

VONAGE HOLDINGS CORP  
Form 10-K  
February 16, 2012  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION • WASHINGTON, D.C. 20549

FORM 10-K

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|--|----|---|
| <input checked="" type="checkbox"/> Annual Report Pursuant to Section 13 or<br>15(d) of The Securities Exchange Act of<br>1934<br>For the fiscal year ended December 31,<br>2011 | or | <input type="checkbox"/> Transition Report Pursuant to Section 13 or<br>15(d) of The Securities Exchange Act of<br>1934<br>For the transition period from            to |
|--|----|---|

Commission file number 001-32887  
VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

|   |  |
|---|--|
| Delaware<br>(State or other jurisdiction of<br>incorporation or organization) | 11-3547680<br>(I.R.S. Employer Identification No.) |
|---|--|

|   |                     |
|---|---------------------|
| 23 Main Street, Holmdel, New Jersey<br>(Address of principal executive offices) | 07733<br>(Zip Code) |
|---|---------------------|

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

|   |   |
|---|---|
| Securities registered pursuant to Section 12(b) of the Act: |   |
| Title of each class   | Name of each exchange on which registered |
| Common Stock, Par Value \$0.001 Per Share                   | The New York Stock Exchange               |
| Securities registered pursuant to Section 12(g) of the Act: |   |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 Regulations 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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant at June 30, 2011 was \$641,189,789 based on the closing price of \$4.41 per share.

The number of shares outstanding of the registrant's common stock as of January 31, 2012 was 225,627,886.

Documents Incorporated By Reference

Selected portions of the Vonage Holdings Corp. definitive Proxy Statement, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2011, are incorporated by reference in Part III of this Form 10-K.

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FORM 10-K  
FOR THE FISCAL YEAR ENDED December 31, 2011

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains statements and other information which are deemed to be “forward-looking” within the meaning of the Private Securities Litigation Reform Act of 1995 (the “Litigation Reform Act”). These forward-looking statements and other information are based on our beliefs as well as assumptions made by us using information currently available.

The words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “will,” “should” and similar expressions, as they relate to us, are intended to identify forward-looking statements. Such statements reflect our current views with respect to future events, are subject to certain risks, uncertainties, and assumptions, and are not a guarantee of future performance.

Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in such forward-looking statements or information. In light of the significant uncertainties in these forward-looking statements, you should not place undue reliance on these forward-looking statements. The forward-looking statements and information contained in this Annual Report on Form 10-K relate to events and state our beliefs and the assumptions made by us only as to the date of this Annual Report on Form 10-K. We do not intend to update these forward-looking statements, except as required by law.

In accordance with the provisions of the Litigation Reform Act, we are making investors aware that such forward-looking statements, because they relate to future events, are by their very nature subject to many important factors that could cause actual results to differ materially from those contemplated by the forward-looking statements contained in this Annual Report on Form 10-K, any exhibits to this Form 10-K and other public statements we make. Such factors 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; our dependence on third party facilities, equipment, systems and services; our ability to implement our new billing and ordering management system; system disruptions or flaws in our technology and systems; intellectual property and other litigation that have been and may be brought against us; failure to protect our trademarks and internally developed software; our ability to obtain or maintain relevant intellectual property licenses; results of regulatory inquiries into our business practices; uncertainties relating to regulation of VoIP services; increased governmental regulation, currency restrictions, and other restraints and burdensome taxes and risks incident to foreign operations; our dependence upon key personnel; our history of net losses and ability to achieve consistent profitability in the future; fraudulent use of our name or services; our ability to maintain data security; security breaches and other compromises of information security; our dependence on our customers' existing broadband connections; differences between our service and traditional phone services, including our 911 service; any reinstatement of holdbacks by our vendors; our ability to obtain additional financing if required; restrictions in our debt agreements that may limit our operating flexibility; and other factors that are set forth in the “Risk Factors” section and other sections of this Annual Report on Form 10-K, as well as in our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

FINANCIAL INFORMATION PRESENTATION

For the financial information discussed in this Annual Report on Form 10-K, 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.

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PART I

ITEM 1. Business

OVERVIEW

OVERVIEW

We are a leading provider of communications services connecting people through broadband devices worldwide. We rely heavily on our network, which is a flexible, scalable Session Initiation Protocol (SIP) based Voice over Internet Protocol, or VoIP, network. 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.

In 2009, we shifted our primary emphasis from the domestic home phone replacement market to the international long distance market. With Vonage World we offer unlimited calling domestically and to more than 60 countries, including India, Mexico, and China, for a flat monthly rate. We believe the value and convenience provided by Vonage World is particularly appealing to international long distance callers compared to offers from our competitors.

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 have continued to build upon our mobile services strategy with two product introductions in mid-2011. 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 low-cost international calling to more than 200 countries to any other phone. In addition, calls by users of the mobile application to Vonage home or business lines are also free. This mobile application works over WiFi, 3G and 4G and in more than 90 countries worldwide. Vonage Mobile consolidates the best features of our prior applications, while adding important functionality, better value, and improved ease of use. Vonage Mobile users can instantly add calling credit from within the application through iTunes or the Android Market for calls to users without the application. Vonage Mobile uses the phone's existing mobile number and contact list, eliminating the need for unique user names and duplicate identities for contacts and allowing users to build a free global calling and messaging network from their existing contacts using the application's multiple invitation system.

We have made significant financial progress over the past four years providing a solid foundation for the future. We have managed a significant strategic shift while transforming the cost structure in our core business to drive significant improvements in profitability. We enhanced the value of our product by investing in upgraded systems, streamlined processes, and improved customer experience, which we believe have helped stabilize our subscriber base while driving structural cost reductions throughout the company. In addition to reducing ongoing costs, these structural improvements enabled us to absorb incremental costs resulting from a growth in international minutes as we added new customers to our Vonage World plan. By lowering international termination costs, lowering domestic calling rates, and reducing the cost of our devices by nearly a third, we have significantly improved our profitability. In 2011, our core business generated substantial net income and cash flow on relatively flat service revenues, driven by an aggressive focus on driving efficiencies throughout our operations. Through two refinancings in the past 14 months, we have reduced our debt by over 50% and lowered interest rates from highs of 20% to less than 4%, saving \$43 million in annual interest expense from the debt structure in place in 2010.

We had approximately 2.4 million subscriber lines for broadband telephone replacement services as of December 31, 2011. We bill customers in the United States, Canada, and the United Kingdom. Customers in the United States represented 94% of our subscriber lines at December 31, 2011.

OUR VISION AND STRATEGY

Building on our solid financial foundation, we are focused on growth in three primary areas that target substantial existing revenue streams.

International long distance calling. We are solidifying our core business through continued penetration of international calling segments. The markets for international long distance are large and growing, and they allow us to leverage our VoIP network by providing customers a low-cost and convenient alternative to services offered by telecom and cable providers and international calling cards. According to industry data, the total outbound >international long distance calling market is estimated to be \$80 billion, and approximately 10 to 15 percent of all US households make international long distance calls, using a mix of home and mobile phones. While our primary emphasis remains the international long distance calling market in the United States, the domestic calling market continues to be attractive. Despite the shift to wireless and a decline in usage, according to industry data there are approximately 75 million households in the United States with landlines. This is a sizable market opportunity.

Our strategic focus on international segments has been successful. Approximately 50 percent of our customers are now on Vonage World, and approximately 35 percent are international long distance callers, which we classify as customers who make 20 or more minutes of international long distance calls per month. To increase the visibility of our Vonage World plan, we have shifted an increasing portion of our marketing budget from broad national advertising as we target attractive segments of the international long distance market. We have prioritized our marketing and sales programs, and in the past year and a half, opened three bilingual sales and service sites. As a result, our base of Hispanic callers has grown by more than 50 percent in the past year.

We have direct sales channels where customers can subscribe to our services on-line or through our toll-free number, as well as a retail distribution channel through regional and national retailers and localized street teams. In 2011, we doubled the number of retail distribution outlets with the recent addition of Best Buy, Kmart and Sears. Combined with our existing partners, Walmart, Fry's and Microcenter, we

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now have distribution agreements to sell our services in approximately 6,000 stores across the country. We now have approximately 60 event teams, up from six in January of 2011. These teams operate in 35 ethnic-concentrated markets across 18 states including California, Texas, Florida, and New York. These teams expand our presence in these communities by marketing and selling Vonage service at Hispanic and Asian-Indian events and community gathering places.

Mobile and other connected device services. We are developing next-generation services to meet the increasing demand for services by users of mobile and other connected devices. We believe that our efforts will capitalize on favorable trends including the proliferation of low or no-cost Wi-Fi and other broadband around the world and the accelerating rate of smart phone adoption. 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 low-cost international calling to more than 200 countries to any other phone. In 2012, we expect to extend our mobile services offering, including standalone mobile products for customers without smartphones as well as building additional features into our Vonage Mobile platform. We also plan to introduce a low cost international roaming feature which would allow customers to receive inbound calls on their mobile device, avoiding high carrier roaming fees while traveling.

Expansion opportunities outside of the United States. We currently have operations in the United States, United Kingdom, and Canada and believe that our low-cost Internet-based communications platform enables us to cost-effectively deliver voice and messaging services to other locations throughout the world.

The global consumer communications market is estimated to be \$200 billion and growing at approximately 7% per year. We expect to expand our geographic footprint through partnerships and are pursuing a range of business concepts which include jointly providing low rates and expanded footprints with international partners, to placing kiosks in foreign locations, to providing a full suite of communications services sold and marketed by other companies.

## SERVICE OFFERINGS

Our home telephone replacement services are offered to residential, small office and home office customers through several service plans with different pricing structures. The service plans include an array of basic and enhanced features, and customers have the opportunity to purchase premium features for an additional fee. We also charge for local and international calling outside of plan limits. Information on our revenues, operating income, and identifiable assets appears in Note 1 to our consolidated financial statements included in Item 8 hereof.

Our primary residential offering is Vonage World with approximately 1.1 million subscriber lines as of December 31, 2011. For a flat monthly fee, this plan includes unlimited local calling and unlimited calling to landline phones in all cities and locations in more than 60 countries, including India, Mexico, and China, and unlimited calling to cellular phones in certain of those countries. In addition, the Vonage World offer includes unlimited Vonage Visual Voicemail, which is "readable voicemail" delivered via email or SMS text message, Vonage Extensions, which extends the plan to additional phone numbers and devices including smartphones and feature phones, and directory assistance. We also market other residential plans that include enhanced features or limited minutes, in addition to offering our legacy Residential Premium Unlimited plan to existing customers.

We view the small and home office market as a potential growth market. Today we offer two small and home office calling plans, one of which offers unlimited local and long distance calling anywhere in the United States, Canada, Puerto Rico, and five European countries and another that includes a specified number of minutes in the United States, Canada, and Puerto Rico. Both plans offer a free dedicated fax line.

As of December 31, 2011, approximately 94% of our United States subscriber lines were for residential service. Approximately 47% of those residential subscriber lines were under the Vonage World plan and 25% were under the Residential Premium Unlimited plan. We offer similar plans in Canada and the United Kingdom. Please see Note 11 to our consolidated financial statements for financial information about our geographic areas.

Each of our residential, small office and home office calling plans provides a number of basic features including call waiting, caller ID with name, call forwarding, and voicemail. We also offer, in some cases for additional fees, a number of enhanced services that we believe help differentiate our service from our competitors, such as:

> Area Code Selection. Customers can select from approximately 270 United States area codes for their telephone number for use with our service, regardless of physical location.

Virtual Phone Number. A customer can have additional inbound telephone numbers that ring on a primary subscriber line, each for an additional fee. Each of these inbound telephone numbers can have a different area code. In addition to United States virtual phone numbers, we offer virtual phone numbers for 19 other countries. For >example, a customer living in New York City with a New York City phone number can purchase a Toronto virtual phone number that rings on the customer's primary subscriber line. In this instance, a caller from Toronto could call the customer's virtual phone number and be billed as if the customer were in Toronto. Virtual phone numbers are not included in our subscriber line count.

Personalized Web-Enabled Voicemail. Our service allows customers to receive e-mail notification of a voicemail >with the voice message attached to the e-mail message as an audio file. Our customers can also check and retrieve voicemails online or from any phone.

Our mobile services include enhancements to our residential, small office and home office calling plans as well as mobile applications that can be initially downloaded for iPhone®, iPad®, iPod touch®, and Android® OS devices for free. In August 2011, we launched Extensions, an enhancement to our flat rate, unlimited international calling plan that extends the plan to additional phone numbers and devices including smartphones and feature phones. A customer may sign-up for up to two extensions with the first extension provided free of charge and the second extension incurring an additional fee. 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 low-cost international calling to more than 200 countries to any other phone. In addition, calls by users of the mobile application to Vonage home or business lines are also free. This mobile application works over WiFi, 3G and 4G and in more than 90 countries worldwide.



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### Devices

In order to access our residential, small office, and home office services, a customer need only connect a standard telephone to a broadband Internet connection through a small Vonage-enabled device. After connecting the device, our customers can use their telephone to make and receive calls. Our adapter includes a networking router and generally permits a subscriber to connect up to two Vonage lines through a high-speed Internet connection. Vonage-enabled devices allow customers to use the Internet connection for their computer and telephones at the same time while ensuring a high quality calling experience. We also offer a cordless multi-phone system solution. Our plug-and-play Vonage-enabled devices permit portability as customers can take their Vonage device to different locations where broadband service is available. Since May 2009, we generally have not charged new customers for the adapters permitting use of our service.

### TWORK OERATIONS

### NETWORK OPERATIONS

Our network operations are conducted by a wholly-owned subsidiary that holds our networking equipment and employs the personnel who develop and operate our technology.

The Vonage network uses our customer's existing high-speed broadband Internet service to allow calls over the Internet either from a standard telephone through a Vonage-enabled device or through soft phone software or mobile client applications. Our service is not dependent on any specific type or provider of Internet service, and our customers are free to change their Internet service provider in response to a competitive alternative, or because they have moved to a different location. Our Vonage-enabled devices, soft phone software, and mobile client applications allow our customers to be authenticated and authorized to access to our network in a secure manner.

Our network is scalable and geographically distributed for robustness, high availability, and reliability across multiple call processing sites, using regional data interconnection points, where calls to non-Vonage customers are interconnected with the public switched telephone network. We periodically assess the locations of our regional data connection points in connection with efforts to improve the quality of and efficiency in delivering our service. In 2011, we consolidated certain interconnection points, increasing efficiencies and creating a platform for growth. Our interconnections with the public switched telephone network are made pursuant to agreements we have with several telecommunications providers. Under these agreements, we transfer calls originated by our customers to other carriers who connect the call to the called party. We pay a per-minute charge for this. The calls are routed from our network to other carriers' interconnected circuits at co-location facilities in which we lease space. This method of connecting to the public switched telephone network allows us to expand capacity quickly, as necessary to meet call volume, and to provide redundancy within our network. In 2011, we enhanced our call routing platform, increasing our control over call routing which lowered costs and improved call quality. Our business is not substantially dependent upon our agreements with any single carrier or our interconnection agreements because we can easily substitute other telecommunications providers in order to obtain the same or similar service.

Because Vonage's system is not constrained to use any specific broadband service provider to connect to our customers, we can centrally manage and share resources across our customer base to minimize capital investment when entering new markets.

The following are also important in supporting our network operations:

**Network Operations Center.** We currently maintain a network operations center at our headquarters with monitoring redundancies at several points within our network. The network operations center monitors and manages the status and health of our network elements, allowing us to manage our network in real time, respond to alert notifications, and re-route network traffic as needed. We pursue a multi-faceted approach to managing our network to ensure high call quality and reliable communications services to our customers.

**Back Office Systems.** In addition to our network management systems, we have developed a number of software systems that enable us to manage our network and service offerings more efficiently and effectively. Key aspects of these systems include:

Network Quality Metrics. We have implemented a suite of advanced metrics gathering and analysis tools that allow us to monitor the performance of our calling and data network, customer premises equipment, and other associated >calling elements in real-time. This suite is proprietary and was developed specifically to address the needs that Vonage has in monitoring, analyzing, understanding, troubleshooting, maintaining, and operating a world-class consumer VoIP platform.

Web Portal. We provide a fully functional customer Web portal that allows our customers to configure and manage almost all aspects of their service on the Internet without requiring intervention of a customer-care representative. >The portal permits customers to add and change features and phone numbers, update billing information, and access all of their call usage and billing details.

Emergency Calling Service and Enhanced 911 Service. We have deployed E-911 service to approximately 99.99% of our U.S. residential and small and home office customer base that is comparable to the emergency calling services provided to customers of traditional wireline telephone companies in the same area. Our E-911 service does not support the calls of our soft phone software users. The emergency calls of our soft phone software users are supported by a national call center. Not all Vonage products require 911 service capabilities, such as our mobile client products. To enable us to effectively deploy and provide our E-911 service, we maintain an agreement with a >provider that assists us in delivering emergency calls to an emergency service dispatcher at the public safety answering point, or PSAP, in the area of the customer's registered location and terminating E-911 calls. We also contract for the national call center that operates 24 hours a day, seven days a week to receive certain emergency calls and for the maintenance of PSAP databases for the purpose of deploying and operating E-911 services. The databases include contact, technical infrastructure, boundary, and routing information for delivery of calls to a PSAP or emergency service providers in the United States.

Local Number Portability. Unlike certain of our VoIP competitors, our system allows our telephone replacement customers to port telephone numbers, which allows new customers to retain their existing telephone numbers when >subscribing to our services. We rely on an agreement with a provider to facilitate the transfer of customer telephone numbers. In addition, we have engaged a provider that performs the third party verification of pertinent local number portability information from our subscribers prior to porting a customer from one local telephone company to us.

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Security. We have developed a service architecture and platform that uses industry-standard security techniques and allows us to remotely manage customer devices. Any Vonage-enabled device used by our customers can be securely managed by us, and these devices use authentication mechanisms to identify themselves to our service in order to place and receive calls. We regularly update our protocols and systems to protect against unauthorized access.

Internet Protocol (IP) Addresses. Every machine on the Internet has a unique identifying number called an Internet Protocol address or IP address. Though there has been recent publicity surrounding the exhaustion of IP addresses under the current Internet Protocol version, we have procured a supply of addresses that we believe will cover our needs for the foreseeable future.

## MARKETING

Our marketing objective is to grow subscriber lines and revenue by cost-effectively acquiring and retaining customers. We employ an integrated multi-channel approach to marketing, whereby we evaluate and focus our efforts on efficient marketing vehicles to accomplish our goals. To do this, we make use of both broad-reaching and highly-targeted media channels in the general market and for specific international long distance markets, including television, direct mail, online, alternative media, telemarketing, partner marketing, and customer referral programs. We regularly evaluate the cost per acquisition by media vehicle and reallocate budgets to identify more effective media mixes. We make use of marketing research to gain consumer insights into brand, product, and service performance, and utilize those learnings to improve our messaging and media plans. Market research is also leveraged in the areas of testing, retention marketing, and product marketing to ensure we bring compelling products and services to market for our customers.

## SALES AND DISTRIBUTION

### Direct Sales

Our primary sales channels for our home telephone replacement services have been in-bound telemarketing and online direct sales. Customers can subscribe to our services at our websites, <http://www.vonage.com>, <http://www.vonage.ca> and <http://www.vonage.co.uk>, or through multiple toll free numbers including 1-877-4VONAGE. We are also increasing efforts to focus on promising international long distance markets. In 2011, we continued to enhance our complete Spanish language experience for our customers, including 24 hour per day inbound telesales, full customer service, a purpose-built Spanish language online environment and purchasing experience, television advertising, as well as direct mail.

### Retail Sales

In addition to our direct sales channel, we also offer sales through our retail channel. In 2011, we doubled our retail presence from 3,000 to 6,000 locations at leading regional and national retailers, including Walmart, Sears, Kmart, Best Buy, Fry's Electronics, and Microcenter. We believe that the availability of our devices through premier retailers enhances and reinforces the Vonage brand, and that the retail channel increases our ability to acquire mainstream consumers by reaching them in a familiar and interactive shopping environment. National and regional retailers provide Vonage with a wide footprint to distribute our service. We have opened Vonage kiosks throughout the United States and continue to look at ways to optimize sales performance at each kiosk location while looking at growth opportunities in favorable geographic markets. We refined our kiosk operations in 2011 by supplementing our fixed cost kiosks with pay for performance cost structures in certain markets. In addition, we expanded our key market presence in markets with high ethnic concentration with the introduction of event teams in 2010. Our event teams provide culturally relevant ways to connect with customers at a grass roots level. We expanded our event team presence in 2011 and now operate in over 35 markets across 18 states including California, Texas, Florida, and New York.

### Customer Service

We offer our customers support 24 hours a day, seven days a week through both our comprehensive online account management website and our toll free number. Many customers use our self-service website when they have a question or problem with their service and are able to resolve their concerns online without needing to speak to a

customer care representative. Our customers can manage almost all aspects of their accounts online. This capability empowers our customers through self-service and reduces our customer care expenses.

Customers who cannot or do not wish to resolve their questions through our website may contact a customer care representative through our toll free number. We staff our customer care organization through a combination of our own employees and outsourced customer care representatives. All new customer care representatives are trained through an established program developed by Vonage. We also have a separate team that provides advanced technical support for resolving customers' complex issues and an on-boarding team, which provides specialized assistance to new customers. We use extensive monitoring of call quality and customer satisfaction scores to determine additional training or coaching requirements for individual associates and to drive continuous improvement in our processes, policies, and technology.

#### Billing

All customer billing for our broadband telephone replacement services is automated through our website. We automatically collect all fees from our customers' credit card, debit card or electronic check payment ("ECP"). 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 exposure, which is recorded as a reduction to revenue. If a customer's credit card, debit card or ECP is declined, we generally suspend international calling. 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 cannot be successfully processed during three billing cycles (i.e. the current and two subsequent monthly billing cycles), we terminate the account.

We are party to a contract with Amdocs, Inc. pursuant to which Amdocs, Inc. will (i) license to us billing and ordering software, (ii) provide professional services relating to the implementation, operation, support, and maintenance of the licensed systems, and (iii) transition support services in connection with migration to the licensed systems. We expect this software to provide us with enhanced ordering and billing capabilities to better suit the current and future needs of the business. The initial term of the agreement with Amdocs, Inc. extends for five years following the earlier to occur of (i) the date on which a specified number of subscribers are successfully migrated from our current billing and order systems to the licensed system or (ii) the first new subscriber is added to the licensed system. The platform is now operational and it is our intention to transition customers

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to the platform throughout 2012. Billing for some of our existing products such as mobile and other connected devices is handled through third party payment platforms such as iTunes and based on customer and business needs we may continue to use a range of payment vehicles including the Amdocs platform for our products and services in the future.

## INTELLECTUAL PROPERTY

We believe that our technological position depends primarily on the experience, technical competence, and the creative ability of our engineering and technology staff. We routinely review our technological developments with our technology staff and business units to identify the aspects of our technology that provide us with a technological or commercial advantage and file patent applications as necessary to protect our technology in the United States and internationally. Our company policies require our employees to assign their intellectual property rights to us and to treat all technology as our confidential information.

In addition to developing technology and intellectual property, we evaluate the licensing and acquisition of technology and intellectual property of third parties to identify opportunities that may provide us with a strategic or commercial advantage in exchange for royalties or other payments. From time to time we receive letters from third parties initiating an opportunity to obtain patent licenses that might be relevant to our business. As a result of these efforts, we have acquired multiple U.S. and foreign patents, and obtained licenses to numerous other patents. We also have become involved in litigation alleging that our products or services infringe on third party patents or other intellectual property rights. See “Item 3. – Legal Proceedings—IP Matters.”

We are the owner of numerous United States and international trademarks and service marks and have applied for registration of our trademarks and service marks in the United States and abroad to establish and protect our brand names as part of our intellectual property strategy. Some of our registered marks are Vonage®, Vonage Mobile® and Vonage Visual Voicemail®.

We endeavor to protect our internally developed systems and maintain our trademarks and service marks. Typically, we enter into confidentiality or license agreements with our employees, consultants, customers, and vendors in an effort to control access to and distribution of our technology, software, documentation, and other information.

## COMPETITION

We face continued strong competition from traditional telephone companies, cable companies, wireless companies, and alternative communication providers. Because most of our target customers are already purchasing communications services from one or more of these providers, our success is dependent upon our ability to attract these customers away from their existing providers. We believe that the principal competitive factors affecting our ability to attract and retain customers are price, call quality, customer service, and enhanced services and features.

Traditional telephone and cable companies

The traditional telephone and cable companies are our primary competitors for our broadband telephone services. Traditional telephone companies in particular have historically dominated their regional markets. These competitors include AT&T, Verizon Communications and CenturyLink, as well as rural incumbents such as Frontier Communications. Cable company competitors include companies such as Cablevision, Charter Communications, Comcast Corporation, Cox Communications, and Time Warner Cable. These traditional phone and cable company competitors are substantially larger and better capitalized than we are and have the advantage of a large existing customer base. Many of these competitors are continuing to make substantial investments in delivering broadband Internet access, VoIP phone service, and cable television to their customers and they often have larger product development and marketing budgets than us. Providing home phone, Internet access, and cable television to many of our existing and potential customers may enhance their image as trusted providers of services.

The traditional phone companies own networks that include a “last mile” connection to substantially all of our existing and potential domestic customers as well as the places our customers call domestically. As a result, the vast majority of the calls placed by a Vonage customer are carried over the “last mile” by a traditional phone company, and we

indirectly pay access charges to these competitors for each of these calls. In contrast, traditional wireline providers do not pay us when their customers call our customers.

Cable companies and, in many cases traditional phone companies, are also aggressively using their existing customer relationships to bundle services. For example, they bundle Internet access, cable television, and home phone service with an implied price for the phone service that may be significantly below ours. Certain traditional phone companies are also able to bundle wireless telephone service. Many of these competitors are able to advertise on their local access channels with no significant out-of-pocket cost and through mailings in bills with little marginal cost. They also receive advertising time as part of their relationships with television networks and are able to use this time to promote their telephone service offerings.

Traditional phone and cable companies' ownership of Internet connections to our customers could enable them to detect and interfere with the completion of our customers' calls. While we are not aware of any such occurrence, it is unclear whether current regulations would permit these companies to degrade the quality of, give low priority to or block entirely the information packets and other data we transmit over their lines. In addition, these companies may attempt to charge their customers more for using our services.

Many traditional phone and cable companies routinely send technicians to customers' premises to initiate service. Although this is expensive, it also can be more attractive to customers than installing their own router. In addition, these technicians may install an independent source of power, which can give customers assurance that their phone service will not be interrupted during power outages.

The traditional phone and cable companies have long-standing relationships with regulators, legislators, lobbyists, and the media. This can be an advantage for them because legislative, regulatory or judicial developments in our rapidly evolving industry could have a negative impact on us.

In many cases, we charge prices that are lower than prices charged by the traditional phone and cable companies. In addition, some of our competitors offer low introductory pricing followed by an increase in price after a certain period of time. We believe that these step-up promotions enable us to gain market share by attracting customers who leave our competitors following these price increases. We believe that we also currently compete successfully with the traditional phone and cable companies on the basis of the features we offer that they do not (such as area code

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selection, portable service, virtual phone numbers, and readable voice mail). We offer many of these features at no extra charge.

### Wireless telephone companies

We also compete with wireless phone companies, such as AT&T, Sprint, T-Mobile, and Verizon Wireless, for both our broadband telephone services and our mobile services. Some consumers use wireless phones, instead of VoIP phones, as a replacement for a wireline phone. Also, wireless phone companies increasingly are providing wireless broadband Internet access to their customers. As wireless providers offer more minutes at lower prices and other services that improve calling quality, their services have become more attractive to households as a competing replacement for wireline service. For example, many wireless phone companies now offer dual mode phones, which permit voice communications over a Wi-Fi network when available and which do not count against mobile plan minutes. Certain wireless phone companies have also made available products incorporating femtocells that utilize broadband connections to act as a miniature cellular tower, listening for and enhancing signals from a subscriber's cell phone, improving call quality at a subscriber's residence or other location. Calls connected via a femtocell signal are carried over the customer's home broadband network allowing the wireless carriers to offer unlimited calling or discounted rates for calls from home. Wireless telephone companies have a strong retail presence and have significant financial resources. We are developing next-generation services to meet the emerging needs of mobile and other connected device users by delivering easy-to-use applications that provide significant cost savings in large existing markets. We believe that our efforts will capitalize on favorable trends including the proliferation of low or no-cost Wi-Fi and other broadband around the world, accelerating smart phone adoption rates, and the growth of social communities.

### Alternative communication providers

We also compete against alternative communication providers such as magicJack, Skype, and Google Voice, some of which are larger than us and have the ability to devote greater resources to their communications services. Some of these service providers, including Internet product and software companies, have chosen to sacrifice telephony revenue in order to gain market share or attract users to their platform and have offered their services at low prices or for free. While not all of these competitors currently offer the ability to call or be called by anyone not using their service, line portability, E911 service, and customer service, in the future they may integrate such capabilities into their service offerings. As we continue the introduction of applications that integrate different forms of voice, messaging, and other services over multiple devices, we face competition from emerging competitors focused on similar integration, as well as from alternative communication providers.

There is a continuing trend toward consolidation of telecommunications companies, including the acquisition of alternative communication providers by Internet product and software companies with significant resources. In addition, certain of 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, which could give rise to significant new competition.

In connection with our increasing emphasis on the international long distance market, we face competition from low-cost international calling cards and VoIP providers in addition to traditional telephone companies, cable companies, and wireless companies.

## EMPLOYEES

As of December 31, 2011, we had 1,008 employees. None of our employees are subject to a collective bargaining agreement.

## AVAILABLE INFORMATION

We were incorporated in Delaware in May 2000 and changed our name to Vonage Holdings Corp. in February 2001. We maintain a website with the address [www.vonage.com](http://www.vonage.com). The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own Internet

access charges, we make available free of charge through our website our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we have electronically filed such material with, or furnished such material to, the Securities and Exchange Commission.



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ITEM 1A. Risk Factors

You should carefully consider the risks below, as well as all of the other information contained in this Annual Report on Form 10-K and our financial statements and the related notes included elsewhere in this Annual Report on Form 10-K, in evaluating our company and our business. Any of these risks could materially adversely affect our business, financial condition and results of operations and the trading price of our common stock.

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

If we are unable to compete successfully, we could lose market share and revenue.

The telecommunications industry is highly competitive. We face continued intense competition from traditional telephone companies, cable companies, wireless companies, and alternative communication providers. Our competitors include the traditional telephone service providers, including AT&T, Verizon Communications, and CenturyLink, which provide telephone service based on the public switched telephone network. Some of these traditional providers also have added VoIP services to their existing telephone and broadband offerings. We also face competition from cable companies, such as Cablevision, Charter Communications, Comcast Corporation, Cox Communications, and Time Warner Cable, which have added VoIP services to their existing cable television and broadband offerings. Further, as wireless providers, including AT&T, Sprint, T-Mobile, and Verizon Wireless, offer more minutes at lower prices, better coverage, and companion landline alternative services, including through products such as dual mode phones and femtocells, their services have become more attractive to households as a replacement for wireline service.

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 greater name and brand name recognition and a large existing customer base. Because most of our target customers are already purchasing communications services from one or more of these providers, our success is dependent upon our ability to attract target customers away from their existing providers. Our competitors' financial resources may allow them to offer services at prices below cost or even for free in order to maintain and gain market share or otherwise improve their competitive positions. Our competitors also could use their greater financial resources to develop and market telephony and messaging services with more attractive features and more robust customer service. In addition, because of the other services our competitors provide, they often choose to offer VoIP 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. This bundle may enable our competitors to offer VoIP service at prices with which we may not be able to compete or to offer functionality that integrates VoIP service with their other offerings, both of which may be more desirable to consumers. Any of these competitive factors could make it more difficult for us to attract and retain customers, reduce our market share and revenues, or cause us to lower our prices or offer additional features that may result in additional costs without commensurate price increases.

