MAGICJACK VOCALTEC LTD
Form 10-Q
August 11, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2014

OR

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

For transition period from __________ to __________

Commission file number: 000-27648

MAGICJACK VOCALTEC LTD.
(Exact name or Registrant as specified in this charter)

STATE OF ISRAEL	
(State or Other Jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

19 HARTOM STREET, BINAT BUILDING 5th FLOOR
HAR HOTZVIM, JERUSALEM 9777518, ISRAEL
(Address of principal executive offices, including zip code)

(561) 749-2255
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

There were 17,832,130 ordinary shares with no par value outstanding at July 31, 2014.

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DEFINITIONS

In this quarterly report on Form 10-Q, unless the context otherwise requires:

- references to “magicJack VocalTec,” the ”Company,” “we,” “us” or “our” are to magicJack VocalTec Ltd., a compa organized under the laws of the State of Israel (the “Registrant”), and its subsidiaries;

- references to “ordinary shares”, “our shares” and similar expressions refer to the Registrant’s Ordinary Shares, no par value;

- references to “$” or “dollars” are to U.S. dollars and all references to “NIS” are to New Israeli Shekels. Except as otherwise indicated, financial statements of, and information regarding, magicJack VocalTec are presented in U.S. dollars; and

- references to the “magicJack devices” are to the original magicJack®, the magicJack PLUSTM and the New magicJack PLUSTM.

PART I – FINANCIAL INFORMATION

ITEM 1. Financial Statements

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

ASSETS	June 30, 2014 (Unaudited)	December 31, 2013
Current assets:		
Cash and cash equivalents	$72,029	$45,997
Marketable securities, at fair value	367	8,782
Accounts receivable, net of allowance for doubtful accounts and billing adjustments of $4,083 and $3,912, respectively	4,264	3,626
Inventories	3,534	4,490
Deferred costs	1,765	4,662
Prepaid income taxes	9,746	11,956
Deferred tax assets, curent	10,540	11,267
Deposits and other current assets	2,715	818
Total current assets	104,960	91,598
Property and equipment, net	3,405	1,959
Intangible assets, net	13,106	15,656
Goodwill	32,304	32,304
Deferred tax assets, non-curent	31,753	29,684
Deposits and other non-current assets	757	693
Total assets	$186,285	$171,894
LIABILITIES AND CAPITAL EQUITY		
Current liabilities:		
Accounts payable	$6,860	$4,237
Accrued expenses and other current liabilities	8,879	9,236
Deferred revenue, current portion	55,023	54,541
Total current liabilities	70,762	68,014
Deferred revenue, net of current portion	59,547	59,951
Other non-current liabilities	6,025	6,487
Total liabilities	136,334	134,452
Commitments and contingencies (Note 9)		
Capital equity:		
Ordinary shares, No par value; 100,000 shares authorized; 25,032 and 25,029 shares issued at June 30, 2014 and December 31, 2013, respectively	111,771	111,744
Additional paid-in capital	7,919	3,692
Accumulated other comprehensive loss	-	(642)
Treasury stock (7,200 and 7,202 shares at June 30, 2014 and December 31, 2013, respectively)	(108,126)	(108,151)

Retained earnings	38,387	30,799
Total capital equity	49,951	37,442
Total liabilities and capital equity	$186,285	$171,894

See accompanying notes to condensed consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share information)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Net revenues	$29,480	$32,902	$64,793	$69,779
Cost of revenues	11,392	12,056	24,414	23,199
Gross profit	18,088	20,846	40,379	46,580
Operating expenses:				
Marketing	4,690	2,757	8,986	5,571
General and administrative	8,669	6,676	17,319	13,494
Research and development	1,375	1,774	3,119	2,636
Total operating expenses	14,734	11,207	29,424	21,701
Operating income	3,354	9,639	10,955	24,879
Other income (expense):				
Gains on investments	37	195	37	722
Interest and dividend income	49	74	95	230
Interest expense	(55)	(84)	(120)	(177)
Fair value loss on common equity put options	-	-	-	(1,047)
Other income, net	2	-	3	1
Total other income (expense)	33	185	15	(271)
Income before income taxes	3,387	9,824	10,970	24,608
Income tax expense	1,118	3,316	3,382	8,514
Net income	$2,269	$6,508	$7,588	$16,094
Net Income per ordinary share:				
Basic	$0.13	$0.35	$0.43	$0.86
Diluted	$0.13	$0.35	$0.43	$0.86
Weighted average ordinary shares outstanding:				
Basic	17,832	18,552	17,830	18,618
Diluted	17,835	18,560	17,833	18,627

See accompanying notes to condensed consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$2,269	$6,508	$7,588	$16,094
Other comprehensive income (loss):				
Reclassification of unrealized loss (gain) on marketable securities to gains on investments	1,006	(204)	642	420
Net unrealized loss on marketable securities	-	(692)	-	(2,035)
Comprehensive income	$3,275	$5,612	$8,230	$14,479

See accompanying notes to condensed consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF CAPITAL EQUITY
(in thousands)

	Ordinary Shares			Accumulated	Treasury Stock			
	Number	Amount	Additional Paid-in Capital	Other Comprehensive Loss	Number	Amount	Retained Earnings	Total Capital Equity
Balance, January 1, 2014	25,029	$111,744	$ 3,692	$ (642)	(7,202)	$(108,151)	$30,799	$37,442
Exercise of ordinary share options	3	27	-	-	-	-	-	27
Share-based compensation	-	-	4,252	-	-	-	-	4,252
Issuance of ordinary shares	-	-	(25)	-	2	25	-	-
Release of unrealized loss on marketabl esecurities to gains on investments	-	-	-	642	-	-	-	642
Net income	-	-	-	-	-	-	7,588	7,588
Balance, June 30, 2014 (unaudited)	25,032	$111,771	$ 7,919	$ -	(7,200)	$(108,126)	$38,387	$49,951

See accompanying notes to condensed consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	For the Six Months Ended June 30, 2014	2013
Cash flows from operating activities:		
Net income	$7,588	$16,094
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts and billing adjustments	298	2,000
Share-based issuances and compensation	4,252	400
Depreciation and amortization	2,830	2,531
Deferred income tax provision (benefit)	(1,342)	47
Interest expense - non-cash	120	177
Gains on investments	(37)	(722)
Fair value loss on common equity put options	-	1,047
Change in operating assets and liabilities:		
Accounts receivable	(936)	(50)
Inventories	956	(1,145)
Deferred costs	2,897	789
Prepaids and other current assets	289	(2,244)
Deposits and other non-current assets	(64)	184
Accounts payable	2,564	(1,262)
Accrued expenses and other current liabilities	(197)	1,524
Deferred revenue	78	(928)
Other non-current liabilities	782	7
Net cash provided by operating activities	20,078	18,449
Cash flows from investing activities:		
Proceeds from sales of investments	9,094	12,622
Purchases of property and equipment	(1,667)	(84)
Acquisition of intangible assets	-	(117)
Net cash provided by investing activities	7,427	12,421
Cash flows from financing activities:		
Purchase of treasury stock	-	(5,704)
Proceeds from exercise of ordinary share options	27	-
Payment of other non-current liabilities	(1,500)	(1,500)
Net cash used in financing activities	(1,473)	(7,204)
Net increase in cash and cash equivalents	26,032	23,666
Cash and cash equivalents, beginning of period	45,997	18,959
Cash and cash equivalents, end of period	$72,029	$42,625

See accompanying notes to condensed consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED
(in thousands)

	For the Six Months Ended June 30,	
	2014	2013
Supplemental disclosures:		
Interest paid	$ -	$ -
Income taxes paid	$ 165	$ 12,078
Non-cash investing and financing activities:		
Property and equipment (acquired but not paid)	$ 59	$ -

See accompanying notes to condensed consolidated financial statements.

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MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 –DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

magicJack VocalTec Ltd. and its subsidiaries (the “Company”) is a cloud communications leader that is the inventor of the magicJack devices and other magicJack products and services. magicJacks weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source, providing users with complete phone service for home, enterprise and while traveling. The Company charges customers for the right (the "access right") to access its servers, and the Company's customers then continue to have the ability to obtain free telephone services. The Company also provides additional products and services, which include voice apps on smart phones, as well as the magicJack PLUS and magicJack GO, which are updated magicJack devices that have their own CPU and can connect a regular phone directly to the user’s broadband modem/router and function as a standalone phone without using a computer. The Company's products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

magicJack VocalTec is a vertically integrated group of companies. The Company owns a micro-processor chip design company, an app server and session border controller company, a wholesale provider of voice-over-Internet-Protocol (“VoIP”) services, a softphone company, and the developer and provider of the magicJack product line. The Company also wholesales telephone service to VoIP providers and telecommunication carriers.

The Company was incorporated in the State of Israel in 1989 and is domiciled in Jerusalem, Israel, with offices in West Palm Beach, Florida.

Basis of Presentation

The Company’s unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the Company’s unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included. The balance sheet at December 31, 2013 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

The Company’s unaudited condensed consolidated financial statements are the basis for the discussion and analysis of the Company’s results of operations, liquidity and capital resources. References to authoritative accounting literature in this report, where applicable, are based on the Accounting Standards Codification (“ASC”). The Company’s functional and reporting currency is the United States Dollar (“U.S. Dollar”), which is the currency of the primary economic environment in which its consolidated operations are conducted. Transactions and balances originally denominated in U.S. Dollars are presented at their original amounts. Transactions and balances in currencies other than U.S. Dollars, including Israeli New Shekel (”NIS”), are re-measured in dollars and any gains or losses are recognized in the Company's unaudited condensed consolidated statement of operations in the period they occur.

The Company prepares its unaudited condensed consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of the Company's revenues in the three and six months ended June 30, 2014 and 2013 were from sales to customers located in the United States. The majority of the Company's revenues recognized were generated from sales of the magicJack product line and from the software access right that accompanies these products, which were $25.2 million and $28.2 million for the three months ended June 30, 2014 and 2013, respectively, and $56.0 million and $60.4 million for the six months ended June 30, 2014 and 2013, respectively. The Company also provides its customers the ability to make prepaid calls using the magicJack devices and magicJack APP by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were $2.7 million and $3.2 million for the three months ended June 30, 2014 and 2013, respectively, and $5.5 million and $6.4 million for the six months ended June 30, 2014 and 2013, respectively.

Basis of Consolidation

The Company's unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications, LLC ("VocalTec US", formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, "Dialmaxx"). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three and six months ended June 30, 2014 may not be indicative of the results for the entire year ending December 31, 2014. The interim unaudited condensed consolidated financial statements should be read in conjunction with the Company's financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this report and in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 filed on March 12, 2014.

NOTE 2 – SUMMARY OF ACCOUNTING POLICIES

A summary of significant accounting policies used in preparing the Company's financial statements follows:

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Such estimates and judgments are revised periodically as required. Actual results could differ from those estimates. Significant estimates include allowances for billing adjustments and doubtful accounts, the recoverability of long-lived assets and goodwill, income taxes, income tax valuation allowance, uncertain tax liabilities, the value of ordinary shares issued in asset acquisitions, business combinations or underlying the Company's ordinary share options, the expected forfeitures of ordinary share options and estimates of likely outcomes related to certain contingent liabilities.

The Company evaluates its estimates on an ongoing basis. The Company's estimates and assumptions are based on factors such as historical experience, trends within the Company and the telecommunications industry, general economic conditions and on various other assumptions that it believes to be reasonable under the circumstances. The results of such assumptions form the basis for making judgments about the carrying values of assets and liabilities that are not readily available. Actual results may differ from the Company's estimates and assumptions as a result of varying market and economic conditions, and may result in lower revenues and lower net income.

Net Revenues

Net revenues consists of revenue from sales of magicJack devices to retailers, wholesalers or directly to customers, access right renewal fees, fees charged for shipping magicJack, usage of domestic and international prepaid minutes, access charges to other carriers and other miscellaneous charges. Revenue is recorded net of sales returns and allowances.

Revenue Recognition

magicJack Devices Revenue

The Company recognizes revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of its software to access the Company's servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period.

Sales Return Policy

The Company offers some of its direct sales customers a 30-day free trial before they have to pay for their magicJack device. The Company does not record or recognize revenue until the 30-day trial period has expired and a customer's credit card has been charged.

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. The Company estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the three and six months ended June 30, 2014 and 2013, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

Prepaid Minutes and Access and Wholesale Charges

Revenue from prepaid minutes and access and wholesale charges are recognized as minutes are used. These revenues are generated from the usage of prepaid minutes, fees for origination of calls to 800-numbers, access fees charged to other telecommunication carriers on a per-minute basis for Interexchange Carriers ("IXC") calls terminated on the Company's servers. Revenues from access fee charges to other telecommunication carriers are recorded based on rates set forth in the respective state and federal tariffs, less a provision for billing adjustments of $18 thousand and $0.8 million for the three months ended June 30, 2014 and 2013, respectively, and $37 thousand and $2.0 million for the six months ended June 30, 2014 and 2013, respectively.

Deferred Revenues

Deferred revenues consist primarily of billings and payments for magicJack devices and sales of access rights received in advance of revenue recognition. The Company bills and collects in advance for magicJack devices, which include the access right for the software to access its servers for an initial access right period in order to obtain free domestic local and long distance broadband telephone service. Deferred revenues to be recognized over the next twelve months are classified as current and included in deferred revenue, current portion in the Company's consolidated balance sheets. The remaining amounts are classified as non-current in the consolidated balance sheets and included in deferred revenue, net of current portion.

Cost of Revenues

Cost of revenues includes direct costs of operation of the Company's servers, which are expensed as incurred. These costs include the Company's internal operating costs, depreciation and amortization expense, access and interconnection charges to terminate domestic and international telephone calls on the public switched telephone network and related taxes. Direct costs also include regulatory costs, server maintenance, and costs to co-locate the Company's equipment in other telephone companies' facilities. Direct costs of producing magicJack devices are deferred on shipment and charged to cost of sales ratably over the initial access right period. Deferred costs are included in current assets in the Company's unaudited condensed consolidated balance sheets.

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were $1.2 million and $1.2 million for the three months ended June 30, 2014 and 2013, respectively, and $2.4 million and $2.5 million for the six months ended June 30, 2014 and 2013, respectively.

Marketing Expenses

Marketing expenses of $4.7 million and $2.8 million for the three months ended June 30, 2014 and 2013, respectively, and $9.0 million and $5.6 million for the six months ended June 30, 2014 and 2013, respectively, consist primarily of advertising media buys for television commercials, Internet advertising and print advertising, as well as marketing related personnel costs and other marketing projects including sponsorships. Marketing costs are expensed when incurred. A break-down of marketing expense by category is as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Advertising media buys	$ 3,101	$ 2,396	$ 5,498	$ 4,589

Marketing personnel related	616	28	1,580	28
Other marketing projects	973	333	1,908	954
Total Marketing Expense	$ 4,690	$ 2,757	$ 8,986	$ 5,571

Research and Development Expenses

The Company's research and development activities consist primarily of the design and development of its proprietary software used in the magicJack devices, magicJack APP and its servers, as well as the development of new products and applications for use in its broadband service offerings. The Company accounts for research and development costs in accordance with applicable accounting pronouncements. These pronouncements specify that costs incurred internally in researching and developing a product should be charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all costs should be capitalized until the product is available for general release to customers. The Company has determined that technological feasibility for its products is reached after all high-risk development issues have been resolved through internal and customer base testing. Generally, new products offered to customers and improvements to the Company's servers are placed in service on attainment of technological feasibility. The Company has not capitalized any of its research and development activities and related costs. Research and development expenses were $1.4 million and $1.8 million for the three months ended June 30, 2014 and 2013, respectively, and $3.1 million and $2.6 million for the six months ended June 30, 2014 and 2013, respectively.

