

VONAGE HOLDINGS CORP  
Form 10-Q  
May 01, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-Q

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

For the Quarterly Period Ended March 31, 2014

or

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

For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-32887

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

Delaware 11-3547680  
(State or other jurisdiction of (IRS Employer  
incorporation or organization) Identification No.)

23 Main Street, 07733  
Holmdel, NJ (Zip Code)

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

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

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

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

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

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

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

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

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Class	Outstanding at	April 30, 2014
Common Stock, par value \$0.001		211,638,792 shares

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Financial Information Presentation

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

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## Part I – Financial Information

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

	March 31, 2014 (unaudited)	December 31, 2013
Assets		
Assets		
Current assets:		
Cash and cash equivalents	\$54,272	\$84,663
Accounts receivable, net of allowance of \$557 and \$683, respectively	19,626	19,649
Inventory, net of allowance of \$175 and \$229, respectively	5,965	10,584
Deferred customer acquisition costs, current	4,580	4,991
Deferred tax assets, current	18,361	18,361
Prepaid expenses and other current assets	19,271	16,892
Total current assets	122,075	155,140
Property and equipment, net	47,921	52,243
Goodwill	83,627	83,627
Software, net	20,679	20,557
Deferred customer acquisition costs, non-current	168	193
Debt related costs, net	1,024	1,313
Restricted cash	4,407	4,405
Intangible assets, net	72,494	76,850
Deferred tax assets, non-current	242,598	246,539
Other assets	1,708	1,882
Total assets	\$596,701	\$642,749
Liabilities and Stockholders' Equity		
Liabilities		
Current liabilities:		
Accounts payable	\$35,565	\$49,867
Accrued expenses	75,953	81,127
Deferred revenue, current portion	36,264	36,899
Current maturities of capital lease obligations	3,002	2,889
Current portion of notes payables	23,333	23,333
Total current liabilities	174,117	194,115
Indebtedness under revolving credit facility	55,000	75,000
Notes payable, net of current portion	17,500	23,333
Deferred revenue, net of current portion	387	436
Capital lease obligations, net of current maturities	9,406	10,201
Other liabilities, net of current portion in accrued expenses	1,644	1,628
Total liabilities	258,054	304,713
Commitments and Contingencies	—	—
Redeemable noncontrolling interest	(440)	(38)
Stockholders' Equity		
Common stock, par value \$0.001 per share; 596,950 shares authorized at March 31, 2014 and December 31, 2013; 249,083 and 246,741 shares issued at March 31,	251	247

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2014 and December 31, 2013, respectively; 212,196 and 212,339 shares  
outstanding at March 31, 2014 and December 31, 2013, respectively

Additional paid-in capital	1,144,415	1,136,289
Accumulated deficit	(693,353)	) (697,941 )
Treasury stock, at cost, 36,887 shares at March 31, 2014 and 34,402 shares at December 31, 2013	(111,278)	) (101,040 )
Accumulated other comprehensive (loss) income	(948)	) 519
Total stockholders' equity	339,087	338,074
Total liabilities, redeemable noncontrolling interest, and stockholders' equity	\$596,701	\$642,749

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

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

	Three Months Ended March 31,	
	2014	2013
Revenues	\$220,733	\$209,087
Operating Expenses:		
Direct cost of telephony services (excluding depreciation and amortization of \$5,154 and \$3,452, respectively)	52,617	55,181
Direct cost of goods sold	9,739	8,878
Selling, general and administrative	78,453	62,910
Marketing	57,264	51,669
Depreciation and amortization	12,338	7,975
	210,411	186,613
Income from operations	10,322	22,474
Other Income (Expense):		
Interest income	91	37
Interest expense	(2,077)	(1,457)
Other expense, net	(13)	(39)
	(1,999)	(1,459)
Income before income tax expense	8,323	21,015
Income tax expense	(4,118)	(7,968)
Net income	\$4,205	\$13,047
Plus: Net loss attributable to noncontrolling interest	383	—
Net income attributable to Vonage	\$4,588	\$13,047
Net income attributable to Vonage per common share:		
Basic	\$0.02	\$0.06
Diluted	\$0.02	\$0.06
Weighted-average common shares outstanding:		
Basic	212,195	214,639
Diluted	225,187	223,202

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

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

	Three Months Ended March 31,	
	2014	2013
Net income	\$4,205	\$13,047
Other comprehensive loss:		
Foreign currency translation adjustment	(1,486 )	(624 )
Total other comprehensive loss	(1,486 )	(624 )
Comprehensive income	2,719	12,423
Comprehensive loss attributable to noncontrolling interest:		
Add: Net loss	(383 )	—
Foreign currency translation adjustment	(19 )	—
Total comprehensive loss attributable to noncontrolling interest	(402 )	—
Comprehensive income attributable to Vonage	\$3,121	\$12,423

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

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

	Three Months Ended	
	March 31,	
	2014	2013
Cash flows from operating activities:		
Net income	\$4,205	\$13,047
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization and impairment charges	7,982	7,382
Amortization of intangibles	4,356	593
Deferred tax expense	3,707	7,994
Allowance for doubtful accounts	(98	) (100
Allowance for obsolete inventory	103	112
Amortization of debt related costs	289	388
Share-based expense	6,294	3,982
Changes in operating assets and liabilities:		
Accounts receivable	131	(265
Inventory	4,480	(2,881
Prepaid expenses and other current assets	(2,368	) (1,324
Deferred customer acquisition costs	436	395
Other assets	174	154
Accounts payable	(14,333	) (21,123
Accrued expenses	(5,349	) 2,435
Deferred revenue	(638	) (1,053
Other liabilities	16	16
Net cash provided by operating activities	9,387	9,752
Cash flows from investing activities:		
Capital expenditures	(942	) (2,031
Acquisition and development of software assets	(2,786	) (2,313
(Increase) decrease in restricted cash	(1	) 1,257
Net cash used in investing activities	(3,729	) (3,087
Cash flows from financing activities:		
Principal payments on capital lease obligations	(682	) (582
Principal payments on notes and revolving credit facility	(25,833	) (5,834
Proceeds received from issuance of notes payable	—	27,500
Debt related costs	—	(2,009
Common stock repurchases	(10,011	) (16,712
Proceeds from exercise of stock options, net of stock cancellation payment	1,836	283
Net cash (used in) provided by financing activities	(34,690	) 2,646
Effect of exchange rate changes on cash	(1,359	) (527
Net change in cash and cash equivalents	(30,391	) 8,784
Cash and cash equivalents, beginning of period	84,663	97,110
Cash and cash equivalents, end of period	\$54,272	\$105,894
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	\$1,391	\$971



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Income taxes	\$93	\$291
Non-cash financing transactions during the periods for:		
Common stock repurchases	\$793	\$436

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

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VONAGE HOLDINGS CORP.  
 CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND  
 REDEEMABLE NONCONTROLLING INTEREST

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income	Total	Redeemable non-controlling interest	Net Income
Balance at December 31, 2013	\$ 247	\$ 1,136,289	\$ (697,941 )	\$ (101,040)	\$ 519	\$ 338,074	\$ (38 )	
Stock option exercises	4	1,832				1,836		
Share-based expense		6,294				6,294		
Share-based award activity				(170 )		(170 )		
Common stock repurchases				(10,068 )		(10,068 )		
Foreign currency translation adjustment					(1,467 )	(1,467 )	(19 )	
Net income (loss)			4,588			4,588	(383 )	\$ 4,205
Balance at March 31, 2014	\$ 251	\$ 1,144,415	\$ (693,353 )	\$ (111,278)	\$ (948 )	\$ 339,087	\$ (440 )	

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 cloud-connected devices worldwide. Customers in the United States represented 94% of our subscriber lines for our broadband telephone replacement services at March 31, 2014, with the balance primarily in Canada and the United Kingdom.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows, and statement of stockholders’ equity for the periods presented. The results for the three months ended March 31, 2014 are not necessarily indicative of the results to be expected for the full year.

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

Significant Accounting Policies

Principles of Consolidation

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

Use of Estimates

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

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

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

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

Revenue Recognition

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

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

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

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

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

#### Telephony Services Revenue

Substantially all of our revenues are telephony services revenues, which are derived primarily from monthly subscription fees that customers are charged under our service plans. We also derive telephony services revenues from per minute fees for international calls if not covered under a plan, including calls made via applications for mobile devices and other stand-alone products, and for any calling minutes in excess of a customer's monthly plan limits. Monthly subscription fees are automatically charged to customers' credit cards, debit cards or electronic check payments ("ECP"), in advance and are recognized over the following month when services are provided. Revenues generated from international calls and from customers exceeding allocated call minutes under limited minute plans are recognized as services are provided, that is, as minutes are used, and are billed to a customer's credit cards, debit cards or ECP in arrears. As a result of multiple billing cycles each month, we estimate the amount of revenues earned from international calls and from customers exceeding allocated call minutes under limited minute plans but not billed from the end of each billing cycle to the end of each reporting period and record these amounts as accounts receivable. These estimates are based primarily upon historical minutes and have been consistent with our actual results. We also provide rebates to customers who purchase their customer equipment from retailers and satisfy minimum service period requirements. These rebates in excess of activation fees are recorded as a reduction of revenues over the service period based upon the estimated number of customers that will ultimately earn and claim the rebates. In the United States, we charge regulatory, compliance, E-911, and intellectual property-related fees on a monthly basis to defray costs, and to cover taxes that we are charged by the suppliers of telecommunications services. In addition, we charge customers Federal Universal Service Fund ("USF") fees. We recognize revenue on a gross basis for USF and related fees. We record these fees as revenue when billed. All other taxes are recorded on a net basis.

