

VONAGE HOLDINGS CORP
Form 10-Q
July 31, 2014
Table of Contents

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

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

For the Quarterly Period Ended June 30, 2014

or

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

For the Transition Period From _____ to _____

Commission File Number 001-32887

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

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

23 Main Street, 07733
Holmdel, NJ (Address of principal executive offices) (Zip Code)

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

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

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

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

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

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

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

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

Edgar Filing: VONAGE HOLDINGS CORP - Form 10-Q

Class	Outstanding at	July 30, 2014
Common Stock, par value \$0.001		209,052,038 shares

Table of Contents

VONAGE HOLDINGS CORP.
INDEX

Part I. Financial Information

	Page
Item 1. <u>Financial Statements</u>	
<u>A) Consolidated Balance Sheets as of June 30, 2014 (Unaudited) and December 31, 2013</u>	<u>3</u>
<u>B) Unaudited Consolidated Statements of Income for the Three and Six Months Ended June 30, 2014 and 2013</u>	<u>4</u>
<u>C) Unaudited Consolidated Statement of Comprehensive Income for the Three and Six Months Ended June 30, 2014 and 2013</u>	<u>5</u>
<u>D) Unaudited Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2014 and 2013</u>	<u>6</u>
<u>E) Unaudited Consolidated Statement of Stockholders' Equity and Redeemable Noncontrolling Interest for the Six Months Ended June 30, 2014</u>	<u>7</u>
<u>F) Notes to Unaudited Consolidated Financial Statements</u>	<u>8</u>

Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>28</u>
------------------------------------------------------------------------------------------------------	-----------

Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>41</u>
---------------------------------------------------------------------------	-----------

Item 4. <u>Controls and Procedures</u>	<u>42</u>
----------------------------------------	-----------

Part II. Other Information

Item 1. <u>Legal Proceedings</u>	<u>43</u>
----------------------------------	-----------

Item 1A. <u>Risk Factors</u>	<u>43</u>
------------------------------	-----------

Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>43</u>
----------------------------------------------------------------------------	-----------

Item 3. <u>Defaults Upon Senior Securities</u>	<u>43</u>
------------------------------------------------	-----------

Item 4. <u>Mine Safety Disclosures</u>	<u>44</u>
----------------------------------------	-----------

Item 5. <u>Other Information</u>	<u>44</u>
----------------------------------	-----------

Item 6. <u>Exhibits</u>	<u>45</u>
-------------------------	-----------

<u>Signature</u>	<u>46</u>
------------------	-----------

Financial Information Presentation

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

Table of Contents

Part I – Financial Information

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

	June 30, 2014 (unaudited)	December 31, 2013
Assets		
Assets		
Current assets:		
Cash and cash equivalents	\$54,962	\$84,663
Accounts receivable, net of allowance of \$699 and \$683, respectively	21,705	19,649
Inventory, net of allowance of \$115 and \$229, respectively	7,266	10,584
Deferred customer acquisition costs, current	4,318	4,991
Deferred tax assets, current	18,361	18,361
Prepaid expenses and other current assets	23,523	16,892
Total current assets	130,135	155,140
Property and equipment, net	44,830	52,243
Goodwill	83,627	83,627
Software, net	22,068	20,557
Deferred customer acquisition costs, non-current	144	193
Debt related costs, net	769	1,313
Restricted cash	3,411	4,405
Intangible assets, net	68,207	76,850
Deferred tax assets, non-current	238,004	246,539
Other assets	1,450	1,882
Total assets	\$592,645	\$642,749
Liabilities and Stockholders' Equity		
Liabilities		
Current liabilities:		
Accounts payable	\$40,684	\$49,867
Accrued expenses	76,406	81,127
Deferred revenue, current portion	35,666	36,899
Current maturities of capital lease obligations	3,119	2,889
Current portion of notes payables	23,333	23,333
Total current liabilities	179,208	194,115
Indebtedness under revolving credit facility	55,000	75,000
Notes payable, net of current portion	11,667	23,333
Deferred revenue, net of current portion	797	436
Capital lease obligations, net of current maturities	8,585	10,201
Other liabilities, net of current portion in accrued expenses	1,660	1,628
Total liabilities	256,917	304,713
Commitments and Contingencies	—	—
Redeemable noncontrolling interest	(587) (38
Stockholders' Equity		
Common stock, par value \$0.001 per share; 596,950 shares authorized at June 30, 2014 and December 31, 2013; 250,994 and 246,741 shares issued at June 30,	253	247

Edgar Filing: VONAGE HOLDINGS CORP - Form 10-Q

2014 and December 31, 2013, respectively; 210,101 and 212,339 shares
outstanding at June 30, 2014 and December 31, 2013, respectively