Earnings per Ordinary Share

Net Income per share attributable to the Company's shareholders – basic, is calculated by dividing net income attributable to shareholders by the weighted average number of ordinary shares outstanding during each period, including redeemable ordinary shares (if applicable). Income per share attributable to the Company's shareholders – diluted, is computed using the weighted average number of ordinary and potentially dilutive ordinary share equivalents outstanding during the period, including redeemable ordinary shares (if applicable). Potentially dilutive ordinary share equivalents consist of shares issuable upon the exercise or settlement of options to purchase ordinary shares or restricted stock units.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity at acquisition of three months or less to be cash equivalents.

Allowance for Doubtful Accounts and Billing Adjustments

The Company maintains an allowance for doubtful accounts and billing adjustments based on the expected collectability of its accounts receivables. That estimate is based on historical collection experience, current economic and market conditions and a review of the current status of each customer's trade accounts receivable. The allowance includes estimates of billing adjustments, which are negotiated with other telecommunications carriers and are common in the telecommunications industry.

Marketable Securities and Other Investments

Marketable securities are considered available-for-sale. Available-for-sale securities are recorded at fair value with any unrealized gains and losses reported in other comprehensive income (loss) and as a separate component of capital equity in the unaudited condensed consolidated balance sheets. Gains and losses are recorded based on specific identification by asset. The Company does not recognize changes in the fair value of its available-for-sale investments in income unless a decline in value is considered other-than-temporary in accordance with the authoritative guidance.

Common Equity Put Options

Common equity put option ("put option") contracts sold in connection with the Company's share repurchase program may expire unexercised or be assigned to the Company on or before the contract expiration date. Put option contracts exercised result in the Company purchasing its ordinary shares. Put option contracts outstanding at the end of a period are liabilities under ASC Subtopic 480-10, "Distinguishing Liabilities from Equity," and are included in accrued expenses and other current liabilities in the Company's consolidated balance sheets. These liabilities are marked-to-market at the unadjusted quoted prices in active markets for identical assets, which are Level 1 inputs. Any unrealized gains or losses are recognized as fair value gains (losses) on common equity put options in the Company's unaudited condensed consolidated statements of operations.

Certain Risks and Concentrations

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, marketable securities and accounts receivable. Cash equivalents generally consist of money market instruments and U.S. government notes. Marketable securities generally consist of equity and debt securities as well as a variety of mutual funds which primarily invest in government securities, debt, preferred stocks and equity securities.

The Company places its cash and cash equivalents in high quality financial institutions and management believes that the Company is not exposed to any significant risk on its cash accounts. The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the Federal Deposit Insurance Corporation or FDIC up to $250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at each Israeli bank are not insured. We have never experienced any losses related to these balances. At June 30, 2014, the Company had cash and cash equivalents totaling $72.0 million, which included (i) $71.7 million in U.S. banks, and (ii) $0.3 million in an Israeli financial institution.

The Company’s non-interest bearing cash balances in U.S. banks, which included $1.5 million in one individual financial institution, were fully insured. The Company had money market accounts with a brokerage institution with balances totaling approximately $70.3 million.

One telecommunications carrier accounted for approximately 26% and 28% of gross accounts receivable at June 30, 2014 and December 31, 2013, respectively. For the three and six months ended June 30, 2014 and 2013, no telecommunications carrier accounted for more than 10% of the Company’s total net revenues.

Two U.S. retail customers accounted for approximately 18% and 12% of gross accounts receivable at June 30, 2014, respectively, and one U.S. retailer accounted for 10% of gross accounts receivable at December 31, 2013. For the three and six months ended June 30, 2014 and 2013, no retailer accounted for more than 10% of the Company’s total net revenues.

Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GAAP establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company’s judgements about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 – Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 – Valuations based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 – Valuation based on inputs that are unobservable and significant to the overall fair value measurement.

When available, the Company uses quoted market prices to determine fair value, and it classifies such measurements within Level 1. Fair value measurements are classified according to the lowest level input or value-driver that is significant to the valuation. Fair value includes the consideration of nonperformance risk. Nonperformance risk refers to the risk that an obligation (either by a counterparty or the Company) will not be fulfilled. For the Company's financial assets traded in an active market (Level 1), the nonperformance risk is included in the market price. The Company’s assets and liabilities measured on a recurring basis at fair value may include marketable securities, time deposits, securities sold, not yet purchased, and common equity put options in the Company's own stock. As of June 30, 2014 and December 31, 2013, all of them are Level 1 instruments. The carrying amounts of the Company’s financial instruments, including cash and cash equivalents, accounts payable and accrued expenses are expected to approximate fair value because of their immediate availability, near term maturities or potential interest payments at settlement.

In connection with the Company’s purchase of certain intangible assets during June 2011, the Company was required to make payments of $1.5 million in May 2011, May 2012, May 2013 and May 2014, respectively, and is required to make a final non-interest bearing annual future payment of $1.5 million in May 2015. The liability for such payments has been discounted at a rate of 10% to a total fair value of $1.4 million and $2.8 million at June 30, 2014 and

December 31, 2013, respectively with $1.4 million and $1.5 million included in accrued expenses and other current liabilities at June 30, 2014 and December 31, 2013, respectively, and $1.3 million included in other non-current liabilities in the Company's December 31, 2013 unaudited condensed consolidated balance sheet. The Company believes that the $1.4 million carrying value at June 30, 2014 approximates fair value based on observable market inputs other than quoted prices for similar traded debt securities, which are Level 2 instruments. The $0.1 million unamortized discount at June 30, 2014 is being amortized using the effective interest method and recorded as interest expense in the Company's unaudited condensed consolidated statements of operations.

Any unrealized gains or losses related to put option contracts sold in connection with the Company's share repurchase program are recognized as fair value gains (losses) on common equity put options in the Company's unaudited condensed consolidated statements of operations. These liabilities are marked-to-market at the unadjusted quoted prices in active markets for identical assets, which are Level 1 inputs. As of June 30, 2014 and December 31, 2013, there were no common equity put options outstanding.

Property, Equipment and Depreciation Expense

Property and equipment consist primarily of servers, computer hardware, furniture, and leasehold improvements. Fixed assets, other than leasehold improvements, are stated at cost with depreciation provided using the straight-line method over the estimated useful lives of the related assets, which range from three to fifteen years. Leasehold improvements are stated at cost and amortized over the shorter of the term of the lease or useful life of the assets. The cost of substantial improvements is capitalized while the cost of maintenance and repairs are charged to operating expenses as incurred.

The Company's hardware consists of routers, gateways and servers that enable the Company's telephony services. Some of these assets may be subject to technological risks and rapid market changes due to the introduction of new technology, products and services and changing customer demand. These changes may result in future adjustments to the estimated useful lives and the carrying value of these assets. Changes in estimated useful lives are accounted on a prospective basis starting with the period in which the change in estimate is made in accordance with ASC Subtopic 250-10, "Accounting Changes and Error Corrections."

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management believes there is no impairment at June 30, 2014.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired. Goodwill and other intangible assets with indefinite lives are not amortized to operations, but instead are reviewed for impairment at least annually, or more frequently if there is an indicator of impairment. Indicators include, but are not limited to: sustained operating losses or a trend of poor operating performance and a decrease in the Company's market capitalization below its book value. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record impairment charges in the future. The Company currently has one reporting unit.

The Company may utilize a qualitative assessment to determine if it is "more-likely-than-not" that the fair value of the reporting unit is less than its carrying value. If so, the two-step goodwill impairment test is required to be performed. If not, no further testing is required and the Company documents the relevant qualitative factors that support the strength of its fair value. Qualitative factors may include, but are not limited to: macroeconomic conditions, industry and market considerations, cost factors that may have a negative effect on earnings, overall financial performance, and other relevant entity-specific events.

If the two-step goodwill impairment test is required to be performed, under the first step, the fair value of the reporting unit is compared with its carrying value (including goodwill). If the fair value of the reporting unit is less than its carrying value, the Company proceeds to step two of the goodwill impairment test. Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its implied fair value.

In connection with the Company's annual goodwill impairment analysis, as of October 1, 2013, the annual measurement date, the Company's analysis did not indicate any impairment of goodwill has occurred. There were no goodwill impairment indicators as of June 30, 2014.

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the period of enactment. The Company's net deferred tax assets consist of primarily foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its' net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. No adjustments were made to the valuation allowance during the three and six months ended June 30, 2014 or 2013.

The Company assesses its income tax positions and records tax benefits for all years subject to examination based upon its evaluation of the facts, circumstances and information available at the reporting date. For those tax positions that we estimate there is a greater than 50% likelihood that a tax benefit will be sustained, the Company has recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that we estimate there is a 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements.

The Company records its income tax expense for interim financial statements by using an estimated annual effective income tax rate based on its expected annual results after elimination of permanent nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2014 and changes in other deferred tax assets and liabilities are recognized during interim periods based on an annual forecast as of the interim reporting date. At June 30, 2014, the estimated annual effective income tax rate is expected to approximate 28.5%, excluding discrete tax items, which includes federal, foreign, state and local taxes. This rate may fluctuate due to changes in jurisdictional income and to the timing of other discrete period transactions during the remainder of the year.

NOTE 3 – MARKETABLE SECURITIES

The Company's marketable securities are classified as available-for-sale. As of June 30, 2014 and December 31, 2013, the available-for-sale securities consisted primarily of equity securities and time deposits, which are invested in the following (in thousands):

	June 30, 2014		
	Fair Value	Unrealized Gains	Unrealized Losses
Common equity securities	$ -	$ -	$ -
Time deposits	367	-	-
Total	$ 367	$ -	$ -

	December 31, 2013		
	Fair Value	Unrealized Gains	Unrealized Losses
Common equity securities	$ 8,415	$ -	$ (642)
Time deposits	367	-	-
Total	$ 8,782	$ -	$ (642)

The fair value of common equity securities at June 30, 2014 and December 31, 2013 was determined based on unadjusted quoted prices in active markets for identical assets, which are Level 1 inputs. The fair value of time deposits at June 30, 2014 and December 31, 2013 was determined based on its face value, which approximates its fair value and is a Level 1 input.

Gains on investments for the three months ended June 30, 2014 and 2013 was $37 thousand and $195 thousand, respectively and included reclassification of unrealized loss on marketable securities from other comprehensive losses on investments of $1.0 million and $0.2 million, respectively. Gains on investments for the six months ended June 30, 2014 and 2013 was $37 thousand and $0.7 million, respectively, and included reclassification of unrealized loss on marketable securities from other comprehensive loss to gains on investments of $0.6 million and $0.2 million, respectively. During the three months ended June 30, 2014, the Company sold investments in marketable equity securities for approximately $9.1 million realizing a gain on the sale of approximately $37 thousand over the cost basis of the investment which was determined based on specific identification.

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NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

	June 30, 2014	December 31, 2013
Raw materials	$ 1,447	$ 1,266
Finished goods	2,087	3,224
Total	$ 3,534	$ 4,490

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished goods are comprised primarily of magicJack devices on hand or in transit to the Company's distribution center in the United States. There were no write-downs of obsolete inventory for the three and six months ended June 30, 2014 and 2013.

NOTE 5 – PROPERTY AND EQUIPMENT

Property and equipment are summarized as follows (in thousands):

	Estimated Useful Lives (in years)	June 30, 2014	December 31, 2013
Switches	3 - 15	$ 8,332	$ 7,099
Computers	3 - 10	2,488	2,370
Furniture	3 - 5	252	160
Leasehold-improvements	*	511	228
Accumulated depreciation and amortization		(8,178)	(7,898)
Total		$ 3,405	$ 1,959

* The estimated useful life for leasehold improvements is the shorter of the term of the lease or life of the asset.

Depreciation expense for each of the three months ended June 30, 2014 and 2013 was $0.2 million and $0.1 million, respectively. Depreciation expense for the six months ended June 30, 2014 and 2013 was $0.3 million and $0.2 million, respectively.

NOTE 6 – INTANGIBLES ASSETS

As of June 30, 2014 and December 31, 2013, the Company had intangible assets with carrying values of $13.1 million and $15.7 million, respectively. Identified intangible assets not subject to amortization consisted of tradename and domain names with combined carrying value of $1.2 million as of June 30, 2014 and December 31, 2013. Identified intangible assets with finite lives subject to amortization consist of the following (in thousands):

Estimated	June 30, 2014			December 31, 2013	
	Accumulated	Weighted-		Accumulated	Weighted-

	Useful Lives (in years)	Gross Carrying Amount	Amortization	Net	Average Life	Gross Carrying Amount	Amortization	Net	Average Life
Technology	3 - 17	$5,221	$ (4,404)	$817	5.76	$5,221	$ (4,254)	$967	6.19
Intellectual property rights	3 - 17	14,161	(6,496)	7,665	5.51	14,161	(5,280)	8,881	5.69
Covenants not-to -compete and not-to-sue	2 - 5	5,781	(2,518)	3,263	1.48	5,781	(1,385)	4,396	1.97
Tradename	3 - 6	321	(286)	35	1.50	321	(274)	47	2.00
Customer relationships	5 - 7	750	(620)	130	3.08	750	(581)	169	3.58
Backlog	1	800	(800)	-	-	800	(800)	-	-
Total		$27,034	$ (15,124)	$11,910		$27,034	$ (12,574)	$14,460	

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Amortization expense for the three months ended June 30, 2014 and 2013 was $1.3 million and $1.2 million, respectively. Amortization expense for the six months ended June 30, 2014 and 2013 was $2.5 million and $2.3 million, respectively. Amortization expense for the six months ended June 30, 2013 included (i) a $0.2 million impairment of certain technology and customer relationships related to the VocalTec legacy products, which the Company discontinued selling in 2013, and (ii) a $0.4 million impairment of a carrier interconnection agreement as a result of more favorable rates that have become available to the Company. Based on the carrying value of identified intangible assets recorded at June 30, 2014, and assuming no subsequent impairment of the underlying assets, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

Fiscal Year		Amortization Expense
Six months ending December 31, 2014	$	2,550
2015		4,163
2016		1,564
2017		1,331
2018		854
Thereafter		1,448
	$	11,910

NOTE 7 – DEFERRED COSTS AND REVENUES

Deferred costs and revenues to be recognized over the next twelve months are classified as current and included in the Company’s unaudited condensed consolidated balance sheets. The remaining deferred revenue amounts are classified as non-current in the unaudited condensed consolidated balance sheets.

Deferred revenues are comprised of the following at June 30, 2014 and December 31, 2013 (in thousands):

		June 30, 2014		December 31, 2013
magicJack devices	$	5,707	$	14,855
Access right renewals		46,377		37,108
Prepaid minutes		2,423		2,578
Other		516		-
Deferred revenue, current		55,023		54,541
Deferred revenue, non-current*		59,547		59,951
Total deferred revenues	$	114,570	$	114,492

* Deferred revenues, non-current, is comprised entirely of deferred revenues originating from the sale of access right renewals.

Costs necessary to fulfill the Company’s obligations to provide broadband telephone service to new and existing customers who have purchased magicJack devices or access rights to access the Company’s servers are expensed as incurred. Such costs were approximately $5.0 million and $5.3 million for the three months ended June 30, 2014 and 2013, respectively, and approximately $10.6 million and $11.3 million for the six months ended June 30, 2014 and 2013, respectively.

NOTE 8 – OTHER LIABILITIES

As of June 30, 2014 and December 31, 2013, the Company had outstanding indebtedness in connection with an agreement entered during June 2011 for the purchase of certain intangible assets, and secured only by such intangible assets, under which the Company is required to make a final non-interest bearing future annual payment of $1.5 million on May 31, 2015. The liability for such payments has been discounted at a rate of 10% to a total net present value of $1.4 million and $2.8 million at June 30, 2014 and December 31, 2013, respectively, with $1.4 million and $1.5 million included in accrued expenses and other current liabilities at June 30, 2014 and December 31, 2013, respectively, and $1.3 million included in other non-current liabilities in the accompanying December 31, 2013 unaudited condensed consolidated balance sheet.