#### Customer Equipment and Shipping Revenue

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

#### Direct Cost of Telephony Services

Direct cost of telephony services consists primarily of direct costs that we pay to third parties in order to provide telephony services. These costs include access and interconnection charges that we pay to other telephone companies

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

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Direct Cost of Goods Sold

Direct cost of goods sold consists primarily of costs that we incur when a customer signs up for our service. These costs include the cost of customer equipment for customers who subscribe through the direct sales channel in excess of activation fees. In addition, these costs include the amortization of deferred customer equipment, the cost of shipping and handling for customer equipment, the installation manual that accompanies the customer equipment, and the cost of certain promotions.

Development Expenses

Costs for research, including predevelopment efforts prior to establishing technological feasibility of software expected to be marketed, are expensed as incurred. Development costs are capitalized when technological feasibility has been established and anticipated future revenues support the recoverability of the capitalized amounts.

Capitalization stops when the product is available for general release to customers. Due to the short time period between achieving technological feasibility and product release and the insignificant amount of costs incurred during such periods, we have not capitalized any software development, and have expensed these costs as incurred. These costs are included in selling, general and administrative expense.

Cash and Cash Equivalents

We maintain cash with several investment grade financial institutions. Highly liquid investments, which are readily convertible into cash, with original maturities of three months or less, are recorded as cash equivalents.

Certain Risks and Concentrations

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents and accounts receivable. They are subject to fluctuations in both market value and yield based upon changes in market conditions, including interest rates, liquidity, general economic conditions, and conditions specific to the issuers.

Accounts receivable are typically unsecured and are derived from revenues earned from customers primarily located in the United States. A portion of our accounts receivable represents the timing difference between when a customer's credit card is billed and the subsequent settlement of that transaction with our credit card processors. This timing difference is generally three days for substantially all of our credit card receivables. We have never experienced any accounts receivable write-offs due to this timing difference. In addition, we collect subscription fees in advance, minimizing our accounts receivable and bad debt exposure. If a customer's credit card, debit card or ECP is declined, we generally suspend international calling capabilities as well as their ability to incur domestic usage charges in excess of their plan minutes. If the customer's credit card, debit card or ECP could not be successfully processed during three billing cycles (i.e., the current and two subsequent monthly billing cycles), we terminate the account. In addition, we automatically charge any per minute fees to our customers' credit card, debit card or ECP monthly in arrears. To further mitigate our bad debt exposure, a customer's credit card, debit card or ECP will be charged in advance of their monthly billing if their international calling or overage charges exceed a certain dollar threshold.

Inventory

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

Property and Equipment

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



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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Software Costs

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

Goodwill and Purchased-Intangible Assets

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

Purchased-intangible assets are accounted for based upon the fair value of assets received. Purchased-intangible assets are amortized on a straight-line or accelerated basis over the periods of benefit, ranging from two to ten years. We perform a review of purchased-intangible assets whenever events or changes in circumstances indicate that the useful life is shorter than we had originally estimated or that the carrying amount of assets may not be recoverable. If such facts and circumstances exist, we assess the recoverability of purchased-intangible assets by comparing the projected undiscounted net cash flows associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairments, if any, are based on the excess of the carrying amount over the fair value of those assets. If the useful life of the asset is shorter than originally estimated, we accelerate the rate of amortization and amortize the remaining carrying value over the new shorter useful life. There was no impairment of purchased-intangible assets identified for the three months ended March 31, 2014.

Intangible Assets

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

Patents and Patent Licenses

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

Long-Lived Assets

We evaluate impairment losses on long-lived assets used in operations when events and changes in circumstances indicate that the assets might be impaired. If our review indicates that the carrying value of an asset will not be recoverable, based on a comparison of the carrying value of the asset to the undiscounted future cash flows, the impairment will be measured by comparing the carrying value of the asset to its fair value. Fair value will be determined based on quoted market values, discounted cash flows or appraisals. Impairments are recorded in the statement of operations as part of depreciation expense.

Debt Related Costs

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

Redeemable Noncontrolling Interest

We consolidate a majority-owned entity where we have the ability to exercise controlling influence. The ownership interest of the noncontrolling party is presented as noncontrolling interest. If we are required to repurchase the noncontrolling interest at fair value, subject to adjustment, under a put option or other contractual redemption requirement, we will report the noncontrolling interest as redeemable in the Consolidated Balance Sheets between liabilities and equity. We adjust the redeemable noncontrolling interest to the redemption values on each balance sheet date with changes recognized as an adjustment to retained earnings, or in

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

the absence of retained earnings, as an adjustment to additional paid-in capital when it becomes probable the noncontrolling interest will become redeemable.

Derivatives

We do not hold or issue derivative instruments for trading purposes. However, in accordance with FASB ASC 815, “Derivatives and Hedging” (“FASB ASC 815”), we review our contractual obligations to determine whether there are terms that possess the characteristics of derivative financial instruments that must be accounted for separately from the financial instrument in which they are embedded. We recognize these features as liabilities in our consolidated balance sheet at fair value each period and recognize any change in the fair value in our statement of operations in the period of change. We estimate the fair value of these liabilities using available market information and appropriate valuation methodologies.

Income Taxes

We recognize deferred tax assets and liabilities at enacted income tax rates for the temporary differences between the financial reporting bases and the tax bases of our assets and liabilities. Any effects of changes in income tax rates or tax laws are included in the provision for income taxes in the period of enactment. Our net deferred tax assets primarily consist of net operating loss carry forwards (“NOLs”). We are required to record a valuation allowance against our net deferred tax assets if we conclude that it is more likely than not that taxable income generated in the future will be insufficient to utilize the future income tax benefit from our net deferred tax assets (namely, the NOLs) prior to expiration. We periodically review this conclusion, which requires significant management judgment. If we are able to conclude in a future period that a future income tax benefit from our net deferred tax assets has a greater than 50 percent likelihood of being realized, we are required in that period to reduce the related valuation allowance with a corresponding decrease in income tax expense. This would result in a non-cash benefit to our net income in the period of the determination. In the fourth quarter of 2011, we released \$325,601 of valuation allowance. In subsequent periods, we would expect to recognize income tax expense equal to our pre-tax income multiplied by our effective income tax rate, an expense that was not recognized prior to the reduction of the valuation allowance. Our effective rate may differ from the federal statutory rate due, in part, to our foreign operations and certain discrete period items. The 2014 estimated annual effective tax rate is expected to approximate 47%, but may fluctuate due to the timing of other discrete period transactions.

We file income tax returns in the U.S. on a federal basis and in U.S. state and foreign jurisdictions. Our federal tax return remains subject to examination by the Internal Revenue Service from 2010 to present, our New Jersey tax returns remain open from 2008 to present, our Canada tax return remains open from 2009 to present, and other domestic and foreign tax returns remain open for all periods to which those filings relate. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate resolution.

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

Business Combinations

We account for business combinations using the acquisition method of accounting. The acquisition method of accounting requires that the purchase price, including the fair value of contingent consideration, of the acquisition be allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. Goodwill as of the acquisition date is measured as the excess of consideration transferred over the net

of the acquisition date fair values of assets acquired and the liabilities assumed. While the Company uses its best estimates and assumptions as part of the purchase price allocation process to accurately value assets acquired and liabilities assumed at the acquisition date, the Company's estimates are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, the Company records adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill to the extent the Company identifies adjustments to the preliminary purchase price allocation. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded to the consolidated statements of operations. We will include the results of all acquisitions in our Consolidated Financial Statements from the date of acquisition.

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

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

Foreign Currency

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

Share-Based Compensation

We account for share-based compensation in accordance with FASB ASC 718, "Compensation-Stock Compensation". Under the fair value recognition provisions of this pronouncement, share-based compensation cost is measured at the grant date based on the fair value of the award, reduced as appropriate based on estimated forfeitures, and is recognized as expense over the applicable vesting period of the stock award using the accelerated method. The excess tax benefit associated with stock compensation deductions have not been recorded in additional paid-in capital. When evaluating whether an excess tax benefit has been realized, share based compensation deductions are not considered realized until NOLs are no longer sufficient to offset taxable income. Such excess tax benefits will be recorded when realized.

Earnings per Share

Net income per share has been computed according to FASB ASC 260, "Earnings per Share", which requires a dual presentation of basic and diluted earnings per share ("EPS"). Basic EPS represents net income divided by the weighted average number of common shares outstanding during a reporting period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, including stock options and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, were exercised or converted into common stock. The dilutive effect of outstanding stock options and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. In applying the treasury stock method for stock-based compensation arrangements, the assumed proceeds are computed as the sum of the amount the employee must pay upon exercise and the amounts of average unrecognized compensation cost attributed to future services.

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The following table sets forth the computation for basic and diluted net income per share for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31,	
	2014	2013
Numerator		
Numerator for basic earnings per share-net income attributable to Vonage	\$4,588	\$13,047
Numerator for diluted earnings per share-net income attributable to Vonage	\$4,588	\$13,047
Denominator		
Basic weighted average common shares outstanding	212,195	214,639
Dilutive effect of stock options and restricted stock units	12,992	8,563
Diluted weighted average common shares outstanding	225,187	223,202
Basic net income per share		
Basic net income per share	\$0.02	\$0.06
Diluted net income per share		
Diluted net income per share	\$0.02	\$0.06

For the three months ended March 31, 2014 and 2013, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three Months Ended March 31,	
	2014	2013
Restricted stock units	5,701	1,620
Stock options	22,144	21,668
	27,845	23,288

#### Comprehensive Income (Loss)

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

#### Reclassifications

Certain reclassifications have been made to prior years' financial statements in order to conform to the current year's presentation. The reclassifications had no impact on net earnings previously reported.