We also compete against alternative communication providers, such as magicJack, Skype, and Google Voice, some of which are larger than us, have greater name and brand recognition, and have the ability to devote greater resources to their communications services. Some of these service providers, including Internet product and software companies, have chosen to sacrifice telephony revenue in order to gain market share or attract customers to their platform or have lower cost structures and have offered their services at low prices or for free or using different payment structures such as one-time or low annual fees. As we continue the introduction of applications that integrate different forms of voice and messaging services over multiple devices, we face competition from emerging competitors focused on similar integration, as well as from established alternative communication providers. In order to compete with such service providers, we may have to reduce our prices, which would impair our profitability, or offer additional features that may cause us to incur additional costs without commensurate price increases.

In connection with our increasing emphasis on the international long distance market, we face competition from low-cost international calling cards and VoIP providers in addition to traditional telephone companies, cable companies, and wireless companies. To the extent that these providers target marketing to the same ethnic segments

that we target or strengthen their offerings to these segments, we may have to reduce our prices or increase promotions, which would impair our profitability, or offer additional features that may cause us to incur additional costs without commensurate price increase.

As a result of increasing competition, domestic and international telephony and messaging rates have generally decreased during the past few years, and we expect this trend to continue. We also receive inquiries or demands from state and municipal taxing authorities seeking payment of taxes or similar fees, which taxes and fees are charged to customers. Continued rate pressures or increasing cost to use our services could lessen or eliminate the pricing advantage that we maintain over certain competitors and cause customers or potential customers to select alternative providers or cause us to lower our prices, which would adversely impact our revenues and profitability.

There is a continuing trend toward consolidation of telecommunications companies, including the acquisition of alternative communication providers by Internet product and software companies, which may create competitors with greater resources. In addition, certain of our competitors have partnered and may in the future partner with other competitors to offer products and services, leveraging their collective competitive positions, which makes it more difficult to compete with them and could adversely affect our profitability.

If we fail to adapt to rapid changes in the market for voice and messaging services, then our products and services could become obsolete.

The market for our products and services is constantly and rapidly evolving as we and our competitors introduce new and enhanced products and services and react to changes in VoIP and messaging technology and customer demands. We may not be able to develop or acquire new products and plans or product and plan enhancements that compete effectively with present or emerging VoIP and messaging technologies or differentiate our products and plans based on functionality and performance. In addition, we may not be able to establish or maintain strategic alliances that will permit enhancement opportunities or innovative distribution methods for our products and plans.

To succeed, we believe that we need to expand into new market segments, develop new sources of revenue from new and existing customers, enhance our current products and plans, and develop new products and plans on a timely basis to keep pace with market needs and satisfy the increasingly sophisticated requirements of customers. VoIP and messaging technology is complex, and new products and plans and product and plan enhancements can require long development and testing periods. Any delays in developing and releasing new or enhanced products and plans, including as a result of any limitations with our internal systems or the integration of our new ordering and billing platforms,

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could cause us to lose revenue opportunities and customers. Any technical flaws in products we release could diminish the innovative impact of the products and have a negative effect on customer adoption and our reputation. We also are subject to the risk of future disruptive technologies. New products based on new technologies or new industry standards could render our existing products obsolete and unmarketable. If new technologies develop that are able to deliver competing voice and messaging services at lower prices, better or more conveniently, it could have a material adverse effect on us.

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. Vonage Mobile is downloadable for free. In the future, we may enhance this service or introduce other similar services for mobile and other connected devices. These services may include optional added cost premium services such as international calling plans, alternatives for high priced international roaming services, and lower cost text messaging. If we are unable to attract users of these premium services offered by Vonage Mobile or future offerings, our net revenues may fail to grow as we expect.

If we are unsuccessful at retaining customers or attracting new customers, including customers who pay for our services for mobile and other Internet connected devices, we may experience a reduction in revenue or may be required to spend more money to grow our customer base.

Our rate of customer terminations for our broadband telephone replacement services, or average monthly customer churn, was 2.6% for the year ended December 31, 2011. During 2011, we added 613,991 customers while 656,641 of our customers terminated. Our churn rate could increase in the future if customers are not satisfied with the quality and reliability of our network, the value proposition of our products, and the ability of our customer service to meet the needs and expectations of our customers. In addition, competition from traditional telephone companies, cable companies, wireless companies, alternative communications providers, and low-cost international calling cards, disruptive technologies, general economic conditions, and our ability to activate and register new customers on the network, also influence our churn rate. While it is a small portion of our current business, we will have similar issues with customers for Vonage Mobile and other services for mobile and other Internet connected devices as that business develops.

As we continue to emphasize the international long distance market, we expect our churn to be impacted by the ethnic segments that we target. For example, we have found that certain ethnic segments have higher churn due to unwillingness to use our existing payment methods. We may not be able to educate these customers in these payment methods or offer alternative payment methods that serve the needs of these customers. In addition, certain ethnic segments that we target may be more likely to have poor or no credit history, indicating that they may have more difficulty affording the service, leading to higher churn for these customers.

Because of customer losses, we have to acquire new customers on an ongoing basis just to maintain our existing level of customers and revenues. As a result, marketing expense is an ongoing requirement of our business. If our churn rate increases, we will have to acquire even more new customers in order to maintain our existing revenues. We incur significant costs to acquire new customers, and expect to continue to do so in connection with the introduction of Vonage Mobile, and those costs are an important factor in maintaining profitability. Therefore, if we are unsuccessful in retaining customers, are required to spend significant amounts to acquire new customers beyond those budgeted, or our marketing and advertising efforts are not effective in targeting specific customer segments, our revenue could decrease or we could incur losses.

If we are unable to establish and expand strategic relationships our ability to grow revenues and offer new products under commercially attractive terms may be inhibited, which could adversely affect our business, results of operations, and financial condition.

An element of our growth strategy is to develop and maintain strategic relationships both in the U.S. and internationally. We have or are pursuing relationships in the U.S. retail industry as well as international concepts ranging from virtual peering relationships to full VoIP communication services to be marketed and distributed as a complement to an existing foreign provider's product suite. The development of these relationships may assist us in enhancing our brand, introducing our products and services to larger numbers of customers, developing and implementing new products and services, and generating additional revenue. We may not be able to enter into new

relationships in the U.S. or internationally on economic terms favorable to us. In addition, if we lose any of our important strategic relationships or if strategic relationships fail to benefit us as expected, our ability to grow revenues and offer new products may be inhibited which could adversely affect our business, results of operations, and financial condition.

Our ability to provide our telephony service and manage related customer accounts is dependent upon third-party facilities, equipment, and systems, the failure of which could cause delays of or interruptions to of our service, damage our reputation, cause us to lose customers, limit our growth, and affect our financial condition.

Our success depends on our ability to provide quality and reliable telephony service, which is in part dependent upon the proper functioning of facilities and equipment owned and operated by third parties and is, therefore, beyond our control. Unlike traditional wireline telephone service or wireless service, our service requires our customers to have an operative broadband Internet connection and an electrical power supply, which are provided by the customer's Internet service provider and electric utility company, respectively, and not by us. The quality of some broadband Internet connections may be too poor for customers to use our services properly. In addition, if there is any interruption to a customer's broadband Internet service or electrical power supply, that customer will be unable to make or receive calls, including emergency calls, using our service.

We outsource several of our network functions to third-party providers. For example, we outsource the maintenance of our regional data connection points, which are the facilities at which our network interconnects with the public switched telephone network. If our third-party service providers fail to maintain these facilities properly, or fail to respond quickly to problems, our customers may experience service interruptions. Interruptions in our service caused by third-party facilities have in the past caused and may in the future cause us to lose customers or cause us to offer substantial customer credits, which could adversely affect our revenue and profitability. If interruptions adversely affect the perceived reliability of our service, we may have difficulty attracting new customers, and our brand, reputation, and growth will be negatively impacted.

In order to access our residential, small office, and home office services, a customer needs to connect a standard telephone to a broadband Internet connection through a Vonage-enabled device that we provide. Although we closely monitor inventory levels, if we are unable to procure a sufficient number of devices from our single supplier in a timely manner, including as a result of a failure by a component supplier, we would be delayed in activating new customers and may lose these customers.

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We also rely on third party platforms for some of our back office functions that allow us to manage customer accounts. For example, we are a party to an agreement with Amdocs, Inc. to license systems to enhance our ordering and billing capabilities. The platform is now operational and it is our intention to transition customers to the platform throughout 2012. If we encounter material challenges during the implementation of the new systems or the transition of customers this could adversely affect customer satisfaction. Any failure to implement this ordering and billing system in the timeframe we expect, or at all, may materially affect our ability to introduce new products on the schedule that we prefer and could result in increased costs to enhance our existing ordering and billing systems or procure replacement systems or alternative means for ordering and billing our products. As a result, our growth, system of internal controls, or results of operations could be materially and adversely affected.

We rely on third parties to provide a portion of our customer service representatives, provide aspects of our E-911 service, and initiate local number portability for our customers. If these third parties do not provide our customers with reliable, high-quality service, our reputation will be harmed and we may lose customers.

We offer our customers support 24 hours a day, seven days a week through both our comprehensive online account management website and our toll free number. Our customer support is currently provided via United States based employees as well as third party partners located in the United States, Philippines, Costa Rica, Chile, Mexico, and India. We offer support in English, Spanish, and French Canadian. Our third-party providers generally represent us without identifying themselves as independent parties. The ability to support our customers may be disrupted by natural disasters, inclement weather conditions, civil unrest, and other adverse events in the locations where our customer support is provided.

We also contract for services required to provide E-911 services including assistance in routing emergency calls, terminating E-911 calls, operating a national call center that is available 24 hours a day, seven days a week to receive certain emergency calls, and maintaining PSAP databases for the purpose of deploying and operating E-911 services. Interruptions in service from our vendor could cause failures in our customers' access to E-911 services and expose us to liability and damage our reputation.

We also have agreements with companies that initiate our local number portability, which allow new customers to retain their existing telephone numbers when subscribing to our services.

If any of these third parties do not provide reliable, high-quality service, our reputation and our business will be harmed. In addition, industry consolidation among providers of services to us may impact our ability to obtain these services or increase our expense for these services.

Flaws in our technology and systems or our failure to adapt our systems to any new Internet Protocol could cause delays or interruptions of service, which could damage our reputation, cause us to lose customers, and limit our growth.

Although we have designed our service network to reduce the possibility of disruptions or other outages, our service may be disrupted by problems with our technology and systems, such as malfunctions in our Vonage-enabled device that we provide to customers, software or facilities and overloading of our network. As we attract new subscribers, we expect increased call volume that we need to manage to avoid network interruptions. In particular, as we have marketed to different international long distance markets, we have seen international call volumes to targeted countries increase. During the next few years we expect wide-spread industry adoption of a new Internet Protocol, which is a set of standard communications and routing mechanisms. Customers may experience periodic delays of service caused by the industry transition to this new Internet Protocol. Interruptions have caused and may in the future cause us to lose customers and offer substantial customer credits, which could adversely affect our revenue and profitability. Network interruptions have also impaired our ability at times to sign-up new customers and the ability of customers to manage their accounts. During 2011, we had multiple outages that affected groups of customers at various times, some of which affected large groups of customers for several hours. If service interruptions or other outages adversely affect the perceived reliability of our telephony service or customer service, we may have difficulty attracting and retaining customers and our brand reputation and growth may suffer.

We may be subject to damaging and disruptive intellectual property litigation that could materially and adversely affect our business, results of operations, and financial condition, as well as the continued viability of our company.

There has been substantial litigation in the VoIP and related industries regarding intellectual property rights and, given the rapid technological change in our industry and our continual development of new products and services, we and/or our commercial partners may be subject to infringement claims from time to time. For example, we may be unaware of filed patent applications and issued patents that could include claims covering our products and services. We were subject to patent infringement claims in the past, including suits that we settled in 2007 and 2008 for a total of \$243,825 with Verizon, Sprint, AT&T, Nortel Networks, and others. We are also currently named as a defendant in two suits that relate to alleged patent infringement and from time to time we receive letters from third parties initiating an opportunity for us to obtain licenses to patents that may be relevant to our business or alleging that our services infringe upon third party patents or other intellectual property. See “Item 3. – Legal Proceedings—IP Matters.” Parties making claims of infringement may be able to obtain injunctive or other equitable relief that could effectively block our ability to provide our services and could cause us to pay substantial royalties, licensing fees, damages or settlement fees. The defense of any lawsuit could divert management’s efforts and attention from ordinary business operations and result in time-consuming and expensive litigation, regardless of the merits of such claims. These outcomes may:

- >result in the loss of a substantial number of existing customers or prohibit the acquisition of new customers;
- >cause us to accelerate expenditures to preserve existing revenues;
- >cause existing or new vendors to require prepayments or letters of credit;
- >cause our credit card processors to demand reserves or letters of credit or make holdbacks;
- >result in substantial employee layoffs;
- >materially and adversely affect our brand in the marketplace and cause a substantial loss of goodwill;

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> cause our stock price to decline significantly or otherwise cause us to fail to meet the continued listing requirements of the New York Stock Exchange, which could distract management and result in the delisting of our common stock from the exchange;

> materially and adversely affect our liquidity, including our ability to pay debts and other obligations as they become due;

> cause us to change our business methods or services;

> require us to cease certain business operations or offering certain products and services; and

> lead to our bankruptcy or liquidation.

If we fail to protect our internally developed systems and software and our trademarks, we may become involved in costly litigation or our business or brand may be harmed.

Our ability to compete effectively is dependent in large part upon the maintenance and protection of systems and software that we have developed internally based on open standards. While we own eight internally developed U.S. issued patents, have a number of pending patent applications, and have acquired third party patents, we cannot patent much of the technology that is important to our business. Our pending patent applications may not be granted. Any issued patent that we own may be challenged, narrowed, invalidated, or circumvented. To date, we have relied on copyright and trade secret laws, as well as confidentiality procedures and licensing arrangements, to establish and protect our rights to this technology. We typically enter into confidentiality or license agreements with our employees, consultants, customers, and vendors in an effort to control access to and distribution of technology, software, documentation, and other information. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use this technology without authorization. Policing unauthorized use of this technology is difficult. The steps we take may not prevent misappropriation of the technology we rely on. In addition, effective protection may be unavailable or limited in some jurisdictions outside the United States, Canada, and the United Kingdom. Litigation may be necessary in the future to enforce or protect our rights or to determine the validity and scope of the rights of others. That litigation could cause us to incur substantial costs and divert resources away from our daily business, which in turn could materially adversely affect our business.

The unlicensed use of our brand by third parties could harm our reputation, cause confusion among our customers, and impair our ability to market our services. To that end, we have registered numerous trademarks and service marks and have applied for registration of our trademarks and service marks in the United States and abroad to establish and protect our brand names as part of our intellectual property strategy. If our applications receive objections or are successfully opposed by third parties, it will be difficult for us to prevent third parties from using our brand without our permission. Moreover, successful opposition to our applications might encourage third parties to make additional oppositions or commence trademark infringement proceedings against us, which could be costly and time consuming to defend against. If we decide to take limited or no action to protect our trademarks, our trademark rights may be diluted and subject to challenge or invalidation, which could materially and adversely affect our brand in the marketplace.

Certain rights to third party patents and technology may expire and not be extended, or may not be available.

Certain previously disclosed patent rights granted to the Company under our agreements with AT&T and Sprint will expire between January 2013 and May 2014. It may be necessary to negotiate extensions of such rights, and if so and we are unable to do so on terms acceptable to us upon expiration, our making, using, and selling of existing and future products and services may be subject to challenges as infringing AT&T or Sprint patents. In addition, we may seek to obtain rights to third party technology in the future, but may not be able to agree upon commercially reasonable terms or at all with respect to obtaining such rights. If we are unable to extend existing licenses or are unable to obtain rights to other technology that may be commercially advantageous or necessary for our product and service offerings, we may experience a decrease in the quality of our products or services or we may lose the ability to provide our products

and services on a non-infringing basis until alternative technology or suitable alternative products and services can be developed, identified, obtained (through acquisition, license or other grants of rights), and integrated. We may incur significant costs and harm to our reputation from lawsuits and regulatory inquiries related to our business practices, which may also divert the attention of our management from other aspects of our business. In 2010, we reached a settlement in several purported class actions in California, New Jersey, and Washington that alleged a wide variety of deficiencies with respect to our business practices, marketing disclosures, e-mail marketing, and quality issues for both phone and fax service. The settlement included a release and dismissal with prejudice of all consumer claims against us and provided a settlement benefit of \$4,750 into a common fund for the benefit of class members. The common fund included all awarded fees, costs, and expenses (including attorneys' fees and costs), some of the costs to provide notice of settlement, administrative expenses, and incentive awards, if any, with the remainder of the common fund to be distributed to members of the class who timely filed claims, with the balance of the fund, if any, to be distributed cy pres to charity if approved by the court pursuant to a plan of allocation among class members. We have been subject to periodic regulatory inquiries regarding our business practices, including an investigation settled in 2009 with a group of 32 States attorney generals into certain of our business practices. There was no finding of any violation or wrongdoing by us, and the 32 states participating in the settlement have released us and our affiliates from the matters investigated. We paid \$3,000 in connection with the settlement and compliance with other provisions of the settlement is ongoing. On July 18, 2011 we entered into an amended settlement agreement initiated at our request to reflect revised business practices associated with our new "consumable" product offerings. Any similar claims or regulatory inquiries, whether successful or not, could require us to devote significant amounts of monetary or human resources to defend ourselves and could harm our reputation. We may need to spend significant amounts on our legal defense, senior management may be required to divert their attention from other portions of our business, new product launches may be deferred or canceled as a result of any proceedings, and we may be required to make changes to our present and planned products or services. If, as a result of any proceedings, a judgment is rendered or a decree is entered against us, it may materially and adversely affect our business, financial condition, and results of operations and harm our reputation.



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Our services are subject to regulation, and future legislative, regulatory or judicial actions could adversely affect our business and expose us to liability.

Our business has developed in a relatively lightly regulated environment. However, the United States and other countries have applied some traditional telephone company regulations to VoIP and continue to evaluate how VoIP should be regulated. The effects of future regulatory developments are uncertain.

Interconnected VoIP providers, such as Vonage, are subject to certain Federal Communications Commission ("FCC") rules. For example, on August 5, 2005, the FCC released an Order extending the obligations of the Communications Assistance for Law Enforcement Act ("CALEA") to interconnected VoIP providers. Under CALEA, telecommunications carriers must assist law enforcement in executing electronic surveillance, which include the capability of providing call content and call-identifying information to a local enforcement agency, or LEA, pursuant to a court order or other lawful authorization. To date, we have taken significant steps towards CALEA compliance. We could be subject to an enforcement action by the FCC if our CALEA solution is deemed not fully operational. Effective February 2, 2011, another FCC order reduced to one business day the amount of time that a telecommunications provider such as Vonage has to port a telephone number to another provider. If we, or third parties we rely upon for porting, have difficulty complying with the new one-day porting requirement, we could be subject to FCC enforcement action.

Future legislative, judicial or other regulatory actions could have a negative effect on our business. If we become subject to the rules and regulations applicable to telecommunications providers in individual states, we may incur significant litigation and compliance costs, and we may have to restructure our service offerings, exit certain markets, or raise the price of our services, any of which could cause our services to be less attractive to customers. In addition, future regulatory developments could increase our cost of doing business and limit our growth.

As we expand our international operations into new geographies, we will be increasingly subject to risks that are inherent in operating abroad, including increased governmental regulation, currency restrictions and other restraints, and burdensome taxes.

Our services are in use in countries outside of the United States, Canada, and the United Kingdom where we have regular operations, including countries where providing VoIP services is or may be illegal. It is possible that governments outside of the United States, Canada, and the United Kingdom may try to subject our services to governmental regulations, including telecommunications, data retention, privacy, consumer protection, financial, and other laws and regulations. In addition, if these governments believe that we are providing unauthorized service in their countries, they may pursue fines, penalties, or other governmental action, including criminal action, that may damage our brand and reputation.

As we expand our international operations into new geographies, we expect to become subject to numerous additional governmental regulations, including telecommunications, data retention, privacy, consumer protection, financial, and other applicable laws and regulations. Some of these regulations may be complicated or unsettled. Any failure to comply with governmental regulation could result in fines, penalties, or other governmental action, including criminal action, and may damage our brand and reputation. In addition, changes in legislation or regulations and actions by regulators, including changes in administration and enforcement policies, may from time to time require modifications to our offerings or the payment of fines and penalties, or both. In the United States, Canada, and United Kingdom, we are not a regulated telecommunications business. We may need to change our service offerings to avoid regulation as a telecommunications business in a jurisdiction or if we are treated as a regulated telecommunications business, we may be required to incur additional expenses. If we use a local partner to provide services in a country and the local partner does not comply with applicable governmental regulations, we may face additional regulation, liabilities, penalties or other governmental action, and our brand and reputation may be harmed.

As a United States-based company, any foreign subsidiary that we use for international operations may be subject to a variety of governmental regulations in the countries where we market our products, including tariffs and taxes. For example, distributions of earnings and other payments, including interest, received from our foreign subsidiaries may be subject to withholding taxes imposed by the jurisdiction in which such entities are formed or operating, which will reduce the amount of after-tax cash we can receive. In general, as a United States corporation, we may claim a foreign tax credit against our federal income tax expense for such foreign withholding taxes and for foreign income taxes paid

directly by foreign corporate entities in which we own 10% or more of the voting stock. The ability to claim such foreign tax credits and to utilize net foreign losses is, however, subject to numerous limitations, and we may incur incremental tax costs as a result of these limitations or because we are not currently in a tax-paying position in the United States. We may also be required to include in our income for United States federal income tax purposes our proportionate share of certain earnings of those foreign subsidiaries that are classified as “controlled foreign corporations” without regard to whether distributions have been actually received from such subsidiaries. As we expand international operations we will become more dependent on the economies of the markets in which we have operations. These markets are expected to be in countries with economies in various stages of development or structural reform, and our operations in such markets also could be affected by:

- > political, social and economic instability;
- > war, civil disturbance or acts of terrorism;
- > taking of property by nationalization or expropriation without fair compensation;
- > imposition of limitations on conversions of foreign currencies into United States dollars or remittance of dividends and other payments by foreign subsidiaries;
- > hyperinflation; and
- > impositions or increase of investment and other restrictions or requirements by foreign governments.

In particular, our research and development personnel and facility are located in Israel. Political, economic and military conditions in Israel directly affect our operations. For example, increased violence or armed conflict in Israel or the Palestinian territories may disrupt travel and communications in the region, harming our operations there. Furthermore, some of our employees in Israel are obligated to perform up to 36 days of military reserve duty annually and may be called to active duty in a time of crisis. The absence of these employees for significant periods may

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cause us to operate inefficiently during these periods.

Our international operations involve transactions in a variety of currencies. Our financial results may be significantly affected by fluctuations of currency exchange rates. To the extent that foreign subsidiaries distribute dividends in local currencies in the future, the amount of cash to be received by us will be affected by fluctuations in exchange rates, and such shifts in the currency exchange rates may have a material adverse effect on us. We do not maintain derivatives for managing foreign currency exchange rate risks.

A number of our agreements are governed by the laws of, and subject to dispute resolution in the courts of, or through arbitration proceedings in, the country or region in which the operations are located. We cannot accurately predict whether such forum will provide us with an effective and efficient means of resolving disputes that may arise in the future. Even if we are able to obtain a satisfactory decision through arbitration or a court proceeding, we could have difficulty enforcing any award or judgment on a timely basis. Our ability to obtain or enforce relief in the United States is uncertain.

We may be exposed to liabilities under the Foreign Corrupt Practices Act, the UK Bribery Act, and similar laws, and any determination that we violated any of these laws could have a material adverse effect on our business.

We are subject to the Foreign Corrupt Practice Act ("FCPA"), the UK Bribery Act and other laws that prohibit improper payments or offers of payments to foreign governments and their officials and political parties by persons and entities for the purpose of obtaining or retaining business. We have operations, agreements with third parties, and make sales internationally. Our international activities create the risk of unauthorized payments or offers of payments by one of our employees, consultants, sales agents or distributors, even though these parties are not always subject to our control. It is our policy to implement safeguards to discourage these practices by our employees, consultants, sales agents or distributors. However, our existing safeguards and any future improvements may prove to be less than effective, and our employees, consultants, sales agents or distributors may engage in conduct for which we might be held responsible. Violations of the FCPA, the UK Bribery Act or other laws may result in severe criminal or civil sanctions, and we may be subject to other liabilities, which could negatively affect our business, operating results, and financial condition.

We are dependent on a small number of individuals, and if we lose key personnel upon whom we are dependent, our business will be adversely affected.

Many of the key responsibilities of our business have been assigned to a relatively small number of individuals. Our future success depends to a considerable degree on the vision, skills, experience, and effort of our senior management, especially Marc P. Lefar, our Chief Executive Officer. The loss of the services of these officers could have a material adverse effect on our business. In addition, our continued growth depends on our ability to attract and retain experienced key employees.

We have incurred cumulative losses since our inception and may not achieve consistent profitability in the future.

While we achieved net income of \$409,044, which included the release of \$325,601 of the valuation allowance recorded against our net deferred tax assets that we recorded as a one-time non-cash income tax benefit, for the year ended December 31, 2011, from our inception through December 31, 2011, our accumulated deficit is \$762,857.

Although we believe we will achieve consistent profitability in the future, we ultimately may not be successful. We believe that our ability to achieve consistent profitability will depend, among other factors, on our ability to continue to achieve and maintain substantive operational improvements and structural cost reductions while maintaining and growing our net revenues. In addition, certain of the costs of our business are not within our control and may increase. For example, we and other telecommunications providers are subject to regulatory termination charges imposed by regulatory authorities in countries to which customers make calls, such as India where regulatory authorities have been petitioned by local providers to consider termination rate increases. As we attract additional international long distance callers, we will be more affected by these increases to the extent that we are unable to offset such costs by passing through price increases to customers.

We may be unable to fully realize the benefits of our net operating loss ("NOL") carry forwards if an ownership change occurs.

If we were to experience a "change in ownership" under Section 382 of the Internal Revenue Code ("Section 382"), the NOL carry forward limitations under Section 382 would impose an annual limit on the amount of the future taxable

income that may be offset by our NOL generated prior to the change in ownership. If a change in ownership were to occur, we may be unable to use a significant portion of our NOL to offset future taxable income. In general, a change in ownership occurs when, as of any testing date, there has been a cumulative change in the stock ownership of the corporation held by 5% stockholders of more than 50 percentage points over an applicable three-year period. For these purposes, a 5% stockholder is generally any person or group of persons that at any time during an applicable three-year period has owned 5% or more of our outstanding common stock. In addition, persons who own less than 5% of the outstanding common stock are grouped together as one or more “public group” 5% stockholders. Under Section 382, stock ownership would be determined under complex attribution rules and generally includes shares held directly, indirectly (through intervening entities), and constructively (by certain related parties and certain unrelated parties acting as a group).

Third parties may fraudulently use our name to obtain access to customer accounts and other personal information, use our services to commit fraud or steal our services, which could damage our reputation, limit our growth, and cause us to incur additional expenses.

Our customers have been subject to “phishing,” which occurs when a third party calls or sends an email or pop-up message to a customer that claims to be from a business or organization that provides services to the customer. The purpose of the inquiry is typically to encourage the customer to visit a bogus website designed to look like a website operated by the legitimate business or organization or provide information to the operator. At the bogus website, the operator attempts to trick the customer into divulging customer account or other personal information such as credit card information or to introduce viruses through “trojan horse” programs to the customers’ computers. This has resulted in identity theft from our customers and the unauthorized use of Vonage services. Third parties have also used our communications services to commit fraud. Although we have engaged a third party to assist in the shutdown of purported phishing sites, if we are unable to detect and prevent “phishing,” use of our services for fraud, and similar activities, our brand reputation and growth may suffer and we may incur additional costs, including costs to increase

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security, or be required to credit significant amounts to customers.

Third parties also have used our communications services without paying, including by submitting fraudulent credit card information. This has resulted in our incurring the cost of providing the services, including incurring call termination fees, without any corresponding revenues. We have implemented anti-fraud procedures in order to limit the expenses resulting from theft of service, which were not material in 2011. If our procedures are not effective, theft of service could significantly increase our expenses and negatively impact our profitability.

Our business may be harmed if we are unable to maintain data security and meet Payment Card Industry data security standards.

We are dependent upon automated information technology processes. Any failure to maintain the security of our data and our employees' and customers' confidential information, including via the penetration of our network security and the misappropriation of confidential information, could result in financial obligations to third parties, fines, penalties, regulatory proceedings, and private litigation with potentially large costs. Any such failure also could put us at a competitive disadvantage and result in deterioration in our employees' and customers' confidence in us, which may have a material adverse impact on our business, financial condition, and results of operations.

We make available on our website our privacy policy, which describes how we collect, use, and disclose our customers' personal information. As we expand our international operations into new geographies, we may become subject to local data security, privacy, data retention, and disclosure laws and regulations. It may be difficult for us to comply with these laws and regulations if they were deemed to be applicable to us.

We are subject to Payment Card Industry ("PCI") data security standards, which require periodic audits by independent third parties to assess compliance. PCI data security standards are a comprehensive set of requirements for enhancing payment account data security that was developed by the PCI Security Standards Council including American Express, Discover Financial Services, JCB International, MasterCard Worldwide, and VISA Inc., to help facilitate the broad adoption of consistent data security measures. Failure to comply with the security requirements as identified in subsequent audits or rectify a security issue may result in fines. While we believe it is unusual, restrictions on accepting payment cards, including a complete restriction, may be imposed on companies that are not compliant. Security breaches and other disruptions could compromise our information and expose us to liability, which would cause our business and reputation to suffer.

In the ordinary course of our business, we collect and store sensitive data, including intellectual property, our proprietary business information and that of our customers, suppliers, and business partners, and personally identifiable information of our customers and employees, in our data centers and on our networks. The secure processing, maintenance, and transmission of this information is critical to our operations and business strategy.

Despite our security measures, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to error, malfeasance or other disruptions by an employee or third-party provider. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, regulatory penalties, disruption to our operations, damage to our reputation, and a loss of confidence in our products and services, which could adversely affect our business.

The success of our business relies on customers' continued and unimpeded access to broadband service. Providers of broadband services may be able to block our services or charge their customers more for also using our services, which could adversely affect our revenue and growth.

Our customers must have broadband access to the Internet in order to use our service. Some providers of broadband access, including outside of the United States, may take measures that affect their customers' ability to use our service, such as degrading the quality of the data packets we transmit over their lines, giving those packets low priority, giving other packets higher priority than ours, blocking our packets entirely or attempting to charge their customers more for also using our services.

In the United States, there continues to be some uncertainty regarding whether suppliers of broadband Internet access have a legal obligation to allow their customers to access and use our service without interference. In December 2010, the FCC adopted new net neutrality rules that would protect services like ours from such interference. Several parties have sought judicial review of the FCC's net neutrality rules. These appeals are currently pending. Interference with

our service or higher charges for using our service could cause us to lose existing customers, impair our ability to attract new customers, and harm our revenue and growth. These problems could also arise in international markets. Most foreign countries have not adopted formal net neutrality rules like those adopted by the FCC.

If customers do not accept the differences between our service and traditional telephone service, they may choose to remain with their current telephone service provider or may choose to return to service provided by traditional telephone companies.

For certain users, aspects of our service are not the same as traditional telephone service. Our continued growth is dependent on the adoption of our services by mainstream customers, so these differences are important. For example:

> Both our E-911 and emergency calling services are different, in significant respects, from the 911 service associated with traditional wireline and wireless telephone providers and, in certain cases, with other VoIP providers.