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Legal Proceedings

The Company is subject to various legal proceedings and claims, including intellectual property claims, contractual and commercial disputes, employment claims, state and local tax matters and other matters which arise in the ordinary course of business. The Company’s policy is to vigorously defend any legal proceedings. Management regularly evaluates the status of legal proceedings in which the Company is involved in order to assess whether a loss is probable or there is a reasonable possibility that a loss or additional loss may have been incurred and to determine if accruals are appropriate. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on the Company’s business, operating results, financial condition or cash flows. However, an unexpected adverse resolution of one or more of these matters could have a material adverse effect on the Company’s results of operations in a particular fiscal year or quarter.

On April 22, 2013, Arthur M. Bussel (a/k/a "Mel Arthur"), Lori A. Bussel and As Seen On TV.US, Inc. filed a lawsuit against Daniel M. Borislow, "magicJack VocalTec LLC," and YMax Corporation in Florida's Sixth Judicial Circuit Court, Pinellas County, for various claims including breach of contract. The suit is captioned Bussel v. Borislow, et al., Case No. 13-004178-CI. The Plaintiffs contend that the three Defendants were served with Summonses and Complaints on May 8, 2013; the three Defendants dispute that they were served. The three Plaintiffs filed a Motion for Default on May 29, 2013, and the Clerk of the Court entered Defaults against the three named Defendants on May 31, 2013. On June 4, 2013, the three Plaintiffs filed a Motion for Default Judgment, seeking, (i) a judgment for money damages against all three named Defendants, jointly and severally, for approximately $5.9 million, together with interest since May 31, 2012, and (ii) an Order awarding to the three Plaintiffs legal title to a 2009 Cadillac Escalade motor vehicle. No ruling has been made on Plaintiffs’ Motion for Default Judgment. On June 18, 2013, the Company and the other Defendants filed several Motions, including a Motion to Vacate Clerk’s Default, together with Motions seeking to Dismiss the Complaint, to Quash Service, and to Transfer or Dismiss the suit based on improper venue. The Company and the other Defendants also filed affidavits in support of their Motions. On September 4, 2013, the Plaintiffs filed a “Motion to Correct Misnomer in the Name of one of the Defendants.” That Motion acknowledged that references to “magicJack VocalTec, LLC” in the Complaint, and in the corresponding summons, service return and Clerk’s Default, were incorrect, and that the party being sued is properly referred to as “magicJack VocalTec, Ltd.” Plaintiff’s Motion asks the Court to amend the pleadings and process, so that they accurately reflect the name the entity that Plaintiffs contend they sought to sue, and so that Plaintiffs might gain benefit of the Clerk’s Default against the correctly named entity. The Court scheduled a hearing to address the merits of the various pending motions on May 29, 2014. On the date of the scheduled hearing the Company settled the suit at an amount that approximates the amount accrued for at December 31, 2013.

The Company believes that it files all required tax returns and pays all required state and municipal taxes (such as sales, excise, utility, and ad valorem taxes), fees and surcharges. The Company is the subject of inquiries and examinations by various state and municipalities in the normal course of business. In accordance with generally accepted accounting principles, the Company makes a provision for a liability for taxes, other than income taxes, when it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impact of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. The Company strongly believes any possible claims are without merit and vigorously defends its rights. However, if a state or municipality were to prevail in any matter, it could have a material adverse effect on the Company’s financial condition, results of operation and cash flows. In addition, it is at least reasonably possible that a potential loss may exist for tax contingencies in addition to the provisions taken by the Company. For those potential additional tax contingencies which can be reasonably estimated, that additional potential liability ranges from $0 to $2.5 million dollars.

NOTE 10 –TREASURY STOCK AND FAIR VALUE (LOSS) GAIN ON COMMON EQUITY PUT OPTIONS

The Company's Board of Directors authorized a stock repurchase program to enable the Company to purchase its ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of $100 million as of June 30, 2014. The primary objective of the Company's stock repurchase program is to improve stockholders' returns. The Company expended $91.3 million under its repurchase program through June 30, 2014. At June 30, 2014, there was $8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased, not yet retired, are recorded as treasury stock.

In prior years, the Company has bought call option contracts and has sold put option contracts in connection with its share repurchase program in order to attempt to lower the average price paid for ordinary shares it purchases. There were no outstanding put option contracts at June 30, 2014 and December 31, 2013. The Company did not repurchase any shares in the three and six months ended June 30, 2014 in connection with its share repurchase program. Taking into consideration the proceeds received from the sale of put option contracts exercised, put option contracts that expired unexercised and the purchase price of call option contracts exercised, the Company expended approximately $3.3 million purchasing 190,000 shares of outstanding ordinary shares at an average price of $17.27 during the six months ended June 30, 2013.

The Company issued 2,015 of its ordinary shares held as treasury stock with a cost of $25 thousand, or $12.32 per share, to a director as a result of restricted stock units that were granted in mid-2013, which vested during the six months ended June 30, 2014. Refer to Note 11, "Share-Based Compensation" for further details.

The Company issued 32,129 of its ordinary shares held as treasury stock with a cost of $0.5 million, or $15.54 per share (and a fair value of $0.4 million, or $12.45 per share), to settle a liability during the six months ended June 30, 2013.

The changes in treasury stock during the six months ended June 30, 2014 are as follows (in thousands, except for number of shares):

	Six Months Ended June 30, 2014	
	Number	Amount
Balance, beginning of period	7,202,242	$ 108,151
Ordinary shares issued due to vesting of restricted stock units	(2,015)	(25)
Balance, end of period	7,200,227	$ 108,126

NOTE 11 – SHARE-BASED COMPENSATION

The Company has granted ordinary share options, issued restricted stock units and ordinary shares as an alternative or supplement to the compensation of its executives, employees, directors and outside consultants. The Company's share-based compensation program is a long-term retention program intended to attract and reward talented executives, employees and outside consultants, and align their interests with stockholders. The Company is currently granting share-based awards under the magicJack Vocaltec Ltd. 2013 Stock Incentive Plan and the magicJack Vocaltec Ltd. 2013 Israeli Stock Incentive Plan (together, the "2013 Plans"). In July 2013, the shareholders approved the 2013 Plans at the annual general meeting of shareholders to allow grants of ordinary share options, restricted stock units and ordinary shares. In April 2014, the shareholders approved amendments to the 2013 Plans increasing the number of share based awards available for grant. As of June 30, 2014, the aggregate number of shares subject to awards under the 2013 Plans is 3,600,000. The Company had previously granted shares under the VocalTec amended Master Stock Plan (the "2003 Plan") which expired in April 2013. Share-based awards are generally exercisable or issuable upon vesting. The Company's policy is to recognize compensation expense for awards with only service conditions and a graded vesting on a straight-line basis over the requisite vesting period for the entire award.

The Company's share-based compensation expense for ordinary share options, issued restricted stock units and ordinary shares for the three and six months ended June 30, 2014 and 2013 was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Ordinary share options	$ 1,268	$ -	$ 3,706	$ -
Restricted stock units	315	-	546	-
Ordinary shares	-	-	-	400
	$ 1,583	$ -	$ 4,252	$ 400

The detail of total stock-based compensation recognized by classification on the condensed consolidated statements of operations is as follows (in thousands):

	Three Months Ended June 30,	Six Months Ended June 30,

	2014	2013	2014	2013
Cost of revenues	$ 127	$ -	$ 352	$ -
Marketing	323	-	1,035	-
General and administrative	966	-	2,437	400
Research and development	167	-	428	-
	$ 1,583	$ -	$ 4,252	$ 400

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Ordinary Share Options

Ordinary share options granted under the 2013 Plans have a five-year life and vest over a period of 24 to 36 months beginning at the date of grant. The 2013 Plans currently allow for a maximum term of five years for awards granted. The following table provides additional information regarding ordinary share options issued, outstanding and exercisable for the year ended December 31, 2013, and six months ended June 30, 2014 (aggregate intrinsic value in thousands):

Date of Grant	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value *
January 1, 2013	11,500	$ 6.25	7.13	$ 165
Granted	1,274,607	$ 15.04		
Exercised	(900)	$ 0.45		
Expired or cancelled	-	$ -		
December 31, 2013	1,285,207	$ 14.95	4.41	$ -
Granted	677,500	$ 14.89		
Exercised	(3,820)	$ 7.33		
Expired or cancelled	(30)	$ 147.55		
Outstanding at June 30, 2014 (unaudited)	1,958,857	$ 14.94	4.27	$ 353
Vested at June 30, 2014 (unaudited)	379,690	$ 15.29	3.99	$ -

* The aggregate intrinsic value is the amount by which the market value for the Company's common stock exceeds the weighted average exercise price of the outstanding stock options on the measurement date.

Share-based compensation expense recognized for ordinary share options was approximately $1.3 million and $0 for the three months ended June 30, 2014 and 2013, respectively, and approximately $3.7 million and $0 for the six months ended June 30, 2014 and 2013, respectively. The total intrinsic value of ordinary share options exercised during the six months ended June 30, 2014 and 2013 was $42 thousand and $7 thousand, respectively. As of June 30, 2014, there was approximately $8.4 million of unrecognized share-based compensation expense related to unvested ordinary share options, which is expected to be recognized over a weighted average period of 1.97 years.

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company’s stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include the Company’s expected stock price volatility over the term of the awards, assumed employee exercise behaviors, risk-free interest rate and expected dividends. For purposes of valuing ordinary share options, the Company used historical volatility at the date of grant. The approximate risk-free interest rate was based on the U.S. Treasury yield for comparable periods. As the Company does not have historical data available regarding employee exercise patterns, it did not anticipate any forfeiture of the ordinary share options granted and the expected term of the ordinary share options was calculated using the simplified method in accordance with SAB No. 107, “Share Based Payment.” The Company does not expect to pay dividends on its ordinary shares in the foreseeable future. Accordingly, the Company used a dividend yield of zero in its option pricing model. The weighted average fair value of ordinary share options granted during the six months ended June 30, 2014 is $5.48, and was measured at the date of grant using the following assumptions:

	Six Months Ended June 30, 2014
Expected term (in years)	3.2 - 3.5
Dividend yield	0.00 %
Expected volatility	57.2% to 58.8%
Risk free interest rate	1.08% to 1.64%
Forfeiture rate	0.00 %

Restricted Stock Units

The Company may also award non-vested restricted stock units to its executives, employees, directors and outside consultants under the 2013 Plans, which may vest based on service or a combination of service and other conditions, such as the market price of the Company's stock. The compensation expense for the award will be recognized assuming that the requisite service is rendered regardless of whether the market conditions are achieved. Each non-vested stock unit, upon vesting, represents the right to receive one ordinary share of the Company. During the six months ended June 30, 2014, the Company granted 30,500 restricted stock units under the 2013 Plans.

The following table summarizes the Company's restricted stock unit activity for the six months ended June 30, 2014:

	Number of Shares	Average Fair Value at Grant Date
December 31, 2013	154,746	$ 14.08
Granted	30,500	$ 19.15
Vested	(2,015)	$ 14.42
Forfeited	-	$ -
Non-vested at June 30, 2014	183,231	$ 14.92

During the three and six months ended June 30, 2014, the Company recognized approximately $0.3 million and $0.5 million, respectively, in share-based compensation expense related to restricted stock units. As of June 30, 2014, there was $2.0 million in unrecognized share-based compensation costs related to restricted stock units. The unrecognized share-based compensation expense is expected to be recognized over a weighted average period of 1.32 years.

Share based compensaton expense recognized for ordinary shares was approximately $0 for the three months ended June 30, 2014 and 2013, respectively, and approximately $0 and $0.4 million for the six months ended June 30, 2014 and 2013, respectively.

NOTE 12 – INCOME TAXES

Total income tax expense was $1.1 million and $3.3 million for the three months ended June 30, 2014 and 2013, respectively, and $3.4 million and $8.5 million for the six months ended June 30, 2014 and 2013, respectively. Income taxes for the three and six months ended June 30, 2014 and 2013 are the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Income before income taxes	$ 3,387	$ 9,824	$ 10,970	$ 24,608
Income tax expense	1,118	3,316	3,382	8,514
Effective income tax rate	33.01 %	33.75 %	30.83 %	34.60 %

The effective income tax rate for the three and six months ended June 30, 2014 is lower than the federal statutory rate of 35% due, in part, to the net impact of increases in the effective rate for items that are not deductible for tax purposes and state income tax expense, offset by a lower statutory tax rate on the Company's Israeli operations, which is 26.5%. The 2014 estimated annual effective tax rate is expected to approximate 28.5%, excluding discrete tax items, but may fluctuate during the year due to changes in the Company's jurisdictional income and other discrete period transactions.

NOTE 13 – INCOME PER SHARE

Net Income per share – basic, is calculated by dividing net income by the weighted average number of ordinary shares outstanding during each period. Net income per share – diluted, is computed by dividing net income attributable to shareholders by the weighted average number of ordinary and potentially dilutive ordinary share equivalents outstanding during the period. Potentially dilutive ordinary share equivalents consist of shares issuable upon the exercise or settlement of options to purchase ordinary shares, restricted stock unit grants and outstanding put option contracts on the Company’s own stock (if applicable).

Potentially dilutive securities, using the treasury stock method are set forth in the following table, which presents the computation of basic and diluted net income per ordinary share attributable to shareholders (in thousands, except for per share information):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Numerator:		(in thousands)		
Net income	$ 2,269	$ 6,508	$ 7,588	$ 16,094
Denominator:				
Denominator for basic net income per share - weighted average ordinary shares outstanding	17,832	18,552	17,830	18,618
Effect of dilutive options to purchase ordinary shares	3	8	3	9
Denominator for diluted net income per share - weighted average ordinary shares outstanding	17,835	18,560	17,833	18,627
Net income per ordinary share attributable to shareholders				
Basic	$ 0.13	$ 0.35	$ 0.43	$ 0.86
Diluted	$ 0.13	$ 0.35	$ 0.43	$ 0.86

NOTE 14 – SUBSEQUENT EVENTS

Included in intangible assets in the unaudited condensed consolidated balance sheets is a covenant not-to-compete agreement with the Company's founder and former CEO with a carrying value of approximately $2.5 million as of June 30, 2014. In July 2014, the founder and former CEO passed away. Accordingly, during the third quarter the Company will evaluate for impairment the remaining carrying value of this asset and will record any impairment charges related to this asset deemed necessary.

NOTE 15 – RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." The standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. The standard will become effective for the Company beginning January 1, 2017. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows, and financial statement disclosures.

In June 2014, the FASB issued ASU 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." The standard requires entities to treat a performance target that affects vesting and that could be achieved after the requisite service period as a performance condition. The standard is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. ASU 2014-12 may be adopted either prospectively for share-based payment awards granted or modified on or after the effective date, or retrospectively, using a modified retrospective approach. The modified retrospective approach would apply to share-based payment awards outstanding as of the beginning of the earliest annual period presented in the financial statements on adoption, and to all new or modified awards thereafter. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited condensed consolidated financial statements as of June 30, 2014 and for the three and six month periods ended June 30, 2014 and 2013, as well as our Annual Report on Form 10-K for the year ended December 31, 2013. This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, the accuracy of which involves risk and uncertainties. We use words such as "anticipates," "believes," "plans," "expects," "future," "intends," "estimates," "projects," and similar expressions to forward-looking statements. Readers should not place undue reliance on these forward-looking statements, which apply only as of the date of this report. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons. Factors that might cause or contribute to such differences include, but are not limited to those discussed under the section titled "Risk Factors" of our Form 10-K for the year ended December 31, 2013 filed on March 12, 2014.