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Note 2. Supplemental Balance Sheet Account Information  
 Prepaid expenses and other current assets

	March 31, 2014	December 31, 2013
Nontrade receivables	\$7,758	\$7,402
Services	8,674	7,084
Telecommunications	485	479
Insurance	343	757
Marketing	691	312
Other prepaids	1,320	858
Prepaid expenses and other current assets	\$19,271	\$16,892
Property and equipment, net		
	March 31, 2014	December 31, 2013
Building (under capital lease)	\$25,709	\$25,709
Network equipment and computer hardware	77,013	78,312
Leasehold improvements	44,835	44,141
Furniture	731	812
Vehicles	16	109
	148,304	149,083
Less: accumulated depreciation and amortization	(100,383	) (96,840 )
Property and equipment, net	\$47,921	\$52,243
Software, net		
	March 31, 2014	December 31, 2013
Purchased	\$47,689	\$45,178
Licensed	909	909
Internally developed	36,088	36,088
	84,686	82,175
Less: accumulated amortization	(64,007	) (61,618 )
Software, net	\$20,679	\$20,557
Debt related costs, net		
	March 31, 2014	December 31, 2013
Senior secured term loan	\$4,706	\$4,706

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Less: accumulated amortization	(3,682	) (3,393	)
Debt related costs, net	\$1,024	\$1,313	

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## Restricted cash

	March 31, 2014	December 31, 2013
Letter of credit-lease deposits	\$4,307	\$4,306
Cash reserves	100	99
Restricted cash	\$4,407	\$4,405

## Intangible assets, net

	March 31, 2014	December 31, 2013
Customer relationships	\$39,100	\$39,100
Developed technology	35,200	35,200
Patents and patent licenses	18,264	18,264
Trademark	560	560
Trade names	500	500
Non-compete agreements	200	200
	93,824	93,824
Less: accumulated amortization	(21,330	) (16,974
Intangible assets, net	\$72,494	\$76,850

## Accrued expenses

	March 31, 2014	December 31, 2013
Compensation and related taxes and temporary labor	\$13,034	\$20,276
Marketing	25,133	23,277
Taxes and fees	17,893	18,207
Litigation and settlements	239	89
Telecommunications	8,229	7,942
Other accruals	4,566	6,063
Customer credits	1,808	1,719
Professional fees	3,879	2,490
Accrued interest	18	12
Inventory	869	769
Credit card fees	285	283
Accrued expenses	\$75,953	\$81,127

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Note 3. Supplemental Income Statement Account Information  
 Amounts included in revenues

	Three Months Ended March 31,	
	2014	2013
USF fees	\$18,636	\$18,105
Disconnect fees	\$773	\$1,240
Initial activation fees	\$314	\$354
Customer equipment fees	\$411	\$158
Equipment recovery fees	\$20	\$29
Shipping and handling fees	\$379	\$368

Amount included in direct cost of telephony services

	Three Months Ended March 31,	
	2014	2013
USF costs	\$18,693	\$18,105

Amount included in direct cost of goods sold

	Three Months Ended March 31,	
	2014	2013
Shipping and handling cost	\$1,557	\$1,408

Amount included in selling, general and administrative expense

	Three Months Ended March 31,	
	2014	2013
Advertising costs	\$112	\$88
Acquisition related costs	\$20	\$—
Acquisition integration cost	\$94	\$—

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## Amount included in marketing

	Three Months Ended March 31,	
	2014	2013
Advertising costs	\$34,574	\$31,726

## Depreciation and amortization expense

	Three Months Ended March 31,	
	2014	2013
Network equipment and computer hardware	\$3,609	\$3,308
Software	2,715	2,490
Capital leases	550	549
Other leasehold improvements	1,073	1,004
Furniture	34	27
Vehicles	1	5
Patents	576	594
Trademarks	18	—
Customer relationship	2,134	—
Acquired technology	1,574	—
Trade names	50	—
Non-compete agreements	4	—
	12,338	7,977
Property and equipment impairments	—	(2 )
Depreciation and amortization expense	\$12,338	\$7,975

## Amount included in interest expense

	Three Months Ended March 31,	
	2014	2013
Debt related costs amortization	\$289	\$388

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

	Three Months Ended March 31,	
	2014	2013
Net (loss) income resulting from foreign exchange transactions	\$(15 )	\$(40 )



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Note 4. Long-Term Debt and Revolving Credit Facility

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

	March 31, 2014	December 31, 2013
3.125-3.625% Credit Facility - due 2016	\$17,500	\$23,333
3.125-3.625% Revolving Credit Facility - due 2016	55,000	75,000

At March 31, 2014, future payments under long-term debt obligations over each of the next five years and thereafter were as follows:

	Credit Facility
2014	\$17,500
2015	23,333
2016	55,000
Minimum future payments of principal	95,833
Less: current portion	23,333
Long-term portion	\$72,500

2013 Financing

On February 11, 2013 we entered into Amendment No. 1 to the 2011 Credit Agreement (as further amended by Amendment No. 2 to our 2011 Credit Facility, the "2013 Credit Facility"). The 2013 Credit Facility consists of a \$70,000 senior secured term loan and a \$75,000 revolving credit facility. The co-borrowers under the 2013 Credit Facility are our wholly owned subsidiary, Vonage America Inc., and us. Obligations under the 2013 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. On July 26, 2013 we entered into Amendment No. 2 to our 2011 Credit Agreement, which amends our financial covenant related to our consolidated fixed charge coverage ratio by increasing the amount of restricted payments excluded from such calculation from \$50,000 to \$80,000.

Use of Proceeds

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

2013 Credit Facility Terms

The following description summarizes the material terms of the 2013 Credit Facility:

The loans under the 2013 Credit Facility mature in February 2016. Principal amounts under the 2013 Credit Facility are repayable in quarterly installments of \$5,833 per quarter for the senior secured term loan. The unused portion of our revolving credit facility incurs a 0.45% commitment fee.

Outstanding amounts under the 2013 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 3.125% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.375% 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 3.625% if our consolidated leverage ratio is greater than or equal to

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1.50 to 1.00, payable on the last day of each relevant interest period or, if the interest period is longer than 3 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 2.125% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.275% 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 2.625% 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 2013 Credit Facility.

The 2013 Credit Facility provides greater flexibility to us in funding acquisitions and restricted payments, such as stock buybacks, than the 2011 Credit Facility.

We may prepay the 2013 Credit Facility at our option at any time without premium or penalty. The 2013 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 2013 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 2013 Credit Facility. The 2013 Credit Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition, the 2013 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 subject to adjustment to exclude up to \$80,000 in specified restricted payments;
- minimum cash of \$25,000 including the unused portion of the revolving credit facility or \$35,000 in the event of certain specified corporate actions; and

maximum capital expenditures not to exceed \$55,000 during any fiscal year, provided that the unused amount of any permitted capital expenditures in any fiscal year may be carried forward to the next following fiscal year; in addition, annual excess cash flow up to \$8,000 increases permitted capital expenditures.

As of March 31, 2014, we were in compliance with all covenants, including financial covenants, for the 2013 Credit Facility.

The 2013 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.

Note 5. Common Stock

Net Operating Loss Rights Agreement

On June 7, 2012, we entered into a Tax Benefits Preservation Plan ("Preservation Plan") designed to preserve stockholder value and tax assets. Our ability to use our tax attributes to offset tax on U.S. taxable income would be substantially limited if there were an "ownership change" as defined under Section 382 of the U.S. Internal Revenue Code. In general, an ownership change would occur if one or more "5-percent shareholders," as defined under Section 382, collectively increase their ownership in us by more than 50 percent over a rolling three-year period.

In connection with the adoption of the Preservation Plan, our board of directors declared a dividend of one preferred share purchase right for each outstanding share of the Company's common stock. The preferred share purchase rights were distributed



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to stockholders of record as of June 18, 2012, as well as to holders of the Company's common stock issued after that date, but will only be activated if certain triggering events under the Preservation Plan occur.

Under the Preservation Plan, preferred share purchase rights will work to impose significant dilution upon any person or group which acquires beneficial ownership of 4.9% or more of the outstanding common stock, without the approval of our board of directors, from and after June 7, 2012. Stockholders that own 4.9% or more of the outstanding common stock as of the opening of business on June 7, 2012, will not trigger the preferred share purchase rights so long as they do not (i) acquire additional shares of common stock or (ii) fall under 4.9% ownership of common stock and then re-acquire shares that in the aggregate equal 4.9% or more of the common stock.

The Preservation Plan was set to expire no later than the close of business June 7, 2013, unless extended by our board of directors. On April 4, 2013, after consultation with our advisors, our board of directors determined to extend the Preservation Plan through June 7, 2015, subject to ratification of the extension by stockholders at the Vonage 2013 annual meeting of stockholders. On June 6, 2013, at the Vonage 2013 annual meeting of stockholders, stockholders ratified the extension of the Preservation Plan through June 7, 2015.

**Common Stock Repurchases**

On July 25, 2012, our board of directors authorized a program to repurchase up to \$50,000 of Vonage common stock (the "\$50,000 repurchase program") through December 31, 2013. The specific timing and amount of repurchases would vary based on available capital resources and other financial and operational performance, market conditions, securities law limitations, and other factors. The repurchases would be made using our cash resources.

We repurchased the following shares of common stock with cash resources under the \$50,000 repurchase program during the three months ended March 31, 2013:

	Three Months Ended March 31, 2013
Shares of common stock repurchased	2,189
Value of common stock repurchased	\$5,374

On February 7, 2013, our board of directors discontinued the remainder of our existing \$50,000 repurchase program effective at the close of business on February 12, 2013 with \$16,682 of availability remaining, and authorized a new program to repurchase up to \$100,000 of Vonage common stock (the "\$100,000 repurchase program") by December 31, 2014. The specific timing and amount of repurchases will vary based on available capital resources and other financial and operational performance, market conditions, securities law limitations, and other factors. The repurchases will be made using our cash resources. The \$100,000 repurchase program may be suspended or discontinued at any time without prior notice.

