VONAGE HOLDINGS CORP
Form 10-Q
July 31, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2013
or
o 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 (State or other jurisdiction of incorporation or organization)	11-3547680 (IRS Employer Identification No.)
23 Main Street, Holmdel, NJ (Address of principal executive offices)	07733 (Zip Code)

Registrant’s telephone number, including area code: (732) 528-2600
(Former name, former address and former fiscal year, if changed since last report): Not Applicable

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
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 x No o
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	o	Accelerated filer	x
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Class	Outstanding at		July 30, 2013
Common Stock, par value $0.001		210,197,769	shares

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

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Part I – Financial Information

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

	June 30, 2013	December 31, 2012
Assets	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$98,548	$97,110
Accounts receivable, net of allowance of $665 and $753, respectively	23,296	20,416
Inventory, net of allowance of $231 and $268, respectively	10,299	5,470
Deferred customer acquisition costs, current	6,507	5,418
Deferred tax assets, current	15,947	15,947
Prepaid expenses and other current assets	23,700	15,487
Total current assets	178,297	159,848
Property and equipment, net	56,436	60,533
Software, net	20,609	19,560
Deferred customer acquisition costs, non-current	250	347
Debt related costs, net	1,998	772
Restricted cash	4,393	5,656
Intangible assets, net	5,494	6,681
Deferred tax assets, non-current	277,395	290,166
Other assets	2,158	3,826
Total assets	$547,030	$547,389
Liabilities and Stockholders' Equity		
Liabilities		
Current liabilities:		
Accounts payable	$43,554	$74,028
Accrued expenses	73,086	55,787
Deferred revenue, current portion	35,397	35,803
Current maturities of capital lease obligations	2,673	2,471
Current portion of notes payables	23,333	28,333
Total current liabilities	178,043	196,422
Notes payable, net of current portion	35,000	14,167
Deferred revenue, net of current portion	551	730
Capital lease obligations, net of current maturities	11,704	13,090
Other liabilities, net of current portion in accrued expenses	1,596	1,565
Total liabilities	226,894	225,974
Commitments and Contingencies	—	—
Stockholders' Equity		
Common stock, par value $0.001 per share; 596,950 shares authorized at June 30, 2013 and December 31, 2012; 237,226 and 230,118 shares issued at June 30, 2013 and December 31, 2012, respectively; 211,096 and 215,306 shares outstanding at June 30	237	230

30, 2013 and December 31, 2012, respectively		
Additional paid-in capital	1,099,085	1,088,186
Accumulated deficit	(705,736)	(726,230)
Treasury stock, at cost, 26,130 shares at June 30, 2013 and 14,812 shares at December 31, 2012	(74,335)	(43,343)
Accumulated other comprehensive income	885	2,572
Total stockholders' equity	320,136	321,415
Total liabilities and stockholders' equity	$547,030	$547,389

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

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

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Revenues	$204,776	$211,916	$413,863	$427,819
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of $3,510, $3,929, $6,962 and $7,859, respectively)	53,527	58,195	108,708	119,818
Direct cost of goods sold	9,217	9,275	18,095	19,121
Selling, general and administrative	61,481	58,396	124,391	120,231
Marketing	58,330	54,956	109,999	108,378
Depreciation and amortization	8,205	8,518	16,180	17,162
Loss from abandonment of software assets	—	25,262	—	25,262
	190,760	214,602	377,373	409,972
Income (loss) from operations	14,016	(2,686)	36,490	17,847
Other Income (Expense):				
Interest income	74	30	111	50
Interest expense	(1,732)	(1,566)	(3,189)	(3,317)
Other (expense) income, net	(17)	(65)	(56)	(23)
	(1,675)	(1,601)	(3,134)	(3,290)
Income (loss) before income tax expense	12,341	(4,287)	33,356	14,557
Income tax (expense) benefit	(4,894)	947	(12,862)	(3,976)
Net income (loss)	$7,447	$(3,340)	$20,494	$10,581
Net income (loss) per common share:				
Basic	$0.04	$(0.01)	$0.10	$0.05
Diluted	$0.03	$(0.01)	$0.09	$0.05
Weighted-average common shares outstanding:				
Basic	212,169	226,429	213,404	226,081
Diluted	219,837	226,429	222,331	234,219

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income (loss)	$7,447	$(3,340)	$20,494	$10,581
Other comprehensive loss:				
Foreign currency translation adjustment	(1,063)	(741)	(1,687)	(145)
Total other comprehensive loss	(1,063)	(741)	(1,687)	(145)
Comprehensive income (loss)	$6,384	$(4,081)	$18,807	$10,436

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

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

	Six Months Ended June 30, 2013	2012
Cash flows from operating activities:		
Net income	$20,494	$10,581
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization and impairment charges	14,993	15,974
Amortization of intangibles	1,187	1,188
Loss from abandonment of software assets	—	25,262
Deferred tax expense	12,469	3,175
Allowance for doubtful accounts	(100)	953
Allowance for obsolete inventory	230	92
Amortization of debt related costs	783	689
Share-based expense	8,401	6,128
Changes in operating assets and liabilities:		
Accounts receivable	(2,823)	(2,413)
Inventory	(5,118)	(3,129)
Prepaid expenses and other current assets	(8,229)	(1,092)
Deferred customer acquisition costs	(1,009)	255
Other assets	1,668	(652)
Accounts payable	(30,397)	(8,102)
Accrued expenses	16,490	(6,158)
Deferred revenue	(466)	(2,162)
Other liabilities	31	51
Net cash provided by operating activities	28,604	40,640
Cash flows from investing activities:		
Capital expenditures	(5,803)	(3,692)
Acquisition and development of software assets	(6,197)	(9,647)
Decrease in restricted cash	1,256	998
Net cash used in investing activities	(10,744)	(12,341)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(1,184)	(1,006)
Principal payments on notes	(11,667)	(14,167)
Proceeds received from issuance of notes payable	27,500	—
Debt related costs	(2,009)	—
Common stock repurchases	(30,066)	—
Proceeds from exercise of stock options, net of stock cancellation payment	2,505	558
Net cash used in financing activities	(14,921)	(14,615)
Effect of exchange rate changes on cash	(1,501)	(165)
Net change in cash and cash equivalents	1,438	13,519
Cash and cash equivalents, beginning of period	97,110	58,863
Cash and cash equivalents, end of period	$98,548	$72,382
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		

Interest	$2,032	$2,530
Income taxes	$1,448	$1,863
Non-cash financing transactions during the periods for:		
Common stock repurchases	$629	$—

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

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VONAGE HOLDINGS CORP.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(In thousands)
(Unaudited)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2012	$230	$1,088,186	$(726,230)	$(43,343)	$ 2,572	$321,415
Stock option exercises	7	7,961				7,968
Stock option cancellation		(5,463)				(5,463)
Share-based expense		8,401				8,401
Share-based award activity				(941)		(941)
Common stock repurchases				(30,051)		(30,051)
Foreign currency translation adjustment					(1,687)	(1,687)
Net income			20,494			20,494
Balance at June 30, 2013	$237	$1,099,085	$(705,736)	$(74,335)	$ 885	$320,136

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

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

Note 1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Vonage Holdings Corp. ("Vonage", "Company", "we", "our", "us") is incorporated as a Delaware corporation. We are a leadin provider of low-cost communications services connecting people through cloud-connected devices worldwide. Customers in the United States represented 93% of our subscriber lines for our broadband telephone replacement services at June 30, 2013, 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, 2013 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, 2012 filed with the Securities and Exchange Commission on February 13, 2013.

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:

- 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 ("Model"), and various other assumptions that we believe to be reasonable; the key inputs for this Model are our stock price at valuation date, exercise price, the dividend yield, risk-free interest rate, life in years, and historical volatility of our common stock; 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

Revenues consist of telephony services revenues and customer equipment (which enables our telephony services) and shipping revenues. The point in time at which revenues are recognized is determined in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, Revenue Recognition, and Financial Accounting

Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 605, Revenue Recognition.

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(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 provided free of charge to our customers and in most instances there are no activation 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 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 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, comprising an incidental portion of our revenue, derives from 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 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.

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.

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

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

Property and Equipment

Property and equipment includes acquired assets and those accounted for under capital leases and consist principally of network equipment and computer hardware, furniture, software, and leasehold improvements. In addition, the lease of our corporate headquarters has been accounted for as a capital lease and is included in property and equipment. Network equipment and computer hardware and furniture are stated at cost with depreciation provided using the straight-line method over the estimated useful lives of the related assets, which range from three to five years. Leasehold improvements are amortized over their estimated useful life of the related assets or the life of the lease, whichever is shorter. The cost of renewals and substantial improvements is capitalized while the cost of maintenance and repairs is charged to operating expenses as incurred.

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

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(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. As previously disclosed, we experienced delays and incremental costs during the course of the development and implementation of a new billing and ordering system by Amdocs Software Systems Limited and Amdocs, Inc. (collectively, "Amdocs") and the transition of customers to the system. We conducted discussions with Amdocs to resolve the issues associated with the billing and ordering system. Based on these discussions, and after our consideration of the progress made improving our overall IT infrastructure, the incremental time and costs to develop and implement the Amdocs system, as well as the expected reduction in capital expenditures, in June 2012 we and Amdocs determined that terminating the program was in the best interest of both parties. On July 30, 2012, we entered into a Settlement Agreement with Amdocs terminating the related license agreement. As a result, we wrote off our investment in the system of $25,262, net of settlement amounts to us, in the second quarter of 2012. This charge is recorded as loss from abandonment of software assets in the statement of operations.

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 of long-lived assets used in operations are recorded in the statement of operations as part of depreciation expense.

Debt Related Costs

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

Derivatives

We do not hold or issue derivative instruments for trading purposes. However, in accordance with FASB ASC 815, “Derivatives and Hedging” (“FASB ASC 815”), we review our contractual obligations to determine whether there are terms that possess the characteristics of derivative financial instruments that must be accounted for separately from the financial instrument in which they are embedded. We would recognize these features, if any, as liabilities in our consolidated balance sheet at fair value each period and would recognize any change in the fair value in our statement of operations in the period of change. We would 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 to the extent 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. In the fourth quarter of 2011, we concluded that it was more likely than not that taxable income in the future would be sufficient to utilize a significant portion of the future

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

income tax benefit from our net deferred tax assets (namely, the NOLs) prior to expiration and we released $325,601 of the valuation allowance. We periodically review this conclusion, which requires significant management judgment. In the future, if available evidence changes our conclusions, we will make an adjustment to the related valuation allowance and income tax expense at that time. The June 30, 2012 effective rate is less than the federal statutory rate due, in part, to our Canadian operations and certain discrete period items, which primarily consisted of adjustments related to stock compensation, including a non-cash deferred tax adjustment totaling $4,077 for certain stock compensation previously considered nondeductible under Section 162(m) of the Internal Revenue Code. The 2013 estimated annual effective tax rate is expected to approximate 41%, but may fluctuate due to the timing of other discrete period transactions.

We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate resolution.

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

Fair Value of Financial Instruments

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

Level 1:	Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets and liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.
Level 2:	Observable prices that are based on inputs not quoted on active markets but corroborated by market data.
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.

Fair Value of Other Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, accounts receivable, and accounts payable, approximate fair value because of their short maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management’s best estimates of interest rates that would be available for similar debt obligations at June 30, 2013 and December 31, 2012. We believe the fair value of our debt at June 30, 2013 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 February 11, 2013 for a similar debt instrument.

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.

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Share-Based Compensation

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

Earnings per Share

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

The following table sets forth the computation for basic and diluted net income per share for the three and six months ended June 30, 2013 and 2012:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Numerator				
Numerator for basic earnings per share-net income (loss)	$7,447	$(3,340)	$20,494	$10,581
Numerator for diluted earnings per share-net income (loss)	$7,447	$(3,340)	$20,494	$10,581
Denominator				
Basic weighted average common shares outstanding	212,169	226,429	213,404	226,081
Dilutive effect of stock options and restricted stock units	7,668	—	8,927	8,138
Diluted weighted average common shares outstanding	219,837	226,429	222,331	234,219
Basic net income (loss) per share				
Basic net income (loss) per share	$0.04	$(0.01)	$0.10	$0.05
Diluted net income (loss) per share				
Diluted net income (loss) per share	$0.03	$(0.01)	$0.09	$0.05

For the three and six months ended June 30, 2013 and 2012, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Restricted stock units	2,171	2,899	2,357	2,356

Stock options	27,796	39,944	26,349	32,349
	29,967	42,843	28,706	34,705

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Comprehensive Income (Loss)
Comprehensive income (loss) consists of net income and other comprehensive items. Other comprehensive items include foreign currency translation adjustments.
Reclassifications
Certain reclassifications have been made to prior years' financial statements in order to conform to the current year's presentation. The reclassifications had no impact on net earnings previously reported.
Note 2. Supplemental Balance Sheet Account Information
Prepaid expenses and other current assets

	June 30, 2013	December 31, 2012
Nontrade receivables	$9,318	$6,599
Services	8,405	6,092
Telecommunications	2,880	1,503
Insurance	1,216	389
Marketing	1,233	639
Other prepaids	648	265
Prepaid expenses and other current assets	$23,700	$15,487

Property and equipment, net

	June 30, 2013	December 31, 2012
Building (under capital lease)	$25,709	$25,709
Network equipment and computer hardware	74,308	87,145
Leasehold improvements	44,666	43,774
Furniture	811	842
Vehicles	109	97
	145,603	157,567
Less: accumulated depreciation and amortization	(89,167)	(97,034)
Property and equipment, net	$56,436	$60,533

Software, net

	June 30, 2013	December 31, 2012
Purchased	$43,282	$89,538
Licensed	909	909
Internally developed	36,088	36,088
	80,279	126,535
Less: accumulated amortization	(59,670)	(71,428)
abandonment of software assets	—	(35,547)
Software, net	$20,609	$19,560

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Debt related costs, net

	June 30, 2013	December 31, 2012
Senior secured term loan	$4,706	$2,697
Less: accumulated amortization	(2,708)	(1,925)
Debt related costs, net	$1,998	$772

Restricted cash

	June 30, 2013	December 31, 2012
Letter of credit-lease deposits	$4,302	$5,300
Letter of credit-energy curtailment program	—	258
	4,302	5,558
Cash reserves	91	98
Restricted cash	$4,393	$5,656

Intangible assets, net

	June 30, 2013	December 31, 2012
Patents and patent licenses	$18,164	$18,164
Trademark	560	560
	18,724	18,724
Less: accumulated amortization	(13,230)	(12,043)
Intangible assets, net	$5,494	$6,681

Accrued expenses

	June 30, 2013	December 31, 2012
Compensation and related taxes and temporary labor	$12,619	$16,376
Marketing	23,752	10,889
Taxes and fees	16,917	9,747
Litigation and settlements	89	89
Telecommunications	9,583	9,135
Other accruals	4,373	4,412
Customer credits	2,069	2,056
Professional fees	3,234	2,200
Accrued interest	104	5
Inventory	19	572
Credit card fees	327	306

Accrued expenses	$73,086	$55,787

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Note 3. Supplemental Income Statement Account Information

Amounts included in revenues

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
USF fees	$17,125	$19,799	$35,230	$40,423
Disconnect fees	$1,066	$464	$2,306	$572
Initial activation fees	$319	$509	$673	$1,247
Customer equipment fees	$12	$179	$170	$390
Equipment recovery fees	$26	$18	$55	$55
Shipping and handling fees	$322	$314	$690	$563

Amount included in direct cost of telephony services

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
USF costs	$17,125	$19,799	$35,230	$40,423

Amount included in direct cost of goods sold

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Shipping and handling cost	$1,436	$1,696	$2,844	$3,570

Amount included in selling, general and administrative expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Advertising costs	$100	$236	$188	$1,660

Amount included in marketing

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Advertising costs	$36,089	$35,180	$67,815	$69,855

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Depreciation and amortization expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Network equipment and computer hardware	$3,339	$3,896	$6,647	$7,796
Software	2,659	2,399	5,149	4,932
Capital leases	549	550	1,098	1,100
Other leasehold improvements	1,032	991	2,036	1,997
Furniture	29	31	56	74
Vehicles	3	4	8	8
Patents	594	594	1,188	1,188
	8,205	8,465	16,182	17,095
Property and equipment impairments	—	7	(2)	12
Software impairments	—	46	—	55
Depreciation and amortization expense	$8,205	$8,518	$16,180	$17,162

Amount included in interest expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Debt related costs amortization	$395	$327	$783	$689

Amount included in other income (expense), net

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net losses resulting from foreign exchange transactions	$(22)	$(63)	$(62)	$(23)

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Note 4. Long-Term Debt and Revolving Credit Facility

A schedule of long-term debt at June 30, 2013 and December 31, 2012 is as follows:

	June 30, 2013	December 31, 2012
3.125-3.625% Credit Facility - due 2016	$35,000	$—
3.25-3.75% Credit Facility - due 2014	—	14,167

At June 30, 2013, future payments under long-term debt obligations over each of the next five years and thereafter were as follows:

	Credit Facility
2013	$11,667
2014	23,333
2015	23,333
Minimum future payments of principal	58,333
Less: current portion	23,333
Long-term portion	$35,000

July 2011 Financing