Overview

magicJack VocalTec Ltd. and its subsidiaries (the "Company") is a cloud communications leader that is the inventor of the magicJack devices and other magicJack products and services. magicJacks weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source, providing users with complete phone service for home, enterprise and while traveling. We charge our customers highly competitive rates for the right (the "access right") to access our servers, and our customers then continue to have the ability to obtain free telephone services. We also provide additional products and services, which include voice apps on smart phones, as well as the magicJack PLUS, which is an updated magicJack device that has its own CPU and can connect a regular phone directly to the user's broadband modem/router and function as a standalone phone without using a computer. Our products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

magicJack VocalTec is a vertically integrated group of companies. We own a micro-processor chip design company, an appserver and session border controller company, a wholesale provider of VoIP services, a softphone company, and the developer and provider of the magicJack product line. We also wholesale telephone services to VoIP providers and telecommunications carriers.

Our strategy since 2007 has been to vertically integrate our technology, design and suppliers, and we have completed four acquisitions between 2007 and 2010, including a merger with the company that invented VoIP, in order to implement this strategy.

During September 2011, we began promoting the magicJack APP that can be used to make or receive telephone calls between two computers or between the customer's computer and a public switch telephone network. The customer can use a headphone or a computer's speakers and microphone to make and receive telephone calls. In September 2011, the magicJack APP also became available for the iPhone, iPad and iPod Touch. In August 2012, the magicJack APP became available for Android phones. In June 2013, we introduced the New magicJack PLUS. This new device has superior voice quality, expanded memory and enhanced processing power. The New magicJack PLUS includes a six-month right to access our servers in order to make and receive telephone calls for free. In July 2014, the Company introduced the magicJack GO which includes a twelve month right to access our servers.

Basis of Presentation

Our consolidated financial statements are prepared in conformity with United States generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, our consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in our Annual Report on Form 10-K for the year ended December 31, 2013. The balance sheet at December 31, 2013 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included.

Our consolidated financial statements are the basis for the discussion and analysis of our results of operations, liquidity and capital resources. References to authoritative accounting literature in this report, where applicable, are based on the Accounting Standards Codification ("ASC"). Our functional and reporting currency is the United States Dollar ("U.S. Dollar"), which is the currency of the primary economic environment in which our consolidated operations are conducted. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in currencies other than dollars, including Israeli New Shekel ("NIS"), are re-measured in dollars and any gains or losses are recognized in our consolidated financial statements in the period they occur.

We prepare our consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of our revenues in the three and six months ended June 30, 2014 and 2013 were derived from sales to customers located in the United States.

Basis of Consolidation

Our consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications LLC ("VocalTec US", formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, "Dialmaxx"). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three and six months ended June 30, 2014 may not be indicative of the results for the entire year ending December 31, 2014. The interim unaudited consolidated financial statements should be read in conjunction with our financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this report and in our Annual Report on Form 10-K for the year ended December 31, 2013 filed on March 12, 2014.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Such estimates and judgments are revised periodically as required. Actual results could differ from those estimates. Significant estimates include allowances for billing adjustments and doubtful accounts, the recoverability of long-lived assets and goodwill, income taxes, income tax valuation allowance, uncertain tax liabilities, the value of ordinary shares issued in business combinations or underlying our ordinary share options, the expected forfeitures of ordinary share options and estimates of likely outcomes related to certain contingent liabilities.

We evaluate our estimates on an ongoing basis. Our estimates and assumptions are based on factors such as historical experience, trends within the Company and the telecommunications industry, general economic conditions and on various other assumptions that we believe to be reasonable under the circumstances. The results of such assumptions form the basis for making judgments about the carrying values of assets and liabilities that are not readily available. Actual results may differ from our estimates and assumptions as a result of varying market and economic conditions, and may result in lower revenues and lower operating income.

CRITICAL ACCOUNTING POLICIES

We have identified below our critical accounting policies. These policies are both the most important to the portrayal of our financial condition and results of operations and require our management's most difficult, subjective and complex judgments and estimates. Actual results may differ from these estimates under different assumptions or conditions.

REVENUE RECOGNITION

Net revenues consists of revenue from sales of the magicJack devices to retailers, wholesalers or directly to customers, access rights fees, fees charged for shipping the magicJack devices, usage of prepaid minutes, access charges to other carriers and other miscellaneous charges for telecommunication usage. Revenue is recorded net of sales returns and allowances.

magicJack Devices Revenue

We recognize revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of our software to access our servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period.

Sales Return Policy

We offer some of our direct sales customers a 30-day free trial before they have to pay for their magicJack device. We do not record or recognize revenue until the 30-day trial period has expired and a customer's credit card has been charged.

Returns from retailers are accepted on an authorized basis for devices deemed defective. We may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. We estimate potential returns under these arrangements at point of sale and re-estimate potential returns on a quarterly basis. For the three months and six months ended June 30, 2014 and 2013, our estimates of returns and actual returns from initial stocking orders have not been materially different.

Prepaid Minutes and Access and Wholesale Charges

Revenue from prepaid minutes and access and wholesale charges are recognized as minutes are used. These revenues are generated from the usage of prepaid minutes, fees charged to telecommunications carriers or providers for origination of their calls to 800-numbers, access fees charged to other telecommunications carriers or providers on a per-minute basis for Interexchange Carriers ("IXC") calls terminated to our end-users. Revenues from access fee charges to other telecommunications carriers are recorded based on rates set forth in the respective state and federal tariffs or negotiated contract rates, less a provision for billing adjustments.

INCOME TAXES

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. Our net deferred tax assets consist of primarily foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. We record a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. At December 31, 2013, based on a number of factors, including cumulative profitability over the preceding three years and expected future results, we released $40.5 million of the valuation allowance recorded against net deferred tax assets. We determined that a valuation allowance of $17.6 million at December 31, 2013 was necessary to reduce the net deferred tax assets to the amount that will more-likely-than-not be realized. We periodically review the composition of our net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required. No adjustments were made during the six months ended June 30, 2014.

We assess our income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting date. For those tax positions that we estimate there is a greater than 50% likelihood that a tax benefit will be sustained, we have recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that we estimate there is a 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements.

We record our income tax expense for interim financial statements by using an estimated annual effective income tax rate based on our expected annual results after elimination of nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2014 and certain other deferred tax assets were recognized for financial reporting purposes at December 31, 2013. At June 30, 2014, the estimated annual effective income tax rate is expected to approximate 28.5%, which includes federal, foreign, and state and local taxes. This rate may fluctuate due to changes in our jurisdictional income and due to the timing of other discrete period transactions during the remainder of the year.

SHARE-BASED COMPENSATION

Share-based compensation generally consists of option grants or ordinary share and restricted stock units awards to directors, officers, employees or consultants. We account for share-based compensation in accordance with ASC Topic 718, "Compensation - Stock Compensation" (“ASC 718”). ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant based on the fair value of the award. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in our consolidated statement of operations.

RESULTS OF OPERATIONS

The following table presents our consolidated results of operations for the periods indicated (in thousands). The condensed consolidated statements of operations below have been expanded to show the composition of our net revenues and cost of revenues items to enable a more meaningful discussion of our operations.

	Three Months Ended June 30,		2014 Compared to 2013		Six Months Ended June 30,		2014 Compared to 2013	
	2014	2013			2014	2013		
Net Revenues								
Sale of magicJack devices	$6,497	$11,172	$(4,675)	(41.8)%	$18,479	$26,193	$(7,714)	(29.5)%
Access right renewals	16,138	14,149	1,989	14.1	31,544	27,669	3,875	14.0
Shipping and handling	638	938	(300)	(32.0)	1,512	1,918	(406)	(21.2)
magicJack-related products	1,931	1,967	(36)	(1.8)	4,428	4,584	(156)	(3.4)
Prepaid minutes	2,648	3,209	(561)	(17.5)	5,476	6,442	(966)	(15.0)
Access and wholesale charges	1,625	1,494	131	8.8	3,347	3,037	310	10.2
Other	3	(27)	30	111.1	7	(64)	71	110.9
Total Net Revenue	29,480	32,902	(3,422)	(10.4)	64,793	69,779	(4,986)	(7.1)
Cost of Revenues								
Cost of magicJack devices	3,189	3,731	(542)	(14.5)	7,648	6,011	1,637	27.2
Shipping and handling	575	597	(22)	(3.7)	948	1,181	(233)	(19.7)
Credit card processing fees	668	584	84	14.4	1,450	1,352	98	7.2
Network and carrier charges	5,025	5,299	(274)	(5.2)	10,572	11,296	(724)	(6.4)
Other	1,935	1,845	90	4.9	3,796	3,359	437	13.0
Total Cost of Revenues	11,392	12,056	(664)	(5.5)	24,414	23,199	1,215	5.2
Gross Profit	18,088	20,846	(2,758)	(13.2)	40,379	46,580	(6,201)	(13.3)
Operating expenses:								
Marketing	4,690	2,757	1,933	70.1	8,986	5,571	3,415	61.3
General and administrative	8,669	6,676	1,993	29.9	17,319	13,494	3,825	28.3
Research and development	1,375	1,774	(399)	(22.5)	3,119	2,636	483	18.3
Total operating expenses	14,734	11,207	3,527	31.5	29,424	21,701	7,723	35.6
Operating income	3,354	9,639	(6,285)	(65.2)	10,955	24,879	(13,924)	(56.0)

Other income (expense):								
Gains on investments	37	195	(158)	*	37	722	(685)	*
Interest and dividend income	49	74	(25)	*	95	230	(135)	*
Interest expense	(55)	(84)	29	*	(120)	(177)	57	*
Fair value loss on common equity put options	-	-	-	*	-	(1,047)	1,047	*
Other income, net	2	-	2	*	3	1	2	*
Total other income (expense)	33	185	(152)	*	15	(271)	286	*
Income before income taxes	3,387	9,824	(6,437)	(65.5)	10,970	24,608	(13,638)	(55.4)
Income tax expense	1,118	3,316	(2,198)	*	3,382	8,514	(5,132)	*
Net income	$2,269	$6,508	$(4,239)	(65.1)	$7,588	$16,094	$(8,506)	(52.9)

* - Not meaningful.

Components of Net Revenues

Our net revenues are comprised of the following sources:

- Sales of the magicJack devices – represents revenues recognized from sales of the magicJack devices to retailers, wholesalers, or direct to customers, net of returns, over the period associated with the initial six or twelve months access right period. These revenues are recorded net of sales allowance, chargebacks, retailer discounts and advertising allowances;

- Access right renewals – represents revenues from customers purchasing rights to access our servers beyond the initial access right period included with a magicJack device or magicJack service. The extended access right ranges from one month to five years. These fees charged to customers are initially deferred and recognized as revenue ratably over the extended access right period;

- Shipping and handling – represents charges for shipping and handling fees for magicJack devices shipped directly to customers. The fees are initially deferred and recognized as revenues over the initial six or twelve months access right period associated with the magicJack device;

- magicJack-related products – represents revenues recognized from the sale of other items related to the magicJack devices and access right renewals we offer our customers, including: (i) porting fees charged to customers to port their existing phone number to a magicJack device or service, (ii) fees charged for customers to select a custom, vanity or Canadian phone number, (iii) fees charged to customers to change their existing number, and (iv) insurance covering the replacement of a damaged or lost device;

- Prepaid minutes – represents revenues recognized primarily from the usage and expiration of international prepaid minutes, net of chargebacks;

- Access and wholesale charges – represents revenues generated from: (i) access fees charged to other telecommunication carriers or providers for Inter-exchange Carriers (“IXC”) calls terminated to our end-users, and (ii) fees charged to telecommunications carriers or providers for origination of calls to their 800-numbers. These revenues are recorded based on rates set forth in the respective state and federal tariffs or negotiated contract rates, less provisions for billing adjustments; and

- Other – represents primarily revenues generated by ancillary revenue sources.

Components of Cost of Revenues

Our cost of revenues is comprised of the following components:

- Cost of magicJack devices – represents the costs of components and manufacturing of the magicJack devices, as well as broker commissions, production, packaging and other inventory-related costs. The cost of components and manufacturing of the magicJack devices is recognized from sales of the magicJack devices to retailers, wholesalers, or direct to customers and is charged to expense over the period associated with the initial six or twelve months access right period;

- Shipping and handling – represents freight, postage and other transportation costs related to: (i) transportation of the magicJack devices from the manufacturer to our warehouse and distribution center, and (ii) freight, shipping and handling fees incurred to ship the magicJack devices to retailers and directly to customers. These costs are expensed as incurred;

- Credit card processing fees – represents transaction and other fees incurred as a result of accepting credit card payments for sales of magicJack devices, access right renewals, shipping and handling charges, magicJack related products and prepaid minutes sold directly to customers through our website. These fees are expensed as incurred;

- Network and carrier charges – represents facilities charges to establish and maintain our network as well as network usage fee charges from other telecommunications carriers. These rates or charges are based upon commercial agreements or applicable state and/or federal tariffs. These charges are expensed as incurred; and

- Other – represents allocation of personnel-related costs, amortization and depreciation expense related to assets employed in generating our revenues, as well as costs from sources we ceased selling.

THREE MONTHS ENDED JUNE 30, 2014 COMPARED TO THREE MONTHS ENDED JUNE 30, 2013

Net Revenues

Total net revenue was $29.5 million and $32.9 million for the three months ended June 30, 2014 and 2013, respectively, representing a decrease of $3.4 million, or 10.4%. The decrease in the components of net revenues was primarily attributable to the following:

- $4.7 million decrease in revenues from the sale of magicJack devices and related products primarily reflecting lower price points and sales volumes as the Company's retail partners were decreasing their on-hand-inventory levels of the New magicJack Plus device in preparation for the July 2014 launch of the magicJack Go device;
- $0.3 million decrease in shipping and handling revenue reflecting the lower sales volumes; and
- $0.6 million decrease in revenues from prepaid minutes resulting from lower usage levels.

These decreases in components of net revenue were partially offset by a $2.0 million increase in access right renewal revenues reflecting higher average renewal rates, a higher number of devices on renewal and the impact of e-mail marketing to expiring customers. In addition, access and wholesale charges increased $0.1 million reflecting increased network access fees resulting from increased network usage.

For the three months ended June 30, 2014 and 2013, sales of the magicJack devices through retail outlets represented approximately 80% and 78%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 20% and 22%, respectively, of magicJack devices sold. For the three months ended June 30, 2014 and 2013, no retailer accounted for more than 10% of the Company's total net revenue.

Cost of Revenues

Total cost of revenues was $11.4 million and $12.1 million for the three months ended June 30, 2014 and 2013, respectively, representing a decrease of approximately $0.7 million, or 5.5%. This decrease in cost of revenues was primarily attributable to a $0.5 million, or 14.5% decrease in the cost of magicJack devices resulting primarily from lower device sales volumes partially offset by higher per unit costs reflecting shorter amortization periods on the new devices. Additionally, network and carrier charges decreased $0.3 million, or 5.2% reflecting better negotiated rates with other carriers.

These decreases in cost of revenues were partially offset by a $0.1 million, or 14.4% increase in credit card processing fees reflecting higher access renewal volume in the three months ended June 30, 2014.