We repurchased the following shares of common stock with cash resources under the \$100,000 repurchase program during the three months ended March 31, 2014:

	Three Months Ended March 31,	
	2014 (1)	2013 (2)
Shares of common stock repurchased	2,447	4,039
Value of common stock repurchased	\$10,043	\$11,007

(1) including 186 shares, or \$791, of common stock repurchases settled in April 2014; excluding commission of \$2.

(2) including 150 shares, or \$433, of common stock repurchases settled in April 2013; excluding commission of \$3.

As of March 31, 2014, approximately \$39,304 remained of our \$100,000 repurchase program. The repurchase program expires on December 31, 2014 but may be suspended or discontinued at any time without notice.

In any period under either repurchase program, cash used in financing activities related to common stock repurchases may differ from the comparable change in stockholders' equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

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Stock Option Cancellation

As part of our strategy to build shareholder value and to facilitate our goal of reducing the number of shares of common stock outstanding, on February 19, 2013, we entered into an agreement with our Chief Executive Officer to cancel a total of 4,500 of his vested stock options for \$5,463. The payment reflects a discount, in favor of the Company, from the closing price of the common stock on the New York Stock Exchange on February 19, 2013.

Note 6. Commitments and Contingencies

Litigation

IP Matters

Bear Creek Technologies, Inc. On February 22, 2011, Bear Creek Technologies, Inc. (“Bear Creek”) filed a lawsuit against Vonage Holdings Corp., Vonage America, Inc., Vonage Marketing LLC, and Aptela Inc. (a subsidiary of Vocalocity, Inc., a wholly-owned subsidiary of the Company which was acquired on November 15, 2013 pursuant to an Agreement and Plan of Merger dated October 9, 2013) in the United States District Court for the Eastern District of Virginia (Norfolk Division) alleging that Vonage’s and Aptela’s products and services are covered by United States Patent No. 7,889,722, 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 August 17, 2011, the Court dismissed Bear Creek’s case against the Vonage entities and Aptela, 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; and also re-filed a separate complaint concerning the ‘722 Patent in the United States District Court for the Eastern District of Virginia against Aptela. In each complaint, Bear Creek alleges that Vonage and Aptela, respectively, are infringing one or more claims of the ‘722 Patent. In addition, Bear Creek alleges that each party is contributing to and inducing infringement of one or more claims of the ‘722 Patent. On January 25, 2012, Bear Creek filed a motion with the United States Judicial Panel on Multidistrict Litigation seeking to transfer and consolidate its litigations against Vonage and Aptela with twelve other separate actions Bear Creek filed in the U.S. District Courts for Delaware and the Eastern District of Virginia. On May 2, 2012, the Multidistrict Litigation Panel granted Bear Creek’s motion and ordered the coordination or consolidation for pretrial proceedings of all fourteen actions in the U.S. District Court for the District of Delaware. On October 11, 2012, Vonage filed an answer to Bear Creek’s complaint, including counterclaims of non-infringement and invalidity of the ‘722 patent. Aptela, which filed a motion to dismiss Bear Creek’s complaint on September 27, 2011, has not yet answered, as its motion remains pending and awaiting disposition by the court. On November 5, 2012, Bear Creek filed an answer to Vonage’s counterclaims. On March 1, 2013, several defendants including Vonage moved the Court to stay the case pending resolution of the reexamination of the ‘722 patent requested by Cisco Systems, Inc. (“Cisco”) as described below; the motion was granted on July 17, 2013, and the case is now stayed pending the resolution of the reexamination. On November 8, 2013, the Court granted Bear Creek’s request to terminate and substitute counsel representing it in the litigation.

On March 8, 2012, a third-party requested the United States Patent and Trademark Office (“USPTO”) to reexamine the validity of the asserted ‘722 Patent. The USPTO granted the request on April 26, 2012, and subsequently issued an initial Office Action rejecting all of the ‘722 Patent claims. After reconsideration based on statements made by the patentee, the USPTO on September 19, 2012, reversed its initial rejection, and confirmed all claims as patentable over the references cited in the reexamination request. A second request for reexamination of the ‘722 Patent was filed on September 12, 2012, by Cisco, challenging the validity of the ‘722 Patent. Cisco’s request was granted by the USPTO on November 28, 2012. On March 24, 2014, the Patent Office issued an Action Closing Prosecution, confirming its rejection of all claims of the ‘722 patent on multiple independent grounds. A third request for reexamination of the ‘722

Patent was filed on September 14, 2012, and the USPTO denied this request on December 6, 2012. OpinionLab, Inc. On July 18, 2012, OpinionLab, Inc. (“OpinionLab”) filed a lawsuit against IPerceptions, Inc. and IPerceptions US, Inc. (collectively, “IPerceptions”) in the United States District Court for the Northern District of Illinois (Eastern Division) alleging claims of patent infringement, breach of contract, misappropriation of trade secrets, and tortious interference with business expectancy. On August 16, 2012, OpinionLab filed an amended complaint, adding Vonage Marketing LLC and Vonage Holdings Corp. as defendants, and alleging that Vonage’s products and services are covered by United States Patent Nos. 6,421,724, 6,606,581, 6,928,392, 7,085,820, 7,370,285, 8,024,668, and 8,041,805. OpinionLab alleged direct, indirect and willful infringement by Vonage. IPerceptions, the supplier to Vonage of the accused product in this lawsuit, has agreed to fully defend and indemnify Vonage in this lawsuit. On September 11, 2012, IPerceptions and Vonage each moved to dismiss OpinionLab’s indirect and willful patent infringement claims. The motions were denied on November 8, 2012. Vonage answered the complaint

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on December 7, 2012. On July 11, 2013, the Court issued an order setting the case schedule. On September 6, 2013, OpinionLab filed a second amended complaint, which defendants answered on September 23, 2013. On October 14, 2013, OpinionLab made an unopposed motion to consolidate the case for pre-trial purposes with Case No. 13-CV-1574, OpinionLab, Inc. v. Qualtrics Labs, Inc., currently pending in the United States District Court for the Northern District of Illinois. The motion was granted October 17, 2013. On February 14, 2014, defendants Vonage and iPerceptions moved to stay the case pending inter partes reviews requested by Qualtrics as to the '724, '581, '820, '285, '668 and '805 patents.

RPost Holdings, Inc. On August 24, 2012, RPost Holdings, Inc., RPost Communications Limited, and RMail Limited (collectively, "RPost") filed a lawsuit against StrongMail Systems, Inc. ("StrongMail") in the United States District Court for the Eastern District of Texas (Marshall Division) alleging that StrongMail's products and services, including its electronic mail marketing services, are covered by United States Patent Nos. 8,224,913, 8,209,389, 8,161,104, 7,966,372, and 6,182,219. On January 16, 2013, StrongMail moved the Court to transfer the venue of the lawsuit to the Northern District of California. That motion was denied by the Court on August 19, 2013. On February 11, 2013, RPost filed an amended complaint, adding 27 new defendants, including Vonage America Inc. RPost's amended complaint alleges willful infringement of the RPost patents by Vonage and each of the other new defendants because they are customers of StrongMail. StrongMail has agreed to fully defend and indemnify Vonage in this lawsuit. Vonage answered the complaint on May 7, 2013. On January 30, 2014, RPost informed the Court that it is ready for a scheduling conference; the Court has not yet scheduled a conference.

Straight Path IP Group Inc. On November 4, 2013, Straight Path IP Group Inc. ("Straight Path"), a subsidiary of Straight Path Communications Inc., filed a lawsuit against Vonage Holdings Corp., Vonage America, Inc., and Vonage Marketing LLC in the U.S. District Court for the Eastern District of Virginia (Norfolk Division) alleging that Vonage's products and services are covered by United States Patent Nos. 6,009,469, 6,131,121, 6,513,066, and 6,701,365. Straight Path alleged direct and indirect infringement by Vonage. On December 20, 2013, Vonage moved to transfer the case to the District of New Jersey and that motion was granted by the court on January 17, 2014. On December 30, 2013, Vonage answered the complaint and filed a motion to dismiss Straight Path's claims for induced and contributory infringement. In response, Straight Path amended its complaint on January 7, 2014. On February 7, 2014, Vonage answered the amended complaint and moved to dismiss Straight Path's claims for indirect infringement. On March 26, 2014, the Court granted Vonage's motion to dismiss in its entirety, dismissing Straight Path's induced and contributory infringement claims without prejudice. Straight Path filed a second amended complaint on April 23, 2014. On April 16, 2014, Vonage moved to stay the case pending inter partes reviews requested by Sony Corporation as to the '121 and '469 patents. The Court is scheduled to hear Vonage's motion on May 19, 2014.

Previously, on August 2, 2013, Straight Path filed a lawsuit against Vocalocity, Inc. in the U.S. District Court for the Eastern District of Virginia (Richmond Division) alleging that Vocalocity's products and services are covered by the '066 and '365 patents. Straight Path alleged direct and indirect infringement by Vocalocity. On September 11, 2013, the lawsuit was ordered consolidated with two other lawsuits by Straight Path filed in early August 2013 against Bandwidth.com, Inc. and Telesphere Networks Ltd., relating to the same patents. On October 15, 2013, Vocalocity moved to dismiss the complaint for failure to state a claim upon which relief could be granted. On October 18, 2013, Straight Path filed an amended complaint. Vocalocity answered the amended complaint on November 4, 2013, and asserted counterclaims for declaratory judgment of non-infringement and invalidity against both patents. Straight Path answered the counterclaims on November 20, 2013. On January 13, 2014, the Court dismissed the case against Bandwidth, based on the parties' settlement. Discovery concluded on February 14, 2014. On February 17, 2014, defendants Vocalocity and Telesphere each moved for summary judgment of non-infringement of the asserted patent claims; Vocalocity additionally moved for summary judgment of no pre-suit damages based on Straight Path's failure

to comply with the patent marking statute. On February 20, 2014, the Court held a pretrial conference, setting a trial date of June 23, 2014. Also on February 20, 2014, the defendants moved to sever their cases for trial. On February 25, 2014, the Court issued its Markman order, construing several terms of the asserted patents. Oral argument on the motions for summary judgment and the motion to sever took place on March 21, 2014 and are pending the Court's decision. A court-ordered mediation was held on April 30, 2014.