> Our customers may experience lower call quality than they are used to from traditional wireline telephone companies, including static, echoes, and delays in transmissions.

> Our customers may experience higher dropped-call rates than they are used to from traditional wireline telephone companies.

> Customers who obtain new phone numbers from us do not appear in the phone book and their phone numbers are not available through directory assistance services offered by traditional telephone companies.

> Our customers cannot accept collect calls.

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>Our customers cannot call premium-rate telephone numbers such as 1-900 numbers and 976 numbers.

In the event of a power loss or Internet access interruption experienced by a customer, our service is interrupted.

> Unlike some of our competitors, we have not installed batteries at customer premises to provide emergency power for our customers' equipment if they lose power, although we do have backup power systems for our network equipment and service platform.

If customers do not accept the differences between our service and traditional telephone service, they may choose to remain with their current telephone service provider or may choose to return to service provided by traditional telephone companies.

Our emergency and E-911 calling services may expose us to significant liability.

The FCC rules for the provision of 911 service by interconnected VoIP providers, such as the VoIP service we provide, require that for all geographic areas covered by the traditional wireline E-911 network, interconnected VoIP providers must provide E-911 service as defined by the FCC's rules. Under the FCC's rules, E-911 service means that interconnected VoIP providers must transmit the caller's telephone number and registered location information to the appropriate PSAP for the caller's registered location. Vonage provides E-911 service, under the FCC's rules, to approximately 99.99% of its subscriber lines.

The remaining subscriber lines do not have E-911 service for a variety of reasons including refusal by PSAPs to accept VoIP 911 calls, the inability of PSAPs to receive the registered location data from us, and the failure by third party companies with whom we contract to provide aspects of our E-911 service to obtain the necessary access or complete implementation of the necessary interfaces to the traditional wireline E-911 infrastructure. In addition, certain of our services designed to be highly mobile including soft phone service, which is software that enables a customer to make telephone calls from a computer, route callers to a national emergency call center that in turns routes the call to the appropriate PSAP.

We could be subject to enforcement action by the FCC for our subscriber lines that do not have E-911 service. This enforcement action could result in significant monetary penalties and restrictions on our ability to offer non-compliant services.

Delays our customers may encounter when making emergency services calls and any inability of a PSAP to automatically recognize the caller's location or telephone number can have devastating consequences. Customers have attempted, and may in the future attempt, to hold us responsible for any loss, damage, personal injury or death suffered as a result. In July 2008, the New and Emerging Technologies 911 Improvement Act of 2008 became law and provided that interconnected VoIP providers have the same protections from liability for the operation of 911 service as traditional wireline and wireless providers. Limitations on liability for the provision of 911 service are normally governed by state law and these limitations typically are not absolute. Thus, for example, we could be subject to liability for a problem with our 911 service where our failures are greater than mere negligence. It is also unclear under the FCC's rules whether the limitations on liability would apply to those subscriber lines where Vonage does not provide E-911 service.

Our credit card processors have the ability to impose significant holdbacks in certain circumstances. The reinstatement of such holdbacks likely would have a material adverse effect on our liquidity.

Historically, our credit card processors have established reserves to cover any exposure that they may have as we collect revenue in advance of providing services to our customers, which is a customary practice for companies that bill their customers in advance of providing services. During 2010, our credit card processors released all reserves which consisted of cash reserves of \$23,101 and a cash-collateralized letter of credit for \$10,500. Under our credit card processing agreements with our Visa, MasterCard, American Express, and Discover credit card processors, the credit card processor has the right, in certain circumstances, including adverse events affecting our business, to impose a holdback of our advanced payments purchased using a Visa, MasterCard, American Express, or Discover credit card, as applicable, or demand additional reserves or other security. If circumstances were to occur that would allow any of these processors to reinstate a holdback, the negative impact on our liquidity likely would be significant. In addition, our Visa and MasterCard credit card processing agreement may be terminated by the credit card processor at its discretion if we are deemed to be financially insecure. As a significant portion of payments to us are made through

Visa and MasterCard credit cards, if the credit card processor does not assist in transitioning our business to another credit card processor, the negative impact on our liquidity likely would be significant. There were no cash reserves and cash-collateralized letters of credit with any credit card processors as of December 31, 2011.

If we require additional capital, we may not be able to obtain additional financing on favorable terms or at all.

We may need to pursue additional financing to respond to new competitive pressures, pay extraordinary expenses such as litigation settlements or judgments or fund growth, including through acquisitions. Because of our past significant losses and our limited tangible assets, we do not fit traditional credit lending criteria, which, in particular, could make it difficult for us to obtain loans or to access the capital markets. In addition, the credit documentation for our recent financing contains affirmative and negative covenants that affect, and in many respects may significantly limit or prohibit, among other things, our and certain of our subsidiaries' ability to incur, refinance or modify indebtedness and create liens.

The debt agreements governing our July 2011 financing contain restrictions that may limit our flexibility in operating our business.

On July 29, 2011, we consummated a financing consisting of an \$85,000 senior secured term loan and a \$35,000 revolving credit facility (the "2011 Credit Facility") replacing our December 14, 2010 financing. The 2011 Credit Facility contains customary representations and warranties and affirmative covenants that limit our ability and/or the ability of certain of our subsidiaries to engage in specified types of transactions. These covenants and other restrictions may under certain circumstances limit, but not necessarily preclude, our and certain of our subsidiaries' ability to, among other things:

- >consolidate or merge;
- >create liens;
- >incur additional indebtedness;
- >dispose of assets;
- >consummate acquisitions;
- >make investments; or
- >pay dividends and other distributions.



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Under the 2011 Credit Facility, we are required to comply with the following financial covenants: specified maximum consolidated leverage ratio, specified minimum consolidated fixed coverage charge ratio, minimum cash position and maximum capital expenditures. Our ability to comply with such financial and other covenants may be affected by events beyond our control, so we may not be able to comply with these covenants. A breach of any such covenant could result in a default under the 2011 Credit Facility. In that case, the lenders could elect to declare due and payable immediately all amounts due under the 2011 Credit Facility, including principal and accrued interest.

The market price of our common stock has been and may continue to be volatile, and purchasers of our common stock could incur substantial losses.

Securities markets experience significant price and volume fluctuations. This market volatility, as well as general economic conditions, could cause the market price of our common stock to fluctuate substantially. The trading price of our common stock has been, and is likely to continue to be, volatile. Many factors that are beyond our control may significantly affect the market price of our shares. These factors include:

- >changes in our earnings or variations in operating results;
- >any shortfall in revenue or increase in losses from levels expected by securities analysts;
- >judgments in litigation;
- >operating performance of companies comparable to us;
- >general economic trends and other external factors; and
- >market conditions and competitive pressures that prevent us from executing on our future growth initiatives.

If any of these factors causes the price of our common stock to fall, investors may not be able to sell their common stock at or above their respective purchase prices, or we may face delisting from the New York Stock Exchange. Jeffrey A. Citron, our founder, non-executive Chairman, and a significant stockholder, exerts significant influence over us.

As of December 31, 2011, Mr. Citron beneficially owned approximately 22.6% of our outstanding common stock, including outstanding securities exercisable for common stock within 60 days of such date. As a result, Mr. Citron is able to exert significant influence over all matters presented to our stockholders for approval, including election and removal of our directors and change of control transactions. In addition, as our non-executive Chairman, Mr. Citron has and will continue to have influence over our strategy and other matters as a board member. Mr. Citron's interests may not always coincide with the interests of other holders of our common stock.

Our certificate of incorporation and bylaws, the agreements governing our indebtedness, and the terms of certain settlement agreements to which we are a party contain provisions that could delay or discourage a takeover attempt, which could prevent the completion of a transaction in which our stockholders could receive a substantial premium over the then-current market price for their shares.

Certain provisions of our restated certificate of incorporation and our second amended and restated bylaws may make it more difficult for, or have the effect of discouraging, a third party from acquiring control of us or changing our board of directors and management. These provisions:

- > permit our board of directors to issue additional shares of common stock and preferred stock and to establish the number of shares, series designation, voting powers (if any), preferences, other special rights, qualifications, limitations or restrictions of any series of preferred stock;
- > limit the ability of stockholders to amend our restated certificate of incorporation and second amended and restated bylaws, including supermajority requirements;

- > allow only our board of directors, Chairman of the board of directors or Chief Executive Officer to call special meetings of our stockholders;
- > eliminate the ability of stockholders to act by written consent;
- > require advance notice for stockholder proposals and director nominations;
- > limit the removal of directors and the filling of director vacancies; and
- > establish a classified board of directors with staggered three-year terms.

In addition, a change of control would constitute an event of default under our 2011 Credit Facility. Upon the occurrence of an event of default, the lenders could elect to declare due and payable immediately all amounts due under our 2011 Credit Facility, including principal and accrued interest, and may take action to foreclose upon the collateral securing the indebtedness.

Under our 2011 Credit Facility, a “change of control” would result from the occurrence of, among other things, the acquisition by any person or group (other than Mr. Citron and his majority-controlled affiliates) of 35% or more of the voting and/or economic interest of our outstanding common stock on a fully-diluted basis.

We encourage you to read the agreement in full, including the definition of “change of control” therein. The 2011 Credit Facility has been previously filed with the Securities and Exchange Commission as Exhibit 10.1 to a Form 8-K filed by us on July 29, 2011.

Further, we were named as a defendant in several suits that related to patent infringement and entered into agreements to settle certain

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of the suits in 2007. Certain terms of those agreements, including licenses and covenants not to sue, will be restricted upon a change of control, which may discourage certain potential purchasers from acquiring us. Such provisions could have the effect of depriving stockholders of an opportunity to sell their shares at a premium over prevailing market prices. Any delay or prevention of, or significant payments required to be made upon, a change of control transaction or changes in our board of directors or management could deter potential acquirors or prevent the completion of a transaction in which our stockholders could receive a substantial premium over the then-current market price for their shares.

## ITEM 1B. Unresolved Staff Comments

Not applicable.

## ITEM 2. Properties

The following is a summary of our offices and locations:

| Location               | Business Use  | Square Footage | Lease Expiration Date |
|------------------------|---|----------------|-----------------------|
| Holmdel, New Jersey    | Corporate Headquarters, Network Operations, Customer Service, Sales and Marketing, and Administration | 350,000        | 2017                  |
| London, United Kingdom | Sales and Marketing, Administration   | 3,472          | 2015                  |
| Atlanta, Georgia       | Product Development   | 2,588          | 2013                  |
| Tel Aviv, Israel       | Application Development   | 7,158          | 2015                  |
|                        |   | 363,218        |                       |

We believe that the facilities that we occupy are adequate for our current needs and do not anticipate leasing any additional space.

## ITEM 3. Legal Proceedings

From time to time, we may become party to litigation and subject to claims, normally incidental to the ordinary course of our business.

## Litigation

## IP Matters

Alcatel-Lucent. On November 4, 2008, we received a letter from Alcatel-Lucent initiating an opportunity for us to obtain a non-exclusive license to certain of its patents that may be relevant to our business. After analyzing the applicability of the patents to our business and negotiations with Alcatel-Lucent, on November 29, 2011, Vonage and Alcatel-Lucent executed a bi-lateral licensing agreement.

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

Bear Creek Technologies, Inc. On February 22, 2011, Bear Creek Technologies, Inc. (“Bear Creek”) filed a lawsuit against Vonage Holdings Corp., Vonage America, Inc., and Vonage Marketing LLC in the United States District

Court for the Eastern District of Virginia (Norfolk Division) alleging that Vonage's products and services are covered by United States Patent No. 7,899,722, entitled "System for Interconnecting Standard Telephony Communications Equipment to Internet Protocol Networks" (the "722 Patent"). The suit also named numerous other defendants, including Verizon Communications, Inc., Comcast Corporation, Time-Warner Cable, Inc., AT&T, Inc., and T-Mobile USA Inc. On April 26, 2011, Bear Creek amended its complaint adding several defendants, dropping Vonage Communications (a non-existent entity) from the suit, and adding allegations of induced infringement and willful infringement. On May 9, 2011, Vonage filed a Motion to Sever Plaintiff's Claims against the Vonage entities and transfer them to New Jersey. On May 27, 2011, Vonage filed a Motion to Dismiss Bear Creek's claims of induced and willful infringement. Subsequently, other defendants filed similar motions to dismiss and sever and transfer. A hearing on the motions was held on August 12, 2011. On August 17, 2011, the Court dismissed Bear Creek's case against the Vonage entities, as well as all the other defendants, except for one defendant. Later, on August 17, 2011, Bear Creek re-filed its complaint concerning the '722 Patent in the United States District Court for the District of Delaware against the same Vonage entities. In its Delaware complaint, Bear Creek alleges that Vonage is infringing one or more claims of the '722 Patent. In addition, Bear Creek alleges that Vonage is contributing to and inducing infringement of one or more claims of the '722 Patent. On September 28, 2011, Vonage filed a motion to dismiss Bear Creek's claims for induced, contributory, and willful inducement. The motion is now fully briefed, but has not been ruled upon. On January 25, 2012, Bear Creek filed a motion with the United States Judicial Panel on Multidistrict Litigation seeking to transfer and consolidate its litigation against Vonage with thirteen separate actions Bear Creek filed in the U.S. District Courts for Delaware and the Eastern District of Virginia. By its motion, Bear Creek seeks to have all fourteen actions consolidated and transferred to the U.S. District Court for the District

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of Delaware. Vonage filed its response to Bear Creek's motion on February 15, 2012. Oral argument on Bear Creek's motion is scheduled for March 29, 2012.

GZTM Technology Ventures Ltd. On September 8, 2011, GZTM Technology Ventures Ltd. ("GZTM") filed a lawsuit against Vonage Holdings Corp., Vonage America Inc. and Vonage Marketing LLC in the United States District Court for the District of Delaware alleging that Vonage's products and services are covered by United States Patent No. 5,455,859, entitled "Telephone Handset Interface for Device Having Audio Input". The suit also named numerous other defendants, including Comcast Corporation, Cox Communications, Inc. and Time Warner Cable. On October 25, 2011, Vonage filed a Motion to Sever GTZM's claims against Vonage entities from GTZM's claims against the other defendants. The motion is now fully briefed, but has not been ruled upon. GTZM filed a First Amended Complaint on November 2, 2011. Vonage filed its answer to GTZM's First Amended Complaint on December 6, 2011. On January 20, 2012, the parties submitted a proposed scheduling order for the Court's consideration. The Court has not yet acted on the parties' proposed scheduling order. A scheduling conference with the Court is scheduled for February 28, 2012. From time to time, in addition to those identified above, we are subject to legal proceedings, claims, investigations, and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment, and other matters. From time to time we receive letters or other communications from third parties initiating an opportunity for us to obtain patent licenses that might be relevant to our business 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, 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 - CALEA

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

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

### Federal - Local Number Portability

On May 13, 2009, the FCC adopted an order that reduced to one business day the amount of time that an interconnected VoIP provider such as us has to port a telephone number to another provider. If we, or third parties we

rely upon for porting, have difficulty executing the new one-day porting requirement, we could be subject to FCC enforcement action.

#### Federal - Net Neutrality

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

#### 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 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

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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). We believe that the order would positively impact our costs over time. 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.

### 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.

### State and Municipal Taxes

In accordance with generally accepted accounting principles, we make a provision for a liability for taxes when it is both probable that a liability has been incurred and the amount of the liability or range of liability can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. For a period of time, we did not collect or remit state or municipal taxes (such as sales, excise, utility, use, and ad valorem taxes), fees or surcharges (“Taxes”) on the charges to our customers for our services, except that we historically complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these Taxes do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes to expressly include VoIP and we are now collecting and remitting sales taxes in those states. In addition, many states address how VoIP providers should contribute to support public safety agencies, and in those states we remit fees to the appropriate state agencies. We could also be contacted by state or municipal taxing and 911 agencies regarding Taxes that do explicitly apply to VoIP and these agencies could seek retroactive payment of Taxes. As such, we have a reserve of \$2,231 as of December 31, 2011 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is approximately \$5,000 as of December 31, 2011.

ITEM 4. Mine Safety Disclosures  
Not Applicable.



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## PART II

## ITEM 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

## Price Range of Common Stock

Our common stock has been listed on the New York Stock Exchange under the ticker symbol “VG” since May 24, 2006. Prior to that time, there was no public market for our common stock. The following table sets forth the high and low sales prices for our common stock as reported on the NYSE for the quarterly periods indicated.

|                | Price Range of<br>Common Stock |        |
|----------------|--------------------------------|--------|
|                | High                           | Low    |
| 2011           |                                |        |
| Fourth quarter | \$3.52                         | \$2.04 |
| Third quarter  | \$4.82                         | \$2.51 |
| Second quarter | \$5.39                         | \$3.99 |
| First quarter  | \$4.94                         | \$2.25 |
| 2010           |                                |        |
| Fourth quarter | \$2.79                         | \$2.10 |
| Third quarter  | \$2.62                         | \$1.92 |
| Second quarter | \$2.79                         | \$1.35 |
| First quarter  | \$1.83                         | \$1.30 |

## Holders

At January 31, 2012, we had approximately 167 stockholders of record. This number does not include beneficial owners whose shares are held in street name.

## Dividends

We have never paid cash dividends on our common stock, and we do not anticipate paying any cash dividends on our common stock for at least the next 12 months. We intend to retain all of our earnings, if any, for general corporate purposes, and, if appropriate, to finance the expansion of our business.

## Stock Performance Graph

The graph below compares the cumulative total return of our common stock between December 31, 2006 and December 31, 2011, with the cumulative total return of (1) the S&P 500 Index, (2) the NASDAQ Telecom Index and (3) the NYSE Composite Index. This graph assumes the investment of \$100 on December 31, 2006 in our common stock, the S&P 500 Index, the NASDAQ Telecom Index and the NYSE Composite Index, and assumes the reinvestment of dividends, if any.

The graph below and related information shall not be deemed “soliciting material” or “filed” with the Securities and Exchange Commission or otherwise subject to the liabilities of Section 18 of the Securities Exchange Act of 1934 (the “Exchange Act”), nor shall such information be deemed incorporated by reference into any filing under the Securities Act of 1933 (the “Securities Act”) or the Exchange Act, except to the extent we specifically request that such information be treated as soliciting material or specifically incorporate such information by reference into a document filed under the Securities Act or the Exchange Act.

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COMPARISON OF THE CUMULATIVE TOTAL RETURN ON COMMON STOCK BETWEEN DECEMBER 31, 2006 AND DECEMBER 31, 2011

Among Vonage Holdings Corp., the S&P 500 Index, the NASDAQ Telecom Index and the NYSE Composite Index.

|                       | December 31, |         |         |         |         |
|-----------------------|--------------|---------|---------|---------|---------|
|                       | 2007         | 2008    | 2009    | 2010    | 2011    |
| Vonage Holdings Corp. | \$33.14      | \$9.51  | \$20.17 | \$32.28 | \$35.30 |
| S&P 500 Index         | \$103.53     | \$63.69 | \$78.62 | \$88.67 | \$88.67 |
| NASDAQ Telecom Index  | \$109.17     | \$62.25 | \$95.25 | \$95.89 | \$83.79 |
| NYSE Composite Index  | \$106.58     | \$62.99 | \$81.22 | \$87.14 | \$81.81 |

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## ITEM 6. Selected Financial Data

The following table sets forth our selected historical financial information. The statement of operations and cash flow data for the years ended December 31, 2011, 2010, and 2009 and the balance sheet data as of December 31, 2011 and 2010 are derived from our audited consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K. The statement of operations and cash flow data for the years ended December 31, 2008 and 2007 and the balance sheet data as of December 31, 2009, 2008 and 2007 are derived from our audited consolidated financial statements and related notes not included in this Annual Report on Form 10-K. The results included below and elsewhere are not necessarily indicative of our future performance. You should read this information together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K.

| (In thousands, except per share amounts)   | For the Years Ended December 31, |            |            |            |             |
|--|----------------------------------|------------|------------|------------|-------------|
|  | 2011                             | 2010       | 2009       | 2008       | 2007        |
| Statement of Operations Data:  |                                  |            |            |            |             |
| Operating Revenues:  |                                  |            |            |            |             |
| Telephony services   | \$866,560                        | \$872,934  | \$864,848  | \$865,765  | \$803,522   |
| Customer equipment and shipping  | 3,763                            | 12,108     | 24,232     | 34,355     | 24,706      |
|  | 870,323                          | 885,042    | 889,080    | 900,120    | 828,228     |
| Operating Expenses:  |                                  |            |            |            |             |
| Direct cost of telephony services (1)  | 236,149                          | 243,794    | 213,553    | 226,210    | 216,831     |
| Royalty  | —                                | —          | —          | —          | 32,606      |
| Total direct cost of telephony services  | 236,149                          | 243,794    | 213,553    | 226,210    | 249,437     |
| Direct cost of goods sold  | 41,756                           | 55,965     | 71,488     | 79,382     | 59,117      |
| Selling, general and administrative  | 234,754                          | 238,986    | 265,456    | 298,985    | 461,768     |
| Marketing  | 204,263                          | 198,170    | 227,990    | 253,370    | 283,968     |
| Depreciation and amortization  | 37,051                           | 53,073     | 53,391     | 48,612     | 35,718      |
|  | 753,973                          | 789,988    | 831,878    | 906,559    | 1,090,008   |
| Income (loss) from operations  | 116,350                          | 95,054     | 57,202     | (6,439)    | (261,780)   |
| Other Income (Expense):  |                                  |            |            |            |             |
| Interest income  | 135                              | 519        | 277        | 3,236      | 17,582      |
| Interest expense   | (17,118)                         | (48,541)   | (54,192)   | (29,878)   | (22,810)    |
| Change in fair value of embedded features within notes payable and stock warrant | (950)                            | (99,338)   | (49,933)   | —          | —           |
| Gain (loss) on extinguishment of notes   | (11,806)                         | (31,023)   | 4,041      | (30,570)   | —           |
| Other income (expense), net  | (271)                            | (18)       | 843        | (247)      | (238)       |
|  | (30,010)                         | (178,401)  | (98,964)   | (57,459)   | (5,466)     |
| Income (loss) before income tax benefit (expense)                                | 86,340                           | (83,347)   | (41,762)   | (63,898)   | (267,246)   |
| Income tax benefit (expense)   | 322,704                          | (318)      | (836)      | (678)      | (182)       |
| Net Income (loss)  | \$409,044                        | \$(83,665) | \$(42,598) | \$(64,576) | \$(267,428) |
| Net income (loss) per common share:  |                                  |            |            |            |             |
| Basic  | \$1.82                           | \$(0.40)   | \$(0.25)   | \$(0.41)   | \$(1.72)    |
| Diluted  | \$1.69                           | \$(0.40)   | \$(0.25)   | \$(0.41)   | \$(1.72)    |
| Weighted-average common shares outstanding:                                      |                                  |            |            |            |             |
| Basic  | 224,324                          | 209,868    | 170,314    | 156,258    | 155,593     |
| Diluted  | 241,744                          | 209,868    | 170,314    | 156,258    | 155,593     |



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| (dollars in thousands)  | December 31, |            |           |           |             |
|---|--------------|------------|-----------|-----------|-------------|
|   | 2011         | 2010       | 2009      | 2008      | 2007        |
| Statement of Cash Flow Data:                                    |              |            |           |           |             |
| Net cash provided by (used in) operating activities             | \$ 146,786   | \$ 194,212 | \$ 38,396 | \$ 3,555  | \$(270,926) |
| Net cash provided by (used in) investing activities             | (37,604 )    | (4,686 )   | (50,565 ) | 40,486    | 131,457     |
| Net cash provided by (used in) financing activities             | (130,138 )   | (143,762 ) | (3,253 )  | (68,370 ) | 245         |
| Balance Sheet Data (at period end):                             |              |            |           |           |             |
| Cash, cash equivalents and marketable securities                | \$58,863     | \$78,934   | \$32,213  | \$46,134  | \$151,484   |
| Property and equipment, net                                     | 67,978       | 79,050     | 90,548    | 98,292    | 118,666     |
| Total deferred tax assets, including current portion, net       | 325,601      | —          | —         | —         | —           |
| Restricted cash   | 6,929        | 7,978      | 43,700    | 39,585    | 38,928      |
| Total assets  | 566,215      | 260,392    | 313,384   | 336,905   | 462,297     |
| Total notes payable, including current portion, net of discount | 70,833       | 193,004    | 201,771   | 194,050   | 253,320     |
| Capital lease obligations                                       | 17,665       | 19,448     | 20,948    | 22,199    | 23,235      |
| Total liabilities   | 266,648      | 390,039    | 405,293   | 427,647   | 537,424     |
| Total stockholders' equity (deficit)                            | 299,567      | (129,647 ) | (91,909 ) | (90,742 ) | (75,127 )   |

(1) Excludes depreciation and amortization of \$15,824 for 2011, \$18,725 for 2010, \$18,958 for 2009, \$20,254 for 2008, and \$18,434 for 2007.

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion together with "Selected Financial Data" and our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements, which involve risks and uncertainties. Our actual results may differ materially from those we currently anticipate as a result of many factors, including the factors we describe under "Item 1A—Risk Factors," and elsewhere in this Annual Report on Form 10-K.

OVERVIEW

We are a leading provider of communications services connecting people through broadband devices worldwide. We rely heavily on our network, which is a flexible, scalable Session Initiation Protocol (SIP) based Voice over Internet Protocol, or VoIP, network. 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.

In 2009, we shifted our primary emphasis from the domestic home phone replacement market to the international long distance market. With Vonage World we offer unlimited calling domestically and to more than 60 countries, including India, Mexico, and China, for a flat monthly rate. We believe the value and convenience provided by Vonage World is particularly appealing to international long distance callers compared to offers from our competitors.

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 have continued to build upon our mobile services strategy with two product introductions in mid-2011. 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 low-cost international calling to more than 200 countries to any other phone. In addition, calls by users of the mobile application to Vonage home or business lines are also free. This mobile application works over WiFi, 3G and 4G and in more than 90 countries worldwide. Vonage Mobile consolidates the best features of our prior applications, while adding important functionality, better value, and improved ease of use. Vonage Mobile users can instantly add calling credit from within the application through iTunes or the Android Market for calls to users without the application. Vonage Mobile uses the phone's existing mobile number and contact list, eliminating the need for unique user names and duplicate identities for contacts and allowing users to build a free global calling and messaging network from their existing contacts using the application's multiple invitation system.

We have made significant financial progress over the past four years providing a solid foundation for the future. We have managed a significant strategic shift while transforming the cost structure in our core business to drive significant improvements in profitability. We enhanced the value of our product by investing in upgraded systems, streamlined processes, and improved customer experience, which we believe have helped stabilize our subscriber base while driving structural cost reductions throughout the company. In addition to reducing ongoing costs, these structural improvements enabled us to absorb incremental costs resulting from a growth in international minutes as we added new customers to our Vonage World plan. By lowering international termination costs, lowering domestic calling rates, and reducing the cost of our devices by nearly a third, we have significantly improved our profitability. In 2011, our core business generated substantial net income and cash flow on relatively flat service revenues, driven by an aggressive focus on driving efficiencies throughout our operations. Through two refinancings in the past 14 months, we have reduced our debt by over 50% and lowered interest rates from highs of 20% to less than 4%, saving \$43 million in annual interest expense from the debt structure in place in 2010.

We had approximately 2.4 million subscriber lines for broadband telephone replacement services as of December 31, 2011. We bill customers in the United States, Canada, and the United Kingdom. Customers in the United States

represented 94% of our subscriber lines at December 31, 2011.

Recent Developments Net deferred tax assets represent the temporary differences between the financial reporting bases and the tax return bases of our assets and liabilities. Our net deferred tax assets primarily consist of net operating loss carry forwards (“NOLs”). We are required to record a valuation allowance which reduces these 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 these net deferred tax assets prior to expiration. We periodically review this conclusion, which requires significant management judgment. Until the fourth quarter of 2011, we recorded a valuation allowance which reduced our net deferred tax assets to zero. In the fourth quarter of 2011, based upon our sustained profitable operating performance over the past three years excluding certain losses associated with our prior convertible notes and our December 2010 debt refinancing and our positive outlook for taxable income in the future, our evaluation determined that the benefit resulting from our net deferred tax assets (namely, the NOLs) are likely to be usable prior to their expiration. Accordingly, we released the related valuation allowance against our United States and Canada net deferred tax assets, and a portion of the allowance against our state net deferred tax assets as certain NOLs may expire prior to utilization due to shorter utilization periods in certain states, resulting in a one-time non-cash income tax benefit of \$325,601 that we recorded in our statement of operations and a corresponding net deferred tax asset of \$325,601 that we recorded on our balance sheet on December 31, 2011. 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 has not been recognized prior to the reduction of the valuation allowance and that will reduce our net income and earnings per share. In the future, if available evidence changes our conclusion that it is more likely than not that we will utilize our net deferred tax assets prior to their expiration, we will make an adjustment to the related valuation allowance at that time.

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Trends in Our Industry 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 voice 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. 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 voice 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, 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. The November 2010 order by the FCC in response to a request by Kansas and Nebraska that permits states to impose state universal service fund obligations on VoIP service, discussed in Note 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. These rules make it more difficult for broadband Internet service providers to block or discriminate against Vonage service. Several broadband Internet service providers have filed appeals of the FCC’s new rules at the D.C. Circuit Court of Appeals alleging that the FCC lacks authority to apply its rules to broadband Internet service providers. 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). We believe that the order would positively impact our costs over time. See also the discussion under “Regulation” in Note 10 to our financial statements for a discussion of certain other regulatory issues that impact us.



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

|  | For the Years Ended December 31, |           |            |
|--|----------------------------------|-----------|------------|
|  | 2011                             | 2010      | 2009       |
| Gross subscriber line additions                            | 672,274                          | 640,205   | 748,681    |
| Change in net subscriber lines                             | (29,996 )                        | (30,013 ) | (155,458 ) |
| Subscriber lines (at period end)                           | 2,374,887                        | 2,404,883 | 2,434,896  |
| Average monthly customer churn                             | 2.6 %                            | 2.4 %     | 3.1 %      |
| Average monthly revenue per line                           | \$30.35                          | \$30.48   | \$29.49    |
| Average monthly telephony services revenue per line        | \$30.22                          | \$30.06   | \$28.68    |
| Average monthly direct cost of telephony services per line | \$8.23                           | \$8.40    | \$7.08     |
| Marketing costs per gross subscriber line addition         | \$303.84                         | \$309.54  | \$304.52   |
| Employees (excluding temporary help) (at period end)       | 1,008                            | 1,140     | 1,225      |

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 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 decreased by 29,996 from 2,404,883 as of December 31,

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2010 to 2,374,887 as of December 31, 2011.

**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 increased from 2.4% in 2010 to 2.6% in 2011. We believe the increase in churn was primarily due to higher early life churn as a result of no longer requiring a service agreement and higher churn rates of some ethnic calling segments that we targeted. 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. Our churn will fluctuate over time due to economic conditions, competitive pressures including wireless substitution, marketplace perception of our services, and our ability to provide high quality customer care and network quality and add future innovative products and services.

**Average monthly revenue per line.** Average monthly revenue per line for a particular period is calculated by dividing our total revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two. Our average monthly revenue per line decreased slightly to \$30.35 for 2011 compared to \$30.48 for 2010. This decrease was attributable to the elimination of equipment recovery fees and disconnect fees which were discontinued for new customers beginning September 2010.

**Average monthly telephony services revenue per line.** Average monthly telephony services revenue per line for a particular period is calculated by dividing our total telephony services revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. Our average monthly telephony services revenue per line increased slightly from \$30.06 for 2010 to \$30.22 for 2011. This increase was due to an increase in the number of customers signing up for higher priced rate plans, selective pricing actions we implemented along with enhancements to our service, and improved customer credit quality that reduced bad debt costs. These increases were partially offset by the elimination of disconnect fees which were discontinued for new customers beginning September 2010 and a decrease in activation fees as the historical deferred activation fees are amortized and new activation fees are no longer charged and deferred.