Operating Expenses

Total operating expenses were $14.7 million and $11.2 million for three months ended June 30, 2014 and 2013, respectively, representing an increase of $3.5 million, or 31.5%. This increase in operating expenses is attributable to: (i) a $1.9 million increase in marketing expense reflecting increased media buys and marketing related spends related to the Company's brand refresh and new advertising campaigns as well as higher personnel related costs reflecting the ramp up of staff and other payroll related allocations; (ii) a $2.0 million increase in G&A expense due to several factors including higher personnel related costs reflecting increased stock-based and executive compensation costs which were not present in the first quarter of 2013, higher legal and professional fees related to legal and tax matters, amortization expense associated with a non-compete with the Company's founder, increases in customer service related costs reflecting our commitment to investing in the customer experience, as well as smaller increases in occupancy costs and insurance expense. These increases were partially offset by a $0.4 million decrease in R&D related expenses reflecting lower consulting costs that were partially offset by an increase in personnel related costs primarily related to allocated costs associated with new positions and stock based compensation costs.

Other Income

Total other income was $33 thousand and $185 thousand for the three months ended June 30, 2014 and 2013, respectively, representing a decrease of $152 thousand. This decrease in other income was primarily due to a decrease in gains on investments of $158 thousand for the three months ended June 30, 2014 vs. the three months ended June 30, 2013. During the three months ended June 30, 2014, we sold the last of our investments in marketable equity securities realizing a gain on the sale of approximately $37 thousand.

Income Taxes

Total income tax expense was $1.1 million and $3.3 million for the three months ended June 30, 2014 and 2013, respectively. The principal components of our income taxes for the three months ended June 30, 2014 and 2013 are the following (in thousands):

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013
Income before income taxes	$ 3,387	$ 9,824
Income tax expense	1,118	3,316
Effective income tax rate	33.01 %	33.75 %

At December 31, 2013, we released $40.5 million of our valuation allowance against certain deferred tax assets related primarily to foreign net operating loss carry-forwards and deferred revenue that are expected to be realized in 2014, 2015 and 2016. These benefits are expected to reduce income taxes payable as realized and will not affect our effective tax rate. The effective income tax rate for the three months ended June 30, 2014 is lower than the federal statutory rate of 35% due, in part, to the net impact of increases in the effective rate for items that are not deductible for income tax purposes and state income tax expense, offset by a lower statutory tax rate on our Israeli operations, which is 26.5%. The 2014 estimated annual effective tax rate is expected to approximate 28.5%, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

Net income

As a result of the foregoing items, net income decreased to $2.3 million in the three months ended June 30, 2014, as compared to $6.5 million in the three months ended June 30, 2013. Net income per diluted share decreased to $0.13 per ordinary share for the three months ended June 30, 2014, as compared to $0.35 per ordinary share in the prior year comparable period primarily as a result of decreased profitability, offset in part by a decrease of approximately 0.7 million (or 4%) in the weighted average number of diluted ordinary shares outstanding in the three months ended June 30, 2014 as compared to the prior year comparable period.

SIX MONTHS ENDED JUNE 30, 2014 COMPARED TO SIX MONTHS ENDED JUNE 30, 2013

Net Revenues

Total net revenue was $64.8 million and $69.8 million for the six months ended June 30, 2014 and 2013, respectively, representing a decrease of $5.0 million, or 7.1%. The decrease in the components of net revenues was primarily attributable to the following:

- $7.7 million decrease in revenues from the sale of magicJack devices primarily reflecting lower price points and sales volumes as the Company’s retail partners were decreasing their on-hand-inventory levels of the New magicJack Plus device in preparation for the July 2014 launch of the magicJack Go device;
- $0.4 million decrease in shipping and handling revenue reflecting the lower sales volumes;
- $0.2 million decrease in magicJack related product revenue reflecting lower volumes; and
- $1.0 million decrease in revenues from prepaid minutes resulting from lower usage levels.

These decreases in components of net revenue were partially offset by a $3.9 million increase in access right renewal revenues reflecting higher average renewal rates, a higher number of devices on renewal and the impact of e-mail marketing to expiring customers. In addition, access and wholesale charges increased $0.3 million reflecting increased network access fees resulting from increased network usage.

For the six months ended June 30, 2014 and 2013, sales of the magicJack devices through retail outlets represented approximately 75% of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 25% of magicJack devices sold. For the six months ended June 30, 2014 and 2013, no retailer accounted for more than 10% of the Company’s total net revenue.

Cost of Revenues

Total cost of revenues was $24.4 million and $23.2 million for the six months ended June 30, 2014 and 2013, respectively, representing an increase of approximately $1.2 million, or 5.2%. This increase in cost of revenues was primarily attributable to a $1.6 million increase in the cost of magicJack devices resulting from higher per unit costs reflecting shorter amortization periods on the new devices as well as higher broker commissions due to a $1.1 million one-time first quarter 2013 favorable settlement with a retail sales broker, and an increase in overhead allocation primarily reflecting higher personnel related costs.

These increases in cost of revenues were partially offset by a $0.2 million decrease in shipping and handling costs as a result of fewer units sold in the six months ended June 30, 2014 as we started preparing to launch a new product in mid-2014, and a $0.7 million reduction in network and carrier charges reflecting better negotiated rates with other carriers, the net favorable settlement of certain billing disputes and the continued implementation of a 2011 Federal Communications Commission ("FCC") ruling which favorably impacted the rating and pricing of some of our of our network traffic.

Operating Expenses

Total operating expenses were $29.4 million and $21.7 million for the six months ended June 30, 2014 and 2013, respectively, representing an increase of $7.7 million, or 35.6%. This increase in operating expenses is attributable to: (i) a $3.4 million increase in marketing expense reflecting increased media buys and marketing related spends related to the Company's brand refresh and new advertising campaigns as well as higher personnel related costs reflecting the ramp up of staff and other payroll related allocations; (ii) a $3.8 million increase in G&A expense due to several factors including higher personnel related costs reflecting increased stock-based and executive compensation costs which were not present in the first half of 2013, higher legal and professional fees related to legal and tax matters, amortization expense associated with a non-compete with the Company's founder, increases in customer service related costs reflecting our commitment to investing in the customer experience, as well as smaller increases in occupancy costs and insurance expense; (iii) a $0.5 million increase in R&D related expenses related to new product costs and increased personnel related costs primarily related to allocated costs associated with new positions and stock based compensation costs.

Other Income

Total other income was $15 thousand for the six months ended June 30, 2014 versus total other expense of $271 thousand for the six months ended June 30, 2013, representing an increase of $0.3 million. This increase in other income was primarily due to a fair value loss on common equity put options of approximately $1.0 million in 2013 when we sold common equity put option contracts in connection with our share repurchase program in order to attempt to lower the average share price paid for ordinary shares we purchased. There was no such loss in 2014 as we did not repurchase shares during the six months ended June 30, 2014. This was partially offset in part by a decrease in gains on investments of $0.7 million and a reduction of interest and dividend income of $0.1 million.

Income Taxes

Total income tax expense was $3.4 million and $8.5 million for the six months ended June 30, 2014 and 2013, respectively. The principal components of our income taxes for the six months ended June 30, 2014 and 2013 are the following (in thousands):

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Income before income taxes	$ 10,970	$ 24,608
Income tax expense	3,382	8,514
Effective income tax rate	30.83 %	34.60 %

At December 31, 2013, we released $40.5 million of our valuation allowance against certain deferred tax assets related primarily to foreign net operating loss carry-forwards and deferred revenue that are expected to be realized in 2014, 2015 and 2016. These benefits are expected to reduce income taxes payable as realized and will not affect our effective tax rate. The effective income tax rate for the six months ended June 30, 2014 is lower than the federal statutory rate due, in part, to the net impact of increases in the effective rate for items that are not deductible for income tax purposes and state income tax expense, offset by a lower statutory tax rate on our Israeli operations, which is 26.5%. The 2014 estimated annual effective tax rate is expected to approximate 28.5%, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

Net income

As a result of the foregoing items, net income decreased to $7.6 million in the six months ended June 30, 2014, as compared to $16.1 million in the six months ended June 30, 2013. Net income per diluted share decreased to $0.43per ordinary share for the six months ended June 30, 2014, as compared to $0.86 per ordinary share in the prior year comparable period as a result of decreased profitability, offset in part by a decrease of approximately 0.8 million (or 4%) in the weighted average number of diluted ordinary shares outstanding in the six months ended June 30, 2014 as compared to the prior year comparable period due to our share repurchase program.

BUSINESS TRENDS

Renewal revenues have remained strong during the three and six months ended June 30, 2014. We are encouraged by the loyalty of our existing customer base and we continue to undertake efforts to improve our customer renewal rates. Direct and retail device sales declined during the three and six months ended June 30, 2014, primarily reflecting lower sales volumes as our retail partners were decreasing their on-hand-inventory levels of the New magicJack Plus device in preparation for the launch of the magicJack GO device. We are repositioning the device with the launch of the magicJack GO and the accompanying increased promotion of the magicApp companion service. We believe that there will continue to be solid consumer demand for our low priced, unlimited phone service, whether through our magicJack device, our magicAPP, or a combination of both.

Furthermore, we are working with Telefonica to expand distribution of our product into Latin American markets where we believe that there is significant potential for growth. With the launch of the magicJack GO and the strategic shift of more fully integrating the device with the app, we are focused during the second half of 2014 and beyond on driving sales growth through monetizing the magicApp and integrating the full range of our product offerings including the sale of international prepaid minutes. The following factors could materially adversely effect our growth strategy to integrate the device with the app and monetize the magicApp: if we experience any further delays in the implementation of technical developments needed to position the magicAPP for monetization; the fact that we have not previously generated any material revenues from the magicAPP as it has been a free service to date; and the redeveloped magicAPP will, when launched, compete with other large, well-capitalized global companies in the telecom APP industry who are introducing low priced consumer offers into the marketplace on an ongoing basis. We cannot assure that the features we offer for monetization of the magicAPP will, when introduced, be attractive to consumers at the price points we offer, or at all.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash generated from operations and cash on hand and investments. As of June 30, 2014, we had cash and cash equivalents of $72.0 million, available-for-sale marketable securities of $0.4 million and accounts receivables of $4.3 million. Our accounts payable at June 30, 2014 was $6.9 million.

During the six months ended June 30, 2014, we generated positive operating cash flows of $20.0 million, as compared to $18.4 million for the six months ended June 30, 2013. The $1.6 million increase was primarily due to higher sales of access right renewals, offset in part by lower sales of magicJack devices in the six months ended June 30, 2014, and estimated income tax payments made in 2013. Net income was $7.6 million for the six months ended June 30, 2014 as compared to $16.1 million for the six months ended June 30, 2013. We currently believe that available funds and cash flows generated by operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months. If we decide to make future acquisitions, we may require new sources of funding, including additional debt, equity financing or some combination thereof. There can be no assurances that we will be able to secure additional sources of funding or that such additional sources of funding will be available to us on acceptable terms.

Cash Flow – Operating Activities

Net cash provided by operating activities was $20.1 million and $18.4 million for the six months ended June 30, 2014 and 2013, respectively.

During the six months ended June 30, 2014, net cash provided by operating activities was primarily attributable to: (i) $7.6 million of net income, (ii) $6.1 million in non-cash items consisting of $4.3 million of stock-based compensation expense, $2.8 million of depreciation and amortization expense, and a $0.3 million provision for billing adjustments partially offset by a $1.3 million decrease in the deferred income tax provision, (iii) $0.3 million decrease in prepaid and other current assets including prepaid income taxes, (iv) $2.9 million decrease in deferred costs, (v) a $1.0 million decrease in inventory levels, (vi) a $2.6 million increase in accounts payable, (vii) a $0.1 million increase in deferred revenue primarily associated with access right renewals, and (viii) a $0.8 million increase in other non-current liabilities. These items were partially offset by: (i) a $0.9 million increase in accounts receivable (ii) a $0.1 million increase in deposits and other non-current assets, and (iii) a $0.2 million decrease in accrued expenses.

During the six months ended June 30, 2013, net cash provided by operating activities was primarily attributable to: (i) a $16.1 million net income, (ii) $5.5 million in non-cash items consisting of $2.5 million for depreciation and amortization expense, a $2.0 million provision for billing adjustments, $0.4 million in treasury stock issued to settle a liability and a $0.3 million combined net loss on common equity put options and investments, and (ii) a $1.5 million decrease in accrued expenses and other current liabilities driven primarily by the accrual of executive bonuses. These items were partially offset by: (i) an increase in prepaid income taxes attributable to us making estimated tax payments, and (ii) an increase in inventories as a result of an increase in finished goods inventory for the launch of the New magicJack PLUS in late June 2013.

Cash Flow – Investing Activities

Net cash provided by investing activities was $7.4 million and $12.4 million for the six months ended June 30, 2014, and 2013, respectively.

Net cash provided by investing activities during the six months ended June 30, 2014 was primarily attributable to $9.1 million proceeds from sale of investments, offset in part by $1.7 million used to purchase equipment and leasehold improvements primarily due to upgrades to our data storage facility and new warehouse and distribution center.

Net cash provided by investing activities during the six months ended June 30, 2013 was primarily attributable to $12.6 million proceeds from sale of investments, offset in part by $0.1 million used to purchase certain intangible assets and $0.1 million used to purchase equipment.

Cash Flow –Financing Activities

Net cash used in financing activities was $1.5 million and $7.2 million for the six months ended June 30, 2014 and 2013, respectively.

Net cash used in financing activities during the six months ended June 30, 2014 consisted primarily of a $1.5 million annual payment in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets.

Net cash used in financing activities during the six months ended June 30, 2013 consisted of: (i) $5.7 million in cash used to purchase ordinary shares as part of our stock repurchase program, and (ii) $1.5 million annual payment in connection with an agreement entered during June 2011 for the purchase of certain intangible assets.

Stock Repurchase Program

Our Board of Directors authorized a stock repurchase program to enable us to purchase our ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of $100.0 million as of June 30, 2014. The primary objective of our stock repurchase program is to improve stockholders' returns. We expended $91.3 million under our repurchase program through June 30, 2014. At June 30, 2014, there was $8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased, not yet retired, are recorded as treasury stock.

We have bought call option contracts and have sold put option contracts in connection with our share repurchase program in order to attempt to lower the average price paid for ordinary shares we purchase. There were no outstanding put option contracts at June 30, 2014. We did not repurchase any ordinary shares under our stock repurchase program during the six months ended June 30, 2014. Taking into consideration the proceeds received from the sale of put option contracts exercised, put option contracts that expired unexercised and the purchase price of call option contracts exercised during the six months ended June 30, 2013, we expended approximately $3.3 million purchasing 190,000 shares of outstanding ordinary shares at an average price of $17.27 during the six months ended June 30, 2013.

Other Liabilities

As of June 30, 2014, we had outstanding indebtedness in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets, and secured only by such intangible assets, under which we are required to make a final non-interest bearing future annual payment of $1.5 million on May 31, 2014. The liability for such payments has been discounted at a rate of 10% to a net present value of $1.4 million at June 30, 2014. Refer to Note 8, "Other Liabilities," in the Notes to our unaudited condensed consolidated financial statements included in Item 1 for further details.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to financial market risks that are inherent in our financial statements, including changes in interest rates, equity and derivative prices and foreign currency exchange rates that could adversely affect our results of operations or financial condition.

Exposure to Interest Rates

The primary objective of our investment activities is to preserve our capital until it is required to fund operations while at the same time maximizing the income we receive from our investments without incurring investment market volatility risk. Our investment income is sensitive to the general level of United States interest rates. In this regard, changes in the United States interest rates affect the interest earned on our cash and cash equivalents. Due to the short-term nature of our cash and cash equivalent holdings, a 10% movement in market interest rates would not materially impact the total fair value of our portfolio as of June 30, 2014.

Exposure to Exchange Rates

Our overseas expenses are incurred primarily in connection with the manufacturing of the magicJack devices and expenses related to our operations in Israel. The majority of our overseas expenses are influenced by exchange rate fluctuations in local currencies, including NIS, Hong Kong dollars, Taiwan dollars and Chinese yuan. Due to the small percentage of our expenses that are influenced by exchange rate fluctuations, a 10% movement in currency exchange rates would not materially impact our results of operations.