AIP Acquisition LLC. On January 3, 2014, AIP Acquisition LLC ("AIP"), filed a lawsuit against Vonage Holdings Corp., Vonage America, Inc., and Vonage Marketing LLC in the U.S. District Court for the District of Delaware (Norfolk Division) alleging that Vonage's products and services are covered by United States Patent No. 7,269,247. Vonage filed an answer and counterclaims on February 25, 2014. AIP filed an amended complaint on March 18, 2014, which Vonage answered on April 4, 2014. On April 8, 2014, the Court ordered a stay of the case pending final resolution of non-party Level 3's inter partes review request of United States Patent No. 7,724,879, which is a continuation of the '247 patent.

#### Commercial Litigation

Merkin & Smith, et als. On September 27, 2013, Arthur Merkin and James Smith filed a putative class action lawsuit against Vonage America, Inc. in the Superior Court of the State of California, County of Los Angeles, alleging that Vonage violated

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(In thousands, except per share amounts)

(Unaudited)

California's Unfair Competition Law by charging its customers fictitious 911 taxes and fees. On October 30, 2013, Vonage filed a notice removing the case to the United States District Court for the Central District of California. On October 30, 2013 the case was assigned to a United States District Judge and a Magistrate Judge. On November 26, 2013, Vonage filed its Answer to the Complaint. On December 4, 2013, Vonage filed a Motion to Compel Arbitration. On February 4, 2014, the Court denied Vonage's Motion to Compel Arbitration. On March 5, 2014, Vonage filed an appeal with the United States Court of Appeals for the Ninth Circuit of the decision denying Vonage's Motion to Compel Arbitration. On March 6, 2014, Vonage moved to stay the district court proceedings pending its appeal; the Court granted Vonage's stay motion on March 26, 2014. On April 30, 2014, the Ninth Circuit held a Mediation Assessment Conference.

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 inviting us to obtain patent licenses that might be relevant to our business or alleging that our services infringe upon third party patents or other intellectual property. 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, if any, 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. 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 and our inability to reasonably estimate the amount of loss or range of loss, 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 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 - 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. A number of parties filed appeals of the rules. On January 14, 2014, the D.C. Circuit vacated the anti-blocking and the unreasonable discrimination provisions of the rules. The D.C. Circuit decision did not foreclose the FCC from adopting anti-blocking or non-discrimination rules. On February 19, 2014, FCC Chairman Tom Wheeler announced that the FCC would not appeal the D.C. Circuit decision, electing to pursue restoration of the vacated provisions using the authority that the FCC has over broadband services, as recognized by the D.C. Circuit. The FCC is scheduled to vote on a Notice of Proposed Rulemaking at its May 15, 2014.

Federal - Intercarrier Compensation

On February 9, 2011, the FCC released a Notice of Proposed Rulemaking 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



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of proposals for how VoIP should 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). Numerous parties filed appeals of the FCC order in multiple federal circuit courts of appeal. The 10th Circuit Court of Appeals was selected by lottery to decide the appeals. The appeals are pending.

Federal - Universal Service Contribution Reform

On April 30, 2012, the FCC released a Further Notice of Proposed Rulemaking on reforming federal universal service fund ("USF") contributions. Currently USF contributions are assessed on the interstate and international revenue of traditional telephone carriers and interconnected VoIP providers like Vonage. The level of USF assessments on these providers has been going up over time because of decreases in the revenue subject to assessment due to substitution of non-assessable services such as non-interconnected VoIP services. If the FCC does reform USF contributions, it is likely that Vonage's contribution burden will decline.

Federal - Rural Call Completion Issues

On February 7, 2013, the FCC released a Notice of Proposed Rulemaking on rural call completion issues. The Notice of Proposed Rulemaking (NPRM) proposed new detailed reporting requirements to gauge rural call completion performance. Rural carriers have argued that VoIP provider call completion performance to rural areas is generally poor. On October 28, 2013, the FCC adopted an order on rural call completion that imposes new reporting obligations and restricts certain call signaling practices. The call signaling rules went into effect on January 31, 2014. We filed for extensions that the FCC granted on January 30, 2014 and February 28, 2014 and as of April 17, 2014, we are compliant with the new FCC call signaling rules. We could be subject to an FCC enforcement action in the future in the event the FCC took the position that our rural call completion performance is inadequate or we were not compliant with the FCC's order.

Federal - Numbering Rights

On April 18, 2013, the FCC issued a Notice of Proposed Rulemaking (NPRM) that proposing to modify FCC rules to allow VoIP providers to directly access telephone numbers. In addition, the FCC granted a waiver from its existing rules to allow Vonage to conduct a trial of direct access to telephone numbers. The trial would allow the FCC to obtain real-world data on direct access to telephone numbers by VoIP providers to inform consideration of the NPRM. Direct access to telephone numbers would facilitate IP to IP interconnection, which may allow VoIP providers to provide higher quality, lower cost services, promote the deployment of innovative new voice services, and experience reductions in the cost of telephony services. Vonage successfully completed the trial in certain markets and filed the required reports on the trial with the FCC. On January 31, 2014, the FCC Wireline Competition Bureau issued a positive report on the trial, concluding that Vonage's successful trial confirmed the technical feasibility of interconnected VoIP providers obtaining telephone numbers directly from the numbering administrators. Given the positive report, the FCC may adopt its proposed rule to allow VoIP providers to directly access telephone numbers.

Pakistan Termination Rate Increase

On October 1, 2012, Pakistani carriers formed the International Clearing House (ICH). This cartel subsequently took action to increase the cost to terminate international calls to Pakistan by approximately 500 percent. As a result of the implementation of higher termination costs, Vonage was forced to remove Pakistan from unlimited calling in its Vonage World plan. Vonage filed a petition at the FCC, shortly after the ICH rates became effective, seeking an order

prohibiting U.S. carriers from paying the new higher ICH rates. On March 5, 2013, the FCC issued an order that prohibits U.S. carriers from paying more than the prevailing termination rate prior to the implementation of the ICH rates. In addition to the Vonage challenge in the U.S., a Pakistani carrier challenged the ICH action under Pakistani competition law. After the trial court found that the ICH violated Pakistani competition law, the Supreme Court of Pakistan overturned the trial court decision and remanded the case to the Competition Commission of Pakistan (CCP). On April 30, 2013, the CCP issued an order that holds that the ICH violates Pakistani competition law. On May 9, 2013, the Sindh High Court temporarily suspended the CCP order while the court considers constitutional challenges to the order made by several Pakistani carriers. Despite favorable action by both U.S. and Pakistani authorities, it is currently unclear if or how long it will take for international termination rates in Pakistan to return to a more competitive level.

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(Unaudited)

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 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 \$4,307 and \$4,306, as of March 31, 2014 and December 31, 2013, 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 marketing infrastructure and services from a vendor. We have committed to pay this vendor approximately \$410 in 2014, \$1,641 in 2015 and 2016, and \$1,231 in 2017 respectively. We may terminate the contract sooner subject to a minimum payment of \$1,390 .

We have committed to purchase customer care services from a vendor. We have committed to pay this vendor approximately \$3,735 in 2014, \$4,980 in 2015, and \$1,245 in 2016 respectively. We may terminate the contract sooner subject to a minimum payment of \$2,490.

We have committed to purchase software licenses from vendors. We have committed to pay these vendors approximately \$1,182 in 2014, \$1,966 in 2015 and 2016, \$943 in 2017, \$214 in 2018, and \$36 in 2019, respectively.

We have committed to purchase network services from a vendor. We have committed to pay this vendor approximately \$990 in 2014 and 2015, respectively.

#### 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

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(Unaudited)

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, we are now collecting and remitting sales taxes in certain of those states including a number of states that have changed their statutes to expressly include VoIP. 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 \$6,308 as of March 31, 2014 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is approximately \$8,000 as of March 31, 2014.

## Note 7. Redeemable Noncontrolling Interest

In the third quarter of 2013, we formed a consolidated foreign subsidiary in Brazil in connection with our previously announced joint venture in Brazil, creating a redeemable noncontrolling interest. The redeemable noncontrolling interest consists of the 30.0% interest in this subsidiary held by our joint venture partner.

Pursuant to the stockholder agreement governing the joint venture, we have the right to purchase this noncontrolling interest (“call right”) from the joint venture partner and our joint venture partner has the right to sell the noncontrolling interest (“put right”) to us subject to certain triggering events. The amounts at which the call right can be exercised are based on appraised value as prescribed by the stockholder agreement, subject to certain adjustments ranging from 50% to 150%, multiplied by the noncontrolling interest holder’s percentage ownership of the subsidiary that is subject to the triggering event. The amounts at which the put right can be exercised are based on appraised value as prescribed by the stockholder agreement, subject to certain adjustments ranging from 50% to 120%, multiplied by the noncontrolling interest holder’s percentage ownership of the subsidiary that is subject to the triggering event. We adjust the redeemable noncontrolling interest to the redemption values at the end of each reporting period should it become probable that the noncontrolling interest will be redeemable. At that time the changes in the noncontrolling interest will be recognized as an adjustment to retained earnings, or in the absence of retained earnings, as an adjustment to additional paid-in capital.

On December 3, 2013, we extended a loan of \$545 to our consolidated foreign subsidiary in Brazil pursuant to the shareholder agreement to meet the capital call requirement of our joint venture partner. The loan bore interest at a rate equal to 105% of rate of the Sistema Especial de Liquidação e Custódia (SELIC) (“SELIC Rate”).

