, and $9,343 and $4,813, including impairment of $969 and $83, for the six months ended June 30, 2009 and 2008, respectively.

Long-Lived Assets

We review the carrying values of our property and equipment for possible impairment whenever circumstances indicate the carrying amount of an asset may not be recoverable. An impairment loss is recognized to the extent the sum of the undiscounted estimated future cash flow expected to result from the use of the asset is less than the carrying value. We incurred impairment losses of $1,413 and $229, respectively, for the three months ended June 30, 2009 and 2008, and $1,460 and $316, respectively, for the six months ended June 30, 2009 and 2008. The impairment is mainly for marketing displays, network equipment and computer hardware. Impairment is 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. In connection with our financing transaction in November 2008, we recorded debt related costs of $12,270, which are being amortized over the life of the debt which is five years and seven years. Amortization expense related to these costs is included in interest expense in the consolidated statements of operations and was $782 and $1,516 for the three and six months ended June 30, 2009, respectively. Accumulated amortization of debt related costs was $1,994 and $478 at June 30, 2009 and December 31, 2008, respectively.

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

In June 2006, we purchased three patents related to the compression of packetized digital signals commonly used in Voice over Internet Protocol (VoIP) technology at a cost of $5,268. In July 2006, we began amortizing the cost of these patents over their estimated useful lives of 2.7 years.

Amortization expense was $424 for the three and six months ended June 30, 2009, and $484 and $969 for the three and six months ended June 30, 2008, respectively. These patents were fully amortized as of March 31, 2009.

In October 2007, in connection with the settlement of our patent litigation with Sprint, we acquired a license to use Sprint s portfolio of Voice over Packet patents. The fair value assigned to these patents was $5,500. We began amortizing the cost of these patents in October 2007 over their patent lives of 6.6 years. Amortization expense was $206 and $413 for the three and six months ended June 30, 2009 and 2008, respectively. Annual amortization is approximately $825.

Trademark

In April 2008, in connection with the settlement of a trademark dispute, we acquired the right to use the trademark in question. The fair value assigned to the trademark was $560. This trademark is being amortized over its remaining life of 8 years. Amortization expense was $18 and $17 for the three months ended June 30, 2009 and 2008, respectively, and was $35 and $17 for the six months ended June 30, 2009 and 2008, respectively. Annual amortization is approximately $70.

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Embedded Derivative

In accordance with Emerging Issues Task Force (EITF) Issue No. 07-5, *Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity s Own Stock* (EITF 07-5), which we adopted on January 1, 2009, our $18,000, 20% senior secured third lien notes due 2015 (the Convertible Notes) contain an embedded derivative that requires separate valuation from the Convertible Notes. We recognize this derivative as a liability in our consolidated balance sheet at its estimated fair value each period, and recognize any change in its estimated fair value in our statement of operations in the period of change. We estimate the fair value of the embedded derivative using available market information and appropriate valuation methodologies (see Note 3).

Fair Value of Financial Instruments

Effective January 1, 2008, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS No. 157). 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 SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159).

SFAS No. 157 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. SFAS No. 157 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. SFAS No. 157 describes the following three levels of inputs that may be used:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets and liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2: Observable prices that are based on inputs not quoted on active markets but corroborated by market data.

Level 3: Unobservable inputs when there is little or no market data available, thereby requiring an entity to develop its own assumptions. The fair value hierarchy gives the lowest priority to Level 3 inputs.

Currently, SFAS No. 157 applies to the derivative that is embedded within our Convertible Notes (see Note 3), which is included in long term liabilities in our consolidated balance sheet. The embedded derivative was valued using the Monte Carlo simulation model. The key inputs in the model are as follows:

	June 30, 2009		January 1, 2009	
Maturity date	October 31, 2015		October 31, 2015	
Risk-free interest rate		3.00%		2.24%
Price of common stock	$	0.38	$	0.66
Volatility		90%		87%

The embedded derivative within our Convertible Notes is measured at fair value on a recurring basis using significant unobservable inputs (Level 3). The amount of total gain in earnings for the six months ended June 30, 2009 is as follows:

Liabilities:	**Derivatives**
Beginning balance	$ 32,720
Total unrealized gain in earnings	$ (14,120)
Ending balance	$ 18,600

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 June 30, 2009. We believe the fair value of our debt at June 30, 2009 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.