**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 slightly to \$8.23 for 2011 compared to \$8.40 for 2010, due primarily to more favorable rates negotiated with our service providers, the decrease in our network costs, and the decrease in E-911 costs. These decreases were offset by a larger base of Vonage World customers which increased international termination costs. Direct cost of telephony services both overall and on a per line basis is expected to increase in 2012. The drivers of this increase are increased international calling by our growing base of Vonage World customers partially offset by next generation call routing and peering relationships we are implementing.

**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, customer equipment subsidies, which are accounted for as direct cost of goods sold, or kiosk and community based events teams costs, which are accounted for as selling, general and administrative expenses. 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 decreased to \$303.84 for 2011 from \$309.54 in 2010, as our

increased marketing investment in direct mail to targeted ethnic segments yielded incremental gross subscriber line additions.

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

## OPERATING REVENUES

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

Telephony services revenue. Substantially all of our operating revenues are telephony services revenue. In the United States, we have six residential plans, “Vonage World”, “World Premium Unlimited”, “Vonage Pro”, “U.S. and Canada Unlimited”, “U.S. and Canada 300”, and “U.S. and Canada 750”, two mobile plans, “Vonage World Mobile” and “Vonage Mobile Pay per Use” and two small office and home office calling plans, “Small Business Premium Unlimited Minutes” and “Small Business Basic 1500 Minutes”. Each of our unlimited plans other than Vonage World offers unlimited domestic calling as well as unlimited calling to Puerto Rico, Canada, and selected European countries, subject to certain restrictions. Each of our basic plans offers a limited number of domestic calling minutes per month. We also offer international calling plans that are bundled with our Residential Premium Unlimited plan where a customer can make calls to a chosen international region. We offer similar plans in Canada and the United Kingdom. The “Vonage World” plan, now available in the United States and Canada, offers unlimited calling across the United States and Puerto Rico, unlimited international calling to over 60 countries including India, Mexico, and Canada, subject to certain restrictions, and free voicemail to text messages with Vonage Visual Voicemail. Under our basic plans, we charge on a per minute basis when the number of domestic calling minutes included in the plan is exceeded for a particular month. International calls (except for calls to Puerto Rico, Canada and certain European countries under our unlimited plans and a variety of countries under international calling plans and Vonage World) are charged on a per minute basis. These per minute fees are not included in our monthly subscription fees.

In 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 have continued to build upon our mobile services strategy with two product introductions in mid-2011. 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, better value and improved ease of use including direct payment through iTunes.

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

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service. One business fax line is included with each of our two small office and home office plans, but we charge monthly fees for additional business fax lines. We automatically charge these fees to our customers' credit cards, debit cards, or electronic check payments ("ECP"), monthly in advance. We also automatically charge the per minute fees not included in our monthly subscription fees to our customers' credit cards, debit cards or ECP monthly in arrears unless they exceed a certain dollar threshold, in which case they are charged immediately.

By collecting monthly subscription fees in advance and certain other charges immediately after they are incurred, we are able to reduce the amount of accounts receivable that we have outstanding, thus allowing us to have lower working capital requirements. Collecting in this manner also helps us mitigate bad debt losses, which are recorded as a reduction to revenue. If a customer's credit card, debit card or ECP is declined, we generally suspend international calling capabilities as well as the customer's ability to incur domestic usage charges in excess of their plan minutes. Historically, in most cases, we are able to correct the problem with the customer within the current monthly billing cycle. If the customer's credit card, debit card or ECP could not be successfully processed during three billing cycles (i.e., the current and two subsequent monthly billing cycles), we terminate the account.

From time to time we have generated revenue by charging a fee for activating service, although we do not currently or expect to charge an activation fee to customers. In these instances when no activation fee is being collected, no customer acquisition costs are deferred. Customer activation fees when collected, along with the related incremental direct customer acquisition amounts for customer equipment in the direct channel and for rebates and retailer commissions in the retail channel, up to but not exceeding the activation fee, are deferred and amortized over the estimated average customer relationship period ("customer life"). The amortization of deferred customer equipment is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction of telephony services revenues. The amortization of deferred retailer commissions is recorded as marketing expense. This customer life is solely used to amortize deferred activation fees collected, which we have waived for almost all new customers since May 2009, including those signing up for our Vonage World plan, along with the related incremental customer acquisition costs. Customers signing up for our Vonage World plan currently churn at lower rates than other customers, and therefore appear to have a longer customer life. Because these customers have not paid an activation fee, this does not impact the customer life used in determining the amortization period. The customer life was 38 months for 2011 and will remain at 38 months for 2012 based on consistent historical trends.

In the United States, we charge regulatory, compliance, E-911, and intellectual property-related recovery fees on a monthly basis to defray costs and to cover taxes that we are charged by the suppliers of telecommunications services. In addition, we recognize revenue on a gross basis for contributions to the Federal Universal Service Fund ("USF") and related fees. All other taxes are recorded on a net basis.

In addition, historically, we charged a disconnect fee for customers who terminated their service plan within the first twelve months of service. Disconnect fees are recorded as revenue and are recognized at the time the customer terminates service. Beginning in September 2010, we eliminated the disconnect fee for new customers. 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. Customer equipment and shipping revenue consists of revenue from sales of customer equipment to our wholesalers or directly to customers and retailers. In addition, customer equipment and shipping revenue includes the fees, when collected, that we charge our customers for shipping any equipment to them. In addition, historically, we charged an equipment recovery fee for customers who terminated their service plan within the first twelve months of service. Equipment recovery fees are recorded as revenue and are recognized at the time the customer terminates service. Beginning in September 2010, we eliminated the equipment recovery fee for new customers.

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

> Access charges that we pay to other telephone companies to terminate domestic and international calls on the public switched telephone network. These costs represented approximately 50% and 49% of our total direct cost of telephony services for 2011 and 2010, respectively, with a portion of these payments ultimately being made to incumbent telephone companies. When a Vonage subscriber calls another Vonage subscriber, we do not pay an access charge.

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

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

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

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

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

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

> Royalties for use of third-party intellectual property.

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

> The cost of the equipment that we provide to customers who subscribe to our service through our direct sales channel in excess of

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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 community based events teams, and retail in-store support activities.

>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.

>Litigation settlements.

Marketing expense. Marketing expense consists of:

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

>Creative and production costs.

>The costs to serve and track our online advertising.

>Certain amounts we pay to retailers for activation commissions.

>The cost associated with our customer referral program.

Depreciation and amortization expenses. Depreciation and amortization expenses include:

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

>Amortization of leasehold improvements and purchased and developed software.

>Amortization of intangible assets (patents and trademarks).

>Loss on disposal or impairment of property and equipment.

OTHER INCOME (EXPENSE)

Other Income (Expense) consists of:

>Interest income on cash and cash equivalents.

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

>Amortization of debt related costs.

>Accretion of notes.

>Realized and unrealized gains (losses) on foreign currency.

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

>Gain (loss) on extinguishment of notes.

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

>Life insurance proceeds.

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## RESULTS OF OPERATION

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

|  | For the Years Ended December 31, |       |       |    |
|--|----------------------------------|-------|-------|----|
|  | 2011                             | 2010  | 2009  |    |
| Operating Revenues:  |                                  |       |       |    |
| Telephony services   | 100                              | % 99  | % 97  | %  |
| Customer equipment and shipping  | —                                | 1     | 3     |    |
|  | 100                              | 100   | 100   |    |
| Operating Expenses:  |                                  |       |       |    |
| Direct cost of telephony services (excluding depreciation and amortization)      | 27                               | 28    | 24    |    |
| Direct cost of goods sold  | 5                                | 6     | 8     |    |
| Selling, general and administrative  | 27                               | 27    | 30    |    |
| Marketing  | 24                               | 22    | 26    |    |
| Depreciation and amortization  | 4                                | 6     | 6     |    |
|  | 87                               | 89    | 94    |    |
| Income from operations   | 13                               | 11    | 6     |    |
| Other Income (Expense):  |                                  |       |       |    |
| Interest income  | —                                | —     | —     |    |
| Interest expense   | (2                               | ) (5  | ) (6  | )  |
| Change in fair value of embedded features within notes payable and stock warrant | —                                | (11   | ) (6  | )  |
| Gain (loss) on extinguishment of notes   | (1                               | ) (4  | ) 1   |    |
| Other income (expense), net  | —                                | —     | —     |    |
|  | (3                               | ) (20 | ) (11 | )  |
| Income (loss) before income tax benefit (expense)                                | 10                               | (9    | ) (5  | )  |
| Income tax benefit (expense)   | 37                               | —     | —     |    |
| Net income (loss)  | 47                               | % (9  | )% (5 | )% |

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## Summary of Results for the Years Ended December 31, 2011, 2010, and 2009

| Telephony Services Revenue and Direct Cost of Services<br>(in thousands, except percentages)                                  | 2011      | 2010      | 2009      | Dollar                        | Dollar                        | Percent                    | Percent                    |
|---|-----------|-----------|-----------|-------------------------------|-------------------------------|----------------------------|----------------------------|
|   |           |           |           | Change<br>2011<br>vs.<br>2010 | Change<br>2010<br>vs.<br>2009 | Change<br>2011<br>vs. 2010 | Change<br>2010<br>vs. 2009 |
| Telephony services  | \$866,560 | \$872,934 | \$864,848 | \$(6,374)                     | \$8,086                       | (1)                        | 1%                         |
| Direct cost of telephony services (excluding depreciation and amortization of \$15,824, \$18,725, and \$18,958, respectively) | 236,149   | 243,794   | 213,553   | (7,645)                       | 30,241                        | (3)                        | 14%                        |

## 2011 compared to 2010

Telephony services revenue. The decrease in telephony services revenue of \$6,374, or 1%, was primarily driven by a decrease in activation fees of \$13,193 as the historical deferred activation fees are amortized and new activation fees are no longer charged and deferred, a decrease in fees that we charged for disconnecting our service of \$8,587 due to fewer disconnections and elimination of this fee for new customers beginning in September 2010, and a reduction in international minutes of use revenue of \$2,248 primarily due to customers moving, as expected, to our fixed rate Vonage World plan. In addition, there was an increase in credits issued to subscribers of \$2,889 and a decrease in additional features revenue of \$3,420 due primarily to customers opting for our Vonage World offering, which now includes directory assistance and voice mail to text. These decreases were offset by an increase in our regulatory recovery and E-911 fees of \$9,000 that we collected from subscribers due to pricing actions in 2010, which included \$4,257 of USF and related fees, a decrease of \$10,455 in bad debt expense due to improved customer credit quality and lower non-pay churn, an increase in other revenue of \$1,268, and an increase in monthly subscription fees of \$3,153 due to changes in plan mix.

Direct cost of telephony services. The decrease in direct cost of telephony services of \$7,645, or 3%, was primarily due to a decrease in domestic termination costs of \$16,828 due to improved termination rates, which are costs that we pay other phone companies for terminating phone calls, and fewer minutes of use and a decrease in our network costs of \$7,258, which includes costs for co-locating in other carriers' facilities, leasing phone numbers, routing calls on the Internet, E-911 costs, and transferring calls to and from the Internet to the public switched telephone network due to improved rates. There was also a decrease in other cost of \$920 and a decrease in local number portability costs of \$838 due to lower rates. These decreases were partially offset by an increased cost of \$14,739 from higher international call volume associated with Vonage World and an increase of USF and related fees imposed by government agencies of \$3,460.

## 2010 compared to 2009

Telephony services revenue. The increase in telephony services revenue of \$8,086, or 1%, was primarily driven by an increase in regulatory fees that we collected from subscribers of \$38,605, which included \$8,457 of USF and related fees, with the remaining increase the result of pricing actions, a decrease in credits we issued to subscribers of \$15,153, and a decrease of \$16,076 in bad debt expense. These increases were offset by a decrease in international revenue of \$18,500 primarily due to customers moving, as expected, to our fixed rate Vonage World plan, a decrease in fees that we charged for disconnecting our service of \$11,797 due to fewer disconnections and elimination of termination fees for new customers beginning in September 2010, and a decrease in additional features, domestic overage charges, and other revenue of \$5,460. Fewer subscriber lines translated into a decrease in monthly subscription fees of \$15,329 and our discontinuation of collecting activation fees, beginning in most cases in May 2009, contributed to a decrease in activation fees of \$10,661, which was partially offset by an increase of \$3,014 for the change in our customer life from 44 months to 38 months in the first quarter of 2010.

Direct cost of telephony services. The increase in direct cost of telephony services of \$30,241, or 14%, was primarily due to the increased costs of \$33,408 from higher international call volume associated with Vonage World, an increase of USF and related fees imposed by government agencies of \$8,279, and an increase in other cost of \$1,663 primarily related to licensing fees. These increases were offset by a decrease in domestic termination costs of \$9,222,



which are costs that we pay other phone companies for terminating phone calls, a decrease in our network costs of \$2,261, which includes costs for co-locating equipment in other carriers' facilities, leasing phone numbers, routing calls on the Internet, transferring calls to and from the Internet to the public switched telephone network, and E-911 costs, and a decrease in local number portability costs of \$1,626 due to fewer customer additions.

| Customer Equipment and Shipping<br>Revenue and Direct Cost of<br>Goods Sold<br>(in thousands, except percentages) | For the Years Ended December 31, |           |           | Dollar<br>Change<br>2011 vs.<br>2010 | Dollar<br>Change<br>2010 vs.<br>2009 | Percent<br>Change<br>2011<br>vs. 2010 | Percent<br>Change<br>2010<br>vs. 2009 |
|---|----------------------------------|-----------|-----------|--------------------------------------|--------------------------------------|---------------------------------------|---------------------------------------|
|   | 2011                             | 2010      | 2009      |                                      |                                      |                                       |                                       |
| Customer equipment and shipping   | \$ 3,763                         | \$ 12,108 | \$ 24,232 | \$(8,345 )                           | \$(12,124)                           | (69 )%                                | (50 )%                                |
| Direct cost of goods sold   | 41,756                           | 55,965    | 71,488    | (14,209 )                            | (15,523 )                            | (25 )%                                | (22 )%                                |
| Customer equipment and shipping<br>gross loss   | (37,993 )                        | (43,857 ) | (47,256 ) |                                      |                                      |                                       |                                       |

#### 2011 compared to 2010

Customer equipment and shipping revenue. Our customer equipment and shipping revenue decreased by \$8,345, or 69%, primarily due to a decrease in equipment sales, net of rebates, of \$7,508 related to lower equipment recovery fees due to fewer disconnections and elimination of equipment recovery fees for new customers beginning in September 2010 and a decrease in customer shipping revenue of \$837 due to higher priority shipping in 2010, partially offset by higher customer additions in 2011.

Direct cost of goods sold. The decrease in direct cost of goods sold of \$14,209, or 25%, was primarily due to a decrease in customer equipment costs of \$5,758 resulting from a lower cost device introduced in September 2010 and lower home installations. There was also a corresponding decrease in shipping costs of \$595 and a decrease in amortization costs on deferred customer equipment of \$10,572 as the historical deferred customer equipment costs are amortized and new customer equipment costs are no longer charged and deferred. These decreases were

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offset by an increase in waived activation fees for new customers of \$2,716.

2010 compared to 2009

Customer equipment and shipping revenue. Our customer equipment and shipping revenue decreased by \$12,124, or 50%, primarily due to the impact of a \$1,500 reserve made to cover refunds in connection with the settlement of the consumer class action litigation and a decrease in equipment sales, net of rebates, of \$8,363 related to lower equipment recovery fees due to fewer terminations and elimination of equipment recovery fees for new customers beginning in September 2010. In addition, there was a decrease in customer shipping revenue of \$2,260 due to promotions providing free shipping for customers who signed up for our residential unlimited plan or our Vonage World plan.

Direct cost of goods sold. The decrease in direct cost of goods sold of \$15,523, or 22%, was primarily due to a decrease in customer equipment costs of \$3,970 resulting from fewer period over period customer additions, a lower cost device introduced in September 2010, and lower home installations and a corresponding decrease in shipping costs of \$2,506. There was also a decrease in amortization costs on deferred customer equipment of \$7,500, which included an offset of \$2,627 due to the change of our customer life from 44 months to 38 months in the first quarter of 2010, and a decrease in waived activation fees for new customers of \$1,547.

| Selling, General and Administrative | For the Years Ended December 31, |            |            | Dollar Change | Dollar Change | Percent Change | Percent Change |
|-------------------------------------|----------------------------------|------------|------------|---------------|---------------|----------------|----------------|
|                                     | 2011                             | 2010       | 2009       | 2011 vs. 2010 | 2010 vs. 2009 | 2011 vs. 2010  | 2010 vs. 2009  |
| (in thousands, except percentages)  |                                  |            |            |               |               |                |                |
| Selling, general and administrative | \$ 234,754                       | \$ 238,986 | \$ 265,456 | \$(4,232)     | \$(26,470)    | (2)            | (10)           |

2011 compared to 2010

Selling, general and administrative. The decrease in selling, general and administrative expense of \$4,232, or 2%, was primarily due to a decrease in salary related expense, outsourced temporary labor, and severance costs of \$9,589 and a decrease in credit card fees of \$1,957 as a result of the Durbin Amendment. Additionally, we had a decrease in settlement costs related to litigation and contractual disputes of \$2,505, a decrease in uncollected state and municipal tax expense of \$1,921, and a decrease in professional fees of \$571. These decreases were offset by an increase in share based cost of \$6,024, an increase in selling costs of \$5,981 due to the expansion of community based event teams, and an increase in facility and other costs of \$306.

2010 compared to 2009

Selling, general and administrative. The decrease in selling, general and administrative expense of \$26,470, or 10%, was primarily due to a decrease in salary related expense and outsourced temporary labor cost of \$13,780, facility and other costs of \$3,091, and credit card fees of \$2,308. Additionally, we had lower costs of \$2,894 for settlements related to litigation and contractual disputes and lower costs of \$863 for severance costs related to the close down of our Canadian facility in 2009. We had a decrease in professional fees of \$2,322, a decrease in shared based cost of \$219, and lower retail kiosk costs of \$1,294 due to fewer kiosk locations for most of 2010.

| Marketing | For the Years Ended December 31, |            |            | Dollar Change | Dollar Change | Percent Change | Percent Change |
|-----------|----------------------------------|------------|------------|---------------|---------------|----------------|----------------|
|           | 2011                             | 2010       | 2009       | 2011 vs. 2010 | 2010 vs. 2009 | 2011 vs. 2010  | 2010 vs. 2009  |
| Marketing | \$ 204,263                       | \$ 198,170 | \$ 227,990 | \$ 6,093      | \$(29,820)    | 3              | (13)           |

2011 compared to 2010

Marketing. The increase in marketing expense of \$6,093, or 3%, resulted from increasing our marketing investment in direct mail to targeted ethnic segments which drove a 5% improvement in gross subscriber line additions.

## 2010 compared to 2009

Marketing. The decrease in marketing expense of \$29,820, or 13%, resulted from reduced marketing investment as we refined our marketing strategies including the use of certain promotions which are recorded as a reduction to revenue.

| Depreciation and Amortization<br>(in thousands, except percentages) | For the Years Ended December 31, |           |           | Dollar<br>Change<br>2011 vs.<br>2010 | Dollar<br>Change<br>2010<br>vs.<br>2009 | Percent<br>Change<br>2011<br>vs. 2010 | Percent<br>Change<br>2010<br>vs. 2009 |
|---|----------------------------------|-----------|-----------|--------------------------------------|---|---------------------------------------|---------------------------------------|
|   | 2011                             | 2010      | 2009      |                                      |   |                                       |                                       |
| Depreciation and amortization                                       | \$ 37,051                        | \$ 53,073 | \$ 53,391 | \$(16,022)                           | \$(318 )                                | (30 )%                                | (1 )%                                 |

## 2011 compared to 2010

Depreciation and amortization. The decrease in depreciation and amortization of \$16,022, or 30%, was primarily due to lower software amortization of \$10,455 due to our internally developed customer acquisition and customer care automation tools projects being fully amortized, lower depreciation of network equipment, computer hardware, and furniture of \$5,284, and lower impairment charges of \$411.

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## 2010 compared to 2009

Depreciation and amortization. The decrease in depreciation and amortization of \$318, or 1%, was primarily due to lower impairment charges of \$2,235, lower depreciation of network equipment, computer hardware, and furniture of \$1,045, and lower patent amortization of \$174, partially offset by an increase in software amortization of \$3,184.

| Other Income (Expense)<br>(in thousands, except percentages)                     | For the Years Ended December 31, |             |            | Dollar                        | Dollar                        | Percent                    | Percent                    |      |    |
|--|----------------------------------|-------------|------------|-------------------------------|-------------------------------|----------------------------|----------------------------|------|----|
|  | 2011                             | 2010        | 2009       | Change<br>2011<br>vs.<br>2010 | Change<br>2010<br>vs.<br>2009 | Change<br>2011<br>vs. 2010 | Change<br>2010<br>vs. 2009 |      |    |
| Interest income  | \$ 135                           | \$ 519      | \$ 277     | \$(384 )                      | \$242                         | (74 )%                     | 87                         | %    |    |
| Interest expense   | (17,118 )                        | (48,541 )   | (54,192 )  | 31,423                        | 5,651                         | 65                         | %                          | 10   | %  |
| Change in fair value of embedded features within notes payable and stock warrant | (950 )                           | (99,338 )   | (49,933 )  | 98,388                        | (49,405)                      | 99                         | %                          | (99  | )% |
| Gain (loss) on extinguishment of notes   | (11,806 )                        | (31,023 )   | 4,041      | 19,217                        | (35,064)                      | 62                         | %                          | (868 | )% |
| Other income (expense), net  | (271 )                           | (18 )       | 843        | (253 )                        | (861 )                        | *                          | (102                       | )%   |    |
|  | \$(30,010)                       | \$(178,401) | \$(98,964) |                               |                               |                            |                            |      |    |

## 2011 compared to 2010

Interest income. The decrease in interest income of \$384, or 74%, was due to lower interest rates and lower average cash balances driven by prepayments on the credit agreement we entered into in December 2010 (the "2010 Credit Facility") and the repayments on the credit agreement we entered into in July 2011 (the "2011 Credit Facility").

Interest expense. The decrease in interest expense of \$31,423, or 65%, was due to the reduced interest rate on our 2010 Credit Facility and our 2011 Credit Facility resulting from our refinancings in December 2010 and July 2011 and lower principal outstanding due to the refinancings and prepayments in 2011.

Change in fair value of embedded features within notes payable and stock warrant. The change in fair value of the embedded conversion option within our prior third lien convertible notes fluctuated with changes in the price of our common stock and was \$0 during 2011 compared to loss of \$7,308 in 2010 as all convertible notes had been converted as of December 31, 2010. The change in the fair value of our stock warrant fluctuated with changes in the price of our common stock and was an expense of \$950 in 2011 compared to \$344 in 2010. An increase in our stock price resulted in expense while a decrease in our stock price resulted in income. In addition, due to the progress of our repurchase negotiations and other factors, the make-whole premiums in our prior senior secured first lien credit facility and prior senior secured second lien credit facility from our 2008 financing were ascribed a value of \$91,686 at the time the make-whole premiums were paid in December 2010.

Gain (loss) on extinguishment of notes. The loss on extinguishment of notes of \$11,806 in 2011 was due to the acceleration of unamortized debt discount and debt related costs in connection with prepayments of our 2010 Credit Facility and our refinancing of the 2010 Credit Facility in July 2011. The loss on extinguishment of notes of \$31,023 in 2010 was due to the acceleration of unamortized debt discount, debt related costs, and administrative agent fees associated with our prior senior secured first lien credit facility and prior senior secured second lien credit facility from our 2008 financing prepayments partially offset by gains associated with conversion of our prior third lien convertible notes.

Other. Net other income and expense decreased by \$253 in 2011 compared to 2010.

## 2010 compared to 2009

Interest income. The increase in interest income of \$242, or 87%, was due to an increase in cash and cash equivalents in 2010.

Interest expense. The decrease in interest expense was due to lower interest on our prior senior secured first lien credit facility due to reduced principal and on our prior third lien convertible notes due to conversions, partially offset by

higher interest on our prior senior secured second lien credit facility due to an increase in the principal balance as interest was paid-in-kind.

Change in fair value of embedded features within notes payable and stock warrant. The change in fair value of the embedded conversion option within our prior third lien convertible notes fluctuated with changes in the price of our common stock and was \$7,308 during 2010 compared to \$49,380 in 2009. The change in the fair value of our stock warrant fluctuated with changes in the price of our common stock and was \$344 in 2010 compared to \$553 in 2009. An increase in our stock price resulted in expense while a decrease in our stock price resulted in income. This account was also impacted due to the fact that we had fewer convertible notes outstanding during 2010 compared to 2009 due to conversions. All convertible notes were converted as of December 31, 2010. In addition, the make-whole premiums in our prior senior secured first lien credit facility and prior senior secured second lien credit facility were ascribed a value of \$91,686 at the time the make-whole premiums were paid in December 2010.

Gain (loss) on extinguishment of notes. The incremental loss on extinguishment of notes was due to the acceleration of unamortized debt discount, debt related costs, administrative agent fees, and other fees associated with the prepayments and extinguishment of our prior senior secured first lien credit facility, our prior senior secured second lien credit facility, and our prior third lien convertible notes.

Other. We recognized \$792 in other income for the year ended December 31, 2009 for the net proceeds we received from a key-man term life insurance policy related to the passing of a former executive.

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| Income Tax Benefit (Expense)<br><br>(in thousands, except percentages) | For the Years Ended December 31, |           |           | Dollar<br>Change<br>2011 vs.<br>2010 | Dollar<br>Change<br>2010<br>vs.<br>2009 | Percent<br>Change<br>2011<br>vs. 2010 | Percent<br>Change<br>2010<br>vs. 2009 |
|--|----------------------------------|-----------|-----------|--------------------------------------|---|---------------------------------------|---------------------------------------|
|  | 2011                             | 2010      | 2009      | 2011 vs.<br>2010                     | vs.<br>2009                             | vs. 2010                              | vs. 2009                              |
| Income tax benefit (expense)   | \$ 322,704                       | \$ (318 ) | \$ (836 ) | \$ 323,022                           | \$ 518                                  | 101,579 %                             | 62 %                                  |

The provision includes the federal alternative minimum tax in 2011 and state and local income taxes in 2011, 2010, and 2009.

We are required to record a valuation allowance which reduces 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 these net deferred tax assets prior to expiration. Our net deferred tax assets primarily consist of net operating loss carry forwards (“NOLs”). We periodically review this conclusion, which requires significant management judgment. Until the fourth quarter of 2011, we recorded a valuation allowance which reduced our net deferred tax assets to zero. In the fourth quarter of 2011, based upon our sustained profitable operating performance over the past three years excluding certain losses associated with our prior convertible notes and our December 2010 debt refinancing and our positive outlook for taxable income in the future, our evaluation determined that the benefit resulting from our net deferred tax assets (namely, the NOLs) are likely to be usable prior to their expiration. Accordingly, we released the related valuation allowance against our United States and Canada net deferred tax assets, and a portion of the allowance against our state net deferred tax assets as certain NOLs may expire prior to utilization due to shorter utilization periods in certain states, resulting in a one-time non-cash income tax benefit of \$325,601 that we recorded in our statement of operations and a corresponding net deferred tax asset of \$325,601 that we recorded on our balance sheet on December 31, 2011. 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 has not been recognized prior to the reduction of the valuation allowance and that will reduce our net income and earnings per share. In the future, if available evidence changes our conclusion that it is more likely than not that we will utilize our net deferred tax assets prior to their expiration, we will make an adjustment to the related valuation allowance at that time.

We participated in the State of New Jersey’s corporation business tax benefit certificate transfer program, which allows certain high technology and biotechnology companies to transfer unused New Jersey net operating loss carryovers to other New Jersey corporation business taxpayers. During 2003 and 2004, we submitted an application to the New Jersey Economic Development Authority, or EDA, to participate in the program and the application was approved. The EDA then issued a certificate certifying our eligibility to participate in the program. The program requires that a purchaser pay at least 75% of the amount of the surrendered tax benefit. In tax years 2009, 2010, and 2011, we sold approximately, \$0, \$2,194, and \$0, respectively, of our New Jersey State net operating loss carry forwards for a recognized benefit of approximately \$0 in 2009, \$168 in 2010, and \$0 in 2011. Collectively, all transactions represent approximately 85% of the surrendered tax benefit each year and have been recognized in the year received.

As of December 31, 2011, we had net operating loss carry forwards for United States federal and state tax purposes of \$794,714 and \$423,963, respectively, expiring at various times from years ending 2012 through 2030. In addition, we had net operating loss carry forwards for Canadian tax purposes of \$37,564 expiring through 2027. We also had net operating loss carry forwards for United Kingdom tax purposes of \$34,568 with no expiration date.

| Net Income (Loss)<br><br>(in thousands, except percentages) | For the Years Ended December 31, |              |              | Dollar<br>Change<br>2011 vs.<br>2010 | Dollar<br>Change<br>2010 vs.<br>2009 | Percent<br>Change<br>2011<br>vs. 2010 | Percent<br>Change<br>2010<br>vs. 2009 |
|---|----------------------------------|--------------|--------------|--------------------------------------|--------------------------------------|---------------------------------------|---------------------------------------|
|   | 2011                             | 2010         | 2009         | 2011 vs.<br>2010                     | 2010 vs.<br>2009                     | vs. 2010                              | 2009                                  |
| Net income (loss)   | \$ 409,044                       | \$ (83,665 ) | \$ (42,598 ) | \$ 492,709                           | \$ (41,067 )                         | 589 %                                 | (96%)                                 |

2011 compared to 2010

Net Income (Loss). Based on the activity described above, our net income of \$409,044 for the year ended December 31, 2011 increased by \$492,709, or 589%, from net loss of \$83,665 for the year ended December 31, 2010.

2010 compared to 2009

Net Loss. Based on the activity described above, our net loss of \$83,665 for the year ended December 31, 2010 increased by \$41,067, or 96%, from \$42,598 for the year ended December 31, 2009.

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## QUARTERLY RESULTS OF OPERATIONS

The following table sets forth quarterly statement of operations data. We derived this data from our unaudited consolidated financial statements, which we believe have been prepared on substantially the same basis as our audited consolidated financial statements. The operating results in any quarter are not necessarily indicative of the results that may be expected for any future period.

| (dollars in thousands, except operating data)                                    | For the Quarter Ended |                 |                 |                 |                 |                 |             |
|--|-----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-------------|
|  | Mar 31,<br>2010       | Jun 30,<br>2010 | Sep 30,<br>2010 | Dec 31,<br>2010 | Mar 31,<br>2011 | Jun 30,<br>2011 | Sep<br>2011 |
| <b>Revenue:</b>  |                       |                 |                 |                 |                 |                 |             |
| Telephony services   | \$224,527             | \$221,704       | \$212,135       | \$214,568       | \$218,230       | \$217,288       | \$215,111   |
| Customer equipment and shipping  | 3,424                 | 3,637           | 1,991           | 3,056           | 1,611           | 997             | 683         |
|  | 227,951               | 225,341         | 214,126         | 217,624         | 219,841         | 218,285         | 216,000     |
| <b>Operating expenses:</b>   |                       |                 |                 |                 |                 |                 |             |
| Direct cost of telephony services (1)  | 62,495                | 62,969          | 60,263          | 58,067          | 60,189          | 57,883          | 59,200      |
| Direct cost of goods sold  | 16,647                | 14,053          | 13,214          | 12,051          | 11,055          | 9,865           | 10,700      |
| Selling, general and administrative  | 60,787                | 60,768          | 58,908          | 58,523          | 58,243          | 58,481          | 59,400      |
| Marketing  | 49,240                | 49,324          | 49,254          | 50,352          | 49,404          | 52,211          | 51,000      |
| Depreciation and amortization  | 13,768                | 13,929          | 12,649          | 12,727          | 11,066          | 8,664           | 8,680       |
|  | 202,937               | 201,043         | 194,288         | 191,720         | 189,957         | 187,104         | 189,000     |
| Income from operations   | 25,014                | 24,298          | 19,838          | 25,904          | 29,884          | 31,181          | 27,300      |
| <b>Other income (expense):</b>   |                       |                 |                 |                 |                 |                 |             |
| Interest income  | 53                    | 173             | 154             | 139             | 42              | 37              | 33          |
| Interest expense   | (13,211 )             | (12,423 )       | (11,569 )       | (11,338 )       | (6,602 )        | (5,588 )        | (2,920 )    |
| Change in fair value of embedded features within notes payable and stock warrant | 835                   | (8,241 )        | (62,150 )       | (29,782 )       | (950 )          | —               | —           |
| Gain (loss) on early extinguishment of debt                                      | 1,038                 | (3,985 )        | (1,545 )        | (26,531 )       | (593 )          | (3,228 )        | (7,980 )    |
| Other, net   | 103                   | (43 )           | (19 )           | (59 )           | (2 )            | 44              | (47 )       |
|  | (11,182 )             | (24,519 )       | (75,129 )       | (67,571 )       | (8,105 )        | (8,735 )        | (10,900 )   |
| Income (loss) before income tax benefit (expense)                                | 13,832                | (221 )          | (55,291 )       | (41,667 )       | 21,779          | 22,446          | 16,400      |
| Income tax benefit (expense)   | 136                   | (341 )          | (91 )           | (22 )           | (666 )          | (698 )          | (426 )      |
| Net income (loss)  | \$13,968              | \$(562 )        | \$(55,382 )     | \$(41,689 )     | \$21,113        | \$21,748        | \$16,000    |
| <b>Net income (loss) per common share:</b>                                       |                       |                 |                 |                 |                 |                 |             |
| Basic  | \$0.07                | \$—             | \$(0.26 )       | \$(0.19 )       | \$0.10          | \$0.10          | \$0.00      |
| Diluted  | \$0.06                | \$—             | \$(0.26 )       | \$(0.19 )       | \$0.09          | \$0.09          | \$0.00      |
| <b>Weighted-average common shares outstanding:</b>                               |                       |                 |                 |                 |                 |                 |             |
| Basic  | 201,324               | 211,305         | 212,086         | 214,586         | 222,162         | 224,233         | 225,000     |
| Diluted  | 221,947               | 211,305         | 212,086         | 214,586         | 240,340         | 244,590         | 241,000     |
| <b>Operating Data:</b>   |                       |                 |                 |                 |                 |                 |             |
| Gross subscriber line additions  | 154,718               | 154,997         | 163,055         | 167,435         | 175,388         | 158,004         | 170,000     |
| Net subscriber line additions  | (25,779 )             | (5,236 )        | (4,846 )        | 5,848           | 3,345           | (10,568 )       | (8,900 )    |
| Subscriber lines at end of period  | 2,409,117             | 2,403,881       | 2,399,035       | 2,404,883       | 2,408,228       | 2,397,660       | 2,380,000   |
| Average monthly customer churn   | 2.6 %                 | 2.3 %           | 2.4 %           | 2.4 %           | 2.5 %           | 2.5 %           | 2.7 %       |
| Average monthly revenue per line   | \$31.37               | \$31.21         | \$29.72         | \$30.20         | \$30.45         | \$30.28         | \$30.00     |
| Average monthly telephony services revenue per line                              | \$30.90               | \$30.71         | \$29.45         | \$29.78         | \$30.23         | \$30.14         | \$30.00     |



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|   |          |          |          |          |          |          |       |
|---|----------|----------|----------|----------|----------|----------|-------|
| Average monthly direct costs of telephony services per line | \$8.60   | \$8.72   | \$8.36   | \$8.06   | \$8.34   | \$8.03   | \$8.2 |
| Marketing costs per gross subscriber line additions         | \$318.26 | \$318.23 | \$302.07 | \$300.73 | \$281.68 | \$330.44 | \$299 |
| Employees at end of period                                  | 1,207    | 1,158    | 1,145    | 1,140    | 1,126    | 1,059    | 1,03  |

Excludes depreciation and amortization of \$4,981, \$4,959, \$4,357, and \$4,428 for the quarters ended March 31, (1)June 30, September 30 and December 31, 2010, respectively, and \$4,124, \$3,867, \$3,864, and \$3,969 for the quarters ended March 31, June 30, September 30 and December 31, 2011, respectively.

Telephony services revenue. Telephony services revenue generally has been flat on a quarterly basis with the exception of the first and second quarters of 2010. The increases in telephony services revenue in the first and second quarters of 2010 were related to fewer service credits due to programs implemented in 2010, higher activation fees and termination fees, and slightly higher USF fees.

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Customer equipment and shipping revenue. Customer equipment and shipping revenue was lower in 2011 compared to 2010 due to the elimination of the equipment recovery fee for new customers beginning in September 2010. In addition, during the third quarter of 2010, a \$1,500 reserve was made to cover potential refunds in connection with the settlement of consumer class action litigation.

Direct cost of telephony services. The decrease in direct cost of telephony services from 2010 to 2011 was due to more favorable termination rates negotiated with our service providers. USF fees fluctuated from quarter to quarter, and were lower in the third and fourth quarters of 2010.

Direct cost of goods sold. The change in direct cost of goods sold expenses was due to fluctuations in subscriber line additions. The decrease in quarterly direct cost of goods sold from 2011 to 2010 was primarily due to the decrease in customer equipment costs resulting from a lower cost device introduced in September 2010, lower promotional activity, and the decrease in amortization costs on deferred customer equipment as the historical deferred customer equipment costs are amortized and new customer equipment costs are no longer charged and deferred.

Selling, general and administrative. Selling, general and administrative expenses decreased quarterly in 2010 as a result of our cost management initiatives and have been stable in 2011. The 2010 selling, general and administrative expenses declined primarily due to a decrease in professional fees, and a decrease in outsourced customer care costs. In 2011, there were further decreases in professional fees, in salary related expense, in outsourced temporary labor costs, in litigation and contractual disputes costs, and in uncollected state and municipal tax expense, which was offset by an increase in share based cost and higher retail kiosk cost due to the expansion of in-market event teams.

Marketing. In 2010, marketing expense was relatively flat as we allocated our marketing investment across channels based upon performance as we continued to refine our marketing strategy. In 2011, we increased our marketing investment in direct mail to targeted ethnic segments which drove a 5% improvement in gross subscriber line additions.

Interest expense. In 2011, interest expense decreased as a result of refinancing our debt in December 2010 and July 2011.

Income tax benefit (expense). In the fourth quarter of 2011, we released \$325,601 of the valuation allowance previously recorded against our net deferred tax assets resulting in a one-time non-cash benefit.

## LIQUIDITY AND CAPITAL RESOURCES

### Overview

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

| (dollars in thousands)                    | For the Years Ended December 31, |            |           |
|---|----------------------------------|------------|-----------|
|   | 2011                             | 2010       | 2009      |
| Net cash provided by operating activities | \$146,786                        | \$194,212  | \$38,396  |
| Net cash used in investing activities     | (37,604 )                        | (4,686 )   | (50,565 ) |
| Net cash used in financing activities     | (130,138 )                       | (143,762 ) | (3,253 )  |

For the three years ended December 31, 2011, 2010, and 2009 we generated income from operations. We expect to continue to balance efforts to grow our customer base while consistently achieving operating profitability. To grow our customer base, we continue to make investments in marketing, application development as we seek to launch new services, network quality and expansion, and customer care. Although we believe we will achieve consistent profitability in the future, we ultimately may not be successful and we may 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.

December 2010 Financing

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

affiliate of the chairman of our board of directors and one of our principal stockholders was a lender under the 2010 Credit Facility.

#### Use of Proceeds

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

#### Repayments

In 2011, we repaid the entire \$200,000 under the 2010 Credit Facility, with \$20,000 designated to cover our 2011 mandatory amortization, \$50,000 designated to cover our 2011 annual excess cash flow mandatory repayment, if any, and \$130,000 designated to cover the outstanding principal balance under the 2010 Credit Facility at the time of the 2011 Credit Facility financing.

#### July 2011 Financing

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

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assets of each borrower and each of the guarantors.

Use of Proceeds

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

Repayments

In 2011, we made mandatory repayment of \$14,166 under the senior secured term loan. In addition, we repaid the \$15,000 outstanding under the revolving credit facility.

2011 Credit Facility Terms

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

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

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

LIBOR (applicable to one-, two-, three- or six-month periods) plus an applicable margin equal to 3.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.5% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 3.75% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last day of each relevant interest period or, if the interest period is longer than three months, each day that is three months after the first day of the interest period, or the base rate determined by reference to the highest of (a) the federal funds effective rate from time to time plus 0.50%, (b) the prime rate of JPMorgan Chase Bank, N.A., and (c) the LIBOR rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 2.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.5% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 2.75% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last business day of each March, June, September, and December and the maturity date of the 2011 Credit Facility.

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

We may prepay the 2011 Credit Facility at our option at any time without premium or penalty. The 2011 Credit Facility is subject to mandatory prepayments in amounts equal to:

100% of the net cash proceeds from any non-ordinary course sale or other disposition of our property and assets for consideration in excess of a certain amount subject to customary reinvestment provisions and certain other exceptions and

100% of the net cash proceeds received in connection with other non-ordinary course transactions, including insurance proceeds not otherwise applied to the relevant insurance loss.

Subject to certain restrictions and exceptions, the 2011 Credit Facility permits us to obtain one or more incremental term loans and/or revolving credit facilities in an aggregate principal amount of up to \$60,000 plus an amount equal to repayments of the senior secured term loan upon providing documentation reasonably satisfactory to the administrative agent, without the consent of the existing lenders under the 2011 Credit Facility. The 2011 Credit Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition, the 2011 Credit Facility contains customary negative covenants, including, among other things, restrictions on the ability of us and our subsidiaries to consolidate or merge, create liens, incur additional indebtedness, dispose of assets, consummate acquisitions, make investments, and pay dividends and other distributions. We must also comply with the following financial covenants:

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

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

minimum cash of \$25,000 including the unused portion of the revolving credit facility; and

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

As of December 31, 2011, we were in compliance with all covenants, including financial covenants, for the 2011 Credit Facility.

The 2011 Credit Facility contains customary events of default that may permit acceleration of the debt. During the continuance of a payment default, interest will accrue at a default interest rate of 2% above the interest rate which would otherwise be applicable, in the case of loans, and at a rate equal to the rate applicable to base rate loans plus 2%, in the case of all other amounts.

#### State and Local Sales Taxes

We also have contingent liabilities for state and local sales taxes. As of December 31, 2011, we had a reserve of \$2,231. If our ultimate liability exceeds this amount, it could affect our liquidity unfavorably. However, we do not believe it would significantly impair our liquidity.

#### Capital expenditures

For 2011, capital expenditures were primarily for the implementation of software solutions and purchase of network equipment as we continue to expand our network. Our capital expenditures for the year ended 2011 were \$38,653, of which \$22,292 was for software acquisition and development. The majority of these expenditures are comprised of investments in information technology and systems infrastructure, including the new Amdocs billing and order management system we are in the process of implementing. The platform is now operational and it is our intention to transition customers to the platform throughout 2012. For 2012, we believe our capital and software expenditures will be approximately \$40,000 to \$45,000.

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Operating Activities

Cash provided by operating activities decreased to \$146,786 during the year ended December 31, 2011 compared to \$194,212 for the year ended December 31, 2010, primarily due to changes in working capital requirements and higher marketing expenditures partially offset by lower interest expense as a result of our debt refinancings in December 2010 and July 2011.

Changes in working capital requirements include changes in accounts receivable, inventory, prepaid and other assets, other assets, accounts payable, accrued and other liabilities, and deferred revenue and costs. Cash provided by working capital decreased by \$69,137 during the year ended December 31, 2011 compared to the year ended December 31, 2010, primarily due to the timing of payments.

Cash provided by operating activities increased to \$194,212 during the year ended December 31, 2010 compared to \$38,396 for the year ended December 31, 2009, primarily due to changes in working capital requirements, lower marketing expenditures, and overall tighter controls on costs partially offset by higher cost of telephony services attributable to increased international minutes used in connection with our Vonage World plan.

Changes in working capital requirements include changes in accounts receivable, inventory, prepaid and other assets, other assets, accounts payable, accrued and other liabilities, and deferred revenue and costs. Cash provided by working capital decreased by \$119,734 during the year ended December 31, 2010 compared to the year ended December 31, 2009, primarily due to the timing of payments and absence of prepayment opportunities for discounts and the return of an \$8,925 security deposit from our device manufacturer as a result of improvements in credit quality.

Investing Activities

Cash used in investing activities for 2011 of \$37,604 was attributable to capital expenditures of \$12,636, software acquisition and development of \$22,292, and purchase of intangible assets of \$3,725, offset by a decrease in restricted cash of \$1,049 due primarily to the return of part of the security deposit on our leased office property in Holmdel, New Jersey.

Cash used in investing activities for 2010 of \$4,686 was attributable to capital expenditures of \$17,674 and development of software assets of \$22,712, partially offset by a decrease in restricted cash of \$35,700 due primarily to the reduction of \$32,830 of reserves held by our credit card processors as a result of improvements in credit quality and the elimination of the concentration account under our prior credit facilities of \$3,277 as a result of our new Credit Facility.

Cash used in investing activities for 2009 of \$50,565 was attributable to capital expenditures of \$23,724, \$1,250 for the licensing of patents, development of software assets of \$21,654, and an increase in restricted cash of \$3,937.

Financing Activities

Cash used in financing activities for 2011 of \$130,138 was primarily attributable to \$200,000 in 2010 Credit Facility and \$29,166 in 2011 Credit Facility and revolving credit facility principal payments, respectively, \$1,783 in capital lease payments, and \$2,697 in 2011 Credit Facility debt related cost payments, offset by \$100,000 in proceeds received from the issuance of the 2011 Credit Facility and \$4,562 in proceeds received from the exercise of stock options and a common stock warrant.

Cash used in financing activities for 2010 of \$143,762 was attributable to \$128,165 in prior senior secured first lien credit facility principal payments, \$104,349 in prior senior secured second lien credit facility principal payments, including \$32,320 representing paid-in-kind ("PIK") interest payments, payments of \$99,938 to extinguish our prior senior secured first lien credit facility, our prior senior secured second lien credit facility and our prior third lien convertible notes, and \$1,500 in capital lease payments partially offset by proceeds of the 2010 Credit Facility of \$200,000 offset by note discount of \$6,000 and debt related costs of \$5,430, and proceeds of \$1,620 from stock options exercised.

Cash used in financing activities for 2009 of \$3,253 was attributable to \$1,251 in capital lease payments, \$1,809 in prior senior secured first lien credit facility principal payments and \$252 in additional debt related costs.

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## CONTRACTUAL OBLIGATIONS AND OTHER COMMERCIAL COMMITMENTS

The table below summarizes our contractual obligations at December 31, 2011, and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

| (dollars in thousands)   | Payments Due by Period |                  |           |           |               |
|--|------------------------|------------------|-----------|-----------|---------------|
|  | Total                  | Less than 1 year | 2-3 years | 4-5 years | After 5 years |
|  | (unaudited)            |                  |           |           |               |
| Contractual Obligations:                                       |                        |                  |           |           |               |
| 2011 Credit Facility   | \$70,833               | \$28,333         | \$42,500  | \$—       | \$—           |
| Interest related to 2011 Credit Facility                       | 4,023                  | 2,395            | 1,628     | —         | —             |
| Capital lease obligations                                      | 24,926                 | 4,200            | 8,653     | 9,002     | 3,071         |
| Operating lease obligations                                    | 6,234                  | 4,363            | 1,706     | 165       | —             |
| Purchase obligations   | 57,803                 | 25,876           | 25,987    | 5,940     | —             |
| Other obligations  | 2,750                  | —                | 1,000     | 1,750     | —             |
| Total contractual obligations                                  | \$166,569              | \$65,167         | \$81,474  | \$16,857  | \$3,071       |
| Other Commercial Commitments:                                  |                        |                  |           |           |               |
| Standby letters of credit                                      | \$6,836                | \$6,836          | \$—       | \$—       | \$—           |
| Total contractual obligations and other commercial commitments | \$173,405              | \$72,003         | \$81,474  | \$16,857  | \$3,071       |

2011 Credit Facility. On July 29, 2011, we entered into the 2011 Credit Facility which consists of an \$85,000 senior secured term loan and a \$35,000 revolving credit facility. See Note 6 in the notes to the consolidated financial statements.

Capital lease obligations. At December 31, 2011, we had capital lease obligations of \$24,926 related to our corporate headquarters in Holmdel, New Jersey.

Operating lease obligations. At December 31, 2011, we had future commitments for operating leases for co-location facilities mainly in the United States that accommodate a portion of our network equipment, for kiosks leased in various locations throughout the United States, for office space leased for our London, United Kingdom office, for office space leased in Atlanta, Georgia for product development, for office space leased in Tel Aviv, Israel for application development, and for apartment space leased in New Jersey for certain executives.

Purchase obligations. The purchase obligations reflected above are primarily commitments to vendors who will license to us billing and ordering software and provide related services, provide telemarketing services, provide voicemail to text transcription services, provide local inbound services, process our credit card billings, provide E-911 services to our customers, assist us with local number portability, license patents to us, sell us communication devices, lease us collocation facilities, and provide carrier operation services. In certain cases, we may terminate these arrangements early upon payment of specified fees. These amounts do not represent our entire anticipated purchases in the future, but represent only those items for which we are contractually committed. We also purchase products and services as needed with no firm commitment. For this reason, the amounts presented in this table alone do not provide a reliable indicator of our expected future cash outflows or changes in our expected cash position. See also Note 10 to our consolidated financial statements.

## SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

## Use of Estimates

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

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

- > those related to the average period of service to a customer (the “customer life”) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation;
- > the useful lives of property and equipment, software costs, and intangible assets; assumptions used for the purpose of determining share-based compensation and the fair value of our prior stock warrant using the Black-Scholes option pricing model (“Model”), and various other assumptions that we believed to be reasonable; the key inputs for this Model are our stock price at valuation date, exercise price, the dividend yield, risk-free interest rate, life in years, and historical volatility of our common stock;
- > assumptions used in determining the need for, and amount of, a valuation allowance on net deferred tax assets;
- > assumptions used to determine the fair value of the embedded conversion option within our prior third lien convertible notes using



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the Monte Carlo simulation model; the key inputs are maturity date, risk-free interest rate, our stock price at valuation date, and historical volatility of our common stock; and

> assumptions used to determine the fair value of the embedded make-whole premium feature within our prior senior secured first lien credit facility and our prior senior secured second lien credit facility.

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

### Revenue Recognition

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

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

> Providing equipment, if any, to the customer that enables our telephony services and

> Providing telephony services.

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

A further description of our revenues is as follows:

Substantially all of our operating revenues are telephony services revenues, which are derived primarily from monthly subscription fees that customers are charged under our service plans. We also derive telephony services revenues from per minute fees for international calls if not covered under a plan, including 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, or ECP, in advance and are recognized over the following month when services are provided. Revenues generated from international calls and from customers exceeding allocated call minutes under limited minute plans are recognized as services are provided, that is, as minutes are used, and are billed to a customer’s credit cards, debit cards or ECP in arrears. As a result of our multiple billing cycles each month, we estimate the amount of revenues earned from international calls and from customers exceeding allocated call minutes under limited minute plans but not billed from the end of each billing cycle to the end of each reporting period. These estimates are based primarily upon historical minutes and have been consistent with our actual results.

From time to time we have generated revenue by charging a fee for activating service, although we do not currently or expect to charge an activation fee to customers. In these instances when no activation fee is being collected, no customer acquisition costs are deferred. Customer activation fees when collected, along with the related incremental direct customer acquisition amounts for customer equipment in the direct channel and for rebates and retailer commissions in the retail channel, up to but not exceeding the activation fee, are deferred and amortized over the estimated average customer life. The amortization of deferred customer equipment is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction of telephony services revenues. The amortization of deferred retailer commissions is recorded as marketing expense. We estimate customer life by analyzing historical trends and applying those trends to future periods. This customer life is solely used to amortize deferred activation fees collected, along with the related incremental customer acquisition costs. The average customer life was 44 months in 2009 and 38 months for 2010 and 2011, respectively, based on consistent historical trends. The impact of these changes to the average customer life was not material to the consolidated results of operations.

We also provide rebates to customers who purchase their customer equipment from retailers and satisfy minimum service period requirements. These rebates in excess of activation fees are recorded as a reduction of revenues over the service period based upon the estimated number of customers that will ultimately earn and claim the rebates.

Customer equipment and shipping revenues include sales to our retailers, who subsequently resell this customer equipment to customers. Revenues were reduced for payments to retailers and rebates to customers, who purchased their customer equipment through these retailers, to the extent of customer equipment and shipping revenues.

### Inventory

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

#### Income Taxes

We recognize deferred tax assets and liabilities at enacted income tax rates for the temporary differences between the financial reporting bases and the tax bases of our assets and liabilities. Any effects of changes in income tax rates or tax laws are included in the provision for income taxes in the period of enactment. Our net deferred tax assets primarily consist of net operating loss carry forwards (“NOLs”). We 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 will result in a non-cash benefit to our net income in the period of the determination. 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 is not currently recognized each quarter as a result of the valuation allowance. In the future, if available evidence changes our conclusion that it is more likely than not that we will utilize our net deferred tax assets prior to their expiration, we will make an adjustment to the related valuation allowance at that time. In the fourth quarter of 2011, we released \$325,601 of valuation allowance (see Note 5. Income Taxes).

#### Net Operating Loss Carryforwards

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As of December 31, 2011, we had NOLs for United States federal and state tax purposes of \$794,714 and \$423,963, respectively, expiring at various times from years ending 2012 through 2030. In addition, we had NOLs for Canadian tax purposes of \$37,564 expiring through 2027. We also had NOLs for United Kingdom tax purposes of \$34,568 with no expiration date.

Under Section 382 of the Internal Revenue Code, if we undergo an “ownership change” (generally defined as a greater than 50% change (by value) in our equity ownership over a three-year period), our ability to use our pre-change of control NOLs and other pre-change tax attributes against our post-change income may be limited. The Section 382 limitation is applied annually so as to limit the use of our pre-change NOLs to an amount that generally equals the value of our stock immediately before the ownership change multiplied by a designated federal long-term tax-exempt rate. At December 31, 2011, there were no limitations on the use of our NOLs.

### Share-Based Compensation

We account for share-based compensation in accordance with FASB ASC 718, “Compensation-Stock Compensation”. Under the fair value recognition provisions of this pronouncement, share-based compensation cost is measured at the grant date based on the fair value of the award, reduced as appropriate based on estimated forfeitures, and is recognized as expense over the applicable vesting period of the stock award using the accelerated method.

### Recent Accounting Pronouncements

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

In June 2011, the FASB issued Accounting Standards Update No. 2011-05 (“ASU 2011-05”) “Comprehensive Income (Topic 220), Presentation of Comprehensive Income”. The objective of ASU 2011-05 is to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The amendments in ASU 2011-05 should be applied retrospectively. It is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. We adopted ASU 2011-05 as of December 31, 2011 by presenting a separate Statements of Comprehensive Income following the Statements of Operations. The adoption of ASU 2011-05 did not have an impact on our financial statements.

## OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

## ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk

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

### Foreign Exchange Risk

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

We prepared a sensitivity analysis to determine the impact of hypothetical changes foreign currency exchange rates have on our results of operations. The foreign currency rate analysis assumed a uniform movement in currencies by 10% relative to the U.S. Dollar on our results. Based upon the results of this analysis, a 10% change in currency rates

would have resulted in an increase or decrease in our earnings for the year ended December 31, 2011 of approximately \$800.

#### Interest Rate and Debt Risk

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

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

LIBOR plus, an applicable margin equal to 3.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.5% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 3.75% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last day of each relevant interest period or, if the interest period is longer than three months, each day that is three months after the first day of the interest period, or

the base rate determined by reference to the highest of (a) the federal funds effective rate from time to time plus 0.50%, (b) the prime rate of JPMorgan Chase Bank, N.A., and (c) the LIBOR rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 2.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.5% if our consolidated leverage ratio is greater than

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or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 2.75% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last business day of each March, June, September, and December and the maturity date of the Credit Facility.

As of December 31, 2011, if the interest rate on our variable rate debt changed by 1%, our annual debt service payment would change by approximately \$700.

ITEM 8. Financial Statements and Supplementary Data

The information required by this Item is contained on pages F-1 through F-31 of this Annual Report on Form 10-K and incorporated herein by reference.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure  
None.

ITEM 9A. Controls and Procedures  
Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2011. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), as amended, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported, within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2011, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management’s Report on Internal Control Over Financial Reporting.

February 16, 2012

To the Stockholders of Vonage Holdings Corp.:

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the company. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

> Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and  
> dispositions of the assets of the company;

>

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of our management and directors; and  
> Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

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Based on our assessment, management concluded that, as of December 31, 2011, our internal control over financial reporting is effective based on those criteria.

Our independent registered public accounting firm has issued an attestation report on our internal control over financial reporting. This report appears on page F-3.

/s/ MARC LEFAR  
Marc Lefar  
Director, Chief Executive  
Officer

/s/ BARRY ROWAN  
Barry Rowan  
Executive Vice President, Chief Financial Officer, Chief Administrative  
Officer and Treasurer

Report of the Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting.

See Report of Independent Registered Public Accounting Firm on page F-3.

Changes in Internal Control Over Financial Reporting

There were no changes to controls during the quarter ended December 31, 2011 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

ITEM 9B. Other Information

None.

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PART III

ITEM 10. Directors, Executive Officers and Corporate Governance

The discussion under the headings “Proposal No. 1 – Election of Directors,” “Section 16(a) Beneficial Ownership Reporting Compliance,” “Director Nomination Process”, “Corporate Governance – Board Committees – Audit Committee”, and “Executive Officers of Vonage” in our Proxy Statement for the 2012 Annual Meeting of Stockholders is hereby incorporated by reference.

We have adopted a Vonage Code of Conduct applicable to all our officers and employees and a Vonage Finance Code of Ethics applicable to our chief financial officer and other employees in our finance organization. The Vonage Code of Conduct and Vonage Finance Code of Ethics are posted in the Investor Relations section of our website, [www.vonage.com](http://www.vonage.com). We will provide you with print copies of our codes free of charge on written request to Vonage Investor Relations, 23 Main Street, Holmdel NJ, 07733. We intend to disclose any amendments to, or waivers from, provisions of our codes that apply to our principal executive officer, principal financial officer, principal accounting officer or controller, or any person performing in similar functions, on our website promptly following the date of such amendment or waiver.

ITEM 11. Executive Compensation

The discussion under the headings “Compensation”, “Director Compensation”, “Corporate Governance – Compensation Committee Interlocks and Insider Participation”, and “Corporate Governance – Compensation Committee Report” in our Proxy Statement for the 2012 Annual Meeting of Stockholders is hereby incorporated by reference.

The “Compensation Committee Report” contained in our Proxy Statement shall not be deemed “soliciting material” or “filed” with the Securities and Exchange Commission or otherwise subject to the liabilities of Section 18 of the Securities Exchange Act of 1934 (the “Exchange Act”), nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 (the “Securities Act”) or the Exchange Act, except to the extent we specifically request that such information be treated as soliciting material or specifically incorporate such information by reference into a document filed under the Securities Act or the Exchange Act.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The discussion under the headings “Stock Ownership Information” and “Equity Compensation Plan Information” in our Proxy Statement for the 2012 Annual Meeting of Stockholders is hereby incorporated by reference.

ITEM 13. Certain Relationships and Related Transactions, and Director Independence

The discussion under the headings “Proposal No. 1 – Election of Directors – Transactions with Related Persons”, and “Corporate Governance – Board Determination of Independence” in our Proxy Statement for the 2012 Annual Meeting of Stockholders is hereby incorporated by reference.

ITEM 14. Principal Accountant Fees and Services

The discussion under the heading “Proposal No. 2 – Ratification of Independent Registered Public Accounting Firm” in our Proxy Statement for the 2012 Annual Meeting of Stockholders is hereby incorporated by reference.





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## PART IV

## ITEM 15. Exhibits, Financial Statement Schedules

- (a)
- (1) Financial Statements. The index to our financial statements is found on page F-1 of this Form 10-K.
- (2) Financial Statement Schedule. Schedule II—Valuation and Qualifying Accounts is as follows:

|                                      | Balance at<br>Beginning<br>of Period | Additions<br>Revenue | Expense      | Less<br>Deductions | Balance<br>at End<br>of Period |
|--------------------------------------|--------------------------------------|----------------------|--------------|--------------------|--------------------------------|
| Allowance for Doubtful Accounts:     |                                      |                      |              |                    |                                |
| Year ended December 31, 2011         | \$588                                | \$(4 )               | \$7          | \$—                | \$591                          |
| Year ended December 31, 2010         | 1,432                                | (711 )               | —            | (133 )             | 588                            |
| Year ended December 31, 2009         | 2,045                                | (193 )               | —            | (420 )             | 1,432                          |
| Inventory Obsolescence               |                                      |                      |              |                    |                                |
| Year ended December 31, 2011         | \$763                                | \$—                  | \$773        | \$(1,267 )         | \$269                          |
| Year ended December 31, 2010         | 432                                  | —                    | 2,213        | (1,882 )           | 763                            |
| Year ended December 31, 2009         | 1,405                                | —                    | 2,514        | (3,487 )           | 432                            |
| Valuation Allowance for Deferred Tax |                                      |                      |              |                    |                                |
| Year ended December 31, 2011         | \$415,903                            | \$—                  | \$(398,220 ) | (1) \$—            | \$17,683                       |
| Year ended December 31, 2010         | 385,941                              | —                    | 29,962       | (1) —              | 415,903                        |
| Year ended December 31, 2009         | 386,547                              | —                    | (606 )       | (1) —              | 385,941                        |

(1) Amounts charged (credited) to expense represent change in valuation allowance.

(3) Exhibits.

| Exhibit<br>Number | Description of Exhibit   |
|-------------------|--|
| 3.1               | Restated Certificate of Incorporation of Vonage Holdings Corp.(4)  |
| 3.2               | Second Amended and Restated By-laws of Vonage Holdings Corp.(9)  |
| 4.1               | Form of Certificate of Vonage Holdings Corp. Common Stock(3)   |
| 10.1              | 2001 Stock Incentive Plan of Vonage Holdings Corp.(1)*   |
| 10.2              | Form of Incentive Stock Option Agreement under the 2001 Stock Incentive Plan(1)*   |
| 10.3              | Form of Nonqualified Stock Option Agreement for Employees under the 2001 Stock Incentive Plan(1)*  |
| 10.4              | Form of Nonqualified Stock Option Agreement for Outside Directors under the 2001 Stock Incentive Plan(1)*  |
| 10.5              | Amended and Restated Vonage Holding Corp. 2006 Incentive Plan(14)*   |
| 10.6              | Form of Restricted Stock Unit Agreement under the Vonage Holdings Corp. 2006 Incentive Plan(6)*  |
| 10.7              | Form of Nonqualified Stock Option Agreement under the Vonage Holdings Corp. 2006 Incentive Plan(16)*   |
| 10.8              | Form of Restricted Stock Agreement under the Vonage Holdings Corp. 2006 Incentive Plan(6)*   |
| 10.9              | Form of Restricted Stock Agreement for Non-Executive Directors under the Vonage Holdings Corp. 2006 Incentive Plan (10)*                             |
| 10.10             | Form of Nonqualified Stock Option Agreement for Non-Executive Directors (Quarterly Grants) under the Vonage Holdings Corp. 2006 Incentive Plan (10)* |
| 10.11             | Form of Nonqualified Stock Option Agreement for Non-Executive Directors (Sign-on Grant) under the Vonage Holdings Corp. 2006 Incentive Plan (10)*    |
| 10.12             | Vonage Holdings Corp. 401(k) Retirement Plan(1)*   |
| 10.13             |  |

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- Lease Agreement, dated March 24, 2005, between 23 Main Street Holmdel Associates LLC and Vonage USA Inc.(1)
- 10.14 Amended and Restated Employment Agreement dated November 5, 2009 between Vonage Holdings Corp. and Marc P. Lefar(14)\*
- 10.15 Indemnification Agreement dated as of July 29, 2008 by and between Vonage Holdings Corp. and Marc. P. Lefar(9)\*
- 10.16 Form of Nonqualified Stock Option Agreement for Marc P. Lefar under the Vonage Holdings Corp. 2006 Incentive Plan(9)\*

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| Exhibit<br>Number | Description of Exhibit   |
|-------------------|--|
| 10.17             | Employment Agreement dated as of February 24, 2010 by and between Vonage Holdings Corp. and Barry Rowan(16)*                           |
| 10.18             | Indemnification Agreement dated as of May 6, 2010 by and between Vonage Holdings Corp. and Barry Rowan(16)*                            |
| 10.19             | Amended and Restated Employment Agreement, dated February 8, 2006, between Vonage Holdings Corp. and Jeffrey A. Citron(1)*             |
| 10.20             | Separation Agreement and General Release dated as of July 29, 2008 by and between Vonage Holdings Corp. and Jeffrey A. Citron(9)*      |
| 10.21             | Amended and Restated Non-Compete Agreement dated as of October 17, 2008 by and between Vonage Holdings Corp. and Jeffrey A. Citron(12) |
| 10.22             | Form of Nonqualified Stock Option Agreement for Jeffrey A. Citron under the Vonage Holdings Corp. 2006 Incentive Plan(9)*              |
| 10.23             | Letter Agreement, dated May 8, 2011, between Vonage Holdings Corp. and Scott Ballantyne(20)*   |
| 10.24             | Letter Agreement, dated February 9, 2009, between Vonage Holdings Corp. and Nicholas P. Lazzaro(13)*                                   |
| 10.25             | Amendment to Letter Agreement, dated December 30, 2010, between Vonage Holdings Corp. and Nicholas P. Lazzaro(21)*                     |
| 10.26             | Letter Agreement, dated March 24, 2009, between Vonage Holdings Corp. and Kimberly O’Loughlin(13)*                                     |
| 10.27             | Amendment to Letter Agreement, dated December 25, 2010, between Vonage Holdings Corp. and Kimberly O’Loughlin(21)*                     |
| 10.28             | Letter Agreement, dated November 19, 2008, between Vonage Holdings Corp. and Michael A. Tempora(13)*                                   |
| 10.29             | Amendment to Letter Agreement, dated December 23, 2010, between Vonage Holdings Corp. and Michael A. Tempora(21)*                      |
| 10.30.            | Letter Agreement, dated July 15, 2009, between Vonage Holdings Corp. and Kurt Rogers(14)*  |
| 10.31             | Amendment to Letter Agreement, dated December 22, 2010, between Vonage Holdings Corp. and Kurt Rogers(21)*                             |
| 10.32             | Non-Executive Director Compensation Program effective October 14, 2010(19)*  |
| 10.33             | Form of Indemnification Agreement between Vonage Holdings Corp. and its directors and certain officers(7)*                             |

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- 10.34 Third Amended and Restated Investors' Rights Agreement, as amended, dated April 27, 2005, among Vonage Holdings Corp. and the signatories thereto(2)
- 10.35 Written Consent of Vonage Holdings Corp. and Certain Stockholders to the amendment to the Third Amended and Restated Investors' Rights Agreement dated April 27, 2005, as amended, dated November 13, 2006(5)
- 10.36 Registration Rights Agreement, dated December 16, 2005, among Vonage Holdings Corp. and the signatories thereto(1)
- 10.37† License and Managed Services Agreement, dated December 23, 2009 between Vonage Network LLC and Amdocs Software Systems Limited and Amdocs, Inc.(15)
- 10.38† First Amending Agreement to License and Managed Services Agreement, dated December 22, 2010 between Vonage Network LLC and Amdocs Software Systems Limited and Amdocs, Inc.(21)
- 10.39 Settlement Agreement, effective October 27, 2007, between Vonage Holdings Corp. and Sprint Communications Company L.P.(8)
- 10.40 Settlement and Patent License Agreement, dated December 21, 2007, between Vonage Holdings Corp. and AT&T Corp.(8)
- 10.41 Settlement Agreement, effective January 1, 2008 between Vonage Holdings Corp. and Nortel Networks Inc. and Nortel Networks Limited(8)
- 10.42 Credit Agreement, dated as of December 14, 2010 among Vonage Holdings Corp. and Vonage America Inc., as borrowers, various lenders, and Bank of America, N.A., as Administrative Agent(18)
- 10.43 First Lien Credit and Guaranty Agreement, dated as of October 19, 2008 among Vonage Holdings Corp. and Vonage America Inc., as borrowers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various lenders, and Silver Point Finance, LLC, as Administrative Agent, Collateral Agent and Lead Arranger (relating to former first lien credit facility)(11)
- 10.44 Second Lien Credit and Guaranty Agreement, dated as of October 19, 2008 among Vonage Holdings Corp. and Vonage America Inc., as borrowers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various lenders, and Silver Point Finance, LLC, as Administrative Agent, Collateral Agent and Lead Arranger (relating to former second lien credit facility)(11)
- 10.45 Third Lien Note Purchase Agreement dated as of October 19, 2008 among Vonage Holdings Corp. and Vonage America Inc., as co-issuers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various purchasers, and Silver Point Finance, LLC, as Note Agent and Collateral Agent (relating to former third lien convertible notes)(11)
- 10.46 Master Agreement, dated November 2, 2010, among Vonage Holdings Corp. and Vonage America Inc., as borrowers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various lenders, and Silver Point Finance, LLC, as Administrative Agent (relating to former first and second lien credit facilities)(17)



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| Exhibit Number | Description of Exhibit  |
|----------------|---|
| 10.47          | Third Lien Agreement, dated November 2, 2010, among Vonage Holdings Corp. and Vonage America Inc., as co-issuers, and certain holders of convertible notes (relating to former third lien convertible notes)(17)                      |
| 10.48          | Credit Agreement, dated as of July 29, 2011 among Vonage Holdings Corp. and Vonage America Inc., as borrowers, various lenders, JPMorgan Chase Bank, N.A., as Administrative Agent, and RBS Citizens, N.A., as Syndication Agent.(20) |
| 21.1           | List of Subsidiaries of Vonage Holdings Corp.(22)   |
| 23.1           | Consent of BDO USA, LLP, independent registered public accounting firm(22)  |
| 31.1           | Certification of our 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(22)  |
| 31.2           | Certification of our 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(22)  |
| 32.1           | Certification of our 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(22)   |

- (1) Incorporated by reference to Amendment No. 1 to Vonage Holdings Corp.'s Registration Statement on Form S-1 (File No. 333-131659) filed on April 7, 2006.
- (2) Incorporated by reference to Amendment No. 4 to Vonage Holdings Corp.'s Registration Statement on Form S-1 (File No. 333-131659) filed on April 28, 2006.
- (3) Incorporated by reference to Amendment No. 5 to Vonage Holdings Corp.'s Registration Statement on Form S-1 (File No. 333-131659) filed on May 8, 2006.
- (4) Incorporated by reference to Vonage Holdings Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on August 4, 2006.
- (5) Incorporated by reference to Vonage Holding Corp.'s Current Report on Form 8-K (File No. 001-32887) filed on November 14, 2006.
- (6) Incorporated by reference to Vonage Holding Corp.'s Annual Report on Form 10-K (File No. 001-32887) filed on April 17, 2007.
- (7) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on November 14, 2007.
- (8) Incorporated by reference to Vonage Holding Corp.'s Annual Report on Form 10-K (File No. 001-32887) filed on March 17, 2008.
- (9) Incorporated by reference to Vonage Holding Corp.'s Current Report on Form 8-K (File No. 001-32887) filed on August 4, 2008.
- (10) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on August 11, 2008.
- (11) Incorporated by reference to Vonage Holding Corp.'s Amendment No. 8 to Schedule TO (File No. 005-82032) filed on October 22, 2008.
- (12) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on November 10, 2008.
- (13) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on August 6, 2009.

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- (14) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on November 6, 2009.
- (15) Incorporated by reference to Vonage Holding Corp.'s Annual Report on Form 10-K (File No. 001-32887) filed on February 26, 2010.
- Incorporated by reference to Vonage Holding Corp.'s Current Report on Form 8-K (File No. 001-32887) filed on March 1, 2010.
- (16) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on May 7, 2010.
- (17) Incorporated by reference to Vonage Holding Corp.'s Current Report on Form 8-K (File No. 001-32887) filed on November 3, 2010.
- (18) Incorporated by reference to Vonage Holding Corp.'s Current Report on Form 8-K (File No. 001-32887) filed on December 15, 2010.
- (19) Incorporated by reference to Vonage Holding Corp.'s Current Report on Form 8-K (File No. 001-32887) filed on February 15, 2011.
- (20) Incorporated by reference to Vonage Holding Corp.'s Quarterly Report on Form 10-Q (File No. 001-32887) filed on August 4, 2011.
- (21) Incorporated by reference to Vonage Holding Corp.'s Annual Report on Form 10-K (File No. 001-32887) filed on February 17, 2011.
- (22) Filed herewith.

Portions of this Exhibit have been omitted and filed separately with the Securities and Exchange Commission as part of an order or application for confidential treatment pursuant to the Securities Act of 1933, as amended or the Securities Exchange Act of 1934, as amended.

\*Management contract or compensatory plan or arrangement.

(b) Exhibits Filed Herewith

Refer to (a)(3) above.

(c) Financial Statement Schedule

Report of Independent Registered Public Accounting Firm

Schedule II – Valuation and Qualifying Accounts.



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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Vonage Holdings Corp.

Holmdel, New Jersey 07733

The audits referred to in our report dated February 16, 2012 relating to the consolidated financial statements of Vonage Holdings Corp., which is contained in Item 8 of this Form 10-K also included the audit of the financial statement schedule listed in the accompanying index. The financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits.

In our opinion such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ BDO USA, LLP

Woodbridge, New Jersey

February 16, 2012

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Holmdel, State of New Jersey, on February 16, 2012.

## VONAGE HOLDINGS CORP.

Dated: February 16, 2012

By: /S/ BARRY ROWAN  
Barry Rowan  
Executive Vice President, Chief Financial Officer,  
Chief Administrative Officer and Treasurer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the registrant and in the capacities and as of the dates indicated.

| Signature                                  | Title  | Date              |
|--|--|-------------------|
| /S/ MARC P. LEFAR<br>Marc P. Lefar         | Director, Chief Executive Officer<br>(principal executive officer)   | February 16, 2012 |
| /S/ BARRY L. ROWAN<br>Barry L. Rowan       | Executive Vice President,<br>Chief Financial Officer, Chief Administrative<br>Officer and Treasurer<br>(principal financial officer and principal<br>accounting officer) | February 16, 2012 |
| /S/ JEFFREY A. CITRON<br>Jeffrey A. Citron | Director, Chairman   | February 16, 2012 |
| /S/ PETER BARRIS<br>Peter Barris           | Director   | February 16, 2012 |
| /S/ MORTON DAVID<br>Morton David           | Director   | February 16, 2012 |
| /S/ MICHAEL A. KRUPKA<br>Michael A. Krupka | Director   | February 16, 2012 |
| /S/ JEFFREY J. MISNER<br>Jeffrey J. Misner | Director   | February 16, 2012 |
| /S/ DAVID C. NAGEL<br>David C. Nagel       | Director   | February 16, 2012 |
| /S/ JOSEPH M. REDLING<br>Joseph M. Redling | Director   | February 16, 2012 |
| /S/ JOHN J. ROBERTS<br>John J. Roberts     | Director   | February 16, 2012 |

/S/ CARL SPARKS  
Carl Sparks

Director

February 16, 2012

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| <u>Report of Independent Registered Public Accounting Firm—BDO USA, LLP</u>   | <u>F-3</u> |
| <u>Consolidated Balance Sheets as of December 31, 2011 and 2010</u>   | <u>F-4</u> |
| <u>Consolidated Statements of Operations for the years ended December 31, 2011, 2010 and 2009</u>                     | <u>F-5</u> |
| <u>Consolidated Statements of Comprehensive Income (Loss) for the years ended December 31, 2011, 2010 and 2009</u>    | <u>F-6</u> |
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Vonage Holdings Corp.

Holmdel, New Jersey

We have audited the accompanying consolidated balance sheets of Vonage Holdings Corp. as of December 31, 2011 and 2010, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Vonage Holdings Corp. as of December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Vonage Holdings Corp.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 16, 2012 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Woodbridge, New Jersey

February 16, 2012

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Vonage Holdings Corp.

Holmdel, New Jersey

We have audited Vonage Holdings Corp.'s (the "Company") internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Item 9A. Management's Report on Internal Control Over Financial Reporting." Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Vonage Holdings Corp. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Vonage Holdings Corp. as of December 31, 2011 and 2010 and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2011 and our report dated February 16, 2012 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Woodbridge, New Jersey

February 16, 2012

Table of ContentsVONAGE HOLDINGS CORP. CONSOLIDATED BALANCE SHEETS  
VONAGE HOLDINGS CORP. CONSOLIDATED BALANCE SHEETS

| (In thousands, except par value)   | December 31,<br>2011 | December 31,<br>2010 |
|--|----------------------|----------------------|
| Assets   |                      |                      |
| Current assets:  |                      |                      |
| Cash and cash equivalents  | \$ 58,863            | \$ 78,934            |
| Accounts receivable, net of allowance of \$591 and \$588, respectively   | 17,862               | 15,207               |
| Inventory, net of allowance of \$269 and \$763, respectively   | 6,715                | 6,143                |
| Deferred customer acquisition costs, current   | 4,964                | 6,481                |
| Deferred tax assets, current   | 19,546               | —                    |
| Prepaid expenses and other current assets  | 16,820               | 17,231               |
| Total current assets   | 124,770              | 123,996              |
| Property and equipment, net  | 67,978               | 79,050               |
| Software, net  | 45,661               | 35,516               |
| Deferred customer acquisition costs, non-current   | 721                  | 1,093                |
| Debt related costs, net  | 2,007                | 5,372                |
| Restricted cash  | 6,929                | 7,978                |
| Intangible assets, net   | 9,056                | 4,186                |
| Deferred tax assets, non-current   | 306,055              | —                    |
| Other assets   | 3,038                | 3,201                |
| Total assets   | \$ 566,215           | \$ 260,392           |
| Liabilities and Stockholders' Equity (Deficit)   |                      |                      |
| Liabilities  |                      |                      |
| Current liabilities:   |                      |                      |
| Accounts payable   | \$ 66,214            | \$ 37,128            |
| Accrued expenses   | 69,526               | 89,407               |
| Deferred revenue, current portion  | 38,778               | 43,397               |
| Current maturities of capital lease obligations  | 2,104                | 1,783                |
| Current portion of notes payables  | 28,333               | 20,000               |
| Total current liabilities  | 204,955              | 191,715              |
| Notes payable, net of discount and current maturities  | 42,500               | 173,004              |
| Deferred revenue, net of current portion   | 1,203                | 1,784                |
| Capital lease obligations, net of current maturities   | 15,561               | 17,665               |
| Other liabilities, net of current portion in accrued expenses  | 2,429                | 5,871                |
| Total liabilities  | 266,648              | 390,039              |
| Commitments and Contingencies  |                      |                      |
| Stockholders' Equity (Deficit)   |                      |                      |
| Common stock, par value \$0.001 per share; 596,950 shares authorized at December 31, 2011 and December 31, 2010; 227,858 and 223,454 shares issued at December 31, 2011 and December 31, 2010, respectively; 225,586 and 221,566 shares outstanding at December 31, 2011 and December 31, 2010, respectively | 228                  | 223                  |
| Additional paid-in capital   | 1,074,488            | 1,053,805            |
| Accumulated deficit  | (762,857 )           | (1,171,901 )         |
| Treasury stock, at cost, 2,272 shares at December 31, 2011 and 1,888 shares at December 31, 2010   | (14,529 )            | (13,139 )            |
| Accumulated other comprehensive income   | 2,237                | 1,365                |
| Total stockholders' equity (deficit)   | 299,567              | (129,647 )           |

|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity (deficit) | \$ 566,215 | \$ 260,392 |
|--|------------|------------|

The accompanying notes are an integral part of these financial statements

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## VONAGE HOLDINGS CORP. CONSOLIDATED STATEMENTS OF OPERATIONS

| (In thousands, except per share amounts)  | For the Years Ended December 31, |            |            |
|---|----------------------------------|------------|------------|
|   | 2011                             | 2010       | 2009       |
| Operating Revenues:   |                                  |            |            |
| Telephony services  | \$866,560                        | \$872,934  | \$864,848  |
| Customer equipment and shipping   | 3,763                            | 12,108     | 24,232     |
|   | 870,323                          | 885,042    | 889,080    |
| Operating Expenses:   |                                  |            |            |
| Direct cost of telephony services (excluding depreciation and amortization of \$15,824, \$18,725, and \$18,958, respectively) | 236,149                          | 243,794    | 213,553    |
| Direct cost of goods sold   | 41,756                           | 55,965     | 71,488     |
| Selling, general and administrative   | 234,754                          | 238,986    | 265,456    |
| Marketing   | 204,263                          | 198,170    | 227,990    |
| Depreciation and amortization   | 37,051                           | 53,073     | 53,391     |
|   | 753,973                          | 789,988    | 831,878    |
| Income from operations  | 116,350                          | 95,054     | 57,202     |
| Other Income (Expense):   |                                  |            |            |
| Interest income   | 135                              | 519        | 277        |
| Interest expense  | (17,118)                         | (48,541)   | (54,192)   |
| Change in fair value of embedded features within notes payable and stock warrant  | (950)                            | (99,338)   | (49,933)   |
| (Loss) gain on extinguishment of notes  | (11,806)                         | (31,023)   | 4,041      |
| Other (expense) income, net   | (271)                            | (18)       | 843        |
|   | (30,010)                         | (178,401)  | (98,964)   |
| Income (loss) before income tax benefit (expense)   | 86,340                           | (83,347)   | (41,762)   |
| Income tax benefit (expense)  | 322,704                          | (318)      | (836)      |
| Net income (loss)   | \$409,044                        | \$(83,665) | \$(42,598) |
| Net income (loss) per common share:   |                                  |            |            |
| Basic   | \$1.82                           | \$(0.40)   | \$(0.25)   |
| Diluted   | \$1.69                           | \$(0.40)   | \$(0.25)   |
| Weighted-average common shares outstanding:   |                                  |            |            |
| Basic   | 224,324                          | 209,868    | 170,314    |
| Diluted   | 241,744                          | 209,868    | 170,314    |

The accompanying notes are an integral part of these financial statements

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VONAGE HOLDINGS CORP. CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

| (In thousands)                          | For the Years Ended December 31, |             |             |
|---|----------------------------------|-------------|-------------|
|   | 2011                             | 2010        | 2009        |
| Net income (loss)                       | \$409,044                        | \$(83,665 ) | \$(42,598 ) |
| Other comprehensive income:             |                                  |             |             |
| Foreign currency translation adjustment | 872                              | 909         | 1,364       |
| Total other comprehensive income        | 872                              | 909         | 1,364       |
| Comprehensive income (loss)             | \$409,916                        | \$(82,756 ) | \$(41,234 ) |

The accompanying notes are an integral part of these financial statements

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## VONAGE HOLDINGS CORP. CONSOLIDATED STATEMENTS OF CASH FLOWS

| (In thousands)   | December 31, |             |             |
|--|--------------|-------------|-------------|
|  | 2011         | 2010        | 2009        |
| Cash flows from operating activities:  |              |             |             |
| Net income (loss)  | \$409,044    | \$(83,665 ) | \$(42,598 ) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |              |             |             |
| Depreciation and amortization and impairment charges                                     | 35,776       | 51,928      | 52,072      |
| Amortization of intangibles  | 1,275        | 1,145       | 1,319       |
| Deferred tax benefit   | (325,601 )   | —           | —           |
| Change in fair value of embedded features in notes payable and stock warrant             | 950          | 99,338      | 49,933      |
| Loss on extinguishment of notes  | 11,806       | 31,023      | (4,041 )    |
| Amortization of discount on notes  | 914          | 4,732       | 5,469       |
| Accrued interest paid in-kind  | —            | 13,232      | 17,154      |
| Allowance for doubtful accounts  | (4 )         | (711 )      | (193 )      |
| Allowance for obsolete inventory   | 773          | 2,213       | 2,514       |
| Amortization of debt related costs   | 1,391        | 1,402       | 2,708       |
| Share-based expense  | 14,279       | 8,255       | 8,473       |
| Changes in operating assets and liabilities:   |              |             |             |
| Accounts receivable  | (2,663 )     | 573         | 2,930       |
| Inventory  | (1,362 )     | (568 )      | 203         |
| Prepaid expenses and other current assets  | 412          | 21,322      | (22,053 )   |
| Deferred customer acquisition costs  | 1,891        | 15,505      | 21,523      |
| Other assets   | 163          | 9,118       | (1,510 )    |
| Accounts payable   | 29,090       | 25,606      | (22,595 )   |
| Accrued expenses   | (21,216 )    | 19,966      | (4,764 )    |
| Deferred revenue   | (5,167 )     | (19,446 )   | (22,153 )   |
| Other liabilities  | (4,965 )     | (6,756 )    | (5,995 )    |
| Net cash provided by operating activities  | 146,786      | 194,212     | 38,396      |
| Cash flows from investing activities:  |              |             |             |
| Capital expenditures   | (12,636 )    | (17,674 )   | (23,724 )   |
| Purchase of intangible assets  | (3,725 )     | —           | (1,250 )    |
| Acquisition and development of software assets   | (22,292 )    | (22,712 )   | (21,654 )   |
| Decrease (increase) in restricted cash   | 1,049        | 35,700      | (3,937 )    |
| Net cash used in investing activities  | (37,604 )    | (4,686 )    | (50,565 )   |
| Cash flows from financing activities:  |              |             |             |
| Principal payments on capital lease obligations  | (1,783 )     | (1,500 )    | (1,251 )    |
| Principal payments on notes  | (229,166 )   | (232,514 )  | (1,809 )    |
| Proceeds from issuance of notes payable  | 100,000      | 200,000     | —           |
| Discount on notes payable  | —            | (6,000 )    | —           |
| Extinguishment of notes  | (1,054 )     | (99,938 )   | —           |
| Debt related costs   | (2,697 )     | (5,430 )    | (252 )      |
| Proceeds from exercise of stock options and stock warrant                                | 4,562        | 1,620       | 59          |
| Net cash used in financing activities  | (130,138 )   | (143,762 )  | (3,253 )    |
| Effect of exchange rate changes on cash  | 885          | 957         | 1,501       |
| Net change in cash and cash equivalents  | (20,071 )    | 46,721      | (13,921 )   |

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|   |          |          |          |
|---|----------|----------|----------|
| Cash and cash equivalents, beginning of period                            | 78,934   | 32,213   | 46,134   |
| Cash and cash equivalents, end of period                                  | \$58,863 | \$78,934 | \$32,213 |
| Supplemental disclosures of cash flow information:                        |          |          |          |
| Cash paid during the periods for:   |          |          |          |
| Interest  | \$15,563 | \$63,814 | \$28,671 |
| Income taxes  | \$2,289  | \$544    | \$1,206  |
| Non-cash financing transactions during the periods for:                   |          |          |          |
| Conversion of convertible notes into common stock:                        |          |          |          |
| Third lien convertible notes, net of discount and debt related costs      | \$—      | \$4,497  | \$9,361  |
| Embedded conversion option within third lien convertible notes            | \$—      | \$32,358 | \$57,050 |
| The accompanying notes are an integral part of these financial statements |          |          |          |

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## VONAGE HOLDINGS CORP. CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

| (In thousands)  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Stock<br>Subscription<br>Receivable | Accumulated<br>Deficit | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total        |
|---|-----------------|----------------------------------|-------------------------------------|------------------------|-------------------|---|--------------|
| Balance at December 31,<br>2008   | \$ 158          | \$ 980,768                       | \$ (5,195 )                         | \$ (1,052,861 )        | \$ (12,704 )      | \$ (908 )   | \$ (90,742 ) |
| Opening adjustment due to<br>separate valuation of<br>embedded derivative |                 | (37,884 )                        |                                     | 7,223                  |                   |   | (30,661 )    |
| Stock option exercises  | 1               | 58                               |                                     |                        |                   |   | 59           |
| Share-based expense   |                 | 8,473                            |                                     |                        |                   |   | 8,473        |
| Share-based award activity  |                 |                                  |                                     |                        | (174 )            |   | (174 )       |
| Convertible notes conversion  | 43              | 62,327                           |                                     |                        |                   |   | 62,370       |
| Uncollected stock<br>subscription receivable                              |                 | (5,195 )                         | 5,195                               |                        |                   |   | —            |
| Foreign currency translation<br>adjustment                                |                 |                                  |                                     |                        |                   | 1,364   | 1,364        |
| Net loss  |                 |                                  |                                     | (42,598 )              |                   |   | (42,598 )    |
| Balance at December 31,<br>2009   | 202             | 1,008,547                        | —                                   | (1,088,236 )           | (12,878 )         | 456   | (91,909 )    |
| Stock option exercises  | 1               | 1,619                            |                                     |                        |                   |   | 1,620        |
| Share-based expense   |                 | 8,255                            |                                     |                        |                   |   | 8,255        |
| Share-based award activity  |                 |                                  |                                     |                        | (261 )            |   | (261 )       |
| Convertible notes conversion  | 20              | 35,384                           |                                     |                        |                   |   | 35,404       |
| Foreign currency translation<br>adjustment                                |                 |                                  |                                     |                        |                   | 909   | 909          |
| Net loss  |                 |                                  |                                     | (83,665 )              |                   |   | (83,665 )    |
| Balance at December 31,<br>2010   | 223             | 1,053,805                        | —                                   | (1,171,901 )           | (13,139 )         | 1,365   | (129,647 )   |
| Stock option exercises  | 5               | 4,259                            |                                     |                        |                   |   | 4,264        |
| Share-based expense   |                 | 14,279                           |                                     |                        |                   |   | 14,279       |
| Share-based award activity  |                 |                                  |                                     |                        | (1,390 )          |   | (1,390 )     |
| Warrant exercise  |                 | 2,145                            |                                     |                        |                   |   | 2,145        |
| Foreign currency translation<br>adjustment                                |                 |                                  |                                     |                        |                   | 872   | 872          |
| Net income  |                 |                                  |                                     | 409,044                |                   |   | 409,044      |
| Balance at December 31,<br>2011   | \$ 228          | \$ 1,074,488                     | \$ —                                | \$ (762,857 )          | \$ (14,529 )      | \$ 2,237  | \$ 299,567   |

The accompanying notes are an integral part of these financial statements

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

Note 1. Basis of Presentation and Significant Accounting Policies

NATURE OF OPERATIONS

Vonage Holdings Corp. (“Vonage”, “Company”, “we”, “our”, “us”) is incorporated as a Delaware corporation. We are a leading provider of low-cost communications services connecting people through broadband devices worldwide. While customers in the United States represented 94% of our subscriber lines for our broadband telephone replacement services at December 31, 2011, we also bill customers in Canada and the United Kingdom.

SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Vonage and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

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

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

- > those related to the average period of service to a customer (the “customer life”) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation;
- > the useful lives of property and equipment, software costs, and intangible assets; assumptions used for the purpose of determining share-based compensation and the fair value of our prior stock warrant using the Black-Scholes option pricing model (“Model”), and various other assumptions that we believed to be reasonable; the key inputs for this Model are our stock price at valuation date, exercise price, the dividend yield, risk-free interest rate, life in years, and historical volatility of our common stock;
- > assumptions used in determining the need for, and amount of, a valuation allowance on net deferred tax assets; assumptions used to determine the fair value of the embedded conversion option within our prior third lien convertible notes using the Monte Carlo simulation model; the key inputs are maturity date, risk-free interest rate, our stock price at valuation date, and historical volatility of our common stock; and
- > assumptions used to determine the fair value of the embedded make-whole premium feature within our prior senior secured first lien credit facility and our prior senior secured second lien credit facility.

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

Revenue Recognition

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 Staff Accounting Bulletin No. 104, Revenue Recognition, and Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 605, Revenue Recognition.

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

- > Providing equipment, if any, to the customer that enables our telephony services and

> Providing telephony services.

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

#### Telephony Services Revenue

Substantially all of our operating revenues are telephony services revenues, which are derived primarily from monthly subscription fees that customers are charged under our service plans. We also derive telephony services revenues from per minute fees for international calls if not

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

covered under a plan, including 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 our multiple billing cycles each month, we estimate the amount of revenues earned from international calls and from customers exceeding allocated call minutes under limited minute plans but not billed from the end of each billing cycle to the end of each reporting period. These estimates are based primarily upon historical minutes and have been consistent with our actual results.

We also provide rebates to customers who purchase their customer equipment from retailers and satisfy minimum service period requirements. These rebates in excess of activation fees are recorded as a reduction of revenues over the service period based upon the estimated number of customers that will ultimately earn and claim the rebates. From time to time we have generated revenue by charging a fee for activating service, although we do not currently or expect to charge an activation fee to customers. In these instances when no activation fee is being collected, no customer acquisition costs are deferred. Customer activation fees when collected, along with the related incremental direct customer acquisition amounts for customer equipment in the direct channel and for rebates and retailer commissions in the retail channel, up to but not exceeding the activation fee, are deferred and amortized over the estimated average customer life. The amortization of deferred customer equipment is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction of telephony services revenues. The amortization of deferred retailer commissions is recorded as marketing expense. We estimate customer life by analyzing historical trends and applying those trends to future periods. This customer life is solely used to amortize deferred activation fees collected, along with the related incremental customer acquisition costs. The average customer life was 44 months in 2009, and 38 months for 2010 and 2011, respectively, based on consistent historical trends. The impact of these changes to the average customer life was not material to the consolidated results of operations.

In the United States, we charge regulatory, compliance, E-911, and intellectual property-related fees on a monthly basis to defray costs, and to cover taxes that we are charged by the suppliers of telecommunications services. In addition, we charge customers Federal Universal Service Fund ("USF") fees. We recognize revenue on a gross basis for USF and related fees. We record these fees as revenue when billed. All other taxes are recorded on a net basis. In addition, historically, we charged a disconnect fee for customers who terminated their service plan within the first twelve months of service. Disconnect fees are recorded as revenue and are recognized at the time the customer terminates service. Beginning in September 2010, we eliminated the disconnect fee for new customers.

**Customer Equipment and Shipping Revenue**

Customer equipment and shipping revenues consist of revenues from sales of customer equipment to wholesalers or directly to customers for replacement devices, or for upgrading their device at the time of customer sign-up for which we charge an additional fee. In addition, customer equipment and shipping revenues include the fees that customers are charged for shipping their customer equipment to them. Customer equipment and shipping revenues include sales to our retailers, who subsequently resell this customer equipment to customers. Revenues were reduced for payments to retailers and rebates to customers, who purchased their customer equipment through these retailers, to the extent of customer equipment and shipping revenues. In addition, historically, we charged an equipment recovery fee for customers who terminated their service plan within the first twelve months of service. Equipment recovery fees are recorded as revenue and are recognized at the time the customer terminates service. Beginning in September 2010, we eliminated the equipment recovery fees for new customers.