Additional paid-in capital	1,151,033	1,136,289
Accumulated deficit	(687,835) (697,941)
Treasury stock, at cost, 40,893 shares at June 30, 2014 and 34,402 shares at December 31, 2013	(126,597) (101,040)
Accumulated other comprehensive (loss) income	(539) 519
Total stockholders' equity	336,315	338,074
Total liabilities, redeemable noncontrolling interest, and stockholders' equity	\$592,645	\$642,749

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

3

Table of Contents

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Revenues	\$218,882	\$204,776	\$439,615	\$413,863
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of \$5,098, \$3,510, \$10,252, and \$6,962, respectively)	52,385	53,527	105,002	108,708
Direct cost of goods sold	9,450	9,217	19,189	18,095
Selling, general and administrative	73,569	61,481	152,022	124,391
Marketing	59,003	58,330	116,267	109,999
Depreciation and amortization	12,459	8,205	24,797	16,180
	206,866	190,760	417,277	377,373
Income from operations	12,016	14,016	22,338	36,490
Other Income (Expense):				
Interest income	31	74	122	111
Interest expense	(1,434)	(1,732)	(3,511)	(3,189)
Other income (expense), net	36	(17)	23	(56)
	(1,367)	(1,675)	(3,366)	(3,134)
Income before income tax expense	10,649	12,341	18,972	33,356
Income tax expense	(5,266)	(4,894)	(9,384)	(12,862)
Net income	\$5,383	\$7,447	\$9,588	\$20,494
Plus: Net loss attributable to noncontrolling interest	135	—	518	—
Net income attributable to Vonage	\$5,518	\$7,447	\$10,106	\$20,494
Net income attributable to Vonage per common share:				
Basic	\$0.03	\$0.04	\$0.05	\$0.10
Diluted	\$0.02	\$0.03	\$0.05	\$0.09
Weighted-average common shares outstanding:				
Basic	211,390	212,169	211,790	213,404
Diluted	221,002	219,837	221,310	222,331

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

Table of Contents

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Net income	\$5,383	\$7,447	\$9,588	\$20,494
Other comprehensive income (loss):				
Foreign currency translation adjustment	397	(1,063)	(1,089)	(1,687)
Total other comprehensive income (loss)	397	(1,063)	(1,089)	(1,687)
Comprehensive income	5,780	6,384	8,499	18,807
Comprehensive loss attributable to noncontrolling interest:				
Add: Net loss	(135)) —	(518)) —
Foreign currency translation adjustment	(12)) —	(31)) —
Total comprehensive loss attributable to noncontrolling interest	(147)) —	(549)) —
Comprehensive income attributable to Vonage	\$5,927	\$6,384	\$9,048	\$18,807

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

Table of Contents

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

	Six Months Ended	
	June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	\$9,588	\$20,494
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization and impairment charges	16,154	14,993
Amortization of intangibles	8,643	1,187
Deferred tax expense	8,409	12,469
Allowance for doubtful accounts	(183)	(100)
Allowance for obsolete inventory	216	230
Amortization of debt related costs	544	783
Share-based expense	11,114	8,401
Changes in operating assets and liabilities:		
Accounts receivable	(1,814)	(2,823)
Inventory	3,100	(5,118)
Prepaid expenses and other current assets	(6,794)	(8,229)
Deferred customer acquisition costs	729	(1,009)
Other assets	432	1,668
Accounts payable	(9,266)	(30,397)
Accrued expenses	(6,543)	16,490
Deferred revenue	(892)	(466)
Other liabilities	32	31
Net cash provided by operating activities	33,469	28,604
Cash flows from investing activities:		
Capital expenditures	(3,099)	(5,803)
Acquisition and development of software assets	(7,031)	(6,197)
Decrease in restricted cash	998	1,256
Net cash used in investing activities	(9,132)	(10,744)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(1,386)	(1,184)
Principal payments on notes and revolving credit facility	(31,666)	(11,667)
Proceeds received from issuance of notes payable	—	27,500
Debt related costs	—	(2,009)
Common stock repurchases	(23,525)	(30,066)
Proceeds from exercise of stock options, net of stock cancellation payment	3,615	2,505
Net cash used in by financing activities	(52,962)	(14,921)
Effect of exchange rate changes on cash	(1,076)	(1,501)
Net change in cash and cash equivalents	(29,701)	1,438
Cash and cash equivalents, beginning of period	84,663	97,110
Cash and cash equivalents, end of period	\$54,962	\$98,548
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	\$2,690	\$2,032

Edgar Filing: VONAGE HOLDINGS CORP - Form 10-Q

Income taxes	\$1,145	\$1,448
Non-cash financing transactions during the periods for:		
Common stock repurchases	\$558	\$629