In February 2014, pursuant to the shareholder agreement, we notified our joint venture partner that we are exercising our dilution rights as our joint venture partner did not meet a second successive capital call on December 17, 2013. As such, the loan that was provided in December will be converted to equity and we will make the second missed capital call of \$503. The dilution process was completed at the end of March 2014, increasing our ownership interest to 91%

We have provided our joint venture partner with an opportunity to repurchase their diluted equity by making the first capital call in 2014, which is expected to occur in May 2014, in addition to the two previously missed capital calls. Pursuant to the shareholder agreement, the price to be paid by our joint venture partner in order to repurchase their diluted equity is equal to (i) the loan principal amount adjusted from its disbursement date until the date of the repurchase, at a rate equal to 105% of the rate of the SELIC Rate pro rata; plus (ii) \$503, adjusted from December 17, 2013 to the date of the repurchase, at a rate equal to 107% of the SELIC Rate pro rata; and (iii) their share of joint venture losses for diluted equity from the dilution date through the repurchase date.



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## 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; our ability to establish and expand strategic alliances; governmental regulation and related actions and taxes; increased market and competitive risks, including currency restrictions; risks related to the acquisition or integration of businesses or joint ventures; the impact of fluctuations in economic conditions, particularly on our small and medium business customers; our ability to obtain or maintain relevant intellectual property licenses; intellectual property and other litigation that have been and may be brought against us; failure to protect our trademarks and internally developed software; security breaches and other compromises of information security; our dependence on third party facilities, equipment, systems and services; system disruptions or flaws in our technology and systems; uncertainties relating to regulation of VoIP services; liability under anti-corruption laws; results of regulatory inquiries into our business practices; fraudulent use of our name or services; our ability to maintain data security; our dependence upon key personnel; our dependence on our customers' existing broadband connections; differences between our service and traditional phone services; restrictions in our debt agreements that may limit our operating flexibility; our ability to obtain additional financing if required; any reinstatement of holdbacks by our vendors; our history of net losses and ability to achieve consistent profitability in the future; the Company's available capital resources and other financial and operational performance which may cause the Company not to make common stock repurchases as currently anticipated or to commence or suspend such repurchases from time to time without prior notice; 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 people through cloud-connected 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. 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 our customers attractively priced voice and messaging services and other features around the world on a variety of devices.

Since its inception, Vonage has used IP technology to disrupt large existing markets by offering high-value, low cost communications services. From its start-up roots, the Company has evolved into a leader in the VoIP services market, with 2.6 million customer lines serving residential and small and medium business customers. Customers using our core Vonage landline replacement service are located in the United States (94% of lines), Canada and the UK. Our mobile applications serve customers around the world.

Key to the Company's evolution was our strategic, operational and financial transformation, which was largely completed in 2012. This transformation resulted in a dramatic swing to profitability enabled by significant cost reductions, a meaningful lowering of customer defections, and the successful restructuring our balance sheet. This

transformation positioned the Company to pursue our current growth strategy.

Strategically, we shifted our primary focus in our domestic markets to serving the rapidly growing but under-served ethnic segments in the United States with international calling needs. We improved the customer value proposition by being the first to deliver flat-rate, unlimited calling to over 60 countries with the launch of our Vonage World service, and we differentiated our service by providing enhanced features, including our mobile Extensions service, at no extra cost. These strategic shifts have resulted in new customers with a higher average lifetime value and a better churn profile than those in the past.

Our focus on operations during this period has resulted in a significantly improved cost structure. We have implemented operational efficiencies throughout our business and have reduced domestic and international termination costs per minute, and



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customer care costs. Importantly, we have enabled structural cost reductions while significantly improving network call quality and customer service performance. Improvements in the overall customer experience have contributed to lower churn, which has remained in the mid 2% range for six consecutive quarters.

Through debt refinancings in December 2010, July 2011, and February 2013, we have fundamentally improved our balance sheet, reducing interest rates from as high as 20% in 2009 to less than 4%.

In part as a result of our operational and financial stability, and our disciplined approach to cash management, we established our share repurchase program which was first instituted in August of 2012. The Company currently has a \$100,000 repurchase authorization in place which expires on December 31, 2014. We believe our repurchase program reflects our balanced approach to capital allocation as we invest for growth through our growth priorities and deliver value to shareholders without compromising our ongoing operational needs.

Having achieved operational and financial stability, we are focused on driving revenue through three major growth priorities. The first of these is continued penetration of our core North American markets, where we will continue to provide value in international long distance and target under-served ethnic segments, where we have entered the low-end domestic market with our flanker brand, BasicTalk, a low-priced home phone service offering unlimited calling throughout the United States, and where we have expanded our offering to small and medium business (SMB) and small office, home office (SOHO) customers through the acquisition of Vocalocity, Inc. Our second growth priority is international expansion outside of North America through strategic partnerships. Finally, our third growth priority is mobile services, which we view as a strategic enabler of the Company's entire product offering.

We had approximately 2.6 million subscriber lines for broadband telephone replacement services as of March 31, 2014. We bill customers in the United States, Canada, and the United Kingdom. Customers in the United States represented 94% of our subscriber lines at March 31, 2014.

## Trends and Key Operating Data

A number of trends in our industry have a significant effect on our results of operations and are important to an understanding of our financial statements.

**Competitive landscape.** We face intense competition from traditional telephone companies, wireless companies, cable companies, and alternative communication providers. Most traditional wireline 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. In addition, such competitors may in the future require new customers or existing customers making changes to their service to purchase voice services when purchasing high speed Internet access. 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 wireline service. We also compete against alternative communication providers, such as magicJack, Skype, and Google Voice. 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 facing competition from emerging competitors focused on similar integration, as well as from 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. In connection with our increasing emphasis on the international long distance market in the United States, we face competition from low-cost international calling cards and VoIP providers in addition to traditional telephone companies, cable companies, and wireless companies.

**Broadband adoption.** The number of United States households with broadband Internet access has grown significantly. On March 16, 2010, the Federal Communications Commission ("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.

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. A November 2010 order by the FCC that permits states to impose state universal service fund obligations on VoIP service, discussed in Note 10 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.

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These rules made it more difficult for broadband Internet service providers to block or discriminate against Vonage service. On January 14, 2014, the D.C. Circuit Court of Appeals vacated the anti-blocking and the unreasonable discrimination provisions of the rules. The D.C. Circuit decision did not foreclose the FCC from adopting anti-blocking or non-discrimination rules. On February 19, 2014, FCC Chairman Tom Wheeler announced that the FCC would not appeal the D.C. Circuit decision, electing to pursue restoration of the vacated provisions using the authority that the FCC has over broadband services, as recognized by the D.C. Circuit. The FCC is scheduled to vote on a Notice of Proposed Rulemaking at its May 15, 2014. In addition, on February 9, 2011, the FCC released a Notice of Proposed Rulemaking on reforming universal service and the intercarrier compensation (“ICC”) system that governs payments between telecommunications carriers primarily for terminating traffic. 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”). 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). Numerous parties filed appeals of the FCC’s ICC order. We believe that the order, if effected, will positively impact our costs over time.

The table below includes key operating data that our management uses to measure the growth and operating performance of our business:

	Three Months Ended	
	March 31,	
	2014	2013
Gross subscriber line additions	191,413	148,003
Change in net subscriber lines	12,503	(12,400 )
Subscriber lines (at period end)	2,555,429	2,347,416
Average monthly customer churn	2.6	% 2.5
Average monthly operating revenues per line	\$28.86	\$29.61
Average monthly direct cost of telephony services per line	\$6.88	\$7.82
Marketing costs per gross subscriber line addition	\$299	\$349
Employees (excluding temporary help) (at period end)	1,287	966

**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 paid subscriber lines from which a customer can make an outbound telephone call on that date. Our subscriber lines include fax lines including fax lines bundled with subscriber lines in our small office home office calling plans and soft phones but do not include our virtual phone numbers or toll free numbers, which only allow inbound telephone calls to customers. Subscriber lines increased from 2,347,416 as of March 31, 2013 to 2,555,429 as of March 31, 2014, which includes lines at acquisition from Vocalocity. For the three months ended March 31, 2014, we added 12,503 subscriber lines.

**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 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 was 2.6% for the three months ended March 31, 2014 compared to 2.5% for the three months ended March 31, 2013 and from 2.5% for the three months ended December 31 2013. The increase was due primarily to the

higher early life churn rate of customers acquired through retail channels without a minimum service requirement, including assisted selling and community sales channels, which have increased as a percentage of our total customer base. 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 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. In addition, our customers who are international

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callers generally churn at a lower rate than customers who are domestic callers. Our churn will fluctuate over time due to economic conditions, competitive pressures, 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 revenues per line.** Average monthly revenues per line for a particular period is calculated by dividing our revenues 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 revenues per line decreased slightly to \$28.86 for the three months ended March 31, 2014 compared to \$29.61 for the three months ended March 31, 2013 due primarily to rate plan mix. The continued expansion of lower priced plan offerings including BasicTalk to meet customer needs may cause downward pressure on average monthly revenues per line, offset by any selected pricing actions.

**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 \$6.88 for the three months ended March 31, 2014 compared to \$7.82 for the three months ended March 31, 2013, due primarily to the decrease in termination costs driven by more favorable rates negotiated with our service providers and the decrease in our network costs and in our E-911 costs.

**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 lower at \$299 for the three months ended March 31, 2014 compared to \$349 for the three months ended March 31, 2013 as a result of higher gross subscriber line additions driven by BasicTalk and Vonage Business Solutions.

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

#### Revenues

Revenues consist of telephony services revenue and customer equipment and shipping revenue. Substantially all of our revenues are telephony services revenue. In the United States, we offer domestic and international rate plans to meet the needs of our customers, including a variety of residential plans and mobile plans. The “Vonage World” plan, 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 China, subject to certain restrictions, and voicemail to text messages with Vonage Visual Voicemail. 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 offer similar plans in Canada. 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. Through our recent acquisition of Vocalocity, we offer SMB and SOHO customers several service plans with different pricing structures under the Vonage Business Solutions brand. The service plans include an array of basic and enhanced features applicable to the needs of SMB and SOHO customers. Customers also have the opportunity to purchase premium features for additional fees.