**Direct Cost of Telephony Services**



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

#### Direct Cost of Goods Sold

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

#### Development Expenses

Costs for research, including predevelopment efforts prior to establishing technological feasibility of software expected to be marketed, are expensed as incurred. Development costs are capitalized when technological feasibility has been established and anticipated future revenues support the recoverability of the capitalized amounts. Capitalization stops when the product is available for general release to customers. Due to the short time period between achieving technological feasibility and product release and the insignificant amount of costs incurred during such periods, we have not capitalized any software development, and have expensed these costs as incurred. These costs are included in selling, general and administrative expense.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

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.

Software Costs

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

Intangible Assets

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

Patents and Patent Licenses

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

Long-Lived Assets

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

Debt Related Costs

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

Restricted Cash and Letters of Credit

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

We had a cash collateralized letter of credit for \$6,300 and \$7,350 as of December 31, 2011 and 2010, respectively, related to lease deposits for our offices and a cash collateralized letter of credit for \$536 and \$535 as of December 31, 2011 and 2010, respectively, related to an energy curtailment program for our offices. The total amount of collateralized letters of credit was \$6,836 and \$7,885 at December 31, 2011 and 2010, respectively. In the aggregate, cash reserves and collateralized letters of credit of \$6,929 and \$7,978 were recorded as long-term restricted cash at December 31, 2011 and 2010, respectively.

Derivatives

We do not hold or issue derivative instruments for trading purposes. However, in accordance with FASB ASC 815, “Derivatives and Hedging” (“FASB ASC 815”), we review our contractual obligations to determine whether there are terms that possess the characteristics of derivative financial instruments that must be accounted for separately from the financial instrument in which they are embedded. Based upon this review, we are required to value the following features separately for accounting purposes:

- > certain features within a prior common stock warrant to purchase 514 shares of common stock at an exercise price of >\$0.58 because the number of shares to be received by the holder could change under certain conditions;
- > certain features within our prior third lien convertible notes because the number of shares to be received by the >holder could have changed under certain conditions; and
- > the make-whole premium provisions within our prior senior secured first lien credit facility and our prior senior >secured second lien credit facility because upon prepayment under certain circumstances we may have been required to settle the debt for more than its face amount.

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 will result in a non-cash benefit to our net income in the period of the determination. 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 is not currently recognized each quarter as a result of the valuation allowance. In the future, if available evidence changes our conclusion that it is more likely than not that we will utilize our net deferred tax assets prior to their expiration, we will make an adjustment to the related valuation allowance at that time. In the fourth quarter of 2011, we released \$325,601 of valuation allowance (see Note 5. Income Taxes).

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.

#### 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 (Loss) per Share

Net income (loss) per share has been computed according to FASB ASC 260, "Earnings per Share", which requires a dual presentation of basic and diluted earnings per share ("EPS"). Basic EPS represents net income (loss) divided by the weighted average number of common shares outstanding during a reporting period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, including warrants, stock options and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, and our

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

prior third lien convertible notes, were exercised or converted into common stock. The dilutive effect of outstanding warrants, stock options, and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. In applying the treasury stock method for stock-based compensation arrangements, the assumed proceeds are computed as the sum of the amount the employee must pay upon exercise and the amounts of average unrecognized compensation cost attributed to future services. The dilutive effect of our prior third lien convertible notes was reflected in diluted earnings per share using the if-converted method.

The following table sets forth the computation for basic and diluted net income (loss) per share for years ended December 31, 2011 and 2010:

|  | For the Years Ended December 31, |             |             |
|--|----------------------------------|-------------|-------------|
|  | 2011                             | 2010        | 2009        |
| Numerator  |                                  |             |             |
| Numerator for basic earnings per share-net income (loss)     | \$409,044                        | \$(83,665 ) | \$(42,598 ) |
| Numerator for diluted earnings per share - net income (loss) | \$409,044                        | \$(83,665 ) | \$(42,598 ) |
| Denominator  |                                  |             |             |
| Basic weighted average common shares outstanding             | 224,324                          | 209,868     | 170,314     |
| Dilutive effect of stock options and restricted stock units  | 17,420                           | —           | —           |
| Diluted weighted average common shares outstanding           | 241,744                          | 209,868     | 170,314     |
| Basic net income (loss) per share                            |                                  |             |             |
| Basic net income (loss) per share                            | \$1.82                           | \$(0.40 )   | \$(0.25 )   |
| Diluted net income (loss) per share                          |                                  |             |             |
| Diluted net income (loss) per share                          | \$1.69                           | \$(0.40 )   | \$(0.25 )   |

The following shares were excluded from the calculation of diluted loss per share because of their anti-dilutive effects:

|                        | For the Years Ended December 31, |        |        |
|------------------------|----------------------------------|--------|--------|
|                        | 2011                             | 2010   | 2009   |
| Common stock warrant   | 63                               | 514    | 514    |
| Convertible notes      | —                                | 10,421 | 19,638 |
| Restricted stock units | 655                              | 2,332  | 2,792  |
| Employee stock options | 21,482                           | 35,729 | 28,528 |
|                        | 22,200                           | 48,996 | 51,472 |

## Comprehensive Income (Loss)

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

## Recent Accounting Pronouncements

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

In June 2011, the FASB issued Accounting Standards Update No. 2011-05 (“ASU 2011-05”) “Comprehensive Income (Topic 220), Presentation of Comprehensive Income”. The objective of ASU 2011-05 is to improve the comparability,

consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The amendments in ASU 2011-05 should be applied retrospectively. It is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. We adopted ASU 2011-05 as of December 31, 2011 by presenting a separate Statements of Comprehensive Income following the Statements of Operations. The adoption of ASU 2011-05 did not have an impact on our financial statements.

#### Reclassifications

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

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

## Note 2. Supplemental Balance Sheet Account Information

## Prepaid expenses and other current assets

|   | December 31,<br>2011 | December 31,<br>2010 |
|---|----------------------|----------------------|
| Nontrade receivables                      | \$ 6,432             | \$ 6,526             |
| Services                                  | 5,767                | 5,955                |
| Telecommunications                        | 1,886                | 2,792                |
| Insurance                                 | 795                  | 960                  |
| Marketing                                 | 640                  | 603                  |
| Other prepaids                            | 1,300                | 395                  |
| Prepaid expenses and other current assets | \$ 16,820            | \$ 17,231            |

## Property and equipment, net

|   | December 31,<br>2011 | December 31,<br>2010 |
|---|----------------------|----------------------|
| Building (under capital lease)                  | \$ 25,709            | \$ 25,709            |
| Network equipment and computer hardware         | 137,053              | 131,263              |
| Leasehold improvements                          | 43,350               | 42,078               |
| Furniture                                       | 1,102                | 9,721                |
| Vehicles  | 258                  | 260                  |
|   | 207,472              | 209,031              |
| Less: accumulated depreciation and amortization | (139,494 )           | (129,981 )           |
| Property and equipment, net                     | \$ 67,978            | \$ 79,050            |

## Software, net

|                                | December 31,<br>2011 | December 31,<br>2010 |
|--------------------------------|----------------------|----------------------|
| Purchased                      | \$ 77,724            | \$ 55,808            |
| License                        | 909                  | 909                  |
| Internally developed           | 37,696               | 37,696               |
|                                | 116,329              | 94,413               |
| Less: accumulated amortization | (70,668 )            | (58,897 )            |
| Software, net                  | \$ 45,661            | \$ 35,516            |

The total expected future annual amortization of software is as follows:

|            |          |
|------------|----------|
| 2012       | \$13,856 |
| 2013       | 11,107   |
| 2014       | 8,105    |
| 2015       | 5,946    |
| 2016       | 5,698    |
| Thereafter | 949      |
| Total      | \$45,661 |





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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

|                                | December 31,<br>2011 | December 31,<br>2010 |
|--------------------------------|----------------------|----------------------|
| Debt related costs, net        |                      |                      |
| Senior secured term loan       | \$ 2,697             | \$ 5,430             |
| Senior secured lien notes      | —                    | 12,271               |
|                                | 2,697                | 17,701               |
| Less: accumulated amortization | (690                 | ) (4,588             |
| accelerated amortization       | —                    | (7,741               |
| Debt related costs, net        | \$ 2,007             | \$ 5,372             |

|   | December 31,<br>2011 | December 31,<br>2010 |
|---|----------------------|----------------------|
| Restricted cash                             |                      |                      |
| Letter of credit-lease deposits             | \$ 6,300             | \$ 7,350             |
| Letter of credit-energy curtailment program | 536                  | 535                  |
|   | 6,836                | 7,885                |
| Cash reserves                               | 93                   | 93                   |
| Restricted cash                             | \$ 6,929             | \$ 7,978             |

|  | December 31,<br>2011 | December 31,<br>2010 |
|--|----------------------|----------------------|
| Accrued expenses                                   |                      |                      |
| Compensation and related taxes and temporary labor | \$ 14,773            | \$ 19,709            |
| Marketing  | 10,017               | 18,886               |
| Taxes and fees                                     | 17,440               | 15,973               |
| Litigation   | 5,063                | 11,717               |
| Telecommunications                                 | 9,642                | 10,636               |
| Other accruals                                     | 7,776                | 6,295                |
| Customer credits                                   | 2,109                | 2,138                |
| Professional fees                                  | 2,289                | 1,864                |
| Accrued interest                                   | 7                    | 975                  |
| Inventory  | 128                  | 957                  |
| Credit card fees                                   | 282                  | 257                  |
| Accrued expenses                                   | \$ 69,526            | \$ 89,407            |

## Note 3. Intangible Assets

|                             | December 31,<br>2011 | December 31,<br>2010 |
|-----------------------------|----------------------|----------------------|
| Intangible assets, net      |                      |                      |
| Patents and patent licenses | \$ 18,164            | \$ 12,018            |
| Trademark                   | 560                  | 560                  |

|                                |          |          |   |
|--------------------------------|----------|----------|---|
|                                | 18,724   | 12,578   |   |
| Less: accumulated amortization | (9,668   | ) (8,392 | ) |
| Intangible assets, net         | \$ 9,056 | \$ 4,186 |   |

Represents patents and trademarks we have purchased and licensed, including in connection with the settlement of litigation. We amortize these intangibles over their weighted-average remaining lives.

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

The total expected future annual amortization is as follows:

|       |         |
|-------|---------|
| 2012  | \$2,374 |
| 2013  | 2,374   |
| 2014  | 1,893   |
| 2015  | 1,299   |
| 2016  | 1,116   |
| Total | \$9,056 |

## Note 4. Supplemental Income Statement Account Information

## Amounts included in telephony services revenue

|                         | For the Years Ended December 31, |          |          |
|-------------------------|----------------------------------|----------|----------|
|                         | 2011                             | 2010     | 2009     |
| USF fees                | \$70,549                         | \$66,292 | \$57,835 |
| Disconnect fee          | \$1,330                          | \$9,918  | \$21,715 |
| Initial activation fees | \$5,455                          | \$17,629 | \$26,580 |

## Amounts included in customer equipment and shipping revenue

|                           | For the Years Ended December 31, |         |          |
|---------------------------|----------------------------------|---------|----------|
|                           | 2011                             | 2010    | 2009     |
| Equipment recovery fee    | \$1,587                          | \$7,401 | \$17,044 |
| Shipping and handling fee | \$1,563                          | \$2,400 | \$4,660  |

## Amounts included in direct cost of telephony services

|           | For the Years Ended December 31, |          |          |
|-----------|----------------------------------|----------|----------|
|           | 2011                             | 2010     | 2009     |
| USF costs | \$70,549                         | \$66,292 | \$57,835 |

## Amounts included in direct cost of goods sold

|                            | For the Years Ended December 31, |         |          |
|----------------------------|----------------------------------|---------|----------|
|                            | 2011                             | 2010    | 2009     |
| Shipping and handling cost | \$7,624                          | \$8,390 | \$11,565 |

## Amounts included in marketing

|                   | For the Years Ended December 31, |           |           |
|-------------------|----------------------------------|-----------|-----------|
|                   | 2011                             | 2010      | 2009      |
| Advertising costs | \$130,817                        | \$142,753 | \$146,448 |



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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

## Depreciation and amortization expense

|   | For the Years Ended December 31, |          |          |
|---|----------------------------------|----------|----------|
|   | 2011                             | 2010     | 2009     |
| Network equipment and computer hardware | \$16,931                         | \$20,887 | \$21,698 |
| Software                                | 12,147                           | 22,602   | 19,418   |
| Capital leases                          | 2,199                            | 2,199    | 2,199    |
| Other leasehold improvements            | 3,891                            | 3,679    | 3,685    |
| Furniture                               | 282                              | 1,827    | 2,061    |
| Vehicles                                | 19                               | 15       | 9        |
| Display                                 | —                                | —        | 48       |
| Patents                                 | 1,275                            | 1,145    | 1,319    |
|   | 36,744                           | 52,354   | 50,437   |
| Property and equipment impairments      | 307                              | 584      | 1,886    |
| Software impairments                    | —                                | 135      | 1,068    |
| Depreciation and amortization expense   | \$37,051                         | \$53,073 | \$53,391 |

## Amounts included in interest expense

|                                 | For the Years Ended December 31, |         |         |
|---------------------------------|----------------------------------|---------|---------|
|                                 | 2011                             | 2010    | 2009    |
| Debt related costs amortization | \$1,391                          | \$1,402 | \$2,708 |

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

|   | For the Years Ended December 31, |         |      |
|---|----------------------------------|---------|------|
|   | 2011                             | 2010    | 2009 |
| Net (losses) gains resulting from foreign exchange transactions | \$(328 )                         | \$(19 ) | \$46 |

## Note 5. Income Taxes

The components of income (loss) before income tax expense are as follows:

|               | For the Years Ended December 31, |             |             |
|---------------|----------------------------------|-------------|-------------|
|               | 2011                             | 2010        | 2009        |
| United States | \$77,821                         | \$(86,030 ) | \$(41,761 ) |
| Foreign       | 8,519                            | 2,683       | (1 )        |
|               | \$86,340                         | \$(83,347 ) | \$(41,762 ) |

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

The components of the income tax benefit (expense) are as follows:

|                       | For the Years Ended December 31, |         |         |
|-----------------------|----------------------------------|---------|---------|
|                       | 2011                             | 2010    | 2009    |
| Current:              |                                  |         |         |
| State and local taxes | \$1,674                          | \$(304) | \$(836) |
| Foreign               | 24                               | (14)    | —       |
| Federal               | 1,199                            | —       | —       |
|                       | \$2,897                          | \$(318) | \$(836) |
| Deferred:             |                                  |         |         |
| State and local taxes | \$(18,677)                       | \$—     | \$—     |
| Foreign               | (9,797)                          | —       | —       |
| Federal               | (297,127)                        | —       | —       |
|                       | \$(325,601)                      | \$—     | \$—     |
|                       | \$(322,704)                      | \$(318) | \$(836) |

The following table summarizes deferred taxes resulting from differences between financial accounting basis and tax basis of assets and liabilities.

|   | December 31,<br>2011 | December 31,<br>2010 |
|---|----------------------|----------------------|
| Current assets and liabilities:                             |                      |                      |
| Deferred revenue  | \$15,663             | \$17,150             |
| Accounts receivable and inventory allowances                | 314                  | 489                  |
| Accrued expenses  | 3,569                | 4,583                |
|   | 19,546               | 22,222               |
| Valuation allowance   | —                    | (22,222)             |
| Deferred tax assets, net, current                           | \$19,546             | \$—                  |
| Non-current assets and liabilities:                         |                      |                      |
| Depreciation and amortization                               | \$1,986              | \$(8,332)            |
| Accrued expenses  | —                    | 4,789                |
| Research and development and alternative minimum tax credit | 1,711                | 519                  |
| Stock option compensation                                   | 11,891               | 22,153               |
| Capital leases  | (2,455)              | (1,878)              |
| Debt original issue discount                                | —                    | (426)                |
| Net operating loss carryforwards                            | 310,605              | 376,856              |
|   | 323,738              | 393,681              |
| Valuation allowance   | (17,683)             | (393,681)            |
| Deferred tax assets, net, non-current                       | \$306,055            | \$—                  |

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. Until the fourth quarter of 2011, we recorded a valuation allowance fully against our net deferred tax assets. In 2011, we completed our first full year of taxable income and completed our budgetary process for periods subsequent to 2011, which anticipates continued taxable income in the future. Based upon these factors and our sustained profitable operating performance over the past three years excluding certain losses associated with our prior convertible notes and our December 2010 debt refinancing, our evaluation determined that the benefit resulting from our net deferred tax assets (namely, the NOLs), are likely to be realized prior to their expiration. Accordingly, we released the related valuation allowance against our United States federal and Canada net deferred tax assets, and a portion of the allowance against our state net deferred tax assets as certain NOLs may expire prior to utilization due to shorter utilization periods in certain states, resulting in a one-time non-cash income tax benefit of \$325,601 and a corresponding net deferred tax asset of \$325,601 in the fourth quarter of 2011. We still maintain a full valuation allowance against our United Kingdom net deferred tax assets as we are unable to conclude that it is more likely than not that some or all of the related United Kingdom net deferred tax assets will be realized. 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 has not been recognized prior to the reduction of the valuation allowance. In the future, if available evidence changes our conclusion that it is more likely than not that we will utilize our net deferred tax assets prior to their expiration, we will make an adjustment to the related valuation allowance at that time.



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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

The reconciliation between the United States statutory federal income tax rate and the effective rate is as follows:

|   | For the Years Ended December 31, |    |      |    |      |    |
|---|----------------------------------|----|------|----|------|----|
|   | 2011                             |    | 2010 |    | 2009 |    |
| U.S. Federal statutory tax rate               | 35                               | %  | (34  | )% | (34  | )% |
| Permanent items                               | 1                                | %  | 2    | %  | 35   | %  |
| State and local taxes, net of federal benefit | (13                              | )% | —    | %  | 2    | %  |
| International tax                             | (15                              | )% | —    | %  | —    | %  |
| Valuation reserve for income taxes            | (383                             | )% | 32   | %  | (1   | )% |
| Effective tax rate                            | (375                             | )% | —    | %  | 2    | %  |

As of December 31, 2011, we had NOLs for United States federal and state tax purposes of \$794,714 and \$423,963, respectively, expiring at various times from years ending 2012 through 2030 as follows:

|       | Federal   | State     |
|-------|-----------|-----------|
| 2012  | \$—       | \$117,420 |
| 2013  | —         | 35,077    |
| 2014  | —         | 31,703    |
| 2015  | —         | 6,263     |
| 2016  | —         | 6,417     |
| 2017  | —         | 8,670     |
| 2018  | —         | 11,270    |
| 2019  | —         | 10,250    |
| 2020  | —         | 3,410     |
| 2021  | —         | 8,688     |
| 2022  | —         | 17,947    |
| 2023  | —         | 2,328     |
| 2024  | 36,045    | 263       |
| 2025  | 216,597   | 18,424    |
| 2026  | 189,428   | 33,056    |
| 2027  | 232,619   | 55,604    |
| 2028  | 27,015    | 8,827     |
| 2029  | 3,863     | 1,675     |
| 2030  | 89,147    | 41,372    |
| 2031  | —         | 5,299     |
| Total | \$794,714 | \$423,963 |

United States federal and state NOLs of \$4,992 represent excess tax benefits from the exercise of share based awards which will be recorded in additional paid-in capital when realized. In addition, we had NOLs for Canadian tax purposes of \$37,564 with \$21,112 expiring in 2026 and \$16,452 expiring through 2027. We also had NOLs for United Kingdom tax purposes of \$34,568 with no expiration date.

No provision has been made for income taxes on the undistributed earnings of our foreign subsidiaries of \$29,159 at December 31, 2011 as we intend to indefinitely reinvest such earnings.

Under Section 382 of the Internal Revenue Code, if we undergo an “ownership change” (generally defined as a greater than 50% change (by value) in our equity ownership over a three-year period), our ability to use our pre-change of control NOLs and other pre-change tax attributes against our post-change income may be limited. The Section 382 limitation is applied annually so as to limit the use of our pre-change NOLs to an amount that generally equals the value of our stock immediately before the ownership change multiplied by a designated federal long-term tax-exempt rate. At December 31, 2011, there were no limitations on the use of our NOLs.

We participated in the State of New Jersey’s corporation business tax benefit certificate transfer program, which allows certain high technology and biotechnology companies to transfer unused New Jersey net operating loss carryovers to other New Jersey corporation business

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

taxpayers. During 2003 and 2004, we submitted an application to the New Jersey Economic Development Authority, or EDA, to participate in the program and the application was approved. The EDA then issued a certificate certifying our eligibility to participate in the program. The program requires that a purchaser pay at least 75% of the amount of the surrendered tax benefit. In tax years 2009, 2010, and 2011, we sold approximately, \$0, \$2,194, and \$0, respectively, of our New Jersey State net operating loss carry forwards for a recognized benefit of approximately \$0 in 2009, \$168 in 2010, and \$0 in 2011, respectively. Collectively, all transactions represent approximately 85% of the surrendered tax benefit each year and have been recognized in the year received.

## Note 6. Long-Term Debt and Revolving Credit Facility

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

|   | December 31,<br>2011 | December 31,<br>2010 |
|---|----------------------|----------------------|
| 3.25-3.75% 2011 Credit Facility - due 2014  | \$ 42,500            | \$ —                 |
| 9.75% 2010 Credit Facility, net of discount | —                    | 173,004              |
|   | \$ 42,500            | \$ 173,004           |

At December 31, 2011, future payments under long-term debt obligations over each of the next five years and thereafter are as follows:

|                                      | 2011<br>Credit Facility |
|--------------------------------------|-------------------------|
| 2012                                 | 28,333                  |
| 2013                                 | 28,333                  |
| 2014                                 | 14,167                  |
| Minimum future payments of principal | 70,833                  |
| Current portion                      | 28,333                  |
| Long-term portion                    | \$42,500                |
| December 2010 Financing              |                         |

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

## Use of Proceeds

We used the net proceeds of the 2010 Credit Facility of \$194,000 (\$200,000 principal amount less original discount of \$6,000), plus \$102,090 of cash on hand, to (i) exercise our existing right to retire debt under our prior senior secured first lien credit facility, for 100% of the contractual make-whole price, (ii) retire debt under our prior senior secured second lien credit facility at a more than 25% discount to the contractual make-whole price, and (iii) cause the conversion of all then outstanding third lien convertible notes into 8,276 shares of our common stock. We also incurred \$11,444 of fees in connection with the 2010 Credit Facility and repayment of our prior 2008 financing. We agreed to make an additional cash payment to the holders of our prior senior secured second lien credit facility in an aggregate amount of \$9,000 if we engaged in Qualifying Discussions (as defined in the Master Agreement) prior to June 30,

2011 that result in a merger or acquisition transaction (as defined in the Master Agreement) that is consummated prior to June 30, 2012. No such discussions occurred prior to June 30, 2011.

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

#### Repayments

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

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VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

July 2011 Financing

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

Use of Proceeds

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

Repayments

In 2011, we made mandatory repayment of \$14,166 under the senior secured term loan. In addition, we repaid the \$15,000 outstanding under the revolving credit facility.

2011 Credit Facility Terms

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

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

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

LIBOR (applicable to one-, two-, three- or six-month periods) plus an applicable margin equal to 3.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 3.5% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 3.75% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last day of each relevant interest period or, if the interest period is longer than three months, each day that is three months after the first day of the interest period, or the base rate determined by reference to the highest of (a) the federal funds effective rate from time to time plus 0.50%, (b) the prime rate of JPMorgan Chase Bank, N.A., and (c) the LIBOR rate applicable to one month interest periods plus 1.00%, plus an applicable margin equal to 2.25% if our consolidated leverage ratio is less than 0.75 to 1.00, 2.5% if our consolidated leverage ratio is greater than or equal to 0.75 to 1.00 and less than 1.50 to 1.00, and 2.75% if our consolidated leverage ratio is greater than or equal to 1.50 to 1.00, payable on the last business day of each March, June, September, and December and the maturity date of the 2011 Credit Facility.

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

We may prepay the 2011 Credit Facility at our option at any time without premium or penalty. The 2011 Credit Facility is subject to mandatory prepayments in amounts equal to:

100% of the net cash proceeds from any non-ordinary course sale or other disposition of our property and assets for consideration in excess of a certain amount subject to customary reinvestment provisions and certain other exceptions and

100% of the net cash proceeds received in connection with other non-ordinary course transactions, including insurance proceeds not otherwise applied to the relevant insurance loss.

Subject to certain restrictions and exceptions, the 2011 Credit Facility permits us to obtain one or more incremental term loans and/or revolving credit facilities in an aggregate principal amount of up to \$60,000 plus an amount equal to repayments of the senior secured term loan upon providing documentation reasonably satisfactory to the administrative agent, without the consent of the existing lenders under the 2011 Credit Facility. The 2011 Credit

Facility includes customary representations and warranties and affirmative covenants of the borrowers. In addition, the 2011 Credit Facility contains customary negative covenants, including, among other things, restrictions on the ability of us and our subsidiaries to consolidate or merge, create liens, incur additional indebtedness, dispose of assets, consummate acquisitions, make investments, and pay dividends and other distributions. We must also comply with the following financial covenants:

- >a consolidated leverage ratio of no greater than 2.00 to 1.00;
- > a consolidated fixed coverage charge ratio of no less than 1.75 to 1.00;
- > minimum cash of \$25,000 including the unused portion of the revolving credit facility; and
- maximum capital expenditures not to exceed \$55,000 during any fiscal year, provided that the unused amount of any permitted capital expenditures in any fiscal year may be carried forward to the next following fiscal year, plus a portion of annual excess cash flow up to \$8,000.

As of December 31, 2011, we were in compliance with all covenants, including financial covenants, for the 2011 Credit Facility.

The 2011 Credit Facility contains customary events of default that may permit acceleration of the debt. During the continuance of a payment default, interest will accrue at a default interest rate of 2% above the interest rate which would otherwise be applicable, in the case of loans, and at a rate equal to the rate applicable to base rate loans plus 2%, in the case of all other amounts.

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(In thousands, except per share amounts)

## November 2008 Financing

On October 19, 2008, we entered into definitive agreements (collectively, the "Credit Documentation") for a financing consisting of (i) a \$130,300 senior secured first lien credit facility (the "First Lien Senior Facility"), (ii) a \$72,000 senior secured second lien credit facility (the "Second Lien Senior Facility"), and (iii) the sale of \$18,000 of our third lien convertible notes (the "Convertible Notes"). The funding for this transaction was completed on November 3, 2008.

For the First Lien Senior Facility, an aggregate value of \$105,322, or a discount of \$24,978, was recorded. This discount was amortized to interest expense over the life of the debt using the effective interest method. The accumulated amortization was \$24,798 at December 31, 2010, including the acceleration of unamortized discount on notes related to the prepayment and repayment of the First Lien Senior Facility of \$14,539 at December 31, 2010. The amortization for the year ended December 31, 2010 and 2009 was \$ 4,006 and \$4,596, respectively.

For the Second Lien Senior Facility, an aggregate value of \$67,273, or a discount of \$4,727, was recorded. This discount was amortized to interest expense over the life of the debt using the effective interest method. The accumulated amortization was \$4,727 at December 31, 2010, including the acceleration of unamortized discount on notes related to the prepayment and repayment of the Second Lien Senior Facility of \$3,360 at December 31, 2010. The amortization for the year ended December 31, 2010 and 2009 was \$601 and \$650, respectively.

For the Convertible Notes, an aggregate value of \$55,884 or a premium of \$37,884 was recorded. Given the magnitude of the premium, this amount was recorded as additional-paid-in capital as prescribed in FASB ASC 470-20-25 "Debt with Conversions and Other Options-Recognition".

## Consolidated Excess Cash Flow Prepayments

Beginning March 31, 2010, because it was the first quarter during which we had more than \$75,000 of specified unrestricted cash in any quarter, we offered to prepay without premium 50% of the Consolidated Excess Cash Flow (as defined in the Credit Documentation) each quarter.

## First Lien Senior Facility Prepayments

Consolidated Excess Cash Flow - March 31, 2010. On April 22, 2010, we offered to prepay \$24,032 of loans under the First Lien Senior Facility. While certain holders of loans under the First Lien Senior Facility waived their right to receive the prepayment as permitted under the Credit Documentation, the \$24,032 offered was paid on April 27, 2010 to holders that did not waive the prepayment including certain affiliates or associates of the Company's directors. Of this amount, \$23,187 was applied to the outstanding principal balance, and \$845 was applied to accrued but unpaid interest. A loss on extinguishment of \$4,034, representing acceleration of unamortized debt discount, debt related costs, and administrative agent fees of \$3,312, \$662 and \$60, respectively, was recorded in the three-month period ended June 30, 2010 as a result of the prepayment.

Consolidated Excess Cash Flow - June 30, 2010. On July 16, 2010, we offered to prepay \$40,776 of loans under the First Lien Senior Facility. While certain holders of loans under the First Lien Senior Facility waived their right to receive the prepayment as permitted under the Credit Documentation, \$4,655 was paid on July 21, 2010 to holders that did not waive the prepayment, who were affiliates or associates of the Company's directors. Of this amount, \$4,499 was applied to the outstanding principal balance and \$156 was applied to accrued but unpaid interest. A loss on extinguishment of \$731, representing acceleration of unamortized debt discount, debt related costs, and administrative agent fees of \$605, \$120 and \$6, respectively, was recorded in the three-month period ended September 30, 2010 as a result of the prepayment.

Consolidated Excess Cash Flow - September 30, 2010. On November 15, 2010, we offered to prepay loans under the First Lien Senior Facility and the Second Lien Senior Facility in an aggregate amount of \$11,084. The holders of the First Lien Senior Facility and Second Lien Senior Facility waived their right to prepayment.

## Second Lien Senior Facility Prepayments

Consolidated Excess Cash Flow - June 30, 2010. On July 16, 2010, concurrent with the prepayment offer under the First Lien Senior Facility, we offered to prepay \$40,776 of loans under the Second Lien Senior Facility less \$4,655 required to prepay amounts under the First Lien Senior Facility prepayment offer. While certain holders of loans under the Second Lien Senior Facility waived their right to receive the prepayment as permitted under the Credit Documentation, \$13,281 was paid on July 21, 2010 to holders that did not waive the prepayment, who were affiliates or associates of the Company's directors. Of this amount \$13,128 was applied to the outstanding principal balance of which \$3,668 represents payment of PIK interest, which was recorded as a component of cash flows from financing activities, and \$153 was applied to accrued but unpaid interest. A loss on extinguishment of \$813, representing acceleration of unamortized debt discount, debt related costs, and administrative agent fees of \$472, \$325 and \$16, respectively, was recorded in the three-month period ended September 30, 2010 as a result of the prepayment.

#### Other Prepayments under First Lien Senior Facility and Second Lien Senior Facility

The First Lien Senior Facility and Second Lien Senior Facility included make-whole premiums that were bifurcated from the underlying debt instrument and valued as a separate financial instrument because the economic and risk characteristics of the make-whole premiums meet the criteria for separate accounting as set forth in FASB ASC 815. The First Lien Senior Facility and Second Lien Senior Facility make-whole premiums were paid on December 14, 2010 and a nominal fair value as of December 31, 2009.