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Earnings per Share

Net income (loss) per share has been computed according to SFAS No. 128, *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 reported period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, including warrants, stock options and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, and the Convertible Notes, were exercised or converted into common stock. The dilutive effect of outstanding warrants, stock options and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. In applying the treasury stock method for stock-based compensation arrangements, the assumed proceeds are computed as the sum of the amount the employee must pay upon exercise and the amounts of average unrecognized compensation cost attributed to future services. The dilutive effect of the Convertible Notes is reflected in diluted earnings per share using the if-converted method.

The following table sets forth the computation for basic and diluted net income per share for the three and six months ended June 30, 2009.

	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
Numerator		
Numerator for basic earnings per share-net income	$ 2,285	$ 7,556
Add: interest savings on assumed conversion of Convertible Notes		2,420
Numerator for diluted earnings per share	$ 2,285	$ 9,976
Denominator		
Basic weighted average common shares outstanding	156,928	156,824
Dilutive effect of Convertible Notes		62,069
Diluted weighted average common shares outstanding	156,928	218,893
Basic net income per share		
Basic net income per share	$ 0.01	$ 0.05
Diluted net income per share		
Diluted net income per share	$ 0.01	$ 0.05

For the three and six months ended June 30, 2009 and 2008, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Common stock warrants	514	3,085	514	3,085
Convertible notes (1)		17,824		17,824
Convertible Notes	62,069			
Restricted stock units	3,509	3,938	3,509	3,938
Employee stock options	26,390	21,832	26,390	21,832
	92,482	46,679	30,413	46,679

(1) refers to our convertible notes previously issued in December 2005 and January 2006.

Facility Exit and Restructuring Costs

In June 2009, we announced the closing of our office facility in Canada. The facility exit and restructuring costs for the three and six months ended June 30, 2009 were $2,125. These costs included $974 for severance and personnel-related costs which were recorded as selling, general and administrative in the statement of operations, $499 for lease termination and facilities-related costs which were recorded as selling, general and administrative in the statement of operations and $652 for asset impairments which were recorded in the statement of operations as part of depreciation expense. We will complete the closing of the facility in the second half of 2009 and anticipate additional costs of $362, which includes $113 for lease termination and facilities-related expenditures and $249 for asset impairments. As of June 30, 2009, we had paid $35 of the severance and personnel related costs with the remainder recorded in accrued expenses. In addition, the entire amount of the lease termination and facilities-related costs were unpaid at June 30, 2009 with $335 recorded in accrued expenses and $164 recorded in other liabilities.

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles.* (SFAS No. 168 or the Codification). This SFAS replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles.* It will become the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On its effective date, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered non-SEC accounting literature not included in the Codification will become nonauthoritative. SFAS No. 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

In April 2009, the FASB issued FASB Staff Position (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. This FSP provides additional guidance for estimating fair value in accordance with SFAS No. 157, when the volume and level of activity for the asset or liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly. This FSP is effective for interim and annual reporting periods that ended after June 15, 2009. The FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption. We do not expect the changes associated with adoption of this FSP will have a material effect on the reporting of our financial results.

In May 2008, the FASB affirmed the consensus of FSP APB Opinion No. 14-1 (APB 14-1), *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*, which applies to all convertible debt instruments that have a net settlement feature; which means that such convertible debt instruments, by their terms, may be settled either wholly or partially in cash upon conversion. FSP APB 14-1 requires issuers of convertible debt instruments that may be settled wholly or partially in cash upon conversion to separately account for the liability and equity components in a manner reflective of the issuer s nonconvertible debt borrowing rate. Previous guidance provided for accounting for this type of convertible debt instrument entirely as debt. FSP APB 14-1 was effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. The adoption of FSP APB 14-1 did not have an impact on our financial statements.

In April 2008, the FASB issued FSP No. 142-3 (FSP 142-3), *Determination of the Useful Life of Intangible Assets.* FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under FASB Statement No. 142, *Goodwill and Other Intangible Assets.* This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 was effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Since this guidance applied prospectively, on adoption, there was no impact to our consolidated financial statements.

In February 2008, the FASB issued FASB FSP 157-2, which delayed the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. These nonfinancial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. The full adoption of SFAS No. 157 did not have a material impact on our consolidated financial position, results of operations or cash flows.

Note 2. Commitments and Contingencies

Litigation

State Attorney General Proceedings. In 2008, Vonage learned that a group of twenty-eight states attorneys general had begun an investigation into certain of our business practices. We have received document requests from twenty-two of the participating states. The requests seek information that Vonage previously produced to the Wisconsin Attorney General as part of an investigation commenced in November 2007, which consisted of, among other things, sales and retention marketing scripting, advertising disclosures, and information related to our money back guarantee. The most recent requests also seek, among other things, information related to marketing and billing practices, as well as early termination fees. To date, none of the attorney generals have filed a complaint against us or taken other formal action. We are unable to predict whether a formal action will be filed against us. We are fully cooperating in the investigation and have undertaken discussions with the states attorneys general to resolve these issues; we have made a reserve in connection with this matter in an amount material to our consolidated statement of operations for the three and six months ended June 30, 2009, respectively. We cannot predict whether any future amounts recorded in connection with this matter will be material to our financial position, results of operations or cash flows.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

IPO Litigation. During June and July 2006, Vonage, several of our officers and directors, and the firms who served as the underwriters in our IPO were named as defendants in several purported class action lawsuits arising out of our IPO. On January 9, 2007, the Judicial Panel on Multidistrict Litigation transferred all complaints to the District of New Jersey. On September 7, 2007, the Court appointed Zyssman Group as the lead plaintiff, and the law firm of Zwerling, Schachter and Zwerling, LLP as lead counsel. On November 19, 2007, the plaintiffs filed the Amended Complaint, which generally alleges: (i) defendants made misstatements regarding subscriber line growth and average monthly churn rate; (ii) defendants failed to disclose problems with facsimile transmissions and a pending fax litigation case; (iii) defendants failed to disclose all patent infringement claims and issues; and (iv) that the Directed Share Program suffered from various infirmities. On January 18, 2008, defendants filed their motions to dismiss the Amended Complaint. On April 6, 2009, the Court hearing the matter dismissed three claims with leave to amend two of them, and declined at such time to dismiss two of the other claims. On April 20, 2009, the plaintiffs filed a motion asking the Court to reconsider the partial dismissal of their claims. On June 3, 2009, the Court granted-in-part and denied-in-part plaintiffs motion for reconsideration. On June 16, 2009, Vonage and plaintiffs reached an agreement in principle to settle the litigation, which will include a release and dismissal of all stockholder claims against Vonage and its individual directors and officers who were named as defendants. The settlement is subject to final documentation and Court approval. The settlement will be funded by our liability insurance under our directors and officers liability insurance policy.

The firms who served as underwriters to the IPO, pursuant to an indemnification agreement entered into between us and those firms prior to the IPO have demanded that Vonage reimburse them for the costs and fees incurred by them in defense of the IPO litigation. In addition, three of the firms have demanded that Vonage reimburse them for the costs and fees incurred by them in response to various regulatory inquiries by the Financial Industry Regulatory Authority (formerly the NASD) and the New York Stock Exchange, among other things. Vonage has declined to reimburse these three firms any fees or expenses. The settlement described above does not resolve the IPO underwriters claims for indemnification against the Company.

Consumer Class Action Litigations. We have been named in several purported class actions venued in California, New Jersey, and Washington alleging a wide variety of deficiencies with respect to our business practices, marketing disclosures, email marketing and quality issues for both phone and fax service.

For example, there are various class actions, on behalf of both nationwide and state classes, pending in New Jersey, Washington and California generally alleging that we delayed and/or refused to allow consumers to cancel their Vonage service; failed to disclose procedural impediments to cancellation; failed to adequately disclose that their 30-day money back guarantee does not give consumers 30 days to try out our services; suppressed and concealed the true nature of our services and disseminated false advertising about the quality, nature and terms of our services; imposed an unlawful early termination fee; and invoked unconscionable provisions of our Terms of Service to the detriment of customers. On May 11, 2007, plaintiffs in one action petitioned the Judicial Panel on Multidistrict Litigation (the Panel), seeking transfer and consolidation of the pending actions to a single court for coordinated pretrial proceedings. In an Order dated August 15, 2007, the Panel transferred the pending actions to the United States Court for the District of New Jersey, captioned In re Vonage Marketing and Sales Practices Litigation, MDL No. 1862, Master Docket No. 07-CV-3906 (USDC, D.N.J.). On October 1, 2007, counsel for one group of plaintiffs moved before the Court for Consolidation and Appointment of Co-Lead Counsel of the actions, and requested time to file an Amended Consolidated Complaint. On November 6, 2008, the Court entered an Order Granting Consolidation and Appointment of Co-Lead Counsel, and ordered that a consolidated Complaint be filed within 45 days, which Complaint was filed on December 19, 2008. On February 6, 2009, we filed a Motion to Compel Arbitration. Oral argument on the motion is scheduled for September 1, 2009.

Nebraska Public Service Commission. On November 15, 2007, the Director of the Nebraska Telecommunications Infrastructure and Public Safety Department of the Nebraska Public Service Commission filed a complaint (the PSC Complaint) before the Nebraska Public Service Commission (the NPSC) alleging that Vonage is required to contribute to the Nebraska Universal Service Fund (NUSF) and has failed to do so. The PSC Complaint seeks an order compelling Vonage to contribute to the NUSF, as well as administrative penalties. On December 6, 2007, Vonage filed its answer. On or about December 20, 2007, Vonage also brought a complaint for declaratory and injunctive relief against the NPSC in the United States District Court for the District of Nebraska. On March 3, 2008, the United States District Court for the District of Nebraska issued a Memorandum and Order granting Vonage s Motion for a Preliminary Injunction and Declaratory Relief. Specifically, the Court enjoined the NPSC from asserting state jurisdiction over Vonage to force Vonage to contribute to the NUSF and found the NPSC s assertion of state jurisdiction over Vonage to force Vonage to pay into the NUSF is unlawful as preempted by the Federal Communications Commission (FCC). On April 1, 2008, the NPSC filed a Notice of Appeal to the 8th Circuit Court of Appeals. On April 2, 2008, Vonage filed a motion for summary judgment in the District Court, arguing the court should grant our permanent injunction. The District Court, in a May 9, 2008 order, denied Vonage s request for summary judgment without prejudice. On May 1, 2009, the 8th Circuit Court of Appeals affirmed the District Court s decision to grant Vonage a preliminary injunction. On May 14, 2009, the NPSC filed a petition for rehearing en banc at the 8th Circuit. On June 5, 2009, the 8th Circuit denied this petition. On August 3, 2009, the District Court granted Vonage s request for a permanent injunction. We do not know if the NPSC will seek further judicial review.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

New Mexico Public Service Commission. On June 27, 2008, the New Mexico Public Regulation Commission (NMPRC) filed a complaint for Declaratory Judgment (NMPRC Complaint) in the United States District Court for the District of New Mexico, alleging that Vonage is required to contribute to the New Mexico Universal Service Fund (NMUSF) and failed to do so. The NMPRC Complaint seeks an order compelling Vonage to contribute to the NMUSF. On or about July 21, 2008, Vonage filed a Motion to Dismiss the NMPRC Complaint, and the NMPRC filed a response to the Motion to Dismiss. On November 12, 2008 the Magistrate Judge issued Proposed Findings and Recommended Disposition, recommending that the Company s Motion to Dismiss be granted. On November 21, 2008, NMPRC filed its objections to the Magistrate Judge s recommended disposition, and on December 11, 2008 the Company filed its response to the NMPRC objections to the Magistrate Judge s recommendation to dismiss the complaint. On January 28, 2009, the District Court Judge heard oral argument and stayed the litigation pending the 8th Circuit decision in the Nebraska Public Service Commission litigation, referenced above. On July 28, 2009, in light of the 8th Circuit decision, the Court adopted the Magistrate Judge s Proposed Findings and Recommended Disposition and granted Vonage s Motion to Dismiss.