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

6

Table of Contents

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

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total	Redeemable non-controlling interest	Net Income
Balance at December 31, 2013	\$ 247	\$ 1,136,289	\$ (697,941)	\$(101,040)	\$ 519	\$ 338,074	\$ (38)	
Stock option exercises	6	3,609				3,615		
Share-based expense		11,114				11,114		
Share-based award activity				(1,976)		(1,976)		
Common stock repurchases				(23,347)		(23,347)		
Other		21		(234)		(213)		
Foreign currency translation adjustment					(1,058)	(1,058)	(31)	
Net income (loss)			10,106			10,106	(518)	\$ 9,588
Balance at June 30, 2014	\$ 253	\$ 1,151,033	\$ (687,835)	\$(126,597)	\$ (539)	\$ 336,315	\$ (587)	

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

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Vonage Holdings Corp. (“Vonage”, “Company”, “we”, “our”, “us”) is incorporated as a Delaware corporation. We are a leading provider of communications services connecting consumers and businesses through cloud-connected devices worldwide. Customers in the United States represented 94% of our subscriber lines for our broadband telephone replacement services at June 30, 2014, with the balance primarily in Canada and the United Kingdom.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows, and statement of stockholders’ equity for the periods presented. The results for the three and six months ended June 30, 2014 are not necessarily indicative of the results to be expected for the full year.

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

Significant Accounting Policies

Principles of Consolidation

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

Use of Estimates

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

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

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

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

Revenue Recognition

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

Table of Contents

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

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

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

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

Telephony Services Revenue

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

Customer Equipment and Shipping Revenue

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

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.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Direct Cost of Goods Sold

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

Development Expenses

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

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

Cash and Cash Equivalents

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

Certain Risks and Concentrations

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

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

Inventory

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

Property and Equipment

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

Leasehold improvements are amortized over their estimated useful life of the related assets or the life of the lease, whichever is shorter. The cost of renewals and substantial improvements is capitalized while the cost of maintenance and repairs is charged to operating expenses as incurred.

Our network equipment and computer hardware, which consists of routers, gateways, and servers that enable our telephony services, is subject to technological risks and rapid market changes due to new products and services and changing customer demand. These changes may result in future adjustments to the estimated useful lives or the carrying value of these assets, or both.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Software Costs

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

Goodwill and Purchased-Intangible Assets

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

Purchased-intangible assets are accounted for based upon the fair value of assets received. Purchased-intangible assets are amortized on a straight-line or accelerated basis over the periods of benefit, ranging from two to ten years. We perform a review of purchased-intangible assets whenever events or changes in circumstances indicate that the useful life is shorter than we had originally estimated or that the carrying amount of assets may not be recoverable. If such facts and circumstances exist, we assess the recoverability of purchased-intangible assets by comparing the projected undiscounted net cash flows associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairments, if any, are based on the excess of the carrying amount over the fair value of those assets. If the useful life of the asset is shorter than originally estimated, we accelerate the rate of amortization and amortize the remaining carrying value over the new shorter useful life. There was no impairment of purchased-intangible assets identified for the three and six months ended June 30, 2014.

Intangible Assets

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

Patents and Patent Licenses

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

Long-Lived Assets

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

Debt Related Costs

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

Redeemable Noncontrolling Interest

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

Table of Contents

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

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

Derivatives

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

Income Taxes

We recognize deferred tax assets and liabilities at enacted income tax rates for the temporary differences between the financial reporting bases and the tax bases of our assets and liabilities. Any effects of changes in income tax rates or tax laws are included in the provision for income taxes in the period of enactment. Our net deferred tax assets primarily consist of net operating loss carry forwards (“NOLs”). We are required to record a valuation allowance against our net deferred tax assets if we conclude that it is more likely than not that taxable income generated in the future will be insufficient to utilize the future income tax benefit from our net deferred tax assets (namely, the NOLs) prior to expiration. We periodically review this conclusion, which requires significant management judgment. If we are able to conclude in a future period that a future income tax benefit from our net deferred tax assets has a greater than 50 percent likelihood of being realized, we are required in that period to reduce the related valuation allowance with a corresponding decrease in income tax expense. This would result in a non-cash benefit to our net income in the period of the determination. In the fourth quarter of 2011, we released \$325,601 of valuation allowance. In subsequent periods, we would expect to recognize income tax expense equal to our pre-tax income multiplied by our effective income tax rate, an expense that was not recognized prior to the reduction of the valuation allowance. Our effective rate may differ from the federal statutory rate due, in part, to our foreign operations and certain discrete period items. The 2014 estimated annual effective tax rate is expected to approximate 49%, but may fluctuate due to the timing of other discrete period transactions.

We file income tax returns in the U.S. on a federal basis and in U.S. state and foreign jurisdictions. Our federal tax return remains subject to examination by the Internal Revenue Service from 2010 to present, our New Jersey tax returns remain open from 2008 to present, our Canada tax return remains open from 2009 to present, and other domestic and foreign tax returns remain open for all periods to which those filings relate. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax po