

J2 GLOBAL COMMUNICATIONS INC  
Form 10-Q  
March 12, 2007

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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 September 30, 2006**

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: 0-25965**

**j2 GLOBAL COMMUNICATIONS, INC.**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**51-0371142**  
(I.R.S. Employer  
Identification No.)

**6922 Hollywood Boulevard, Suite 500**  
**Los Angeles, California 90028**  
(Address of principal executive offices)

**(323) 860-9200**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required 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 is a large accelerated filer, an accelerated filer, or a non-accelerated

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filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act). (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of February 28, 2007, the registrant had 48,969,601 shares of Common Stock outstanding.

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**j2 GLOBAL COMMUNICATIONS, INC.**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2006**

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PART I. FINANCIAL INFORMATIONItem 1. Financial Statements

**j2 Global Communications, Inc.**  
**Condensed Consolidated Balance Sheets**  
**(Unaudited, in thousands)**

	September 30, 2006	December 31, 2005 (As restated, see Note 2)
<b>ASSETS</b>		
Cash and cash equivalents	\$ 73,443	\$ 36,301
Short-term investments	83,003	76,525
Accounts receivable, net of allowances of \$831 and \$627, respectively	11,217	10,211
Prepaid expenses and other current assets	5,445	3,350
Deferred income taxes	1,091	1,091
Total current assets	174,199	127,478
Long-term investments	14,514	31,673
Property and equipment, net	18,614	17,248
Goodwill	30,510	19,942
Other purchased intangibles, net	20,806	20,299
Deferred income taxes	6,212	4,997
Other assets	501	307
Total assets	\$ 265,356	\$ 221,944
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Accounts payable and accrued expenses	\$ 13,741	\$ 8,782
Income taxes payable	—	2,964
Deferred revenue	10,578	7,201
Current portion of long-term debt	287	593
Total current liabilities	24,606	19,540
Long-term debt	—	149
Other	92	—
Total liabilities	24,698	19,689
Commitments and contingencies		
Total stockholders' equity	240,658	202,255
Total liabilities and stockholders' equity	\$ 265,356	\$ 221,944

**See accompanying notes to condensed consolidated financial statements**

**j2 Global Communications, Inc.**  
**Condensed Consolidated Statements of Operations**  
(Unaudited, in thousands except share and per share data)

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	2005 (As restated, see Note 2)		2005 (As restated, see Note 2)	
Revenues:				
Subscriber	\$ 44,491	\$ 36,487	\$ 127,724	\$ 101,842
Other	1,400	1,202	4,451	2,956
	45,891	37,689	132,175	104,798
Cost of revenues (including stock-based compensation of \$97 and \$303 for the three and nine months of 2006, respectively, and \$10 and \$17 for the three and nine months of 2005, respectively)	9,648	8,120	27,947	21,592
Gross profit	36,243	29,569	104,228	83,206
Operating expenses:				
Sales and marketing (including stock-based compensation of \$266 and \$807 for the three and nine months of 2006, respectively, and \$15 and \$24 for the three and nine months of 2005, respectively)	8,141	5,783	22,498	16,801
Research, development and engineering (including stock-based compensation of \$149 and \$413 for the three and nine months of 2006, respectively, and \$2 and \$10 for the three and nine months of 2005, respectively)	2,129	1,797	5,965	5,263
General and administrative (including stock-based compensation of \$995 and \$3,073 for the three and nine months of 2006, respectively, and \$158 and \$321 for the three and nine months of 2005, respectively)	10,204	5,919	26,454	16,813
Total operating expenses	20,474	13,499	54,917	38,877
Operating earnings	15,769	16,070	49,311	44,329
Gain on sale of investment	—	9,347	—	9,347
Interest and other income, net	1,586	861	3,922	2,192
Earnings before income taxes	17,355	26,278	53,233	55,868
Income tax expense	4,565	8,245	14,933	16,216
Net earnings	\$ 12,790	\$ 18,033	\$ 38,300	\$ 39,652
Net earnings per common share:				
Basic	\$ 0.26	\$ 0.37	\$ 0.78	\$ 0.83

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Diluted	\$	0.25	\$	0.35	\$	0.75	\$	0.78
Weighted average shares outstanding:								
Basic		49,218,918		48,739,730		49,272,631		47,912,344
Diluted		51,107,362		51,154,474		51,072,988		51,023,422

**See accompanying notes to condensed consolidated financial statements**

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**j2 Global Communications, Inc.**  
**Condensed Consolidated Statements of Cash Flows**  
**(Unaudited, in thousands)**

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
		<b>(As restated, see Note 2)</b>
Cash flows from operating activities:		
Net earnings	\$ 38,300	\$ 39,652
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	5,996	5,187
Stock-based compensation	4,596	372
Tax benefit of vested restricted stock	24	—
Tax benefit of stock option exercises	1,381	8,695
Excess tax benefits on stock option exercises	(1,290)	—
Deferred income taxes	(1,214)	(54)
Gain on sale of investment	—	(9,347)
Changes in assets and liabilities, net of effects of business acquisitions:		
Decrease (increase) in:		
Accounts receivable	(1,725)	(299)
Prepaid expenses and other current assets	(2,064)	(292)
Other assets	(177)	(177)
Increase (decrease) in:		
Accounts payable and accrued expenses	3,018	(763)
Income taxes payable	(2,970)	545
Deferred revenue	3,135	1,421
Other	92	—
Net cash provided by operating activities	47,102	44,940
Cash flows from investing activities:		
Net purchases of available-for-sale investments	(18,655)	(25,695)
Net redemptions (purchases) of held-to-maturity investments	29,354	(14,386)
Purchases of property and equipment	(5,226)	(6,326)
Acquisition of businesses, net of cash received	(7,194)	(7,728)
Purchases of intangible assets	(2,950)	(3,787)
Payment of accrued exit costs	—	(43)
Proceeds from sale of investment	822	8,708
Proceeds from sale of property and equipment	10	—
Net cash used in investing activities	(3,839)	(49,257)
Cash flows from financing activities:		
Repurchases of common stock	(9,727)	—
Issuance of common stock under employee stock purchase plan	381	389
Exercise of stock options and warrants	800	3,258
Excess tax benefits on stock option exercises	1,290	—
Repayment of long-term debt	(460)	(1,126)
Net cash (used in) provided by financing activities	(7,716)	2,521
Effect of exchange rate changes on cash and cash equivalents	1,595	(462)



Net increase (decrease) in cash and cash equivalents	37,142	(2,258)
Cash and cash equivalents at beginning of period	36,301	18,814
Cash and cash equivalents at end of period	\$ 73,443	\$ 16,556

**See accompanying notes to condensed consolidated financial statements**

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**j2 GLOBAL COMMUNICATIONS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**  
**(UNAUDITED)**

NOTE 1 - BASIS OF PRESENTATION

j2 Global Communications, Inc. (“j2 Global” or the “Company”) is a Delaware corporation founded in 1995. By leveraging the power of the Internet, the Company provides outsourced, value-added messaging and communications services to individuals and businesses throughout the world. j2 Global offers fax, voicemail, email and call handling services and bundled suites of certain of these services. j2 Global markets its services principally under the brand names eFax<sup>®</sup>, eFax Corporate<sup>®</sup>, UniFax<sup>™</sup>, Send2Fax<sup>®</sup>, eFax Broadcast<sup>™</sup>, jBlast<sup>®</sup>, jConnect<sup>®</sup>, Onebox<sup>®</sup>, Onebox Receptionist<sup>™</sup>, eVoice<sup>®</sup>, eVoiceReceptionist<sup>™</sup> and Electric Mail<sup>®</sup>.

The accompanying interim condensed consolidated financial statements include the accounts of j2 Global and its direct and indirect wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

The accompanying interim condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) including those for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X issued by the Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and note disclosures required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been reflected in these interim financial statements. These financial statements should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2005 included in the Company’s Annual Report on Form 10-K filed with the SEC on March 27, 2006.

The results of operations for these interim periods are not necessarily indicative of the operating results for the full year or for any future period.

On May 25, 2006, the Company effected a two-for-one stock split of its common stock in the form of a stock dividend to each shareholder of record at the close of business on May 15, 2006. All share and per share data included in this Form 10-Q have been restated to reflect the stock split.

*Stock-based compensation*

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123(R)”), which requires all stock-based payments to employees, including grants of employee stock options and purchases under certain employee stock purchase plans, to be recognized as compensation expense in the results of operations. Stock-based compensation expense as required by SFAS 123(R) is recognized over the requisite employee service period based on the grant date fair value of those awards.

The Company adopted SFAS 123(R) using the modified prospective method. Accordingly, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized during the first nine months of 2006 with respect to: (a) unvested stock options granted prior to December 31, 2005 is based on the grant date fair value of such options estimated in accordance with the original provisions of SFAS No. 123, “Accounting for Stock-Based Compensation” (“SFAS 123”); and (b) stock-based awards granted subsequent to December 31, 2005 is based on the grant date fair value estimated in accordance with SFAS 123(R). Stock-based compensation expense recognized during the nine months of 2006 has

been reduced by estimated pre-vesting forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The prospective application of SFAS 123(R) had a material impact on the Company's consolidated financial position, results of operations and cash flows. See Note 6 regarding the Company's stock-

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based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had recorded stock-based compensation expense under SFAS 123(R). The cumulative effect upon adoption of SFAS 123(R) was not material.

In November 2005, the FASB issued FASB Staff Position No. 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards" ("FSP 123R-3"). The Company has elected to adopt the alternative transition method for calculating the tax effects of stock-based compensation pursuant to FAS 123R-3. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool related to the effects of employee share-based compensation, which is available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R).

#### NOTE 2 - RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

The Company has restated the accompanying condensed consolidated financial statements as of December 31, 2005 and for the three and nine months ended September 30, 2005, to record: (1) additional non-cash stock-based compensation expense, related payroll tax expense and income tax effects resulting from stock options granted during the years 1999 through 2005 that were incorrectly accounted for under GAAP; and (2) corrections of certain other previously unrecorded accounting errors relating to the years 2000, 2002, 2003, and 2004. The adjustments in (1) and (2) affected substantially all of the line items in the condensed consolidated statements of operations for the three and nine months ended September 30, 2005. The Company has concluded that the foregoing adjustments are not material to its historical consolidated financial statements for any period and therefore has not amended, and does not intend to amend, any of its previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the restatement.

The stock options mentioned under (1) above had measurement date errors that resulted in additional stock-based compensation and related expenses that were previously not reported under GAAP. The financial statement adjustments relating to these stock options are based on the conclusions of an independent investigation by a special committee of the Company's Board of Directors ("Board") into the Company's stock option grants and related procedures. The special committee concluded, among other things, that the Company's practice of documenting approvals of option grants by unanimous written consent of the Board and/or the Compensation Committee rather than at a meeting, led to inadvertent errors in determining the correct measurement date to be applied to these grants. As a result of the investigation, the Company has established a policy of only approving option grants at a meeting rather than by unanimous written consent.

Given the time required to complete the independent investigation, the Company did not timely file its quarterly report on Form 10-Q for the quarter ended September 30, 2006.

The following table reflects the consolidated statement of operations adjustments, which consisted solely of additional stock-based compensation expense and related payroll tax expense and income tax effects, for the three and nine months ended September 30, 2005 (in thousands):

	<b>Three Months</b>		<b>Nine Months</b>	
	<b>Ended September 30, 2005</b>			
Cost of revenues	\$	15	\$	77
Sales and marketing		41		88
Research, development and engineering		28		70
General and administrative		137		423
Income tax benefit		(65)		(202)
	\$	156	\$	456

The financial impact of these adjustments has been reflected in the accompanying financial statements for the three and nine months ended September 30, 2005. Additionally, the Company has restated the pro forma expense under SFAS 123 in Note 6 to reflect the impact of these adjustments.

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The Company has determined that the impact to the previously reported financial statements from recognizing additional stock-based compensation expense and related payroll tax expense and income tax effects referred to in (1) in the first paragraph of this Note is as follows (in thousands):

<u>Year</u>	<b>Pre-Tax Expense</b>	<b>After Tax Expense</b>
1999	\$ 6	\$ 6
2000	370	370
2001	130	130
2002	270	270
2003	582	88
2004	684	475
First 9 months of 2005	657	456
Last 3 months of 2005	290	184
	\$ 2,989	\$ 1,979

In addition, the Company corrected the following quantitatively and qualitatively immaterial errors previously unrecorded (see (2) in the first paragraph of this Note):

- Understated stock compensation cost of approximately \$354,000 in fiscal 2000, relating to restricted stock and acceleration of stock option vesting, and related understated income tax benefit of \$140,000 in fiscal 2003.
- Overstated income tax benefit of approximately \$377,000 and \$362,000 in fiscal 2002 and 2004, respectively. The errors related to the accounting for deferred tax valuation allowances established in connection with a prior business combination, which resulted in an overstatement of goodwill and an understatement of provisions for deferred income taxes.
- Understated income tax expense of approximately \$154,000 related to purchases of services from a foreign subsidiary in fiscal 2004.

The following is a summary of the adjustments described above to beginning accumulated deficit as of January 1, 2004 and the consolidated statements of operations for the nine months ended September 30, 2005 and for the years ended December 31, 2005 and 2004 (in thousands):

	<b>Net Earnings for the Nine Months Ended September 30, 2005</b>	<b>Net Earnings for the Year Ended December 31, 2005</b>	<b>Net Earnings for the Year Ended December 31, 2004</b>	<b>Accumulated Deficit as of January 1, 2004</b>
Previously reported	\$ 40,108	\$ 51,258	\$ 31,607	\$ (20,175)
Adjustments:				
Stock-based compensation and related payroll taxes, net of related income tax effect	(456)	(640)	(475)	(864)
Other, net of related income tax effects	—	—	(516)	(591)
Decrease	(456)	(640)	(991)	(1,455)(a)
As restated	\$ 39,652	\$ 50,618	\$ 30,616	\$ (21,630)

(a) The impact of errors described above on net earnings and accumulated deficit was \$52, \$(647), \$(130), \$(724) and \$(6) for the years ended December 31, 2003, 2002, 2001, 2000 and 1999, respectively.

The following tables present the effects of the adjustments on certain line items within the Company's consolidated balance sheet as of December 31, 2005 and condensed consolidated statements of operations for the three and nine months ended September 30, 2005 and cash flows for the nine months ended September 30, 2005 (in thousands, except per share amounts):

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**Condensed Consolidated Balance Sheet**

	<b>December 31, 2005</b>		
	<b>Previously Reported</b>	<b>Adjustments</b>	<b>As restated</b>
Goodwill	\$ 20,681	\$ (739)	\$ 19,942
Deferred income taxes	4,559	438	4,997
Total assets	222,245	(301)	221,944
Accounts payable and accrued expenses	7,611	1,171	8,782
Income taxes payable	2,809	155	2,964
Total current liabilities	18,214	1,326	19,540
Total liabilities	18,363	1,326	19,689
Additional-paid-in-capital*	146,439	1,459	147,898
Retained earnings*	62,690	(3,086)	59,604
Total stockholders' equity	203,882	(1,627)	202,255
Total liabilities and stockholders' equity	222,245	(301)	221,944

\* Not presented herein. Additional paid-in-capital has been split adjusted.



## Condensed Consolidated Statements of Operations

## Three Months Ended September 30, 2005

	<b>Previously Reported</b>	<b>Adjustments</b>	<b>As restated</b>
Cost of revenues	\$ 8,105	\$ 15	\$ 8,120
Gross profit	29,584	(15)	29,569
Sales and marketing	5,742	41	5,783
Research, development and engineering	1,769	28	1,797
General and administrative	5,781	138	5,919
Total operating expenses	13,292	207	13,499
Operating earnings	16,292	(222)	16,070
Earnings before income taxes	26,500	(222)	26,278
Income tax expense	8,311	(66)	8,245
Net earnings	18,189	(156)	18,033
Net earnings per common share:			
Basic	\$ 0.37	\$ —	\$ 0.37
Diluted	\$ 0.36	\$ (0.01)	\$ 0.35
Weighted average shares outstanding:			
Basic	48,739,730	—	48,739,730
Diluted	51,007,272	147,202	51,154,474

## Nine Months Ended September 30, 2005

	<b>Previously Reported</b>	<b>Adjustments</b>	<b>As restated</b>
Cost of revenues	\$ 21,514	\$ 78	\$ 21,592
Gross profit	83,284	(78)	83,206
Sales and marketing	16,714	87	16,801
Research, development and engineering	5,193	70	5,263
General and administrative	16,390	423	16,813
Total operating expenses	38,297	580	38,877
Operating earnings	44,987	(658)	44,329
Earnings before income taxes	56,526	(658)	55,868
Income tax expense	16,418	(202)	16,216
Net earnings	40,108	(456)	39,652
Net earnings per common share:			
Basic	\$ 0.84	\$ (0.01)	\$ 0.83
Diluted	\$ 0.79	\$ (0.01)	\$ 0.78
Weighted average shares outstanding:			
Basic	47,912,344	—	47,912,344
Diluted	50,834,676	188,746	51,023,422

**Condensed Consolidated Statement of Cash Flows****Nine Months Ended September 30, 2005**

	<b>Previously Reported</b>	<b>Adjustments</b>	<b>As restated</b>
Cash flows from operating activities:			
Net earnings	\$ 40,108	\$ (456)	\$ 39,652
Stock-based compensation	97	275	372
Tax benefit of stock option exercises	9,077	(382)	8,695
Deferred income taxes	(38)	(16)	(54)
Accounts payable and accrued expenses	(1,342)	579	(763)

**NOTE 3 - USE OF ESTIMATES**

The preparation of consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. On an ongoing basis, management evaluates its estimates, including those related to revenue recognition, allowances for doubtful accounts and the valuation of deferred income taxes, tax contingencies, stock-based compensation expense and long-lived and intangible assets and goodwill. These estimates are based on historical experience and on various other factors that the Company believes to be reasonable under the circumstances. Actual results could differ from those estimates.

**NOTE 4 - RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 creates a single accounting and disclosure model for uncertain tax positions, provides guidance on the minimum threshold that a tax uncertainty is required to meet before it can be recognized in the financial statements and applies to all tax positions taken by a company. FIN 48 establishes a two-step approach for evaluating tax positions. The first step, recognition, occurs when a company concludes (based solely on the technical aspects of the tax matter) that a tax position is more likely than not to be sustained on examination by a taxing authority. The second step, measurement, is only considered after step one has been satisfied and measures any tax benefit at the largest amount that is deemed more likely than not to be realized upon ultimate settlement of the uncertainty. Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period that they meet the more likely than not standard, when they are resolved through negotiation or litigation with the taxing authority or upon the expiration of the statute of limitations. Derecognition of a tax position previously recognized would occur when a company subsequently concludes that a tax position no longer meets the more likely than not threshold of being sustained. FIN 48 also significantly expands the financial statement disclosure requirements relating to uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, FIN 48 will be effective for the Company on January 1, 2007. Differences between the amounts recognized in the balance sheet prior to adoption and the amounts recognized in the balance sheet after adoption will be accounted for as a cumulative effect adjustment to the beginning balance of retained earnings. The Company is currently evaluating the impact of FIN 48 on its consolidated financial statements and expects, upon adoption of FIN 48, to record a cumulative effect adjustment to the beginning balance of retained earnings, which may be material.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements" (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. In the year of

adoption, SAB 108 allows a one-time cumulative effect transition adjustment for errors that were not previously deemed material, but are material under the guidance in SAB 108. The guidance in SAB 108 must be

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applied to annual financial statements for fiscal years ending after November 15, 2006, although early adoption is permitted. The adoption of SAB 108 in 2006 did not have a material impact on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), which defines fair value, provides a framework for measuring fair value, and expands the disclosures required for fair value measurements. SFAS 157 applies to all accounting pronouncements that require fair value measurements. It does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Accordingly, the Company will adopt SFAS 157 commencing in the first quarter of 2008. The Company is currently assessing the potential impact of SFAS 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Liabilities - Including an amendment of FASB Statement No. 115" ("SFAS 159"). SFAS 159 permits entities to choose to measure certain financial assets and liabilities at fair value (the "fair value option"). Unrealized gains and losses, arising subsequent to adoption, are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is required to adopt SFAS 159 in the first quarter of 2008. The Company is currently assessing the impact of SFAS 159 on its consolidated financial statements.

#### NOTE 5 - BUSINESS ACQUISITIONS

In July 2006, the Company purchased substantially all of the assets and operations of Send2Fax, LLC ("Send2Fax"), a South Carolina provider of Internet fax services. The purchase price, including acquisition costs, was approximately \$7.2 million of which \$800,000 was a contingent holdback on the date of acquisition. The purchase price also included current assets of \$41,000, property and equipment of \$99,000 and current liabilities of \$248,000 assumed at acquisition. The contingent holdback amount has release features in 2007 and 2008. Additionally, a revenue based contingent earn-out of \$850,000 was paid in January 2007. The excess of the purchase price over the fair value of identifiable net tangible liabilities acquired amounted to approximately \$8.2 million, of which \$1.8 million was allocated to identifiable intangible assets and \$6.4 million was allocated to goodwill.

The Company paid this amount of goodwill based upon the following factors: (a) management's belief that it would achieve significant cost-savings upon completion of integration of Send2Fax's business into the Company's; (b) management's belief that Send2Fax's business was worth more under the Company's control because of the Company's greater Internet marketing expertise and the complementary nature of the two companies' services; and (c) the fact that Send2Fax had an established, stable and on-going business.

During 2005, the Company completed three acquisitions, none of which were material to the Company's financial position at the dates of acquisition. In January 2005, the Company purchased substantially all of the assets and operations of a European provider of fax-to-email and unified messaging services. The purchase price (in U.S. dollars), including acquisition costs, was approximately \$3.6 million. The excess of the purchase price over the fair value of identifiable net tangible assets acquired amounted to approximately \$3.7 million, of which \$1.4 million was allocated to identifiable intangible assets and \$2.3 million was allocated to goodwill. In June 2005, the Company purchased substantially all of the assets and operations of a California provider of fax-to-email and unified messaging services. The purchase price, including acquisition costs, was approximately \$4.4 million of which \$500,000 was a contingent holdback on the date of acquisition. In December 2005, the Company released one half, or \$250,000, of the unused portion of the contingent holdback amount and the remaining unused portion was released in June 2006. The excess of the purchase price over the fair value of identifiable net tangible assets acquired amounted to approximately \$3.7 million, of which \$1.5 million was allocated to identifiable intangible assets and \$2.2 million was allocated to goodwill. In November 2005, the Company purchased substantially all of the assets and operations of a European provider of fax-to-email and unified messaging services. The purchase price (in U.S. dollars), including acquisition costs, was approximately \$3.1 million. The excess of the purchase price over the fair value of identifiable net tangible assets acquired amounted to approximately \$3.5 million, of which \$0.7 million was allocated to identifiable intangible

assets and \$2.8 million was allocated to goodwill.

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## NOTE 6 - STOCK-BASED COMPENSATION

The Company's stock-based compensation plans include the Second Amended and Restated 1997 Stock Option Plan and the 2001 Employee Stock Purchase Plan (described below).

Effective January 1, 2006, the Company adopted SFAS 123(R), applying the modified prospective method. Prior to the adoption of SFAS 123(R), the Company applied the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", (APB 25) in accounting for stock options.

Under the modified prospective method, SFAS 123(R) applies to new awards and to the unvested portion of awards that were outstanding on January 1, 2006 and to awards that are subsequently modified, repurchased or cancelled. Compensation expense recognized in the first nine months of 2006 includes compensation expense for all stock-based awards granted: (a) on or before, but not yet vested as of December 31, 2005, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123; and (b) subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Prior periods were not restated to reflect the impact of adopting the new standard.

The following table represents the stock-based compensation expense that was included in cost of revenues and operating expenses in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2006 (in thousands):

	<b>Three Months Ended September 30, 2006</b>	<b>Nine Months Ended September 30, 2006</b>
Cost of revenues	\$ 97	\$ 303
Sales and marketing	266	807
Research, development and engineering	149	413
General and administrative	995	3,073
	<b>\$ 1,507</b>	<b>\$ 4,596</b>

The Company receives a cash tax deduction for certain stock option exercises in the year the options are exercised, generally for the excess of the fair value of stock at the date of exercise over the exercise price of the options. Prior to the adoption of SFAS 123(R), the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the statements of cash flows. SFAS 123(R) requires cash flows resulting from excess tax benefits to be classified as part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. In accordance with SFAS 123(R), the Company reported \$1.3 million of excess tax benefits as financing cash flows for the nine months ended September 30, 2006. The total tax benefit realized from stock option exercises for the nine months ended September 30, 2006 and 2005 was \$1.4 million and \$8.7 million, respectively. Cash received from stock option exercises was \$0.8 million and \$3.3 million for the nine months ended September 30, 2006 and 2005, respectively.

Prior to January 1, 2006, the Company applied the intrinsic value-based method of accounting prescribed by APB 25 and related interpretations to account for its stock option plans, and disclosed the pro forma effect on net earnings and net earnings per share as if compensation expense had been recognized based on the fair value-based method at the date of grant for stock options awarded consistent with the provisions of SFAS 123. The Company's reported pro forma information for the three and nine months ended September 30, 2005 has been restated as a result of the completion of the Company's stock option investigation (see Note 2) and is as follows (in thousands, except per share amounts):



		<b>Three Months Ended September 30, 2005</b>		
		<b>As previously reported</b>	<b>Adjustments</b>	<b>As restated, see Note 2</b>
Net earnings, as reported		\$ 18,189	\$ (156)	\$ 18,033
Add:	Stock-based employee compensation expense included in net earnings, net of tax	59	62	121
Deduct:	Stock-based compensation expense determined under the fair value-based method, net of tax	(909)	34	(875)
Pro forma net earnings		\$ 17,339	\$ (60)	\$ 17,279
Basic net earnings per common share:				
As reported		\$ 0.37	\$ —	\$ 0.37
Pro forma		\$ 0.36	\$ (0.01)	\$ 0.35
Diluted net earnings per common share:				
As reported		\$ 0.36	\$ (0.01)	\$ 0.35
Pro forma		\$ 0.34	\$ —	\$ 0.34

		<b>Nine Months Ended September 30, 2005</b>		
		<b>As previously reported</b>	<b>Adjustments</b>	<b>As restated, see Note 2</b>
Net earnings, as reported		\$ 40,108	\$ (456)	\$ 39,652
Add:	Stock-based employee compensation expense included in net earnings, net of tax	59	193	252
Deduct:	Stock-based compensation expense determined under the fair value-based method, net of tax	(2,259)	104	(2,155)
Pro forma net earnings		\$ 37,908	\$ (159)	\$ 37,749
Basic net earnings per common share:				
As reported		\$ 0.84	\$ (0.01)	\$ 0.83
Pro forma		\$ 0.79	\$ —	\$ 0.79
Diluted net earnings per common share:				
As reported		\$ 0.79	\$ (0.01)	\$ 0.78
Pro forma		\$ 0.75	\$ —	\$ 0.75

*Second Amended and Restated 1997 Stock Option Plan (1997 Plan)*

The 1997 Plan was adopted in November 1997 and has twice been amended and restated. This plan provides for the granting of incentive stock options, nonqualified stock options and restricted stock awards. Options under the 1997 Plan may be granted at exercise prices determined by the Compensation Committee of the Board of Directors, or the Board of Directors as a whole, provided that the exercise prices shall not be less than the fair market value of the



Company's common stock on the date of grant for incentive stock options and not less than 85% of the fair value of the Company's common stock on the date of grant for non-statutory stock options. In May 2006, the Company's shareholders approved an increase in the number of authorized shares of common stock reserved for issuance upon exercise of options or as restricted stock from 10,000,000 to 12,000,000. At September 30, 2006, there were 2,067,843 shares available for future awards under the plan.

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In connection with the restatements of the Company's 2005 and prior period financial statements, which are more fully described in Note 2, the Company modified the terms of certain stock options as discussed below.

In December 2006 the Company offered each named executive officer and director the option to increase the exercise price of certain of their stock options in order to avoid potential inadvertent taxation under Internal Revenue Code Section 409A. In the first quarter of 2007 the Company made an aggregate compensating payment to such option holders of \$0.5 million. For the same purpose, the Company increased the exercise price of certain options held by all other employees during the first quarter of 2007 and will make a compensating payment to these employees of approximately \$0.1 million no later than the first quarter of 2008. The Company expects to accrue \$0.1 million in the first quarter of 2007 with respect to this compensating payment.

In addition, if and to the extent employees and directors have already incurred a tax liability under Section 409A the Company plans to reimburse such individuals for that liability plus a gross up for income taxes owed as a result of such reimbursement. The estimated impact of these reimbursements was included in general and administrative expense in the condensed consolidated statement of operations for the fourth quarter 2006 and amounted to \$0.7 million, net of tax.

### *Stock Options*

The Company uses the Black-Scholes option pricing model to calculate the fair-value of each option grant. The expected volatility for the three quarters of 2006 was based on historical volatility of the Company's common stock (its "traded stock"). The Company elected to use the simplified method for estimating the expected term as allowed by Staff Accounting Bulletin No. 107, "Share-Based Payment". Under the simplified method, the expected term is equal to the midpoint between the vesting period and the contractual term of the stock option. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a term equal to the expected term of the option assumed at the date of grant. Forfeitures are estimated at the date of grant based on historical experience. The following weighted average assumptions were used for the respective periods.

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Risk-free interest rate	4.8%	4.1%
Expected term (in years)	6.5	4.0
Dividend yield	0.0%	0.0%
Expected volatility	91.6%	68.0%
Weighted-average volatility	91.6%	68.0%

The following table represents stock option activity for the nine months ended September 30, 2006:

	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted-Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at January 1, 2006	4,868,578	\$ 8.08		
Granted	150,000	23.73		
Exercised	(215,830)	3.71		
Forfeited/Cancelled	(63,577)	17.53		
Outstanding at September 30, 2006	4,739,171	8.65	6.6	\$ 87,791,659
	4,302,184	7.81	6.4	\$ 83,308,071

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Vested and expected to vest at September  
30, 2006

Exercisable at September 30, 2006	3,058,453	4.11	5.6 \$	70,547,133
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For the nine months ended September 30, 2006, the Company granted 150,000 options to purchase shares of common stock pursuant to the 1997 Plan to newly hired members of management. The stock options vest 20% per year and expire 10 years from the date of grant. The weighted-average grant-date fair values of stock options granted during the nine months ended September 30, 2006 and 2005 were \$18.81 and \$10.17, respectively. The aggregate intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$4.3 million and \$23.8 million, respectively, determined as of the date of option exercise. As of September 30, 2006, there was approximately \$15.4 million of total unrecognized compensation cost related to unvested stock-based arrangements granted under the 1997 Plan. The cost is expected to be recognized over a weighted-average period of 3.7 years (i.e., the remaining requisite service period).