#### Third Lien Convertible Notes

Subject to conversion, repayment or repurchase of the Convertible Notes, the Convertible Notes were to mature in October 2015. Subject to customary anti-dilution adjustments (including triggers upon the issuance of common stock below the market price of the common stock or the conversion price of the Convertible Notes), the Convertible Notes were convertible into shares of our common stock at a rate equal to 3,448.2759 shares for each \$1,000 principal amount of Convertible Notes, or approximately \$0.29 per share. During the three months ended, December 31, 2010 we received additional Notices of Conversion from the remaining note holders indicating their desire to convert their Convertible Notes. In the aggregate in 2010 and 2009, \$18,000 principal amount of Convertible Notes were converted into 62,069 shares of our common stock. As of December 31, 2010, there were \$0 principal amount of Convertible Notes outstanding.

Amounts under the Convertible Notes accrued and compounded quarterly. The amount of accrued and compounded interest as of December 31, 2010 and 2009 was \$0 and \$1,478, respectively. In connection with note conversions during the year ended December 31, 2010,



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

\$2,258 was paid for accrued interest.

In accordance with guidance codified in FASB ASC 815, which was effective January 1, 2009, we determined that the Convertible Notes contained an embedded derivative that required separate valuation from the Convertible Notes because an anti-dilution adjustment would have been triggered upon the issuance of common stock by us below the conversion price of the Convertible Notes. As explained below, we recognized this embedded derivative as a liability in our consolidated balance sheet at its fair value each period and recognized any change in the fair value in our statement of operations in the period of change. The fair value of the embedded derivative was determined using the Monte Carlo simulation model. The key inputs in the model were maturity date, risk-free interest rate, current share price and historical volatility of our common stock.

In accordance with FASB ASC 815, we determined the fair value of the conversion feature and recorded applicable amounts as follows:

**Issuance.** The fair value of the conversion feature at issuance was \$39,990 which, upon the adoption of FASB ASC 815, was recorded as a liability with a corresponding reduction in additional-paid-in capital of \$37,884, which was the premium originally recorded at issuance. The remaining \$2,106 was recorded as a discount to be amortized to interest expense over the life of the debt using the effective interest method. Accumulated amortization of the discount was \$2,106 and \$1,541 as of December 31, 2010 and 2009, respectively, including a \$515 and \$1,271 acceleration of unamortized discount on notes related to the conversion of Convertible Notes for the year ended December 31, 2010 and 2009, respectively. Amortization for the year ended December 31, 2010 and 2009 was \$50 and \$223, respectively. December 31, 2008. The fair value of the conversion feature at December 31, 2008 was \$32,720. The \$7,270 difference between the fair value of the conversion feature at December 31, 2008 and the issuance date, together with the \$47 amortization of the discount for the period ended December 31, 2008, were recorded as an adjustment to the opening balance of retained earnings that was recognized as a cumulative effect of a change in accounting principle as of January 1, 2009 in accordance with FASB ASC 815.

**Conversion of Convertible Notes in 2009.** At the time of conversions of \$12,305 principal amount of Convertible Notes, which were converted into 42,431 shares of our common stock, we determined that the aggregate fair value of the conversion feature of those Convertible Notes was \$57,050, which was an increase of \$34,682 in the fair value of the conversion feature from December 31, 2008. The changes in fair value were recorded as an expense within other income (expense) for the year ended December 31, 2009. The aggregate fair value of the common stock issued by us in the conversion was \$62,370 at the time of conversion, which was recorded as common stock and additional paid-in capital. In addition, in connection with the extinguishment of the converted Convertible Notes, we recorded a gain on extinguishment of \$4,041, which represented the difference in the carrying value of those Convertible Notes including the fair value of the conversion feature, which was reduced by the discount of \$1,271 and debt related costs of \$1,673 associated with those Convertible Notes, and the fair value of the common stock issued at the time of conversion.

**Conversion of Convertible Notes in 2010.** At the time of conversions of the remaining \$5,695 principal amount of Convertible Notes (including \$2,400 principal amount of Convertible Notes, which were held by certain affiliates or associates of the Company's directors), which converted into 19,638 shares of our common stock, we determined that the aggregate fair value of the conversion feature of those Convertible Notes was \$32,358, which was an increase in value of \$7,308 from the fair value of the conversion feature as of December 31, 2009. This change in fair value was recorded as income within other income (expense), net for the year ended December 31, 2010. The aggregate fair value of the common stock issued by us in the conversion was \$35,404 at the time of conversion, which was recorded as common stock and additional paid-in capital. In addition, in connection with the extinguishment of the converted Convertible Notes, we recorded a loss on extinguishment of \$786 for the year ended December 31, 2010, which represented the difference in the carrying value of those Convertible Notes including and the fair value of the conversion feature, which was reduced by the discount of \$515 and debt related costs of \$683 for the year ended

December 31, 2010, associated with those Convertible Notes, and the fair value of the common stock issued at the time of conversion and the payment made to note holders of \$2,237 to induce conversion.

NOTE 7. Fair Value of Financial Instruments

Effective January 1, 2008, we adopted FASB ASC 820-10-25, "Fair Value Measurements and Disclosures". This standard establishes a framework for measuring fair value and expands disclosure about fair value measurements. We did not elect fair value accounting for any assets and liabilities allowed by FASB ASC 825, "Financial Instruments". FASB ASC 820-10 defines fair value as the amount that would be received for an asset or paid to transfer a liability (i.e., an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820-10 also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. FASB ASC 820-10 describes the following three levels of inputs that may be used:

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

Level 2: Observable prices that are based on inputs not quoted on active markets but corroborated by market data.  
> Our common stock warrant with a value of \$0 as of December 31, 2011 as the common stock warrant was exercised during the first quarter of 2011, and \$897 as of December 31, 2010 were included as a Level 2 liability.

Level 3: Unobservable inputs when there is little or no market data available, thereby requiring an entity to develop its own assumptions. The fair value hierarchy gives the lowest priority to Level 3 inputs. Level 3 liabilities were \$0  
> as of December 31, 2011 and 2010, as all prior third lien convertible notes were converted as of December 31, 2010.

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

|                                   | Level 1 | Level 2 | Level 3 | Total  |
|-----------------------------------|---------|---------|---------|--------|
| Liabilities:                      |         |         |         |        |
| Stock warrant - 2011              | \$—     | \$—     | \$—     | \$—    |
| Stock warrant - 2010              | —       | 897     | —       | 897    |
| Stock warrant - 2009              | —       | 553     | —       | 553    |
| Embedded conversion option - 2010 | —       | —       | —       | —      |
| Embedded conversion option - 2009 | —       | —       | 25,050  | 25,050 |

All prior third lien convertible notes were converted as of December 31, 2010. The following table sets forth a summary of change in the fair value of our embedded conversion option for the year ended December 31, 2010 and December 31, 2009;

|   | For the Years<br>Ended December<br>31,<br>2010 | For the Years<br>Ended December<br>31,<br>2009 |
|---|--|--|
| Liabilities:                              |  |  |
| Beginning balance                         | \$25,050                                       | \$32,720                                       |
| Increase in value for notes converted     | 7,308  | 34,682   |
| Fair value adjustment for notes converted | (32,358  | ) (57,050                                      |
| Total unrealized loss in earning          | —  | 14,698   |
| Ending balance                            | \$—  | \$25,050                                       |

The following table sets forth a summary of change in the fair value of our make-whole premiums for as of December 31, 2010 and December 31, 2009;

|   | For the Years<br>Ended December<br>31,<br>2010 | For the Years<br>Ended December<br>31,<br>2009 |
|---|--|--|
| Liabilities:                                      |  |  |
| Beginning balance                                 | \$—  | \$—  |
| Increase in value                                 | 91,686   | —  |
| Fair value adjustment for make-whole premium paid | (91,686  | ) —  |
| Total unrealized loss in earning                  | —  | —  |
| Ending balance                                    | \$—  | \$—  |

We estimated the fair value of the make-whole premiums as the difference between the estimated value of our prior senior secured first lien credit facility and our prior senior secured second lien credit facility with and without the make-whole premiums. Since there was no current observable market for valuing the make-whole premiums, we determined the value using a scenario analysis that incorporated the settlement alternatives available to the debt holders in connection with the make-whole premiums. The scenario analysis valuation model combined expected cash outflows with market-based assumptions and estimated of the probability of each scenario occurring. The fair value of our prior senior secured first lien credit facility and our prior senior secured second lien credit facility without the make-whole premiums was estimated using a present value model. The present value model combined expected cash outflows with market-based assumptions regarding available interest rates, credit spread relative to our credit rating, and liquidity. Our analysis was premised on the assumption that the holder would act in a manner that maximizes the

potential return, or “payoff,” at any given point in time. Included in this premise was the assumption that the holder would compare the potential return associated with each available alternative, including, as specified in the terms of the contract, holding the debt instrument. As a component of this, we incorporated a market participant consideration as to our capacity to fulfill the contractual obligations associated with each alternative, including our ability to fulfill any cash settlement obligation associated with payment of the make-whole premiums, as well as the our ability to refinance our prior senior secured first lien credit facility and our prior senior secured second lien credit facility. Through June 30, 2010, we estimated the fair value of the make-whole premiums to have nominal fair value. During the third quarter of 2010, due to our improved financial condition and favorable credit market conditions, we entered into formal negotiations with the administrative agent, who was also the primary lender, regarding repurchasing our prior senior secured first lien credit facility and our prior senior secured second lien credit facility. In addition, unlike a consolidated excess cash flow offer in April 2010 (as provided in the documentation for our 2008 credit facility) that was fully accepted and allowed us to prepay, without premium, specified amounts, holders did not fully accept our consolidated excess cash flow offer in July 2010, indicating our ability to continue to repay debt at par was no longer likely. We also determined that we could obtain financing at acceptable terms, which along with our existing cash on hand, would be sufficient to repurchase our prior senior secured first lien credit facility and our prior senior secured second lien credit facility including any amounts due pursuant to the make-whole premiums. Based upon these factors and our valuation analysis, our prior senior secured first lien credit facility and our prior senior secured second lien credit facility make-whole premiums were estimated to have a fair value of \$60,000 as of September 30, 2010 and had a nominal fair value as of December 31, 2009. This value was increased in the fourth quarter of 2010 to \$91,686 to reflect the actual value that was ultimately paid in December 2010.

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

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

at the reporting date.

## Fair Value of Other Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, accounts receivable, and accounts payable, approximate fair value because of their short maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management's best estimates of interest rates that would be available for similar debt obligations at December 31, 2011 and 2010. We believe the fair value of our debt at December 31, 2011 was approximately the same as its carrying amount as market conditions, including available interest rates, credit spread relative to our credit rating, and illiquidity, remain relatively unchanged from the issuance date of our debt on July 29, 2011 for a similar debt instrument.

## Note 8. Common Stock

## Common Stock Warrant

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

## Note 9. Employee Benefit Plans

## Share-Based Compensation

Our stock option program is a long-term retention program that is intended to attract, retain and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. Currently, we grant options from our 2006 Incentive Plan. Our 2001 Stock Incentive Plan was terminated by our board of directors in 2008. As such, share-based awards are no longer granted under the 2001 Stock Incentive Plan. Under the 2006 Incentive Plan, share-based awards can be granted to all employees, including executive officers, outside consultants, and non-employee directors. Vesting periods for share-based awards are generally four years for both plans. Awards granted under each plan expire in five or 10 years from the effective date of grant. As of April 2010, the Company began routinely granting awards with a 10 year expiration period.

The fair value for these options was estimated at the date of grant using a Black-Scholes option-pricing model. The assumptions used to value options are as follows:

|                                 | 2011         | 2010           | 2009          |
|---------------------------------|--------------|----------------|---------------|
| Risk-free interest rate         | 0.56-1.52%   | 0.99-2.89%     | 1.50-3.12%    |
| Expected stock price volatility | 94.94-98.74% | 100.05-106.55% | 87.70-109.31% |
| Dividend yield                  | 0.00         | % 0.00         | % 0.00        |
| Expected life (in years)        | 3.75-6.25    | 3.75-6.25      | 3.75-6.25     |

Beginning January 1, 2006, we estimated the volatility of our stock using historical volatility of comparable public companies in accordance with guidance in FASB ASC 718, "Compensation-Stock Compensation". Beginning in the first quarter of 2008, we used the historical volatility of our common stock to measure expected volatility for future option grants.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our employee stock options. The expected term of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding, which we derive based on our historical settlement experience.

Our stock incentive plans as of December 31, 2011 are summarized as follows (in thousands):

|                               | Shares<br>Authorized | Shares<br>Available<br>for Grant | Stock<br>Options<br>Outstanding | Restricted<br>Stock and<br>Restricted<br>Stock<br>Units |
|-------------------------------|----------------------|----------------------------------|---------------------------------|---|
| 2001 Incentive Plan           | —                    |                                  | 4,026                           | —   |
| 2006 Incentive Plan           | 66,400               | 18,564                           | 33,256                          | 2,275   |
| Total as of December 31, 2011 | 66,400               | 18,564                           | 37,282                          | 2,275   |

#### 2001 Stock Incentive Plan

In February 2001, we adopted the 2001 Stock Incentive Plan, which is an amendment and restatement of the 2000 Stock Incentive Plan

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

of MIN-X.COM, INC. The 2001 Stock Incentive Plan provides for the granting of options or restricted stock awards to our officers, directors, and employees. The objectives of the 2001 Stock Incentive Plan included attracting and retaining personnel, providing for additional performance incentives, and promoting our success by providing employees the opportunity to acquire stock. In management's opinion, all stock options were granted with an exercise price at or above the fair market value of our common stock at the date of grant with the exception of a grant in 2005 for 125 shares. Initially, we recorded deferred compensation in 2005 related to this option grant. On January 1, 2006, we reversed the remaining deferred compensation balance in accordance with FASB ASC 718. There have not been any options available for future grant under the 2001 Stock Incentive Plan since our board of directors terminated the plan in 2008.

## 2006 Incentive Plan

In May 2006 we adopted the 2006 Incentive Plan. The 2006 Incentive Plan permits the grant of stock options, restricted stock, restricted stock units, stock appreciation rights, performance stock, performance units, annual awards, and other awards based on, or related to, shares of our common stock. Options awarded under our 2006 Incentive Plan may be nonstatutory stock options or may qualify as incentive stock options under Section 422 of the Internal Revenue Code of 1986, as amended. Our 2006 Incentive Plan contains various limits with respect to the types of awards, as follows:

- a maximum of 20,000 shares may be issued under the plan pursuant to incentive stock options;
- a maximum of 10,000 shares may be issued pursuant to options and stock appreciation rights granted to any participant in a calendar year;
- a maximum of \$5,000 may be paid pursuant to annual awards granted to any participant in a calendar year; and a maximum of \$10,000 may be paid (in the case of awards denominated in cash) and a maximum of 10,000 shares may be issued (in the case of awards denominated in shares) pursuant to awards, other than options, stock appreciation rights or annual awards, granted to any participant in a calendar year.

Based upon a June 2010 amendment to the plan, the maximum number of shares of our common stock that are authorized for issuance under our 2006 Incentive Plan is 66,400 shares. Shares issued under the plan may be authorized and unissued shares or may be issued shares that we have reacquired. Shares covered by awards that are forfeited, cancelled or otherwise expire without having been exercised or settled, or that are settled by cash or other non-share consideration, will become available for issuance pursuant to a new award. Shares that are tendered or withheld to pay the exercise price of an award or to satisfy tax withholding obligations will not be available for issuance pursuant to new awards. At December 31, 2011, 18,564 shares were available for future grant under the 2006 Stock Incentive Plan.

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

The following table summarizes the activity for all awards under both of our stock incentive plans:

|   | Stock Options Outstanding |   | Restricted Stock and<br>Restricted Stock Units<br>Outstanding |  |
|---|---------------------------|---|---|--|
|   | Number of<br>Shares       | Weighted<br>Average<br>Exercise<br>Price Per<br>Share | Number of<br>Shares   | Weighted<br>Average<br>Grant<br>Date Fair<br>Market<br>Value<br>Per<br>Share |
|   | (in thousands)            |   | (in thousands)  |  |
| Balance at December 31, 2008  | 29,227                    | \$4.00  | 3,105   | \$2.67   |
| Stock options granted   | 5,631                     | 0.83  |   |  |
| Stock options exercised   | (33                       | ) 1.76  |   |  |
| Stock options canceled  | (6,291                    | ) 7.46  |   |  |
| Restricted stocks and restricted stock units granted                        |                           |   | 1,188   | 0.51   |
| Restricted stocks and restricted stock units exercised                      |                           |   | (971  | ) 2.59   |
| Restricted stocks and restricted stock units canceled                       |                           |   | (536  | ) 2.25   |
| Balance at December 31, 2009  | 28,534                    | 2.68  | 2,786   | 1.86   |
| Stock options granted   | 11,205                    | 1.47  |   |  |
| Stock options exercised   | (1,040                    | ) 1.57  |   |  |
| Stock options canceled  | (2,970                    | ) 3.53  |   |  |
| Restricted stocks and restricted stock units granted                        |                           |   | 1,199   | 1.52   |
| Restricted stocks and restricted stock units exercised                      |                           |   | (1,150  | ) 2.38   |
| Restricted stocks and restricted stock units canceled                       |                           |   | (503  | ) 1.55   |
| Balance at December 31, 2010  | 35,729                    | 2.26  | 2,332   | 1.50   |
| Stock options granted   | 6,217                     | 4.44  |   |  |
| Stock options exercised   | (2,894                    | ) 1.47  |   |  |
| Stock options canceled  | (1,770                    | ) 5.85  |   |  |
| Restricted stocks and restricted stock units granted                        |                           |   | 1,198   | 4.38   |
| Restricted stocks and restricted stock units exercised                      |                           |   | (995  | ) 1.83   |
| Restricted stocks and restricted stock units canceled                       |                           |   | (260  | ) 2.27   |
| Balance at December 31, 2011-stock options                                  | 37,282                    | \$2.51  |   |  |
| Balance at December 31, 2011-Restricted stock and<br>restricted stock units |                           |   | 2,275   | \$2.79   |
| Exercisable at December 31, 2011  | 19,160                    | \$2.67  |   |  |
| Unvested shares at December 31, 2010  | 20,451                    | \$1.44  |   |  |
| Unvested shares at December 31, 2011  | 18,122                    | \$2.35  |   |  |

The weighted average exercise price of options granted was \$4.44, \$1.47, and \$0.83 for the years ended December 31, 2011, 2010, and 2009, respectively. The weighted average grant date fair market value of restricted stock and



restricted stock units granted was \$4.38, \$1.52, and \$0.51 during the year ended December 31, 2011, 2010, and 2009, respectively.

The aggregate intrinsic value of exercised stock options for the years ended December 31, 2011, 2010, and 2009 was \$8,450, \$851, and \$5, respectively. The aggregate intrinsic value of exercised restricted stock and restricted stock units for the years ended December 31, 2011, 2010, and 2009 was \$3,954, \$2,142, and \$880, respectively.

The weighted average grant date fair market value of stock options granted was \$1.65, \$1.35, and \$1.44 for the years ended December 31, 2011, 2010, and 2009.

Total share-based compensation expense recognized for the years ended December 31, 2011, 2010, and 2009 was \$14,279, \$8,255, and \$8,473, respectively, which were recorded to selling, general and administrative expense in the consolidated statement of operations. As of December 31, 2011, total unamortized share-based compensation was \$16,594, which is expected to be amortized over the remaining vesting period of each grant, up to the next 48 months. Compensation costs for all share-based awards are recognized using the ratable single-option approach on an accrual basis and are amortized using an accelerated amortization schedule. Our current policy is to issue new shares to settle the exercise of stock options and prospectively, the vesting of restricted stock units.

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

Information regarding the options outstanding as of December 31, 2011 is summarized below:

| Range of Exercise Prices | Stock Options Outstanding |   |                                 | Aggregate Intrinsic Value | Stock Options Exercisable            |   |                                 | Aggregate Intrinsic Value |
|--------------------------|---------------------------|---|---------------------------------|---------------------------|--------------------------------------|---|---------------------------------|---------------------------|
|                          | Stock Options Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |                           | Stock Options Vested and Exercisable | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |                           |
|                          | (in thousands)            | (in years)                                  |                                 | (in thousands)            | (in thousands)                       | (in years)                                  |                                 | (in thousands)            |
| \$0.33 to \$1.43         | 21,458                    |   | 1.29                            |                           | 10,482                               |   | 1.31                            |                           |
| \$1.44 to \$1.99         | 5,122                     |   | 1.85                            |                           | 4,197                                |   | 1.84                            |                           |
| \$2.00 to \$4.00         | 2,143                     |   | 2.61                            |                           | 1,006                                |   | 2.43                            |                           |
| \$4.01 to \$7.34         | 6,927                     |   | 4.62                            |                           | 1,843                                |   | 4.54                            |                           |
| \$7.35 to \$35.00        | 1,632                     |   | 11.55                           |                           | 1,632                                |   | 11.55                           |                           |
|                          | 37,282                    | 6.2   | 2.51                            | \$ 28,083                 | 19,160                               | 4.8   | 2.67                            | \$ 14,699                 |

The aggregate intrinsic value of restricted stock units outstanding was \$5,575 as of December 31, 2011.

## Retirement Plan

In March 2001, we established a 401(k) Retirement Plan (the "Retirement Plan") available to employees who meet the plan's eligibility requirements. Participants may elect to contribute a percentage of their compensation to the Retirement Plan up to a statutory limit. We may make a contribution to the Retirement Plan in the form of a matching contribution. The employer matching contribution is 50% of each employee's contributions not to exceed \$6 in 2009, 2010, and 2011. Our expense related to the Retirement Plan was \$2,114, \$1,615, and \$620 in 2011, 2010, and 2009, respectively.

## Note 10. Commitments and Contingencies

## Capital Leases

Assets financed under capital lease agreements are included in property and equipment in the consolidated balance sheet and related depreciation and amortization expense is included in the consolidated statements of operations. On March 24, 2005, we entered into a lease for our headquarters in Holmdel, New Jersey. We took possession of a portion of the office space at the inception of the lease, another portion on August 1, 2005 and took over the remainder of the office space in early 2006. The overall lease term is twelve years and five months. In connection with the lease, we issued a letter of credit which requires \$7,350 of cash as collateral, which is classified as restricted cash. The gross amount of the building recorded under capital leases totaled \$25,709 as of December 31, 2011 and accumulated depreciation was approximately \$13,250 as of December 31, 2011.

## Operating Leases

We have entered into various non-cancelable operating lease agreements for certain of our existing office and telecommunications co-location space in the United States and for international subsidiaries with original lease periods expiring between 2011 and 2015. We are committed to pay a portion of the buildings' operating expenses as determined under the agreements.

At December 31, 2011, future payments under capital leases and minimum payments under non-cancelable operating leases are as follows over each of the next five years and thereafter:

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

|                                      | December 31, 2011 |           |
|--------------------------------------|-------------------|-----------|
|                                      | Capital           | Operating |
|                                      | Leases            | Leases    |
| 2012                                 | \$4,200           | \$4,363   |
| 2013                                 | 4,284             | 1,418     |
| 2014                                 | 4,369             | 288       |
| 2015                                 | 4,457             | 165       |
| 2016                                 | 4,545             | —         |
| Thereafter                           | 3,071             | —         |
| Total minimum payments required      | 24,926            | \$6,234   |
| Less amounts representing interest   | (7,261            | )         |
| Minimum future payments of principal | 17,665            |           |
| Current portion                      | 2,104             |           |
| Long-term portion                    | \$ 15,561         |           |

Rent expense was \$4,642 for 2011, \$4,552 for 2010, and \$5,449 for 2009.

**Stand-by Letters of Credit**

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

**End-User Commitments**

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

**Vendor Commitments**

We have several commitments primarily commitments to vendors who will license to us billing and ordering software and provide related services, provide telemarketing services, provide voicemail to text transcription services, provide local inbound services, process our credit card billings, provide E-911 services to our customers, assist us with local number portability, license patents to us, sell us communication devices, lease us collocation facilities, and provide carrier operation services. In certain cases, we may terminate these arrangements early upon payment of specified fees. These commitments total \$57,803. Of this total amount, we expect to purchase \$25,876 in 2012, \$25,987 in 2013 through 2014 and \$5,940 in 2015. These amounts do not represent our entire anticipated purchases in the future, but represent only those items for which we are contractually committed. We also purchase products and services as needed with no firm commitment. For this reason, the amounts presented do not provide a reliable indicator of our expected future cash outflows or changes in our expected cash position.

**Litigation****IP Matters**

**Alcatel-Lucent.** On November 4, 2008, we received a letter from Alcatel-Lucent initiating an opportunity for us to obtain a non-exclusive license to certain of its patents that may be relevant to our business. After analyzing the applicability of the patents to our business and negotiations with Alcatel-Lucent, on November 29, 2011, Vonage and Alcatel-Lucent executed a bi-lateral licensing agreement.

**Hitachi.** On January 27, 2011, we met with Hitachi, Ltd. to discuss an opportunity for us to obtain a non-exclusive license to certain Hitachi patents that Hitachi believes may be relevant to our business. We are currently analyzing the applicability of such patents to our business. If we determine that these patents are applicable to our business and

valid, we may incur an expense in licensing them. If we determine that these patents are inapplicable to our business, invalid or unenforceable, we may incur expense and damages if there is litigation.

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

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

been ruled upon. On January 25, 2012, Bear Creek filed a motion with the United States Judicial Panel on Multidistrict Litigation seeking to transfer and consolidate its litigation against Vonage with thirteen separate actions Bear Creek filed in the U.S. District Courts for Delaware and the Eastern District of Virginia. By its motion, Bear Creek seeks to have all fourteen actions consolidated and transferred to the U.S. District Court for the District of Delaware. Vonage filed its response to Bear Creek's motion on February 15, 2012. Oral argument on Bear Creek's motion is scheduled for March 29, 2012.

GZTM Technology Ventures Ltd. On September 8, 2011, GZTM Technology Ventures Ltd. (“GZTM”) filed a lawsuit against Vonage Holdings Corp., Vonage America Inc. and Vonage Marketing LLC in the United States District Court for the District of Delaware alleging that Vonage's products and services are covered by United States Patent No. 5,455,859, entitled “Telephone Handset Interface for Device Having Audio Input”. The suit also named numerous other defendants, including Comcast Corporation, Cox Communications, Inc. and Time Warner Cable. On October 25, 2011, Vonage filed a Motion to Sever GTZM's claims against Vonage entities from GTZM's claims against the other defendants. The motion is now fully briefed, but has not been ruled upon. GTZM filed a First Amended Complaint on November 2, 2011. Vonage filed its answer to GTZM's First Amended Complaint on December 6, 2011. On January 20, 2012, the parties submitted a proposed scheduling order for the Court's consideration. The Court has not yet acted on the parties' proposed scheduling order. A scheduling conference with the Court is scheduled for February 28, 2012. From time to time, in addition to those identified above, we are subject to legal proceedings, claims, investigations, and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment, and other matters. From time to time we receive letters or other communications from third parties initiating an opportunity for us to obtain patent licenses that might be relevant to our business 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, 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 - CALEA**

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

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

Federal - Local Number Portability

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

Federal - Net Neutrality

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

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(In thousands, except per share amounts)

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 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.

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.

State and Municipal Taxes

In accordance with generally accepted accounting principles, we make a provision for a liability for taxes when it is both probable that a liability has been incurred and the amount of the liability or range of liability can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. For a period of time, we did not collect or remit state or municipal taxes (such as sales, excise, utility, use, and ad valorem taxes), fees or surcharges (“Taxes”) on the charges to our customers for our services, except that we historically



complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these Taxes do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes to expressly include VoIP and we are now collecting and remitting sales taxes in those states. In addition, many states address how VoIP providers should contribute to support public safety agencies, and in those states we remit fees to the appropriate state agencies. We could also be contacted by state or municipal taxing and 911 agencies regarding Taxes that do explicitly apply to VoIP and these agencies could seek retroactive payment of Taxes. As such, we have a reserve of \$2,231 as of December 31, 2011 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is approximately \$5,000 as of December 31, 2011.

#### Employment Agreements

Our Chief Executive Officer and Chief Financial Officer are subject to employment contracts with minimum salary commitments that, subject to annual review, aggregate \$1,435 per annum. Our Chief Executive Officer and Chief Financial Officer are also eligible for annual performance bonuses with targets based upon their then annual salary. The term of the employment contract with our Chief Executive Officer expires in 2012 but is subject to one-year renewals unless prior notice of 90 days is provided by either party. The employment contract with our Chief Financial Officer may be terminated by either party upon 30 days' notice. In the event of the termination of our Chief Executive Officer's employment, depending upon the circumstances, he will be entitled to severance payments up to an amount equal to a prorated annual bonus for the year of termination, two year's base salary, and amounts to cover specified health care coverage premiums and outplacement services. In the event of the termination of our Chief Financial Officer's employment, depending upon the circumstances, he will be entitled to severance payments up to an amount equal to a prorated annual bonus for the year of termination and one year's base salary.

#### Note 11. Geographic Information

Our chief operating decision-makers review financial information presented on a consolidated basis, accompanied by disaggregated

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## VONAGE HOLDINGS CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(In thousands, except per share amounts)

information about revenues and marketing expenses by geographic region for purposes of allocating resources and evaluating financial performance. Accordingly, we consider ourselves to be in a single reporting segment and operating unit structure.

Information about our operations by geographic location is as follows:

|                    | For the Years Ended December 31, |              |           |
|--------------------|----------------------------------|--------------|-----------|
|                    | 2011                             | 2010         | 2009      |
| Revenue:           |                                  |              |           |
| United States      | \$825,928                        | \$842,758    | \$846,981 |
| Canada             | 32,135                           | 30,748       | 31,829    |
| United Kingdom     | 12,260                           | 11,536       | 10,270    |
|                    | \$870,323                        | \$885,042    | \$889,080 |
|                    | December 31,                     | December 31, |           |
|                    | 2011                             | 2010         |           |
| Long-lived assets: |                                  |              |           |
| United States      | \$121,036                        | \$118,367    |           |
| Canada             | 3                                | 24           |           |
| United Kingdom     | 1,246                            | 11           |           |
| Israel             | 410                              | 350          |           |
|                    | \$122,695                        | \$118,752    |           |

## Note 12. Quarterly Financial Information (Unaudited)

The following table sets forth the reviewed consolidated quarterly financial information for 2011 and 2010:

|                                     | For the Quarter Ended |           |               |              |           |
|-------------------------------------|-----------------------|-----------|---------------|--------------|-----------|
|                                     | March 31,             | June 30,  | September 30, | December 31, | Total     |
| Year Ended 2011                     |                       |           |               |              |           |
| Revenue                             | \$219,841             | \$218,285 | \$216,507     | \$215,690    | \$870,323 |
| Net income                          | 21,113                | 21,748    | 16,037        | 350,146      | 409,044   |
| Net income per common share:        |                       |           |               |              |           |
| Basic                               | 0.10                  | 0.10      | 0.07          | 1.55         |           |
| Diluted                             | 0.09                  | 0.09      | 0.07          | 1.48         |           |
| Year Ended 2010                     |                       |           |               |              |           |
| Revenue                             | \$227,951             | \$225,341 | \$214,126     | \$217,624    | \$885,042 |
| Net income (loss)                   | 13,968                | (562)     | (55,382)      | (41,689)     | (83,665)  |
| Net income (loss) per common share: |                       |           |               |              |           |
| Basic                               | 0.07                  | —         | (0.26)        | (0.19)       |           |
| Diluted                             | 0.06                  | —         | (0.26)        | (0.19)       |           |

(1) In the third quarter of 2010, we recorded a charge of \$62,030 for the change in fair value of embedded features within notes payable.

(2) In the fourth quarter of 2010, we recorded a charge of \$29,782 for the change in fair value of embedded features within notes payable and a charge of \$26,531 for loss on extinguishment of notes.

(3)

In the fourth quarter of 2011, we released \$325,601 of the valuation allowance previously recorded against our net deferred tax assets resulting in a one-time non-cash benefit.

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