Exposure to Equity and Derivative Prices

Market prices for equity securities are subject to fluctuation and consequently the amount realized in the subsequent sale of an investment may significantly differ from the reported market value. Fluctuation in the market price of a security may result from perceived changes in the underlying economic characteristics of the investee, the relative price of alternative investments and general market conditions.

Our Investments

As a result of us investing our excess cash, we are also subject to equity price risk with respect to long or short positions in financial instruments such as equity securities, which may include call option and put option contracts. While our ultimate potential loss with respect to these contracts is determined from the movement of the underlying security or index between the contract inception date and expiration date, the change in fair value of the derivative contracts is also affected by changes in other factors such as interest rates, expected dividend rates and the remaining duration of the contract. At June 30, 2014, we did not have any short positions in put option contracts or long positions in call option contracts.

Our Stock Repurchase Program

We have sold put option contracts in connection with our share repurchase program in order to lower the average price paid for ordinary shares we purchase. Option contracts are sensitive to expiration dates of contracts and fluctuations in the sale price of our ordinary shares, which are in turn sensitive to various factors, including but not limited to: (i) our financial performance and (ii) fluctuations in the overall U.S. and foreign stock markets and economies. At June 30, 2014, we did not have any outstanding put option contracts.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended the “Exchange Act”) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

During the quarter ended June 30, 2014, there were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

Legal Proceedings

We are subject to various legal proceedings and claims, including intellectual property claims, contractual and commercial disputes, employment claims, state and local tax matters and other matters which arise in the ordinary course of business. Our policy is to vigorously defend any legal proceedings. Management regularly evaluates the status of legal proceedings in which we are involved in order to assess whether a loss is probable or there is a reasonable possibility that a loss or additional loss may have been incurred and to determine if accruals are appropriate. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on our business, operating results, financial condition or cash flows. However, an unexpected adverse resolution of one or more of these matters could have a material adverse effect on our results of operations in a particular fiscal year or quarter. For additional information, refer to Note 9, "Commitments and Contingencies," in the Notes to our condensed consolidated financial statements included in Item 1 herein for further details.

ITEM 1A. Risk Factors

Many factors and uncertainties could have an effect on the Company's financial condition, cash flow, results of operations or future performance. The Company is subject to various risks resulting from changing economic, political, industry, business and financial conditions. The material risk factors affecting our operations are described below.

RISKS RELATED TO OUR BUSINESS

The market in which the Company participates is highly competitive and if it does not compete effectively, its operating results may be harmed by loss of market share and revenues.

The telecommunications industry is highly competitive. The Company faces intense competition from traditional telephone companies, wireless companies, cable companies and alternative voice communication providers and manufacturers of communication devices.

The principal competitors for the Company's products and services include the traditional telephone service providers, such as AT&T, Inc., CenturyLink, Inc. and Verizon Communications Inc., which provide telephone service using the public switched telephone network. Certain of these traditional providers have also added, or are planning to add, broadband telephone services to their existing telephone and broadband offerings. The Company also faces, or expects to face, competition from cable companies, such as Cablevision Systems Corp., Charter Communications, Inc., Comcast Corporation, Cox Communications, Inc. and Time Warner Cable (a division of Time Warner Inc.), which have added or are planning to add broadband telephone services to their existing cable television, voice and broadband offerings. Further, wireless providers, including AT&T Mobility, Inc., Sprint Nextel Corporation, T-Mobile USA Inc., Verizon Wireless, Inc. and Clearwire Corporation, offer services that some customers may prefer over wireline-based service. In the future, as wireless companies offer more minutes at lower prices, their services may become more attractive to customers as a replacement for wireline-based service.

The Company faces competition on magicJack device sales from Apple, Samsung, Motorola and other manufacturers of smart phones, tablets and other hand held wireless devices. Also, the Company competes against established alternative voice communication providers, such as Vonage, Google Voice, Skype, which is another non-interconnected voice provider, and may face competition from other large, well-capitalized Internet companies, such as America Online, Inc., Yahoo! Inc. and others. In addition, the Company competes with independent broadband telephone service providers.

Our future growth depends on the success of various initiatives we are pursuing. The failure of these growth initiatives could have a material adverse effect on our business, results of operations, financial condition and cash flows.

Our future growth depends primarily on (1) increased sales of magicJack devices, both domestically and internationally, and (2) the successful launch and implementation of monetization initiatives for our proprietary APP, the magicAPP. While renewal revenues have continued to grow and represent a larger percentage of our overall revenues, revenues from magicJack devices have declined in recent quarters. In June 2014, we launched our latest version of the device, the magicJack GO. We intend to aggressively pursue growth in sales of the magicJack GO domestically and, in particular, internationally where we are working on establishing new distribution channels in several geographies. The failure to grow device revenues through increased device sales in the future would make us more reliant on recurring renewal revenues and could, depending on the status of other ongoing growth initiatives, cause a longer-term decrease in our overall revenues which would have a material adverse effect on our business, results of operations, financial condition and cash flows.

The successful launch and implementation of monetization initiatives for the magicAPP are a critical area of projected growth for our business and require ongoing developments to our existing platform. These developments are necessary in order to position the magicAPP for monetization on a large scale basis to a worldwide mobile customer base. Features that are a part of our magicAPP monetization strategy include low-priced unlimited voice/texting packages and international calling plans. We have recently experienced delays in the implementation of developments to our platform needed to position the magicAPP for monetization. In the event that we experience any further material delays in developments to our platform that are necessary for the monetization of the magicAPP, our overall growth prospects could, depending on the status of other ongoing growth initiatives, be materially, adversely impacted. In addition, we have not previously generated any material revenues from the magicAPP as it has been a free service to date and the redeveloped magicAPP will, when launched, compete with other large, well-capitalized global companies in the telecom APP industry who are introducing low priced consumer offers into the marketplace on an ongoing basis. Even if we do not experience further delays in the launch of magicAPP monetization initiatives, we cannot assure that the features we offer for monetization of the magicAPP will, when introduced, be attractive to consumers at the price points we offer, or at all. Failure of our magicAPP monetization initiatives to generate material revenues would have a material adverse effect on our future growth prospects and, ultimately, on our business as a whole, results of operations, financial condition and cash flows.

The Company’s future growth depends in part on its ability to effectively develop and sell additional products, services and features.

The Company invests in the development of new products, services and features with the expectation that it will be able to effectively offer them to consumers. For example, in 2011, the Company launched the magicJack APP for the iPhone, iPad and iPod Touch. In 2012 it launched the magicJack APP for Android smart phones. The magicJack APP allows users to make free calls to numbers within the U.S. and Canada and to all other magicJack numbers in the world. The Company currently allows the magicJack APP to be downloaded free of charge. The Company has not determined when and if it plans to charge customers for use of the magicJack APP and cannot anticipate demand for the product once it begins charging a fee for its use. Accordingly, the Company cannot assure you that the successful introduction of new products or services will not adversely affect sales of its current products and services. In addition, the Company’s inability to successfully commercialize additional products, services and features could have a material adverse effect on its efforts to diversify its product offerings and revenues and ultimately on its business, results of operations, financial condition or cash flows.

The Company may face difficulty in attracting new customers, and if it fails to attract new customers, its business and results of operations may suffer.

Most traditional wireline and wireless telephone service providers and cable companies are substantially larger and better capitalized than the Company is and have the advantage of a large existing customer base. Because most of its customers are purchasing communications services from one or more of these providers, the Company’s success is dependent upon its ability to attract customers away from their existing providers. In addition, these competitors could focus their substantial financial resources to develop competing technology that may be more attractive to potential customers than what the Company offers. The Company’s competitors’ financial resources may allow them to offer services at prices below cost or even for free in order to maintain and gain market share or otherwise improve their competitive positions.

The Company’s competitors also could use their greater financial resources to offer broadband telephone service with more attractive service packages that include on-site installation and more robust customer service. In addition, because of the other services that the Company’s competitors provide, they may choose to offer broadband telephone service as part of a bundle that includes other products, such as video, high speed Internet access and wireless telephone service, which the Company does not offer. This bundle may enable the Company’s competitors to offer broadband telephone service at prices with which it may not be able to compete or to offer functionality that integrates broadband telephone service with their other offerings, both of which may be more desirable to consumers. Any of these competitive factors could make it more difficult for the Company to attract and retain customers to its products, cause the Company to lower its prices in order to compete and reduce its market share and revenues.

The Company may be unable to obtain enough phone numbers in desirable area codes to meet demand, which may adversely affect its ability to attract new customers and its results of operations.

The Company’s operations are subject to varying degrees of federal and state regulation. It currently allows customers to select the area code for their desired phone number from a list of available area codes in cities throughout much of the United States. This selection may become limited if the Company is unable to obtain phone numbers, or a sufficient quantity of phone numbers, including certain area codes, due to exhaustion and consequent shortages of numbers in those area codes, restrictions imposed by federal or state regulatory agencies, or a lack of telephone numbers made available to it by third parties. If the Company is unable to provide its customers with a nationwide selection of phone numbers, or any phone numbers at all, in all geographical areas and is unable to obtain telephone numbers from another alternative source, or is required to incur significant new costs in connection with obtaining such phone numbers, the Company’s relationships with current and future customers may be damaged, causing a shortfall in expected revenue, increased customer attrition, and an inability to attract new customers. As a result, its business, results of operations and financial condition could be materially and adversely affected.

The Company may be unsuccessful in protecting its proprietary rights or may have to defend itself against claims of infringement, which could impair or significantly affect its business.

The Company’s means of protecting its proprietary rights may not be adequate and our competitors may independently develop technology that is similar to the Company’s. Legal protections afford only limited protection for its technology. The laws of many countries do not protect the Company’s proprietary rights to as great an extent as do the laws of the United States. Despite its efforts to protect its proprietary rights, unauthorized parties have in the past attempted, and may in the future attempt, to copy aspects of the Company’s products or to obtain and use information that it regards as proprietary. Third parties may also design around the Company’s proprietary rights, which may render its protected products less valuable, if the design around is favorably received in the marketplace. In addition, if any of the Company’s products or the technology underlying its products is covered by third-party patents or other intellectual property rights, the Company could be subject to various legal actions.

The Company cannot assure you that its products do not infringe intellectual property rights held by others or that they will not in the future. VocalTec, YMax and other subsidiaries have received in the past communications from third parties relating to technologies used in their products (including, with respect to YMax, the magicJack) that have alleged violation of other intellectual property rights. In response to these communications, the Company has contacted these third parties to convey its good faith belief that it does not violate those parties’ rights or otherwise resolved the issues on favorable terms that have not had a material impact on the Company’s results of operations or financial condition.

The Company cannot assure you that it will not receive further correspondence from these parties, or not be subject to additional allegations of infringement from others. Third parties may assert infringement, misappropriation, or breach of license claims against the Company from time to time. Such claims could cause the Company to incur substantial liabilities and to suspend or permanently cease the use of critical technologies or processes or the production or sale of major products. Litigation may be necessary to enforce the Company's intellectual property rights, to protect its trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity, misappropriation, or other claims. Any such litigation could result in substantial costs and diversion of the Company's resources, which in turn could materially adversely affect its business and financial condition. Moreover, any settlement of or adverse judgment resulting from such litigation could require the Company to obtain a license to continue to use the technology that is the subject of the claim, or otherwise restrict or prohibit its use of the technology. Any required licenses may not be available to the Company on acceptable terms, if at all. If the Company attempts to design around the technology at issue or to find another provider of suitable alternative technology to permit it to continue offering applicable software or product solutions, the Company's continued supply of software or product solutions could be disrupted or its introduction of new or enhanced software or products could be significantly delayed.

The Company may experience delays in the deployment of new products. If it is not successful in the continued development, introduction or timely manufacture of new products, demand for its products could decrease.

The development of the magicJack, magicJack Plus and magicJack APP resulted from the Company's ability to anticipate changes in technology, industry standards and service provider service offerings, and to develop and introduce new and enhanced products and services to meet customer demand. While the Company has new products currently in development or beta versions, its continued ability to adapt to such changes will be a significant factor in maintaining or improving its competitive position and its prospects for growth. Factors resulting in delays in product development include:

- rapid technological changes in the broadband communications industry;
- federal, state and local regulations governing our products and services;
- relationships with manufacturers, other carriers and service providers; and
- the availability of third party technology for the development of new products.

There can be no assurance that the Company will successfully introduce new products on a timely basis or achieve sales of new products in the future. In addition, there can be no assurance that the Company will have the financial and product design resources necessary to continue to successfully develop new products or to otherwise successfully respond to changing technology standards and service provider service offerings. If the Company fails to deploy new products on a timely basis, then its product sales will decrease, its quarterly operating results could fluctuate, and its competitive position and financial condition would be materially and adversely affected.

In addition, the Company's pursuit of necessary technology may require substantial time and expense. It may need to license new technologies to respond to technological change. These licenses may not be available to the Company on terms that it can accept or may materially change the gross profits that it is able to obtain on its products. The Company may not succeed in adapting its products to new technologies as they emerge. Development and manufacturing schedules for technology products are difficult to predict, and there can be no assurance that the Company will achieve timely initial customer shipments of new products. The timely availability of these products in volume and their acceptance by customers are important to the Company's future success. Any future delays, whether due to product development delays, manufacturing delays, lack of market acceptance, delays in regulatory approval, or otherwise, could have a material adverse effect on the Company’s results of operations.

The Company's products must comply with various international and domestic regulations and standards.

The Company's products must comply with various international and domestic regulations and standards defined by regulatory agencies. If it does not comply with existing or evolving industry standards and other regulatory requirements or if it fails to obtain in a timely manner any required domestic or foreign regulatory approvals or certificates, the Company will not be able to sell its products where these standards or regulations apply, which may harm its business. Moreover, distribution partners or customers may require the Company, or the Company may otherwise deem it necessary or advisable, to alter its products to address actual or anticipated changes in the regulatory environment. The Company's inability to alter its products to address these requirements and any regulatory changes could have a material adverse effect on its business, financial condition, and operating results.

If the Company does not correctly anticipate demand for its products, it may not be able to secure sufficient quantities or cost-effective production of its products or it could have costly excess production or inventories.

The Company has generally been able to increase production to meet its increasing demand. However, the demand for its products depends on many factors and is difficult to forecast. The Company expects that it will become more difficult to forecast demand as it introduces and supports multiple products, as competition in the market for its products intensifies and as the markets for some of its products mature to the mass market category. Significant unanticipated fluctuations in demand could cause problems in the Company's operations, such as:

- If demand increases beyond what the Company forecasts, it would have to rapidly increase production. It would depend on suppliers to provide additional volumes of components, and those suppliers might not be able or willing to increase production rapidly enough to meet unexpected demand.

- Rapid increases in production levels to meet unanticipated demand could result in higher costs for manufacturing and supply of components and other expenses. These higher costs could lower the Company's profit margins. Further, if production is increased rapidly, manufacturing quality could decline, which may also lower the Company's margins and reduce customer satisfaction.

- If forecasted demand does not develop, the Company could have excess production resulting in higher inventories of finished products and components, which would use cash and could lead to write-offs of some or all of the excess inventories. Lower than forecasted demand could also result in excess manufacturing capacity or reduced manufacturing efficiencies at the Company's facilities, which could result in lower margins.

Certain aspects of the Company's service materially differ from services offered by traditional telephone service providers, which may limit the acceptance of the Company's services by mainstream consumers and its potential for growth.

Certain aspects of the Company's service are not the same as traditional telephone service, which may limit the acceptance of its services by mainstream consumers and its potential for growth. The Company's growth is dependent on the adoption of its services by mainstream customers, and so these differences are becoming increasingly important. For example:

- the Company's E911 and emergency calling services differ, in significant respects, from the 911 service associated with traditional wireline and wireless telephone providers;

- the Company's customers may at times experience lower call quality than they are used to from traditional wireline telephone companies, including static, echoes and delays in transmissions;

- the Company’s customers may at times experience higher dropped-call rates than they are used to from traditional wireline telephone companies;
- customers who obtain new phone numbers from the Company do not appear in the phone book and their phone numbers are not available through directory assistance services offered by traditional telephone companies;
- the Company’s customers cannot accept collect calls;

- the Company's customers cannot reach certain telephone numbers; and
- in the event of a power loss or Internet access interruption experienced by a customer, the Company's service may be interrupted.

If customers do not accept the differences between the Company's service and traditional telephone service, they may choose to remain with their current telephone service provider or may choose to return to service provided by traditional telephone companies, and customer demand for services will decrease.

The Company's emergency and E911 calling services are different from those offered by traditional wireline telephone companies and may expose it to significant liability.

While the Company does not believe it is today subject to regulatory requirements to provide such capability, the Company provides our customers with emergency calling services/E911 calling services that significantly differ from the emergency calling services offered by traditional wireline telephone companies. Those differences may cause significant delays, or even failures, in callers' receipt of the emergency assistance they need. Traditional wireline telephone companies route emergency calls from a fixed location over a dedicated infrastructure directly to an emergency services dispatcher at the public safety answering point, or PSAP, in the caller's area. Generally, the dispatcher automatically receives the caller's phone number and actual location information. Because the magicJack devices are portable or nomadic, the only way the Company can determine to which PSAP to route an emergency call, and the only location information that the Company's E911 service can transmit to a dispatcher at a PSAP is the information that the Company's customers have registered with us. A customer's registered location may be different from the customer's actual location at the time of the call because customers can use their magicJack or magicJack PLUS device to make calls almost anywhere a broadband connection is available. Significant delays may occur in a customer updating its registered location information, and in applicable databases being updated and new routing implemented once a customer has provided new information. If the Company's customers encounter delays when making emergency services calls and any inability to route emergency calls properly, or of the answering point to automatically recognize the caller's location or telephone number, such delays can have devastating consequences. Customers may, in the future, attempt to hold the Company responsible for any loss, damage, personal injury or death suffered as a result.

Traditional phone companies also may be unable to provide the precise location or the caller's telephone number when their customers place emergency calls. However, traditional phone companies are covered by federal legislation exempting them from liability for failures of emergency calling services, and the Company is not afforded such protection. In addition, the Company has lost, and may in the future lose, existing and prospective customers because of the limitations inherent in our emergency calling services. Additionally, service interruptions from the Company's third-party providers could cause failures in its customers' access to E911 services. Finally, the Company may decide not to offer customers E911 services at all. Any of these factors could cause the Company to lose revenues, incur greater expenses or cause the Company's reputation or financial results to suffer.

State and local governments may seek to impose E911 fees.

Many state and local governments have sought to impose fees on customers of VoIP providers, or to collect fees from VoIP providers, to support implementation of E911 services in their area. The application of such fees with respect to magicJack users and the Company is not clear because various statutes and regulation may not cover the Company's services, the Company does not bill its customers monthly, nor does it bill customers at all for telecommunication services. The Company may also not know the end user's location because the magicJack devices and services are nomadic. Should a regulatory authority require payment of money from the Company for such support, magicJack LP may be required to develop a mechanism to collect fees from its customers, which may or may not be satisfactory to the entity requesting us to be a billing agent. The Company cannot predict whether the collection of such additional fees or limitations on where its services are available would impact customers' interest in purchasing its products.

In settlement of litigation, the Company agreed that it would, at least once a year, issue bills for 911 emergency calling services to each user who has access to 911 services through their magicJack services, and who has provided a valid address in a U.S. jurisdiction that provides access to 911 services and which is legally empowered to impose 911 charges on such users in accordance with applicable state and/or local law.

Certain E911 regulatory authorities have asserted or may assert in the future that the Company is liable for damages, including end user assessed E911 taxes, surcharges and/or fees, for not having billed and collected E911 fees from its customers in the past or in the future. If a jurisdiction were to prevail in such claims, the decision could have a material adverse effect on the Company's financial condition and results of operations.

The Company may decide to end its emergency and E911 calling services in the future, which may affect its revenues and expose it to significant liability.

Although the Company currently makes available emergency and E911 services to users, it does not believe that it is required by regulations to do so. The Company may, in the future, decide to discontinue providing such services. Discontinuing such services may adversely affect customer demand, may result in fines by the FCC and may affect the Company's revenues. In addition, customers who fail to reach emergency services may, in the future, attempt to hold the Company responsible for any loss, damage, personal injury or death suffered as a result.

If the Company's services are not commercially accepted by its customers, its prospects for growth will suffer.

The Company's success in deriving a substantial amount of revenues from its broadband telephone service offering sold to consumers and businesses relies on the commercial acceptance of its offering from consumers and business. Although the Company is currently selling its services to a number of customers, it cannot be certain that future customers will find its services attractive. If customer demand for its services does not develop or develops more slowly than anticipated, it would have a material adverse effect on the Company's business, results from operations and financial condition. The Company's success relies on the commercial acceptance of its offering from these advertisers and retailers. The Company is not currently selling its advertising and retailing services and it cannot be certain future online advertisers and retailers will find its services attractive. If demand for these services does not develop or develops more slowly than anticipated, it would have a material adverse effect on the Company's business, results of operations and financial condition.

If the Company is unable to retain its existing customers, its revenue and results of operations would be adversely affected.

The Company offers services pursuant to a software access right agreement that is generally six months to five years in duration and allows its customers to gain access to its servers for telephone calls. The Company's customers do not have an obligation to renew their software access rights after their initial term period expires, and these software access rights may not be renewed on the same or on more profitable terms. As a result, the Company's ability to grow depends in part on software access right renewals. The Company may not be able to accurately predict future trends in customer renewals, and its customers' access right renewal rates may decline or fluctuate because of several factors, including their satisfaction or dissatisfaction with the Company's services, the prices of its services, the fees imposed by government entities, the prices of comparable services offered by its competitors or reductions in its customers' spending levels. If the Company's customers do not renew their access rights for its services, renew on less favorable terms, or do not purchase additional functionality, the Company's revenue may grow more slowly than expected or decline, and its profitability and gross margins may be harmed.

The success of the Company's business is dependent on cost-effective marketing and its growth may be affected by increased media advertising costs.

A major portion of the Company's revenue growth is attributable to its media advertising, including television advertising and banner advertisements on websites. If advertising rates, which the Company does not control, are substantially increased by television stations or by other media and the Company is unable to utilize alternative advertising methods, such increases will have an adverse effect on the Company’s business, results from operations and financial condition. Additionally, if advertisers using web-based banner advertising targeted towards the Company’s magicJack APP users do not achieve the results they desire or expect and cancel their advertising, the Company’s revenues and results of operations may be adversely affected.

Failure to establish and expand strategic alliances could prevent the Company from executing its business model and adversely affect its growth.

The Company's success depends on its continued ability to develop strategic relationships with leaders in the retail, telephony, online advertising and online retail industry segments. These relationships enable the Company to expand its services and products to a larger number of customers; develop and deploy new services and products; enhance the magicJack brand; and generate additional revenue. The Company may not be able to establish relationships with key participants in the telephony, retail, online advertising and online retail industry segments. Once the Company has established strategic relationships, it depends on its partner's ability to generate increased acceptance and use of our services and products. If the Company loses any of these strategic relationships or if it fails to establish additional relationships, or if strategic relationships fail to benefit the Company as expected, it may not be able to execute its business plan and its business will suffer.

The market for the Company's services and products is characterized by rapidly changing technology and its success will depend on its ability to enhance its existing service and product offerings and to introduce new services and products on a timely and cost effective basis.

The market for the Company's services and products is characterized by rapidly changing enabling technology, frequent enhancements and evolving industry standards. The Company's continued success depends on its ability to accurately anticipate the evolution of new products and technologies and to enhance our existing products and services. Historically, several factors have deterred consumers and businesses from using voice over broadband service, including security concerns, inconsistent quality of service, increasing broadband traffic and incompatible software products. If the Company is unable to continue to address those concerns and foster greater consumer demand for its products and services, its business and results of operations will be adversely affected.

The Company's success also depends on its ability to develop and introduce innovative new services and products that gain market acceptance. The Company may not be successful in selecting, developing, manufacturing and marketing new products and services or enhancing existing products and services on a timely basis. The Company may experience difficulties with software development, industry standards, design or marketing that could delay or prevent its development, introduction or implementation of new services and enhancements. The introduction of new services by competitors, the emergence of new industry standards or the development of entirely new technologies to replace existing service offerings could render its existing or future services obsolete. If the Company's services become obsolete due to wide-spread adoption of alternative connectivity technologies, the Company's ability to generate revenue may be impaired. In addition, any new markets into which the Company attempts to sell its services, including new countries or regions, may not be receptive. If the Company is unable to successfully develop or acquire new services, enhance its existing services to anticipate and meet customer preferences or sell its services into new markets, the Company's revenue and results of operations would be adversely affected.

Increases in credit card processing fees and high chargeback costs would increase the Company's operating expenses and adversely affect its results of operations, and an adverse change in, or the termination of, the Company's relationship with any major credit card company would have a severe, negative impact on its business.

A significant number of the Company's customers purchase its products through the Company's website and pay for its products and services using credit or debit cards. The major credit card companies or the issuing banks may increase the fees that they charge for transactions using their cards. An increase in those fees would require the Company to either increase the prices it charges for its products, or suffer a negative impact on its profitability, either of which could adversely affect its business, financial condition and results of operations.

The Company has potential liability for chargebacks associated with the transactions it processes, or are processed on its behalf by merchants selling its products. If a customer returns his or her magicJack products at any time, or claims that the Company’s product was purchased fraudulently, the returned product is “charged back” to the Company or its bank, as applicable. If the Company or its sponsoring banks are unable to collect the chargeback from the merchant’s account, or, if the merchant refuses or is financially unable, due to bankruptcy or other reasons, to reimburse the merchant’s bank for the chargeback, the Company bears the loss for the amount of the refund paid.

The Company is vulnerable to credit fraud, as it sells its magicJack products directly to customers through its website. Card fraud occurs when a customer uses a stolen card (or a stolen card number in a card-not-present-transaction) to purchase merchandise or services. In a traditional card-present transaction, if the merchant swipes the card, receives authorization for the transaction from the card issuing bank and verifies the signature on the back of the card against the paper receipt signed by the customer, the card issuing bank remains liable for any loss. In a fraudulent card-not-present transaction, even if the merchant or the Company receive authorization for the transaction, the Company or the merchant are liable for any loss arising from the transaction. Because sales made directly from the Company's website are card-not-present transactions, the Company is more vulnerable to customer fraud. The Company is also subject to acts of consumer fraud by customers that purchase its products and services and subsequently claim that such purchases were not made.

In addition, as a result of high chargeback rates or other reasons beyond its control, the credit card companies or issuing bank may terminate their relationship with the Company, and there are no assurances that it will be able to enter into a new credit card processing agreement on similar terms, if at all. Upon a termination, if the Company's credit card processor does not assist it in transitioning its business to another credit card processor, or if the Company were not able to obtain a new credit card processor, the negative impact on the Company's liquidity likely would be significant. The credit card processor may also prohibit the Company from billing discounts annually or for any other reason. Any increases in the Company's credit card fees could adversely affect its results of operations, particularly if the Company elects not to raise its service rates to offset the increase. The termination of the Company's ability to process payments on any major credit or debit card, due to high chargebacks or otherwise, would significantly impair its ability to operate its business.

The Company has experienced rapid growth in recent periods. If it fails to manage its growth effectively, the Company may be unable to maintain high levels of service or address competitive challenges adequately.

The Company sells a significant number of magicJack product line units and significantly increased the number of customers using its products and services. These increases have placed, and the Company's anticipated sales will continue to place, a significant strain on its resources. As a result of these sales, the Company may have to implement new operational and financial systems and procedures and controls, to expand, train and manage its employee base, and to maintain close coordination among its technical, marketing, support and finance staffs. The Company must also continue to attract, retain, and integrate personnel in all aspects of operations. To the extent the Company acquires new businesses, it must also assimilate new operations, technologies and personnel. The Company may be unable to manage its expenses effectively in the future, which may negatively impact its gross profit or operating expenses in any particular quarter.

Flaws in the Company's technology and systems could cause delays or interruptions of service, damage its reputation, cause it to lose customers and limit its growth.

The Company's service may be disrupted by problems with its technology and systems, such as malfunctions in its software or other facilities and overloading of its servers. The Company's customers may experience interruptions in the future as a result of these types of problems. Interruptions may in the future cause the Company to lose customers, which could adversely affect its revenue and profitability. In addition, because the Company's systems and its customers' ability to use its services are Internet-dependent, the Company services may be subject to "hacker attacks" from the Internet, which could have a significant impact on its systems and services. If service interruptions adversely affect the perceived reliability of the Company's service, it may have difficulty attracting and retaining customers and its brand reputation and growth may suffer.

Material defects or errors in the software the Company uses to deliver its services could harm its reputation, result in significant costs to the Company and impair its ability to sell its services.

The software applications underlying the Company's products and services, or the products and services sold by its subsidiaries, are inherently complex and may contain material defects or errors, particularly when first introduced or when new versions or enhancements are released. The Company has from time to time found defects in its services, and new errors in its existing services may be detected in the future. Any defects that cause interruptions to the availability of our services could result in:

- a reduction in sales or delay in market acceptance of the Company's services;

- product returns, repairs, replacements or sales credits or refunds to the Company's customers;
- loss of existing customers and difficulty in attracting new customers;
- uncollectible accounts receivable and delays in collecting accounts receivable;
- legal actions by the Company's customers or, with respect to VocalTec and VocalTec Communications LLC ("VocalTec US", formerly known as Stratus Telecommunications, LLC) products, by its customers' end users;
- loss of or delay in market acceptance of the Company's products;
- diversion of development resources;
- harm to our reputation; and
- increased insurance costs.

After the release of the Company's services, defects or errors may also be identified from time to time by its internal team and by its customers. There can be no assurance that, despite testing, errors will not be found in its products after commencement of commercial deployment. The costs incurred in correcting any material defects or errors in its services may be substantial and could harm the Company's operating results.

The Company may in the future incur costs associated with support services. Moreover, as the Company's solutions grow in complexity, this risk may intensify over time and may result in increased expenses.

Customers may bundle, incorporate or connect the Company's telecommunication hardware and software products into or to complex systems that contain errors or defects that may be unrelated to its products. As a result, when the Company's customers encounter problems, it may be difficult to identify the product that caused the problem. In addition, such occurrences may result in undue delays or cancellations of the implementation of the Company's customers' bundled products and services. In such cases, the Company's reputation could be harmed and its results of operations could be adversely affected, which could result in reduced revenues or increased expenses.

The Company's ability to provide its service is dependent upon third-party facilities and equipment, the failure of which could cause delays or interruptions of its service, damage its reputation, cause the Company to lose customers and limit its growth.

The Company's success depends on its ability to provide quality and reliable service, which is in part dependent upon the proper functioning of facilities and equipment owned and operated by third parties and is, therefore, beyond its control. Unlike traditional wireline telephone service or wireless service, the Company's service requires its customers to have an operative broadband Internet connection and an electrical power supply, which are provided by the customer's Internet service provider and electric utility company, respectively, and not by the Company. The quality of some broadband Internet connections in certain geographic areas may be too poor for customers to use the Company's services properly. The Company's future growth could be limited if broadband connections are not, or do not become, widely available in markets that it targets.