We are integrating the combined operations of Vocalocity, now under the Vonage Business Solutions brand, with Vonage, eliminating overlapping processes and integrating products and sales efforts. We are also optimizing lead flow generated by the Vonage brand, directing prospective business customers from Vonage inbound telemarketing or

websites to the Vonage Business Solutions website and inbound telesales channels. We expect these efforts to shift certain core gross subscriber line additions and revenue from the Vonage consumer business to Vonage Business Solutions, leading to subscriber additions with higher total lines and average monthly revenue per line.

In addition to our landline telephony business, we are leveraging our technology to offer services and applications for mobile and other connected devices to address large existing markets. We introduced our first mobile offering in late 2009 and in early 2012 we introduced Vonage Mobile, our all-in-one mobile application that provides free calling and messaging between users who have the application, as well as traditional paid international calling to any other phone. This mobile application works over WiFi, 3G and 4G and in more than 90 countries worldwide. The application consolidates the best features of our prior applications, while adding important functionality, value and ease of use, including direct payment through iTunes.

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We derive most of our telephony services revenue from monthly subscription fees that we charge our customers under our service plans. We also offer fax service, virtual phone numbers, toll free numbers and other services, and charge an additional monthly fee for each service. 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.

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. In February of 2012 we re-introduced service agreements as an option for new customers.

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

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 revenues include revenues from the sale of VoIP telephones in order to access our small and medium business services on a net basis rather than a gross basis as we act as an agent, rather than a principal. Customer equipment and shipping revenue also includes the fees, when collected, that we charge our customers for shipping any equipment to them.

Operating Expenses

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

Direct cost of telephony services. 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 49% and 51% of our total direct cost of telephony services for the three months ended March 31, 2014 and 2013, 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.



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

• License fees 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.

• 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.

• Product awareness advertising.

• Transaction fees paid to credit card, debit card, and ECP companies and other third party billers such as iTunes, which may 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.

• Acquisition related transaction and integration costs.

• Litigation settlements.

• 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 (developed technology, customer relationships, non-compete agreements, patents, trademarks and trade names).

• Loss on disposal or impairment of property and equipment.

• Other Income (Expense)

• Other Income (Expense) includes:

• Interest income on cash and cash equivalents.

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

Amortization of debt related costs.

Realized and unrealized gains (losses) on foreign currency.

## 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			
	March 31,			
	2014	2013		
Revenues	100	% 100		%
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization)	24	26		
Direct cost of goods sold	4	4		
Selling, general and administrative	35	30		
Marketing	26	25		
Depreciation and amortization	6	4		
	95	89		
Income from operations	5	11		
Other Income (Expense):				
Interest income	—	—		
Interest expense	(1	) (1	)	
Other income (expense), net	—	—		
	(1	) (1	)	
Income before income tax expense	4	10		
Income tax expense	(2	) (4	)	
Net income	2	% 6		%
Plus: Net loss attributable to noncontrolling interest	—	% —		%
Net income attributable to Vonage	2	% 6		%

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Revenues, Direct Cost of Telephony Services and Direct Cost of Good Sold

(in thousands, except percentages)	Three Months Ended March 31,			
	2014	2013	Dollar Change	Percent Change
Revenues	\$220,733	\$209,087	\$11,646	6 %
Direct cost of telephony services(1)	52,617	55,181	(2,564 )	(5 )%
Direct cost of goods sold	9,739	8,878	861	10 %
	158,377	145,028	13,349	9 %

(1)Excludes depreciation and amortization of \$5,154 and \$3,452, respectively.

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Revenues. The increase in revenues of \$11,646, or 6%, was driven by an increase of \$12,316 in monthly subscription fees primarily due to revenue of \$16,339 from Vonage Business Solutions, partially offset by rate plan mix and lower customer acquisitions on premium plans of \$4,023. There was an increase in our regulatory fee revenue of \$275, which includes an increase of \$531 in USF fees offset by a decrease in regulatory recovery fees and E-911 fees of \$256. There was also a decrease in credits issued to subscribers of \$432, an increase in equipment and shipping revenue of \$255, and an increase in overage in plan minutes of \$764. These increases were offset by a decrease in international minutes of use revenue of \$1,050 and an increase in bad debt of \$641. There was also a decrease in additional features revenue of \$226 and a decrease in fees that we charged for disconnecting our service of \$468.

Direct cost of telephony services. The decrease in direct cost of telephony services of \$2,564, or 5%, was primarily driven by a decrease in international usage of \$2,621, a decrease in our network costs of \$724, 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. These decreases were offset by an increase in domestic termination costs of \$140, which are costs that we pay other phone companies for terminating phone calls and an increase of USF and related fees imposed by government agencies of \$590.

Direct cost of goods sold. The increase in direct cost of goods sold of \$861, or 10%, was primarily due to an increase in customer equipment costs of \$2,258 from additional customers from our retail expansion, which was offset by a decrease in waived activation fees for new customers of \$1,228 and a decrease in shipping costs of \$104.

Selling, General and Administrative

(in thousands, except percentages)	Three Months Ended March 31,			
	2014	2013	Dollar Change	Percent Change
Selling, general and administrative	\$78,453	\$62,910	\$15,543	25 %

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Selling, general and administrative. Selling expense increased by \$3,637 including \$572 due to the expansion of the number of community sales teams, \$2,597 due to an increase in the number of retail stores with assisted selling, and commissions paid to retailers of \$594. General and administrative expense increased by \$11,906 due mainly to higher share based cost of \$2,312 and an increase in compensation and employee related expense of \$5,657, mainly from inclusion of Vonage Business Solutions. There was also an increase in acquisition related costs of \$115 in connection with the acquisition of Vocalocity, primarily related to professional fees, an increase in customer care costs of \$1,320, an increase in facility expense of \$661, and an increase in state and municipal taxes of \$1,353.



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## Marketing

(in thousands, except percentages)

	Three Months Ended March 31,		Dollar Change	Percent Change
	2014	2013		
Marketing	\$57,264	\$51,669	\$5,595	11 %

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Marketing. The increase in marketing expense of \$5,595, or 11%, primarily resulted from the additional marketing investment generated by our investment in Vonage Business Solutions.

## Depreciation and Amortization

(in thousands, except percentages)

	Three Months Ended March 31,		Dollar Change	Percent Change
	2014	2013		
Depreciation and amortization	\$12,338	\$7,975	\$4,363	55 %

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Depreciation and amortization. The increase in depreciation and amortization of \$4,363, or 55%, was primarily due to the amortization of acquisition-related intangibles of \$3,762, an increase in software amortization of \$225, and an increase in depreciation of network equipment, computer hardware, and furniture of \$373.

## Other Income (Expense)

(in thousands, except percentages)

	Three Months Ended March 31,		Dollar Change	Percent Change
	2014	2013		
Interest income	\$91	\$37	\$54	146 %
Interest expense	(2,077 )	(1,457 )	(620 )	(43 )%
Other income (expense), net	(13 )	(39 )	26	67 %
	\$(1,999 )	\$(1,459 )	\$(540 )	

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Interest expense. The increase in interest expense of \$620, or 43%, was due mainly to the funds we borrowed from the 2013 Revolving Credit Facility in November 2013 in connection with the acquisition of Vocalocity.

## Provision for Income Taxes

(in thousands, except percentages)

	Three Months Ended March 31,		Dollar Change	Percent Change
	2014	2013		
Income tax expense	\$(4,118 )	\$(7,968 )	\$3,850	48 %
Effective tax rate	49.5 %	37.9 %		

We recognize income tax expense equal to pre-tax income multiplied by our effective income tax rate, an expense that had not been recognized prior to the reduction of the valuation allowance in the fourth quarter of 2011. In addition, adjustments are recorded for discrete period items related to stock compensation and changes to our state effective tax rate.

The provision also includes the federal alternative minimum tax and state and local income taxes.



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The effective tax rate is calculated by dividing income tax expense by income before income tax expense. The 2014 estimated annual effective tax rate is expected to approximate 47%, but may fluctuate each quarter due to our foreign operations and certain discrete period transactions. In 2014, our effective tax rate will be impacted by the effect of losses incurred in certain foreign jurisdictions for which we may not realize a tax benefit. The losses reduce our pre-tax income without a corresponding reduction in our tax expense, and therefore increase our effective tax rate.

## Net Income

(in thousands, except percentages)

	Three Months Ended March 31,			
	2014	2013	Dollar Change	Percent Change
Net income	\$4,205	\$13,047	\$(8,842)	(68)%

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Net income. Based on the explanations described above, net income decreased by \$8,842, or 68%.

## Net Loss Attributable to Noncontrolling Interest

(in thousands, except percentages)

	Three Months Ended March 31,			
	2014	2013	Dollar Change	Percent Change
Net loss attributable to noncontrolling interest	\$383	\$—	\$383	—%

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Net loss attributable to noncontrolling interest. The net loss attributable to noncontrolling interest of \$383 for the three months ended March 31, 2014, represented 30% of the net loss of a consolidated subsidiary in Brazil.

## Net Income Attributable to Vonage

(in thousands, except percentages)

	Three Months Ended March 31,			
	2014	2013	Dollar Change	Percent Change
Net income attributable to Vonage	\$4,588	\$13,047	\$(8,459)	(65)%

Three Months Ended March 31, 2014 compared to three months ended March 31, 2013

Net income attributable to Vonage. Based on the explanations described above, net income attributable to Vonage decreased by \$8,459, or 65%.