#### *Restricted Stock*

The Company has awarded restricted shares of common stock to executive officers and directors of the Company pursuant to the 1997 Plan. Compensation expense resulting from restricted stock grants is measured at fair value on the date of grant and is recognized as stock-based compensation expense over a five-year vesting period. The Company granted 33,340 shares of restricted stock to newly hired members of management pursuant to the 1997 Plan during the nine months ended September 30, 2006. As of September 30, 2006, the Company has unrecognized stock-based compensation cost of \$4.4 million associated with these awards. The cost is expected to be recognized over a weighted-average period of 4.0 years.

The following table represents restricted stock activity for the nine months ended September 30, 2006:

	<b>Shares</b>	<b>Weighted-Average Grant-Date Fair Value</b>
Nonvested at January 1, 2006	325,000	\$ 18.94
Granted	33,340	22.31
Vested	(9,500)	18.77
Nonvested at September 30, 2006	348,840	19.27

Upon the adoption of SFAS 123(R) on January 1, 2006, the Company reclassified the unrecognized deferred compensation costs associated with restricted stock awards of approximately \$5.8 million with a corresponding reduction to the Company's additional paid-in capital.

#### *2001 Employee Stock Purchase Plan (Purchase Plan)*

The Purchase Plan provides for stock purchases by all eligible employees. Under the Purchase Plan, eligible employees can have up to 15% of their earnings withheld, up to certain maximums, to be used to purchase shares of the Company's common stock at certain plan-defined dates. Through the offering period ended April 30, 2006, the price of the common stock purchased under the Purchase Plan was equal to 90% of the lower of the fair market value of the common stock on the commencement date of each three-month offering period or the specified purchase date. Effective May 1, 2006, the Company's Board of Directors removed the compensatory features of the Purchase Plan by changing the purchase price of a share of common stock for each offering period to 95% of its fair market value at the end of the offering period. For the nine months ended September 30, 2006 and 2005, 17,333 and 26,568 shares were purchased under the plan, respectively. Cash received upon the issuance of common stock under the Purchase Plan was \$0.4 million for both the nine months ended September 30, 2006 and 2005.

#### **NOTE 7 - EARNINGS PER COMMON SHARE**

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares



outstanding plus the dilutive effect of common stock equivalents using the “treasury stock” method. The components of basic and diluted earnings per share are as follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005 (As restated, see Note 2)</b>	<b>2006</b>	<b>2005 (As restated, see Note 2)</b>
(In thousands, except share and per share data)				
Numerator for basic and diluted net earnings per common share:				
Net earnings	\$ 12,790	\$ 18,033	\$ 38,300	\$ 39,652
Denominator:				
Weighted average outstanding shares of common stock	49,218,918	48,739,730	49,272,631	47,912,344
Dilutive effect of:				
Employee stock options	1,795,721	2,257,135	1,716,251	2,732,846
Restricted stock	92,723	157,599	84,106	152,982
Warrants	—	10	—	225,250
Common stock and common stock equivalents	51,107,362	51,154,474	51,072,988	51,023,422
Net earnings per share:				
Basic	\$ 0.26	\$ 0.37	\$ 0.78	\$ 0.83
Diluted	\$ 0.25	\$ 0.35	\$ 0.75	\$ 0.78

#### NOTE 8 - COMPREHENSIVE INCOME

The components of comprehensive income were net earnings and accumulated other comprehensive income. The change in accumulated other comprehensive income for all periods presented resulted from foreign translation gains and losses. Comprehensive income for the three and nine months ended September 30, 2006 and 2005 is as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005 (As restated, see Note 2)</b>	<b>2006</b>	<b>2005 (As restated, see Note 2)</b>
Net earnings	\$ 12,790	\$ 18,033	\$ 38,300	\$ 39,652
Foreign currency translation adjustment	(73)	(126)	2,646	(1,480)
Comprehensive income	\$ 12,717	\$ 17,907	\$ 40,946	\$ 38,172

#### NOTE 9 - GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. Intangible assets resulting from the acquisitions of entities accounted for using the purchase method of accounting are estimated by management based on the fair value of assets acquired. Identifiable intangible assets subject to amortization are being amortized using the straight-line method over estimated

useful lives ranging from two to twenty years.

The changes in carrying amounts of goodwill and other intangible assets for the nine months ended September 30, 2006 are as follows (in thousands):

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	<b>Balance as of January 1, 2006</b>		<b>Additions</b>		<b>Amortization</b>		<b>Foreign Exchange Translation</b>		<b>Balance as of September 30, 2006</b>
Goodwill	\$ 19,942	\$	10,027	\$	—	\$	541	\$	30,510
Intangible assets with indefinite lives	1,590		404		—		1		1,995
Intangible assets subject to amortization	15,270		5,006		(1,889)		424		18,811
Other - unallocated	3,439		(3,439)		—		—		—
	\$ 40,241	\$	11,998	\$	(1,889)	\$	966	\$	51,316

Intangible assets with indefinite lives relate primarily to a trade name. As of September 30, 2006, intangible assets subject to amortization relate primarily to the following (in thousands):

	<b>Weighted-Average Amortization period</b>		<b>Historical cost</b>		<b>Accumulated amortization</b>		<b>Net</b>
Patents	10.1 years	\$	14,042	\$	2,638	\$	11,404
Technology	2.5 years		3,353		2,941		412
Customer relationships	4.6 years		3,570		1,508		2,062
Trade name	16.6 years		5,352		419		4,933
Total		\$	26,317	\$	7,506	\$	18,811

Amortization expense, included in general and administrative expense, during the three-month periods ended September 30, 2006 and 2005 approximated \$0.7 million and \$0.6 million, respectively. Amortization expense, included in general and administrative expense, during the nine-month periods ended September 30, 2006 and 2005 approximated \$1.9 million and \$1.5 million, respectively. Amortization expense is estimated to approximate \$2.6 million, \$2.6 million, \$2.6 million, \$2.3 million and \$2.0 million for fiscal years 2006 through 2010, respectively.

#### NOTE 10 - GAIN ON SALE OF INVESTMENT

In September 2005, the Company recognized \$9.3 million as a gain on sale of an investment. The gain resulted from the acquisition by SigmaTel, Inc. of Oasis Semiconductor, Inc., a business in which the Company owned a minority equity interest, and a related dividend by Oasis immediately prior to the closing of the merger. The Company received \$8.7 million in cash and had a right to receive \$0.8 million in funds held in escrow in one year from the date of sale. The amount held in escrow was included in prepaid expenses and other current assets in the accompanying December 31, 2005 balance sheet. The Company received the \$0.8 million escrow amount in September 2006.

The Company also had a right to receive additional contingent proceeds amounting to \$0.5 million which was held back from the purchase price to cover purchase price adjustments. This amount was paid to the Company in the fourth quarter of 2005 and additional gain on sale of investment was recognized at that time.

Additionally, the Company has a right to receive a pro rata share of any additional purchase price payable under an earn-out based upon Oasis achieving specified revenues for calendar year 2006. As a result of the earn-out, the Company may receive up to approximately \$3.5 million in additional cash consideration (above and beyond any holdback received), which would be accounted for as additional gain on sale of this investment. As of December 31, 2006, the Company not received such consideration and there is no guarantee that the Company will receive any of these contingent funds.

#### NOTE 11 - SUPPLEMENTAL CASH FLOW INFORMATION



Cash paid for interest during the nine-month periods ended September 30, 2006 and 2005 approximated \$22,000 and \$47,000, respectively, substantially all of which related to long-term debt.

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The Company paid approximately \$19.2 million and \$3.9 million for income taxes during the nine-month periods ended September 30, 2006 and 2005, respectively.

The Company acquired property and equipment for approximately \$249,000 which has not yet been paid at September 30, 2006.

The Company acquired Send2Fax for an aggregate purchase price of \$7.2 million of which \$0.8 million related to a contingent holdback which has not yet been paid at September 30, 2006. Additionally, a revenue based contingent earn-out of \$0.9 million was accrued for as of September 30, 2006 and paid in January 2007.

Through the nine months ended September 30, 2006 and 2005, the Company recorded the tax benefit from the exercise of stock options as a reduction of its income tax liability in the amount of approximately \$1.4 million and \$8.7 million, respectively.

#### NOTE 12 - GEOGRAPHIC INFORMATION

The Company maintains operations in the United States, Canada, Ireland, the United Kingdom and other international territories. Geographic information about the United States and international territories for the reporting periods is presented below. Such information attributes revenues based on the location of a customer's Direct Inward Dial number for services using such a number or a customer's residence for other services:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September</b>	
	<b>2006</b>	<b>2005</b>	<b>30,</b>	<b>2005</b>
	<b>(in thousands)</b>		<b>(in thousands)</b>	
<b>Revenue:</b>				
United States	\$ 40,833	\$ 33,568	\$ 117,882	\$ 93,872
All other countries	5,058	4,121	14,293	10,926
	\$ 45,891	\$ 37,689	\$ 132,175	\$ 104,798
	<b>September</b>	<b>December</b>		
	<b>30,</b>	<b>31,</b>		
	<b>2006</b>	<b>2005</b>		
	<b>(in thousands)</b>			
<b>Long-lived assets:</b>				
United States	\$ 16,944	\$ 15,998		
All other countries	1,670	1,250		
	\$ 18,614	\$ 17,248		

#### NOTE 13 - COMMITMENTS AND CONTINGENCIES

From time to time, the Company is involved in litigation and other disputes or regulatory inquiries that arise in the ordinary course of its business. Many of these actions are filed in response to patent infringement actions filed by the Company against the plaintiffs. Any claims or regulatory actions against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of significant operational resources.

On October 11, 2005, a complaint was filed against the Company in Los Angeles Superior Court in a purported class action alleging violations of California law challenging the pricing policies applicable to the Company's eFax® service

and, in particular, the manner in which users are notified about the terms and conditions of the pricing that applies once free service thresholds are met. The action included claims for false advertising, breach of contract, fraud and violations of Section 17200 of the California Business & Profession Code. The lawsuit sought damages and injunctive relief. In November 2006, the Court sustained the Company's demurrer in all

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respects and gave plaintiffs 10 days leave to amend. Subsequently, on November 29, 2006, this action was dismissed with prejudice.

In February 2004 and July 2005, the Company filed two lawsuits against Venali in the United States District Court for the Central District of California for infringement of several of the Company's U.S. patents. On June 21, 2006, Venali filed suit against the Company and its affiliate in the United States District Court for the Southern District of Florida, alleging violations of antitrust law and various related claims arising out of the Company's procurement and enforcement of its patents. In lieu of any response to Venali's complaint, the parties reached an agreement whereby Venali dismissed its complaint without prejudice and re-filed certain of its claims as counterclaims in the patent infringement actions in California. On December 27, 2006, Venali filed amended counterclaims in the July 2005 action alleging several violations of antitrust law (fraudulent procurement of patents, fraudulent enforcement of patents, tying, and attempted monopolization) as well as tortious interference with business relationships, trademark infringement, and unfair and deceptive trade practices. Venali is seeking damages, including treble damages for the antitrust claims, injunctive relief, attorneys' fees and costs. Venali's claims relate in substantial part to the patent infringement actions by the Company against Venali.

On December 12, 2006, Venali filed suit against the Company in the United States District Court for the Southern District of Florida, alleging infringement of U.S. Patent Number 7,114,004. Venali is seeking damages in the amount of lost profits or a reasonable royalty, a permanent injunction against continued infringement, treble damages, attorneys' fees, interest and costs.

In September 2006, three derivative actions were commenced in California Superior Court for the County of Los Angeles against the Company (as a nominal defendant) and certain of the Company's current and former directors and/or officers. The complaints allege that the individual defendants breached their fiduciary duties and disseminated false financial statements by participating in improperly backdating stock option grants to provide increased compensation to Company insiders. The plaintiffs purport to assert claims for breach of fiduciary duty, unjust enrichment, abuse of control, mismanagement, corporate waste, and violations of California Corporations Code Sections 25402 and 25403. The lawsuits seek a variety of legal and equitable relief, including damages, cancellation of stock options, an accounting, recovery of profits earned by certain individual defendants in exercising the challenged options, and treble damages for violations of the California Corporations Code. One of the actions was dismissed without prejudice in October 2006 and subsequently re-filed in the United States District Court for the Central District of California. The re-filed action is substantively the same as the original complaint, except that it contains an additional claim under Section 10(b) of the Securities Exchange Act of 1934. On November 16, 2006, the same law firm that re-filed its state court action in federal court filed a second, substantively identical, derivative action in the United States District Court for the Central District of California. The two state court actions have been consolidated and the parties have stipulated to consolidate the two federal actions. None of the defendants has yet filed a response to any of the complaints. The plaintiffs in the state actions include Melinda and Anthony Hasselbring and Clement Shaw, and in the federal actions include Phillip Lawrence and Beverly Holt.

On October 17, 2006, Go Daddy Group, Inc. filed suit against the Company and its affiliate in the United States District Court for the District of Arizona. In its complaint, Go Daddy alleges several violations of antitrust law, both federal and Arizona (fraudulent procurement of patents, fraudulent enforcement of patents, conspiracy to monopolize, monopolization and attempted monopolization) as well as unfair competition, and seeks declaratory judgments of invalidity and non-infringement. Go Daddy's claims relate in substantial part to the patent infringement action by the Company against Go Daddy. Go Daddy is seeking damages, including treble damages for the antitrust claims, punitive damages, attorneys' fees and costs. The Company has moved to dismiss the action in its entirety, or alternatively to stay the action pending the reexamination of certain of its patents at issue in the case.

The Company does not believe, based on current knowledge, that the foregoing legal proceedings are likely to have a material adverse effect on its consolidated financial position, results of operations or cash flows. However, the Company may incur substantial expenses in defending against these claims. In the event of a determination adverse to

the Company, it may incur substantial monetary liability, which could have a material adverse effect on its consolidated financial position, results of operations or cash flows. In accordance with SFAS 5, *Accounting for Contingencies*, the Company has not accrued for a loss contingency relating to these legal proceedings because the Company believes that, although unfavorable outcomes in the proceedings may be reasonably possible, they are not considered by management to be probable or reasonably estimable.

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NOTE 14 - STOCKHOLDERS' EQUITY

*Common Stock Repurchase Program*

In March 2006, the Company's Board of Directors approved a common stock repurchase program authorizing the repurchase of up to 2,000,000 shares of the Company's common stock through December 2008. On April 26, 2006, the Company entered into a Rule 10b5-1 trading plan with a broker to facilitate the repurchase program. For the three and nine months ended September 30, 2006, the Company purchased 400,000 shares of common stock under this program at a total cost of \$9.7 million, representing an average price per share of \$24.29. As of September 30, 2006, 1,600,000 additional shares were available for repurchase under the program.

*Stock Split*

In April 2006, the Company's Board of Directors approved a two-for-one stock split of its common stock to be effected in the form of a stock dividend. The Board's approval was subject to approval at the Company's May 3, 2006 Annual Meeting of Stockholders of a proposal to amend Article Fourth of j2 Global's Amended and Restated Certificate of Incorporation to increase the number of shares of common stock authorized for issuance to 95,000,000. This proposal was approved at the Annual Meeting of Stockholders and the stock split was effected May 25, 2006 for shareholders of record at the close of business on May 15, 2006. Each shareholder of record received one additional share for each share held on the record date. All share and per share numbers contained herein, for all periods presented, reflect this stock split.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

*ORGANIZATION AND DESCRIPTION OF BUSINESS*

j2 Global Communications, Inc. ("j2 Global" or the "Company") is a Delaware corporation founded in 1995. By leveraging the power of the Internet, the Company provides outsourced, value-added messaging and communications services to individuals and businesses throughout the world. j2 Global offers fax, voicemail, email and call handling services and bundled suites of certain of these services. j2 Global markets its services principally under the brand names eFax<sup>®</sup>, eFax Corporate<sup>®</sup>, UniFax<sup>™</sup>, Send2Fax<sup>®</sup>, eFax Broadcast<sup>™</sup>, jBlast<sup>®</sup>, jConnect<sup>®</sup>, Onebox<sup>®</sup>, Onebox Receptionist<sup>™</sup>, eVoice<sup>®</sup>, eVoiceReceptionist<sup>™</sup> and Electric Mail<sup>®</sup>.

We deliver many of our services through our global telephony/Internet Protocol ("IP") network, which spans more than 2,700 cities in 37 countries across five continents. We have created this network, and continuously seek to expand it, through negotiating with U.S. and foreign telecommunications and co-location providers for telephone numbers (also referred to as Direct Inward Dial numbers or "DIDs"), Internet bandwidth and co-location space for our equipment. We maintain and seek to grow an inventory of telephone numbers to be assigned to new customers. Most of these numbers are "local" (as opposed to toll-free), which enables us to provide our paying subscription customers telephone numbers with a geographic identity. In addition to growing our business internally, we have used small acquisitions to grow our customer base, enhance our technology and acquire skilled personnel.

Our core services include fax, voicemail, email and call handling, as well as bundled suites of these services. These are business services that make our customers more efficient, more mobile, more cost-effective and more secure than traditional alternatives. We generate substantially all of our revenue from subscribers that pay activation, subscription and usage fees. Activation and subscription fees are referred to as "fixed" revenues, while usage fees are referred to as "variable" revenues. We also generate revenues from advertising, patent licensing fees and revenue share from our customers' use of premium rate telephone numbers. Of the nearly 11.5 million telephone numbers deployed as of September 30, 2006, more than 888,000 were serving paying subscribers, with the balance deployed to free subscribers. We operate in one reportable segment: value-added messaging and communications services, which provides for the delivery of fax, voice and email messages via the telephone and/or Internet networks.

During the past three years, we have derived a substantial portion of our revenues from the sale of our eFax and jConnect paid services, including eFax Corporate<sup>®</sup>, eFax Plus<sup>®</sup>, eFax Pro<sup>™</sup> and jConnect Premier<sup>®</sup>. These services are deployed through DIDs. As a result, we believe that paying DIDs and the revenues associated therewith are an important metric for understanding our business. It has been and continues to be our objective to increase the number of paying DIDs through a variety of distribution channels, marketing arrangements and enhanced brand awareness. In addition, we continuously seek to increase revenues through a combination of stimulating use by our customers of usage-based services, introduction of new services and instituting appropriate price increases to our fixed monthly subscription and other fees.

For the past three years, 90% or more of our total revenues have been produced by our DID based services. DID based annual revenues increased from \$67 million for fiscal 2003 to \$134 million for fiscal 2005. We expect that DID based revenues will continue to be a dominant driver of total revenues.

The following table sets forth our key operating metrics for the three and nine months ended September 30, 2006 and 2005:

**September 30,**  
**2006**                      **2005**  
(In thousands)

Free service telephone numbers	10,619	9,550
Paying telephone numbers	888	691
Total active telephone numbers	11,507	10,241

**Three Months Ended September**                      **Nine Months Ended September**  
**30,**                      **30,**  
**2006**                      **2005**                      **2006**                      **2005**  
(In thousands except percentages and average revenue per paying telephone number)

Subscriber revenues:				
Fixed	\$ 32,179	\$ 25,229	\$ 90,572	\$ 71,759
Variable	12,312	11,258	37,152	30,083
Total subscriber revenues	\$ 44,491	\$ 36,487	\$ 127,724	\$ 101,842
Percentage of total subscriber revenues:				
Fixed	72.3%	69.1%	70.9%	70.5%
Variable	27.7%	30.9%	29.1%	29.5%
Revenues:				
DID based	\$ 42,832	\$ 34,760	\$ 122,233	\$ 97,955
Non-DID based	3,059	2,929	9,942	6,843
Total revenues	\$ 45,891	\$ 37,689	\$ 132,175	\$ 104,798
Average monthly revenue per paying telephone number <sup>(1)</sup>	\$ 15.98	\$ 16.89	\$ 16.14	\$ 16.94

(1) See calculation of average monthly revenue per paying telephone number at the end of this section, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

**RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS**

The discussion and analysis set forth below in this Item 2 has been restated, as described below. For additional information, see Item 1—Note 2 to the Condensed Consolidated Financial Statements in this Form 10-Q.

We have restated the accompanying condensed consolidated financial statements as of and for the three and nine months ended September 30, 2005 to record: (1) additional non-cash stock-based compensation expense, related payroll tax expense and income tax effects resulting from stock options granted during the years 1999 through 2005 that were incorrectly accounted for under GAAP; and (2) corrections of certain other previously unrecorded accounting errors relating to the years 2000, 2002, 2003, and 2004. The adjustments in (1) and (2) affected substantially all of the line items in the condensed consolidated statements of operations for the three and nine months ended September 30, 2005. We have concluded that the foregoing adjustments are not material to our historical



consolidated financial statements for any period and therefore have not amended, and do not intend to amend, any of our previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the restatement. The financial information that has been previously filed or otherwise reported for these periods is superseded by the information in this Quarterly Report on Form 10-Q.

The stock options mentioned under (1) above had measurement date errors that resulted in additional stock-based compensation and related expenses that were previously not reported under GAAP. The financial statement adjustments relating to these stock options are based on the conclusions of an independent investigation by a special committee of our Board of Directors (“Board”) into our stock option grants and related procedures. The special committee concluded, among other things, that our practice of documenting approvals of option grants by unanimous written consent of the Board and/or the Compensation Committee rather than at a meeting, led to inadvertent errors in determining the correct measurement date to be applied to these grants. As a result of the

investigation, we have established a policy of only approving option grants at a meeting rather than by unanimous written consent.

The special committee's investigation was conducted with the assistance of independent legal counsel and independent forensic accountants which included an extensive examination of emails and other written documents and interviews with current and former employees and directors. The investigation lasted approximately four months and was concluded in December 2006. The special committee presented its investigative findings and recommendations to the Board. The following is a summary of the special committee's key findings:

There was no willful backdating.

- While there were measurement date errors associated with some option grants, they did not result from misconduct by any member of our current or former management team or Board members.
- The measurement date errors were in connection with grants to all levels of employees, including new hires and non-executive employees, and were not focused on or confined to option grants to senior executives or Board members.
- The measurement date errors resulted in option grants at prices at, above and below the price on the proper measurement date for accounting purposes.

#### *DISCUSSION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES*

In the ordinary course of business, we have made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of our financial statements. Actual results could differ significantly from those estimates under different assumptions and conditions. During the nine months ended September 30, 2006, there have been no changes in our critical accounting policies described in our 2005 Annual Report on Form 10-K filed with the SEC on March 27, 2006, except as follows:

##### *Stock-based compensation*

Effective January 1, 2006, we began accounting for stock options under the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), which requires all stock-based payments to employees, including grants of employee stock options and purchases under certain employee stock purchase plans, to be recognized as compensation expense in the results of operations. Stock-based compensation expense as required by SFAS 123(R) is recognized over the requisite employee service period based on the grant date fair value of those awards. We applied the Black-Scholes valuation model to estimate fair value of our stock-based awards which requires various assumptions including stock price volatility, forfeiture rates, and expected term.

We adopted SFAS 123(R) using the modified prospective method. Accordingly, our condensed consolidated financial statements for the three and nine months ended September 30, 2006 reflect the application of SFAS 123(R). In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). The cumulative effect upon adoption of SFAS 123(R) was not material.

In November 2005, the FASB issued FASB Staff Position No. 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards" ("FSP 123R-3"). We have elected to adopt the alternative transition method for calculating the tax effects of stock-based compensation pursuant to FAS 123R-3. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool related to the effects of employee share-based compensation, which is available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R).

##### *Section 409A Tax Compensation*

In connection with the restatement described above, we incurred certain tax related charges as discussed below.

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In December 2006 we offered each named executive officer and director the option to increase the exercise price of certain of their stock options in order to avoid potential inadvertent taxation under Internal Revenue Code Section 409A. In the first quarter of 2007 we made an aggregate compensating payment to such option holders of \$0.5 million. For the same purpose, we increased the exercise price of certain options held by all other employees during the first quarter of 2007 and will make a compensating payment to these employees of approximately \$0.1 million no later than the first quarter of 2008. We expect to accrue \$0.1 million in the first quarter of 2007 with respect to this compensating payment.

In addition, if and to the extent employees and directors have already incurred a tax liability under Section 409A we plan to reimburse such individuals for that liability plus a gross up for income taxes owed as a result of such reimbursement. The estimated impact of these reimbursements was included in general and administrative expense in the condensed consolidated statement of operations for the fourth quarter 2006 and amounted to \$0.7 million, net of tax.

*RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2006 AND 2005*

*Revenues*

*Subscriber Revenues.* Subscriber revenues consist of both a fixed monthly recurring subscription component and a variable component which is driven by the actual usage of our service offerings. Over the past three years, the fixed portion of our subscriber revenues has consistently contributed approximately 70% to our subscriber revenues. Subscriber revenues were \$44.5 million and \$36.5 million for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, subscriber revenues were \$127.7 million and \$101.8 million, respectively. The increase in subscriber revenues was primarily due to an increase in the number of our paying subscribers partially offset by a decrease in our average revenue per user as a result of a change in our pricing mix. The increase in our base of paying subscribers was primarily the result of new sign-ups derived from subscribers coming directly to our websites, free-to-paid subscriber upgrades, small to mid-sized corporate and enterprise sales, direct large enterprise and government sales, direct marketing spend for acquisition of paying subscribers and international sales, net of cancellations.

*Other Revenues.* Other revenues were \$1.4 million and \$1.2 million for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, other revenues were \$4.5 million and \$3.0 million, respectively. Other revenues consist primarily of patent licensing revenues and advertising revenues generated by delivering email messages to our free customers on behalf of advertisers. The increase in other revenues for the three and nine months ended September 30, 2006 was due primarily to an increase in patent licensing revenues together with a less significant increase in our advertising revenues.

*Stock-Based Compensation*

The following table represents the stock-based compensation expense that was included in cost of revenues and operating expenses in the accompanying condensed consolidated statements of operations for the three and nine-month periods ended September 30, 2006 and 2005 (in thousands):

	<b>Three Months Ended September</b>		<b>Nine Months Ended September</b>	
	<b>30,</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Cost of revenues	\$ 97	\$ 10	\$ 303	\$ 17
Sales and marketing	266	15	807	24
Research, development and engineering	149	2	413	10
General and administrative	995	158	3,073	321

\$ 1,507 \$ 185 \$ 4,596 \$ 372

*Cost of Revenues.* Cost of revenues are primarily comprised of costs associated with data and voice transmission, telephone numbers, network operations, customer service, on-line processing fees and equipment depreciation.

Cost of revenues was \$9.6 million, or 21% of total revenues, and \$8.1 million, or 22% of total revenues, for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, cost of revenues was \$27.9 million, or 21% of total revenues, and \$21.6 million, or 21% of total revenues, respectively. Cost of revenues as a percentage of revenues for the three and nine months ended September 30, 2006 are comparable to that of the same period of the prior year.

#### *Operating Expenses*

*Sales and Marketing.* Our sales and marketing costs consist primarily of Internet-based advertising, sales and marketing personnel costs and other business development related expenses.

Sales and marketing expenses were \$8.1 million, or 18% of total revenues, and \$5.8 million, or 15% of total revenues, for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, sales and marketing expenses were \$22.5 million, or 17% of total revenues, and \$16.8 million, or 16% of total revenues, respectively. The increase in sales and marketing expenses as a percentage of revenue for the three months ended September 30, 2006 was primarily due to increases in Internet-based marketing and partner marketing spend. The increase in sales and marketing expenses as a percentage of revenue for the nine months ended September 30, 2006 was due primarily to increased international Internet-based advertising and partner marketing spend and additional sales and marketing personnel.

*Research, Development and Engineering.* Our research, development and engineering costs consist primarily of personnel-related expenses to maintain our existing services, accommodate our service enhancements, develop and implement new services and additional service features and functionality to existing services and continue to bolster our infrastructure security.

Research, development and engineering costs were \$2.1 million, or 5% of total revenues, and \$1.8 million, or 5% of total revenues, for the three months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, research, development and engineering costs were \$6.0 million, or 5% of total revenues, and \$5.3 million, or 5% of total revenues, respectively. The increase in research, development and engineering costs for the three and nine months ended September 30, 2006 as compared to the same periods in the prior year was primarily due to stock-based compensation expense and additional personnel costs.

*General and Administrative.* Our general and administrative costs consist primarily of personnel-related expenses, depreciation and amortization, stock-based compensation expense, bad debt expense and insurance costs.

General and administrative costs were \$10.2 million, inclusive of \$1.1 million in investigation costs as more fully described in Item 1-Note 2 of the Notes to Condensed Consolidated Financial Statements of this Form 10-Q, or 22% of total revenues, and \$5.9 million inclusive of zero in investigation costs, or 16% of total revenues, for the three months ended September 30, 2006 and 2005, respectively. General and administrative costs were \$26.5 million inclusive of \$1.1 million in investigation costs, or 20% of total revenues, and \$16.8 million inclusive of zero in investigation costs, or 16% of total revenues, for the nine months ended September 30, 2006 and 2005, respectively. Excluding increases due to investigation costs, the increase in general and administrative expenses for the three and nine months ended September 30, 2006 was primarily attributable to higher stock-based compensation expense, professional fees and bad debt expense, additional personnel due to internal growth and acquisitions, and additional payroll tax expenses. General and administrative expenses as a percentage of revenue for the three and nine months ended September 30, 2006, exclusive of investigation costs and stock-based compensation expense, have remained consistent compared to the same periods in the prior year.

*Interest and Other Income, Net.* Our interest and other income, net, is generated primarily from interest income earned on cash, cash equivalents and short and long-term investments. Interest and other income, net, was \$1.6 million and \$0.9 million for the three months ended September 30, 2006 and 2005, respectively, and \$3.9 million and \$2.2 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in interest and

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other income, net, was primarily due to higher cash and investment balances and higher interest rates period-over-period.

*Gain on Sale of Investment.* In September 2005, we recognized \$9.3 million as a gain on sale of an investment. The gain resulted from the acquisition by SigmaTel, Inc. of Oasis Semiconductor, Inc., a business in which we owned a minority equity interest, and a related dividend by Oasis immediately prior to the closing of the merger. We received \$8.7 million in cash and had a right to receive \$0.8 million in funds held in escrow in one year from the date of sale. The amount held in escrow was included in prepaid expenses and other current assets in the accompanying December 31, 2005 balance sheet. We received the \$0.8 million in September 2006.

We also had a potential right to receive other certain contingent proceeds amounting to \$0.5 million which was held back from the purchase price. This amount was paid to us in the fourth quarter of 2005 and additional gain on sale of investment was recognized at that time.

Additionally, we has a right to receive a pro rata share of any additional purchase price payable under an earn-out based upon Oasis achieving specified revenues for calendar year 2006. As a result of the earn-out, we may receive up to approximately \$3.5 million in additional cash consideration (above and beyond any holdback received), which would be accounted for as additional gain on sale of this investment. As of December 31, 2006, we have not received such consideration and there is no guarantee that we will receive any of these contingent funds.

*Income Taxes.* Our effective tax rate is based on pre-tax income, statutory tax rates and tax regulations in the various jurisdictions in which we operate. Income tax expense amounted to approximately \$4.6 million and \$8.2 million for the three months ended September 30, 2006 and 2005, respectively. Income tax expense for the nine months ended September 30, 2006 and 2005 was \$14.9 million and \$16.2 million, respectively. Income tax expense for the nine months ended September 30, 2006 is based on a worldwide estimated effective tax rate for 2006 of approximately 28% compared to an effective tax rate in 2005 of approximately 31%. The decrease in our income tax rate was primarily attributable to an increasing proportion of our taxable income being sourced in foreign jurisdictions with tax rates lower than those in the U.S.

#### *Liquidity and Capital Resources*

At September 30, 2006, we had total cash and investments of \$171.0 million. This was comprised of cash and cash equivalents of \$73.4 million, short-term investments of \$83.0 million and long-term investments of \$14.6 million. Our investments are comprised primarily of readily marketable corporate debt securities, U.S. government agency securities, and auction rate debt and preferred securities. For financial statement presentation, we classify our investments as short-term and long-term based upon their maturity dates. Short-term investments primarily mature within one year of the date of the financial statements and long-term investments mature between one and six years from September 30, 2006. We classify auction rate securities as short-term investments as the established interest rate reset periods are less than one year.

Our primary sources of liquidity are cash flows generated from operations, together with cash and cash equivalents and short-term investments. For the nine months ended September 30, 2006, cash provided by operating activities primarily consisted of payments received from our subscribers, offset by cash payments we make to third parties for their services, employee compensation and tax payments. Net cash provided by operating activities was \$47.1 million and \$44.9 million for the nine months ended September 30, 2006 and 2005, respectively. Our cash and cash equivalents and short-term investments were \$156.4 million at September 30, 2006.

Prior to the adoption of SFAS 123(R), we presented all tax benefits resulting from the exercise of stock options as operating cash flows in the statement of cash flows. SFAS 123(R) requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits represent tax benefits related to exercised options in excess of the associated deferred tax assets for such options. For the nine months ended



September 30, 2006, approximately \$1.3 million of excess tax benefits have been classified as an operating cash outflow and a financing cash inflow.

Net cash used in investing activities was approximately \$3.8 million and \$49.3 million for the nine months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006, net cash used in

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investing activities was primarily attributable to, acquisitions of businesses, purchases of property and equipment, and purchases of intangible assets, offset by net purchases and redemptions of investments. For the nine months ended September 30, 2005, net cash used in investing activities was primarily comprised of net purchases and redemptions of investments, acquisitions of businesses, net purchases of property and equipment and purchases of intangible assets, partially offset by the sale of an investment.

Net cash provided by (used in) financing activities was approximately \$(7.7) million and \$2.5 million for the nine months ended September 30, 2006 and 2005, respectively. For the nine months ended September 30, 2006, net cash used in financing activities was primarily comprised of the repurchase of our common stock, offset by excess tax benefits resulting from stock option exercises and proceeds from the exercise of stock options and common shares issued under our employee stock purchase plan. For the nine months ended September 30, 2005, net cash provided by financing activities was primarily comprised of proceeds from the exercise of stock options and common shares issued under our employee stock purchase plan offset by repayments of long-term debt.

In March 2006, our Board of Directors approved a common stock repurchase program whereby we were authorized to repurchase up to 2,000,000 shares of our common stock through December 2008. On April 26, 2006, we entered into a Rule 10b5-1 trading plan with a broker to facilitate the repurchase program. For the three and nine months ended September 30, 2006, we purchased 400,000 shares of our own equity securities under this program at a total cost of \$9.7 million, representing an average price per share of \$24.29. As of September 30, 2006, we were authorized to repurchase up to 1,600,000 additional shares.

We currently anticipate that our existing cash and cash equivalents and short-term investment balances will be sufficient to meet our anticipated needs for working capital and capital expenditures for at least the next 12 months.

#### *FORWARD-LOOKING INFORMATION*

*In addition to historical information, the foregoing Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements. These forward-looking statements involve risks, uncertainties and assumptions. The actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including but not limited to those discussed below, the risk factors discussed in Item 1A "Risk Factors" of this Quarterly Report on Form 10-Q and in Part I, Item 1A "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005 (together, the "Risk Factors"), the results of any acquisition we may complete and the factors discussed in the section in this Quarterly Report on Form 10-Q entitled "Quantitative and Qualitative Disclosures About Market Risk". Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date hereof. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Readers should carefully review the risk factors described below the "Risk Factors" and the risk factors set forth in other documents we file from time to time with the SEC.*

Some factors that could cause actual results to differ materially from those anticipated in these forward-looking statements include, but are not limited to, or our ability to:

- o Sustain growth or profitability;
- o Continue to maintain, expand and retain our customer base;
- o Compete with other similar providers with regard to price, service and functionality;
- o Cost-effectively procure and retain large quantities of telephone numbers in desired locations in the United States and abroad;

- o Achieve business and financial objectives in light of burdensome telecommunications or Internet regulation or higher than expected tax rates or exposure to additional income tax liabilities;
- o Successfully manage our cost structure, including but not limited to our telecommunication and personnel related expenses;

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- o Successfully adapt to technological changes in the messaging, communications and document management industries;
  - o Successfully protect our intellectual property and avoid infringing upon the proprietary rights of others;
    - o Adequately manage growth in terms of managerial and operational resources;
- o Maintain and upgrade our systems and infrastructure to deliver acceptable levels of service quality and security of customer data and messages;
  - o Avoid unanticipated tax liabilities worldwide;
- o Introduce new services and achieve acceptable levels of returns-on-investment for those new services; and
  - o Recruit and retain key personnel.

In addition, our financial results could be materially impacted by risks associated with new accounting pronouncements, including but not limited to the impact on our tax rate of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" and Interpretation of FASB Statement No. 109."

**Calculation of Average Revenue per Paying Telephone Number:**

	<b>Three Months Ended September</b>		<b>Nine Months Ended September</b>	
	<b>30,</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(In thousands except average monthly revenue per paying telephone number)			
DID based revenues	\$ 42,832	\$ 34,760	\$ 122,233	\$ 97,955
Less other revenues	1,508	996	3,977	3,055
Total paying telephone number revenues	\$ 41,324	\$ 33,764	\$ 118,256	\$ 94,900
Average paying telephone number monthly revenue (total divided by number of months)	\$ 13,775	\$ 11,255	\$ 13,140	\$ 10,544
Number of paying telephone numbers				
Beginning of period	837	642	740	554
End of period	888	691	888	691
Average of period	862	667	814	623
Average monthly revenue per paying telephone number <sup>(1)</sup>	\$ 15.98	\$ 16.89	\$ 16.14	\$ 16.94

<sup>(1)</sup> Due to rounding, individual numbers may not recalculate.



Item 3. Quantitative and Qualitative Disclosures About Market Risk

*The following discussion of the market risks we face contains forward-looking statements. Forward-looking statements are subject to risks and uncertainties. Actual results could differ materially from those discussed in the forward-looking statements.*

We believe that our exposure to market risk related to changes in interest rates and foreign currency exchange rates is not significant, primarily because our transactions are substantially denominated in U.S. Dollars. During 2007 and in future years, we believe we will expand our international customer base and, as a result, we expect a greater level of foreign currency market risk.

We invest our cash primarily in high-grade interest-bearing securities. Our return on these investments is subject to interest rate fluctuations.

We do not have derivative financial instruments for hedging, speculative or trading purposes.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our disclosure controls and procedures are designed to provide a reasonable level of assurance of reaching our designed disclosure control objectives.

As of the end of the period covered by this report, j2 Global's management, with the participation of Nehemia Zucker, our principal executive officer, and R. Scott Turicchi, our principal financial officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, and after considering the deficiencies in the operation of controls in connection with (i) assessment of the income tax impact of the pricing for intercompany purchases of services as reported in our 2005 Annual Report on Form 10-K, and (ii) determination of the correct measurement dates to be applied to stock option grants as disclosed in Part I, Item 1-Note 2, "Restatement of Previously Issued Financial Statements" in the Notes to Condensed Consolidated Financial Statements contained herein, including the status of the remediation described below, Messrs. Zucker and Turicchi concluded that these disclosure controls and procedures were not effective as of the end of the period covered in this report.

(b) Remediation of Noted Deficiencies in Disclosure Controls and Procedures

As reported in our 2005 Annual Report on Form 10-K, an adjustment to our income tax provision was identified in the course of our annual financial statement audit. This adjustment resulted from a deficiency in the operation of controls requiring the assessment of the income tax impact of the pricing for services purchased by j2 Global Communications, Inc. from a subsidiary.

We have designed new internal control procedures to remediate the control deficiency relating to assessment of the income tax impact of pricing for intercompany purchases of services. During March 2006, we implemented a process whereby senior financial management on a monthly basis reviews and approves pricing for all intercompany transactions. Additionally, we hired a Vice President of Finance responsible for oversight of tax compliance and for

coordination with our accounting department on all intercompany transfer pricing matters. However, as of September 30, 2006 we had not yet conducted sufficient testing in order to confirm the effectiveness of these enhanced internal controls. We also have designed new internal control procedures to remediate the control deficiency over the determination of the correct measurement dates to be applied to stock option grants. These

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procedures include adoption in the fourth quarter of 2006 of new procedures for granting equity compensation which specifically require that all stock option grants be approved at a meeting of the Board of Directors and specifically prohibit approval of stock option grants through the use of unanimous written consents. However, as these new procedures did not exist as of September 30, 2006, this control deficiency was not remediated as of that date.

(c) Changes in Internal Controls

Other than expressly noted in this Item 4, there was no change in internal control over financial reporting that occurred during the third quarter of 2006 that has materially affected or is reasonably likely to materially affect j2 Global's internal control over financial reporting.



## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

#### Overview of Patent Litigation

As part of our continuing effort to prevent the unauthorized use of our intellectual property, we have initiated litigation against the following four companies, among others, for infringing our patents relating to Internet fax and other messaging technologies: Venali, Inc., Callwave, Inc., Protus IP Solutions Inc. and Go Daddy Group, Inc. On November 6, 2006 we settled our patent infringement action against EasyTel.Net. EasyTel.Net has taken a royalty-bearing license under the patents-in-suit and all litigation has been dismissed with prejudice.

#### Overview of Legal Proceedings Against Us

From time to time, we are involved in litigation and other disputes or regulatory inquiries that arise in the ordinary course of our business. Many of these actions are filed in response to patent infringement actions filed by us against the plaintiffs (see “Overview of Patent Litigation” above in this Item 1). Any claims or regulatory actions against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of significant operational resources.

On October 11, 2005, a complaint was filed against us in Los Angeles Superior Court in a purported class action alleging violations of California law challenging the pricing policies applicable to our eFax® service and, in particular, the manner in which users are notified about the terms and conditions of the pricing that applies once free service thresholds are met. The action included claims for false advertising, breach of contract, fraud and violations of Section 17200 of the California Business & Profession Code. The lawsuit sought damages and injunctive relief. In November 2006, the Court sustained our demurrer in all respects and gave plaintiffs 10 days leave to file an amended complaint. Subsequently, on November 29, 2006, this action was dismissed with prejudice.

In February 2004 and July 2005, we filed two lawsuits against Venali in the United States District Court for the Central District of California for infringement of several of our U.S. Patents. On June 21, 2006, Venali filed suit against us and our affiliate in the United States District Court for the Southern District of Florida, alleging violations of antitrust law and various related claims arising out of our procurement and enforcement of our patents. In lieu of any response to Venali’s complaint, the parties reached an agreement whereby Venali dismissed its complaint without prejudice and re-filed certain of its claims as counterclaims in the patent infringement actions in California. On December 27, 2006, Venali filed amended counterclaims in the July 2005 action alleging several violations of antitrust law (fraudulent procurement of patents, fraudulent enforcement of patents, tying, and attempted monopolization) as well as tortious interference with business relationships, trademark infringement, and unfair and deceptive trade practices. Venali is seeking damages, including treble damages for the antitrust claims, injunctive relief, attorneys’ fees and costs. Venali’s claims relate in substantial part to the patent infringement claims by us against Venali.

On December 12, 2006, Venali filed suit against us in the United States District Court for the Southern District of Florida, alleging infringement of U.S. Patent Number 7,114,004. Venali is seeking damages in the amount of lost profits or a reasonable royalty, a permanent injunction against continued infringement, treble damages, attorneys’ fees, interest and costs.

In September 2006, three derivative actions were commenced in California Superior Court for the County of Los Angeles against us (as a nominal defendant) and certain of our current and former directors and/or officers. The complaints allege that the individual defendants breached their fiduciary duties and disseminated false financial statements by participating in improperly backdating stock option grants to provide increased compensation to Company insiders. The plaintiffs purport to assert claims for breach of fiduciary duty, unjust enrichment, abuse of

control, mismanagement, corporate waste, and violations of California Corporations Code Sections 25402 and 25403. The lawsuits seek a variety of legal and equitable relief, including damages, cancellation of stock options, an accounting, recovery of profits earned by certain individual defendants in exercising the challenged options, and treble damages for violations of the California Corporations Code. One of the actions was dismissed without

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prejudice in October 2006 and subsequently re-filed in the United States District Court for the Central District of California. The re-filed action is substantively the same as the original complaint, except that it contains an additional claim under Section 10(b) of the Securities Exchange Act of 1934. On November 16, 2006 the same law firm that re-filed its state court action in federal court filed a second, substantively identical, derivative action in the United States District Court for the Central District of California. The two state court actions have been consolidated and the parties have stipulated to consolidate the two federal actions. None of the defendants has yet filed a response to any of the complaints. The plaintiffs in the state actions include Melinda and Anthony Hasselbring and Clement Shaw, and in the federal actions include Phillip Lawrence and Beverly Holt.

On October 17, 2006, Go Daddy Group, Inc. filed suit against us and our affiliate in the United States District Court for the District of Arizona. In its complaint, Go Daddy alleges several violations of antitrust law, both federal and Arizona (fraudulent procurement of patents, fraudulent enforcement of patents, conspiracy to monopolize, monopolization and attempted monopolization) as well as unfair competition, and seeks declaratory judgments of invalidity and non-infringement. Go Daddy's claims relate in substantial part to the patent infringement action by us against Go Daddy referred to above in this Item 1. Go Daddy is seeking damages, including treble damages for the antitrust claims, punitive damages, attorneys' fees and costs. We have moved to dismiss the action in its entirety, or alternatively to stay the action pending the reexamination of certain of our patents at issue in the case.

We do not believe, based on current knowledge, that any of the foregoing legal proceedings or claims are likely to have a material adverse effect on our financial position, results of operations or cash flows. However, depending on the amount and the timing, an unfavorable resolution of some or all of these matters could materially affect our business, financial position, results of operations or cash flows in a particular period.

#### Item 1A. Risk Factors

In addition to the other information set forth in this report, before deciding to invest in our company or to maintain or increase your investment, you should carefully consider the factors discussed in Part I, Item 1A "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005 (the "10-K Risk Factors"). If any of these risks occur, our business, prospects, financial condition, operating results and cash flows could be materially adversely affected. The 10-K Risk Factors are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. Except as set forth below, there are no material changes from the 10-K Risk Factors.

#### **We are exposed to risk if we cannot maintain or adhere to our internal controls and procedures.**

We have established and continue to maintain, assess and update our internal controls and procedures regarding our business operations and financial reporting. Our internal controls and procedures are designed to provide reasonable assurances regarding our business operations and financial reporting. However, because of the inherent limitations in this process, internal controls and procedures may not prevent or detect all errors or misstatements. To the extent our internal controls are inadequate or not adhered to by our employees, our business, financial condition and operating results could be materially adversely affected.

In the past, we have concluded that our controls and procedures were not effective as a result of deficiencies relating to: (i) assessment of the income tax impact of the pricing for inter-company purchases of services and (ii) determination of the correct measurement dates to be applied to stock option grants. The time needed to investigate these issues has been substantial, particularly in the case of the stock option investigation undertaken by a special committee of our board of directors. In any event, it can take time and the expenditure of significant financial and managerial resources to design and implement new control procedures to remediate a control deficiency. See "Item 4. Controls and Procedures" elsewhere in this Form 10-Q.

The occurrence of these deficiencies, especially any that constitute a material weakness, has in the past, and may in the future, result in delays in the filing of our required reports under the Securities Exchange Act of 1934, as amended. In the case of our Form 10-Q Reports for the second and this third quarter of 2006, the delays were extensive.

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If we are not able to maintain internal controls and procedures in a timely manner, or without adequate compliance, we may be unable to accurately report our financial results or prevent fraud and may be subject to sanctions or investigations by regulatory authorities such as the Securities and Exchange Commission or Nasdaq. Any such action, or restatement of prior-period financial results (see Item 1—Note 2 of the Notes to Condensed Consolidated Financial Statements), could harm our business or investors' confidence in our company, and could cause our stock price to fall.

**We may be engaged in legal proceedings that could cause us to incur unforeseen expenses and could occupy a significant amount of our management's time and attention.**

From time to time, we are subject to litigation or claims that could negatively affect our business operations and financial position. Such disputes could cause us to incur unforeseen expenses, occupy a significant amount of our management's time and attention, and negatively affect our business operations and financial condition. We are unable to predict the outcome of these cases. The defense of such lawsuits could result in substantial costs to us and a diversion of our management's attention and resources, which could impede our ability to achieve our business objectives.. Some or all of the amount we may be required to pay to defend or to satisfy a judgment or settlement of any or all of these proceedings may not be covered by insurance. Under indemnification agreements we have entered into with our current and former officers and directors, we are required to indemnify them, and advance expenses to them, in connection with their participation in proceedings arising out of their service to us. These payments may be material. For a more detailed description of the lawsuits in which we are involved, see "Item 1. Legal Proceedings."

**Price increases could decrease new subscriber sign up rates or increase cancellation rates, which could adversely affect our financial results.**

During the third quarter of 2006, we increased our price for new subscribers to our domestic eFax-branded services and during the fourth quarter of 2006 we began implementing this increase to our existing domestic e-Fax-branded subscribers, with implementation expected to be substantially completed by the end of the second quarter of 2007. The future impact of this price change cannot accurately be predicted at this time. However, the price increase will reduce new subscriber sign up rates and increase existing subscriber cancellation rates. If these negative impacts result in the incremental revenues we receive from the price increase to be lower than our expectations, our business, prospects, financial condition, operating results and cash flows could be materially adversely affected.

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

In March 2006, our Board of Directors approved a common stock repurchase program whereby we were authorized to repurchase up to 2,000,000 shares of our common stock through December 2008. On April 26, 2006, we entered into a Rule 10b5-1 trading plan with a broker to facilitate the repurchase program.

The following table details the repurchases that were made under the program during the third quarter and first nine months of 2006:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Per Share (1)</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Program</b>	<b>Maximun Number of Shares That May Yet Be Purchased Under the Progragm</b>
July 1, 2006 - July 31, 2006	—	—	—	—
August 1, 2006 - August 31, 2006	370,000	\$ 24.19	370,000	1,630,000
September 1, 2006 - September 30, 2006	30,000	\$ 25.51	30,000	1,600,000

(1) Average price paid per share excludes commissions.

Item 6. Exhibits

31(a) Rule 13a-14(a) Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31(b) Rule 13a-14(a) Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32(a) Section 1350 Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32(b) Section 1350 Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Items 3, 4 and 5 are not applicable and have been omitted.

**SIGNATURES**

Pursuant to the requirements 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.

j2 Global Communications, Inc.

Date: March 11, 2007

By: /s/ R. SCOTT TURICCHI

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R. Scott Turicchi  
Co-President and Chief Financial Officer  
(Principal Financial Officer)

j2 Global Communications, Inc.

Date: March 11, 2007

By: /s/ GREGGORY KALVIN

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Greggory Calvin  
Chief Accounting Officer  
(Principal Accounting Officer)



INDEX TO EXHIBITS

<u>Exhibit Number</u>	<u>Description</u>
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