City of New York vs. Verizon and Vonage. On April 21, 2008, the City of New York and the Sheriff of the City of New York filed a complaint (NYC Complaint) in New York State Court against Verizon and Vonage, arising out of collection efforts on the $58,000 judgment entered against Vonage in the Verizon vs. Vonage patent litigation. The City alleges that either Verizon or Vonage is liable for $2,900, which represents a poundage fee of 5% of the value of the property sought to be levied upon. On May 13, 2008, Vonage filed a motion to dismiss one count of the NYC Complaint. On May 16, 2008, Verizon filed a motion to dismiss the NYC Complaint in its entirety. The Court denied both motions and the parties are currently engaged in discovery. On March 19, 2009, Verizon filed a motion for an order granting summary judgment and dismissing all claims against Verizon. Briefing on Verizon s motion, and Vonage s cross-motion for summary judgment filed May 1, 2009 seeking dismissal of all claims against Vonage is complete, and oral argument on the motions is scheduled for August 20, 2009.

PC Management. By letter dated February 2, 2009, PC Management, Inc. (PCM) provided written notice to us of its intent to arbitrate a dispute concerning PCM s right to an early termination fee under a Master Services Agreement (MSA) for mobile services. On April 29, 2009, PCM submitted its Arbitration Demand alleging a breach of the MSA and seeking damages, including interest, attorneys fees, expenses and arbitration costs, in an amount in excess of $1,875. The arbitration hearing is scheduled to commence September 9, 2009.

IP Matters

Alcatel-Lucent. On November 4, 2008, Vonage received a letter from Alcatel-Lucent initiating an opportunity for Vonage to obtain a non-exclusive patent license to certain of its patents that may be relevant to Vonage s business. Vonage is currently analyzing the applicability of such patents to its business, as well as additional patents subsequently identified by Alcatel-Lucent. If Vonage determines that these patents are applicable to its business and valid, it may incur expense in licensing them. If Vonage determines that these patents are not applicable to its business or invalid, it may incur expense and damages if there is litigation.

Centre One. On December 5, 2008, Centre One filed a lawsuit against Vonage and its subsidiary Vonage America Inc. in the United States District Court for the Eastern District of Texas alleging that some of Vonage s products and services are covered by a patent held by Centre One (United States Patent No. 7,068,668) entitled Method and Apparatus for Interfacing a Public Switched Telephone Network and an Internet Protocol Network for Multi-Media Communication . The suit also named Verizon Communications Inc. and deltathree Inc. as defendants. Vonage believes Centre One is a firm owned by a sole inventor. We filed our Answer to the Complaint on February 23, 2009, along with a motion to transfer this matter to the United States District Court for the District of New Jersey. On April 2, 2009, we filed a motion to sever the case against us from the case against the other defendants. During oral argument on the motions on June 22, 2009, the Court orally denied the motions to transfer and to sever. On June 22, 2009, the United States Patent and Trademark Office (PTO) granted Verizon s April 30, 2009 request for *inter partes* reexamination of the claims of Centre One s patent and issued an office action rejecting on multiple grounds as not patentable certain claims of Centre One s patent. On July 9, 2009, Vonage and Verizon moved to stay the litigation pending the resolution of the *inter partes* reexamination.

From time to time, in addition to those identified above, Vonage is 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. In accordance with generally accepted accounting principles, Vonage makes 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 legal counsel, and other information and events pertaining to a particular case. For the quarter ended June 30, 2009, we have recorded an additional reserve of $5,000 to cover the potential exposure relating to litigation and contractual disputes; $1,000 and $600 has been recorded as a reduction to customer equipment and shipping and telephony services revenue, respectively, and $3,400 has been recorded as selling, general and administrative expense in the consolidated statement of operations. Litigation is inherently unpredictable. We believe that we have valid defenses with respect to the legal matters pending against Vonage 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.

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Regulation

Telephony services are subject to a broad spectrum of state and federal regulations. Because of the uncertainty over whether 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 various federal and st