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## Liquidity and Capital Resources

## Overview

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

	Three Months Ended March 31,	
	2014	2013
	(in thousands)	
Net cash provided by operating activities	\$9,387	\$9,752
Net cash used in investing activities	(3,729	) (3,087
Net cash (used in) provided by financing activities	(34,690	) 2,646

## Operating Activities

Cash provided by operating activities decreased slightly to \$9,387 for the three months ended March 31, 2014 compared to \$9,752 for the three months ended March 31, 2013, primarily due to planned investments in our growth initiatives, offset by changes in working capital.

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 used for working capital requirements decreased by \$6,195 during the three months ended March 31, 2014 compared to the prior year period, primarily due to timing of payments.

## Investing Activities

Cash used in investing activities for the three months ended March 31, 2014 of \$3,729 was attributable to capital expenditures of \$942 and development of software assets of \$2,786.

Cash used in investing activities for the three months ended March 31, 2013 of \$3,087 was attributable to capital expenditures of \$2,031 and development of software assets of \$2,313, offset by a decrease in restricted cash of \$1,257 due primarily to the return of part of the security deposit of \$1,000 on our leased office property in Holmdel, New Jersey, and the release of our letter of credit from our energy purchase plan of \$257.

## Financing Activities

Cash used in financing activities for the three months ended March 31, 2014 of \$34,690 was primarily attributable to \$25,833 in 2013 Credit Facility and 2013 Revolving Credit Facility principal payments, \$682 in capital lease payments, \$10,011 in common stock repurchases, offset by \$1,836 in proceeds received from the exercise of stock options.

Cash provided by financing activities for the three months ended March 31, 2013 of \$2,646 was primarily attributable to \$27,500 in net proceeds received from our 2013 Credit Facility and \$5,746 in proceeds received from the exercise of stock options, offset by \$5,463 in proceeds paid in connection with the stock option cancellation, \$5,834 in 2013 Credit Facility principal payments, \$582 in capital lease payments, \$16,712 in common stock repurchases, and \$2,009 in 2013 Credit Facility debt related costs.

For the three months ended March 31, 2014, we generated income from operations. We expect to continue to balance efforts to grow our revenue while consistently achieving operating profitability. To grow our revenue, we continue to make investments in growth initiatives, marketing, application development, 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 not achieve consistent profitability. We believe that cash flow from operations and cash on hand will fund our operations for at least the next twelve months.

## Acquisition of Vocalocity



Vocalocity was acquired for \$130,000 adjusted for \$2,869 of excess cash as of the closing date and the increase in value of the 7,983 shares of Vonage common stock from the signing date to the closing date of \$1,298, resulting in a total acquisition cost of \$134,167. We financed the transaction through \$32,981 of cash and \$75,000 from our credit facility. The acquisition of Vocalocity immediately positioned Vonage as a leader in the SMB hosted VoIP market. SMB and SOHO services are offered under the Vonage Business Solutions brand.

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### 2013 Financing

On February 11, 2013 we entered into Amendment No. 1 to our July 2011 Credit Agreement (as further amended by Amendment No. 2 to our 2011 Credit Facility, the "2013 Credit Facility"). The 2013 Credit Facility consists of a \$70,000 senior secured term loan and a \$75,000 revolving credit facility. The co-borrowers under the 2013 Credit Facility are our wholly owned subsidiary, Vonage America Inc., and us. Obligations under the 2013 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. On July 26, 2013 we entered into Amendment No. 2 to our 2011 Credit Agreement, which amends our financial covenant related to our consolidated fixed charge coverage ratio by increasing the amount of restricted payments excluded from such calculation from \$50,000 to \$80,000.

### Use of Proceeds

We used \$42,500 of the net available proceeds of the 2013 Credit Facility to retire all of the debt under our 2011 Credit Facility. Remaining net proceeds of \$27,500 from the senior secured term loan and the undrawn revolving credit facility under the 2013 Credit Facility will be used for general corporate purposes. We used \$75,000 from the 2013 revolving credit facility in connection with the acquisition of Vocalocity on November 15, 2013. We also incurred \$2,009 of fees in connection with the 2013 Credit Facility, which is amortized, along with the unamortized fees of \$670 in connection with the 2011 Credit Facility, to interest expense over the life of the debt using the effective interest method.

### 2013 Credit Facility Terms

The following description summarizes the material terms of the 2013 Credit Facility:

The loans under the 2013 Credit Facility mature in February 2016. Principal amounts under the 2013 Credit Facility are repayable in quarterly installments of \$5,833 per quarter for the senior secured term loan. The unused portion of our revolving credit facility incurs a 0.45% commitment fee.

Outstanding amounts under the 2013 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 3.125% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.375% 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 3.625% 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 2.125% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.275% 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 2.625% 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 2013 Credit Facility.

The 2013 Credit Facility provides greater flexibility to us in funding acquisitions and restricted payments, such as stock buybacks, than the 2011 Credit Facility.

We may prepay the 2013 Credit Facility at our option at any time without premium or penalty. The 2013 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 2013 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 2013 Credit Facility. The 2013 Credit Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition,

the 2013 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:

- consolidated leverage ratio of no greater than 2.00 to 1.00;

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a consolidated fixed coverage charge ratio of no less than 1.75 to 1.00 subject to adjustment to exclude up to \$80,000 in specified restricted payments;

- minimum cash of \$25,000 including the unused portion of the revolving credit facility or \$35,000 in the event of certain specified corporate actions; and

maximum capital expenditures not to exceed \$55,000 during any fiscal year, provided that the unused amount of any permitted capital expenditures in any fiscal year may be carried forward to the next following fiscal year; in addition, annual excess cash flow up to \$8,000 increases permitted capital expenditures.

As of March 31, 2014, we were in compliance with all covenants, including financial covenants, for the 2013 Credit Facility.

The 2013 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 March 31, 2014, we had a reserve of \$6,308. 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 three months ended March 31, 2014, 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 three months ended March 31, 2014 were \$3,728, of which \$2,786 was for software acquisition and development. The majority of these expenditures are comprised of investments in information technology and systems infrastructure, including an electronic data warehouse, online customer service, and customer management platforms. For 2014, we believe our capital and software expenditures will be no greater than \$30,000.

### Common Stock Repurchases

On July 25, 2012, our board of directors approved a plan to buy back up to \$50,000 of Vonage common stock through December 31, 2013. The specific timing and amount of repurchases would vary based on available capital resources and other financial and operational performance, market conditions, securities law limitations, and other factors. The repurchases would be made using our cash resources. The repurchase program was subject to suspension or discontinuation at any time without prior notice. For the period from January 1, 2013 to February 12, 2013, we repurchased \$5,374, or 2,189 shares of Vonage common stock under the \$50,000 repurchase program.

On February 7, 2013, Vonage's Board of Directors discontinued the remainder of our existing \$50,000 repurchase program effective at the close of business on February 12, 2013 with \$16,682 remaining, and authorized a new program to repurchase up to \$100,000 of the Company's outstanding shares by December 31, 2014. The specific timing and amount of repurchases would vary based on available capital resources and other financial and operational performance, market conditions, securities law limitations, and other factors. The repurchases will be made using our cash resources. The repurchase program may be suspended or discontinued at any time without prior notice. For the three months ended March 31, 2014, we repurchased \$10,043, or 2,447 shares of Vonage common stock under the \$100,000 repurchase program.

In any period under either repurchase program, cash used in financing activities related to common stock repurchases may differ from the comparable change in stockholders' equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

### 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

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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 February 11, 2013, we entered into Amendment No. 1 to the 2011 Credit Agreement. We are exposed to interest rate risk since amounts payable under the 2013 Credit Facility, at our option, bear interest at:

LIBOR (applicable to one-, two-, three- or six-month periods) plus an applicable margin equal to 3.125% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.375% 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 3.625% 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 2.125% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.275% 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 2.625% 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 2013 Credit Facility.

If the interest rate on our variable rate debt changed by 1%, our annual debt service payment would change by approximately \$960.

**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.

**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, 2013.

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

Item 2(a) and (b) are not applicable.

(c) Common stock repurchases (in thousands, except per share value):

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet be Purchased under the Plans or Program
January 1, 2014 - January 31, 2014	917	\$3.49	917	\$46,144
February 1, 2014 - February 28, 2014 (1)	555	\$4.53	555	\$43,631
March 1, 2014 - March 31, 2014 (2)	975	\$4.44	975	\$39,304
	2,447		2,447	

(1) including 146 shares, or \$682, of common stock repurchases settled in March 2014; excluding commission of \$1.

(2) including 186 shares, or \$791, of common stock repurchases settled in April 2014; excluding commission of \$2.

On February 7, 2013, Vonage's Board of Directors discontinued the remainder of the \$50,000 repurchase program, which was announced on July 25, 2012, effective at the close of business on February 12, 2013, with \$16,682 remaining, and authorized a new program to repurchase up to \$100,000 of the Company's outstanding shares. The \$100,000 repurchase program expires on December 31, 2014 but may be suspended or discontinued at any time without notice. The specific timing and amount of repurchases will vary based on available capital resources and other financial and operational performance, market conditions, securities law limitations, and other factors. The repurchases will be made using our cash resources. In any period, cash used in financing activities related to common stock repurchases may differ from the comparable change in stockholders' equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

During the three months ended March 31, 2014, we repurchased 2,447 shares of Vonage Holdings Corp. common stock for \$10,043 using cash resources pursuant to the \$100,000 repurchase program. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of March 31, 2014, approximately \$39,304 remained of our \$100,000 repurchase program.

## Item 3. Defaults Upon Senior Securities

None.

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Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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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 months ended March 31, 2014, filed with the Securities and Exchange Commission on May 1, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statements of Cash Flows; (v) the Consolidated Statements of Stockholders' Deficit; and (vi) 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: May 1, 2014

By: /s/ David T. Pearson  
David T. Pearson  
Chief Financial Officer and Treasurer  
(Principal Financial and Accounting Officer and Duly Authorized  
Officer)

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EXHIBIT INDEX

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(1) Filed herewith.