In addition, if there is any interruption to a customer's broadband Internet service or electrical power supply, that customer will be unable to make or receive calls, including emergency calls, using the Company's service. The Company's customers may experience such interruptions in the future. In addition, the Company's E911 service is currently and will remain dependent upon one or more third-party providers. Interruptions in service from these vendors could cause failures in the Company’s customers’ access to E911 services. If service interruptions adversely affect the perceived reliability of the Company’s service, it may have difficulty attracting new customers and its brand, reputation and growth will be negatively impacted.

The Company depends on overseas manufacturers, and for certain products, third-party suppliers, and its reputation and results of operations would be harmed if these manufacturers or suppliers fail to meet the Company's requirements.

The manufacture of the magicJack devices is conducted by a manufacturing company in China, and certain parts are produced in Taiwan and Hong Kong. These manufacturers supply substantially all of the raw materials and provide all facilities and labor required to manufacture the Company's products. If these companies were to terminate their arrangements with the Company or fail to provide the required capacity and quality on a timely basis, either due to actions of the manufacturers; earthquake, fire, flood, or other natural disaster; or the actions of their respective governments, the Company would be unable to manufacture its products until replacement contract manufacturing services could be obtained. To qualify a new contract manufacturer, familiarize it with the Company's products, quality standards and other requirements, and commence volume production is a costly and time-consuming process. The Company cannot assure you that it would be able to establish alternative manufacturing relationships on acceptable terms or in a timely manner that would not cause disruptions in its supply. The Company's reliance on these contract manufacturers involves certain risks, including the following:

- lack of direct control over production capacity and delivery schedules;
- lack of direct control over quality assurance, manufacturing yields and production costs;
- risk of loss of inventory while in transit from China, Hong Kong or Taiwan;
- the risk of currency fluctuation; and
- risks associated with international commerce, including unexpected changes in legal and regulatory requirements, changes in tariffs and trade policies, risks associated with the protection of intellectual property, political and economic instability and natural disasters, such as earthquakes, typhoons or tsunamis.

Any interruption in the manufacture of the Company's products would be likely to result in delays in shipment, lost sales and revenue and damage to its reputation in the market, all of which would harm its business and results of operations. In addition, while the Company's contract obligations with its contract manufacturer in China is denominated in U.S. dollars, changes in currency exchange rates could impact its suppliers and increase its prices.

The Company relies on independent retailers to sell the magicJack devices, and disruption to these channels would harm its business.

Because the Company sells a majority of its magicJack, magicJack PLUS, other devices and certain services to independent retailers, it is subject to many risks, including risks related to their inventory levels and support for the Company's products. In particular, the Company's retailers maintain significant levels of its products in their inventories. If retailers attempt to reduce their levels of inventory or if they do not maintain sufficient levels to meet customer demand, the Company's sales could be negatively impacted.

Many of the Company's retailers also sell products offered by its competitors. If the Company's competitors offer its retailers more favorable terms, those retailers may de-emphasize or decline to carry its products. In the future, the Company may not be able to retain or attract a sufficient number of qualified retailers. If the Company is unable to maintain successful relationships with retailers or to expand its distribution channels, its business will suffer.

To continue this method of sales, the Company will have to allocate resources to train vendors, systems integrators and business partners as to the use of its products, resulting in additional costs and additional time until sales by such vendors, systems integrators and business partners are made feasible. The Company's business depends to a certain extent upon the success of such channels and the broad market acceptance of their products. To the extent that the Company's channels are unsuccessful in selling their products, and as a result, the Company's products, its revenues and operating results will be adversely affected.

Many factors out of the Company’s control could interfere with its ability to market, license, implement or support its products with any of its channels, which in turn could harm its business. These factors include, but are not limited to, a change in the business strategy of the Company’s channels, the introduction of competitive product offerings by other companies that are sold through one or more of its channels, potential contract defaults by one or more of its channels or changes in ownership or management of one or more of its channels. Some of the Company’s competitors may have stronger relationships with its channels than the Company does or offer more favorable terms with respect to their products, and the Company has limited control, if any, as to whether those channels implement its products rather than its competitors’ products or whether they devote resources to market and support its competitors’ products rather than its offerings. If the Company fails to maintain relationships with these channels, fails to develop new channels, fails to effectively manage, train, or provide incentives to existing channels or if these channels are not successful in their sales efforts, sales of the Company’s products may decrease and its operating results would suffer.

The Company may not be able to maintain adequate customer care during periods of growth or in connection with its addition of new and complex devices or features, which could adversely affect its ability to grow and cause its financial results to be negatively impacted.

The Company considers our customer care to be critically important to acquiring and retaining customers. A portion of its customer care is provided by third parties located in the Philippines. This approach exposes the Company to the risk that it may not maintain service quality, control or effective management within these business operations. The increased elements of risk that arise from conducting certain operating processes in some jurisdictions could lead to an increase in reputational risk. Interruptions in the Company’s customer care caused by disruptions at its third-party facilities may cause it to lose customers, which could adversely affect its revenue and profitability. If the Company’s customer base expands rapidly, it may not be able to expand its outsourced customer care operations quickly enough to meet the needs of its customer base, and the quality of its customer care will suffer and its access right renewal rate may decrease. As the Company broadens its magicJack offerings and its customers build increasingly complex home networking environments, it will face additional challenges in training its customer care staff. The Company could face a high turnover rate among its customer service providers. The Company intends to have its customer care provider hire and train customer care representatives in order to meet the needs of its growing customer base. If they are unable to hire, train and retain sufficient personnel to provide adequate customer care, the Company may experience slower growth, increased costs and higher levels of customer attrition, which would adversely affect its business and results of operations.

If the Company is unable to maintain an effective process for local number portability provisioning, its growth may be negatively impacted.

The Company complies with requests for local number portability from its customers at the end of the 30-day trial period. Local number portability means that its customers can retain their existing telephone numbers when subscribing to the Company’s services, and would in turn allow former customers of its to retain their telephone numbers should they subscribe to another carrier. All carriers, including interconnected VoIP service providers, must complete the porting process within one business day. If the Company is unable to maintain the technology to expedite porting its customers' numbers, demand for its services may be reduced, the Company may be subject to regulatory enforcement activity, and this will adversely affect its revenue and profitability.

Because much of the Company’s potential success and value lies in its use of internally developed hardware, systems and software, its failure to protect the intellectual property associated with them could negatively affect it. Additionally, other parties may have the right to use intellectual property important to the Company’s business.

The Company’s ability to compete effectively is dependent in large part upon the maintenance and protection of systems and software that it has developed internally. While the Company has several pending intellectual property right applications for future service offerings, it cannot patent all of the technology that is important to its business. In addition, the Company’s pending intellectual property right applications may not be successful. The Company will rely on copyright, trademark and trade secret laws, as well as confidentiality procedures and licensing arrangements, to establish and protect its rights to this technology. It may be possible for a third party to copy or otherwise obtain and use this technology without authorization. Policing unauthorized use of this technology is difficult. The steps the Company takes may not prevent misappropriation of the technology it relies on. Enforcement of its intellectual property rights also depends on the Company’s successful legal actions against these infringers, but these actions may not be successful, even when the Company’s rights have been infringed. In addition, effective protection may be unavailable or limited in some jurisdictions. The Company uses certain intellectual property rights under licenses granted to it. Because the Company may not have the exclusive rights to use some of its intellectual property, other parties may be able to compete with it.

The loss of key personnel or an inability to attract and retain additional personnel may impair the Company's ability to grow its business.

The Company is highly dependent upon the continued service and performance of its senior management team, key technical personnel, and key employees. The replacement of these individuals likely would involve significant time and costs, and the loss of these officers may significantly delay or prevent the achievement of the Company's business objectives.

The Company faces intense competition for qualified individuals from numerous technology, software, wireless telephone and traditional telephone service provider companies. If it is unable to attract new employees and retain its current employees, the Company may not be able to develop and maintain its services at the same levels as its competitors and it may, therefore, lose potential customers and sales penetration in certain markets. The Company's failure to attract and retain suitably qualified individuals could have an adverse effect on its ability to implement its business plan and, as a result, its ability to compete would decrease, its operating results would suffer and its revenues would decrease.

The Company may make acquisitions that prove unsuccessful or strain or divert its resources.

The Company intends to consider acquisitions of other companies in its industry that could complement its business, including the acquisition of entities that would expand its service offerings, increase its market share or offer access to other asset classes that it does not currently serve. The Company has limited experience in completing acquisitions of other businesses. If it does acquire other businesses, it may not be able to successfully integrate these businesses with its own and it may be unable to maintain its standards, controls and policies. The Company may fail in its attempt to integrate acquired companies and businesses in such a way that it can realize cross-selling opportunities and other synergies. Further, acquisitions may place additional constraints on the Company's resources by diverting the attention of its management from its business operations. Through acquisitions, the Company may enter areas in which it has no or limited experience, and an acquisition may be unsuccessful in accomplishing the intended benefits of the transaction. Moreover, any acquisition may result in substantial transaction-related expenses, a potentially dilutive issuance of equity securities, the incurrence of debt or amortization of expenses and related intangible assets, all of which could have an adverse effect on the Company's business and results of operations.

The Company may incur operating losses in the future, and it has incurred historical operating losses.

The Company had net losses of $0.8 million and $1.6 million in 2011 and 2010, respectively. It expects to continue to incur significant operating and certain capital expenditures as it increases its sales and marketing activities to expand its customer base and increase its research and development activities as it develops enhanced technologies and features to improve its services, products and offerings, increase its general, administrative and operating functions to support its growing operations. As a result, the Company will need to generate a significant amount of revenues to achieve and maintain profitability. These increased expenses could exceed any revenues the Company may generate. Its efforts to attract new customers and to provide its current communications applications and services to an increased number of customers may be more expensive than the Company currently anticipates. If it does not significantly increase revenues after investing in these efforts, the Company's results from operations would be harmed. Having now achieved profitability, the Company cannot assure you that it can sustain or increase profitability on a quarterly or annual basis in the future. Because of its limited operating history and the early stage of the market for some of its products and services, historical trends and expected performance are difficult to analyze. If revenues do not grow, or if operating expenses exceed the Company's expectations or cannot be adjusted accordingly, its business, results of operations and financial condition could be adversely affected.

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The Company has experienced, and may continue to experience, significant fluctuations in its quarterly results, which might make it difficult for investors to make reliable period-to-period comparisons and may contribute to volatility in the market price of the Company’s ordinary shares.

The Company’s operating results and other income (expenses) have fluctuated and may continue to fluctuate from period to period for a number of reasons. Due to the past volatility of the markets the Company operates in or investments it makes, the Company cannot predict the impact on its revenues, results of operations or other income (expense) that any deterioration or other changes in such market may have.

Significant annual and quarterly fluctuations in the Company’s results of operations may also be caused by its advertising and marketing activities and, among other factors, the timing and composition of orders from its customers, reduced prices for its products, the economic viability and credit-worthiness of its customers, the collectability of its receivables, the timing of new product announcements and releases of new products by it and by its competitors. Significant annual and quarterly fluctuations in other income (expense) are primarily caused by changes in the underlying value of investments and strategies.

The Company’s future results may also be affected by its ability to continue to develop, introduce and deliver enhanced and new products in a timely manner, to offer new products at competitive prices, to offer existing products at lower prices, to compete with competitors that are larger than it and to anticipate and meet customer demands. There can be no assurance that sales in any particular quarter will not be lower than those of the preceding quarters, including comparable quarters.

As a result, the Company believes that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. The volatility in the Company’s operating results may also result in significant volatility in its share price. It is also possible that the Company’s quarterly results of operations may be below the expectations of public market analysts and investors. If this happens, the price of the Company’s ordinary shares is likely to decrease.

The Company’s plans to expand its operations internationally are subject to increased risks which could harm its business, operating results, and financial condition.

The Company plans to expand its operations and market and sell its magicJack products and related services internationally. There are risks inherent in doing business internationally, including:

- evolving or more stringent telecommunication and broadband telephone service standards and requirements of obtaining required permits, licenses and certifications to conduct its business;
- different or more stringent consumer protection, content, data protection, privacy and other laws;
- import or export restrictions, tariffs and changes in trade regulations;
- economic volatility and the global economic slowdown, currency exchange rate fluctuations and inflationary pressures;
- profit repatriation restrictions and foreign currency exchange restrictions;
- laws and business practices that favor local competitors or prohibit foreign ownership of certain businesses;

- credit risk and higher levels of payment fraud;
- longer payment cycles;
- political or social instability; and
- potentially adverse tax developments.

Any of these risks could have a material adverse effect on the Company’s ability to expand its business and harm its business, operating results and financial condition.

The Company may have exposure to greater than anticipated tax liabilities.

The Company is an Israeli corporation that operates through various subsidiaries in a number of countries throughout the world. Consequently, the Company is subject to tax laws, treaties and regulations in and between the countries in which it operates. The Company's income taxes are based upon the applicable tax laws and tax rates in effect in the countries in which it operates and earns income as well as upon its operating structures in these countries. The Company's provision for income taxes is complex and is based on a jurisdictional mix of earnings, statutory rates and enacted tax rules. Significant judgment is required in determining The Company's provision for income taxes and in evaluating its tax positions, including the transfer pricing of our intercompany transactions, and there are many transactions and calculations where the ultimate tax determination is uncertain. Although the Company believes its tax judgments estimates are reasonable based upon its interpretations of applicable tax laws in the jurisdictions in which it files, its tax positions may be challenged, and if successful, such challenges may materially differ from amounts recorded in the Company's financial statements, which could have a significant adverse impact on its effective tax rate, and on its operating results and financial condition.

The Company's income tax returns are subject to audit in various jurisdictions throughout the world and its 2010 and 2011 U.S. federal income tax returns are currently under audit.

The Company's income tax returns are subject to review and audit in the United States and other jurisdictions. The Company does not recognize the benefit of income tax positions it believes are more-likely-than-not to be disallowed upon challenge by a tax authority. If any tax authority successfully challenges the Company's operational structure, transfer pricing policies, or the taxable presence of its key subsidiaries in certain countries, or if the terms of certain income tax treaties are interpreted in a manner that is adverse to the Company's structure, or if the Company loses a material tax dispute in any country, its effective tax rate on its worldwide earnings could increase substantially and the Company's earnings and cash flows from operations could be materially adversely affected.

The Company's consolidated U.S. federal income tax returns for the fiscal years ended December 31, 2010 and December 31, 2011 are currently under audit by the Internal Revenue Service ("IRS"). The Company believes that its tax positions are appropriate and are prepared to vigorously defend any positions challenged. Nonetheless, if the IRS were to challenge the Company's prior tax positions and the Company is unsuccessful in defending them, it may be required to pay taxes for prior periods, interest, fines or penalties, and/or be obligated to pay increased taxes in the future, any of which could have a material adverse effect on the Company's business, financial condition and results of operations.

RISKS RELATED TO REGULATION IN THE UNITED STATES

The Company's business is highly dependent on regulation that continues to change.

Much of the services that the Company provides are subject to significant regulation and may be adversely affected by regulatory developments at the federal, state and local levels. The Company operates in all fifty states under complex and evolving state and local telecommunications and tax laws that vary from jurisdiction to jurisdiction. Although the Company believes that certain regulations do not currently apply to it, certain broadband telephone services have also been subjected to significant regulation and may be subjected to additional regulation in the future. Complying with new or clarified telecommunications, broadband telephone service, or tax regulations, and obtaining required permits, licenses or certifications in numerous jurisdictions, can be costly and disruptive to the Company's business. If the Company fails to comply with applicable regulations, or if those regulations change or are clarified in a manner adverse to it, including in any of the ways described in these risk factors related to regulation, the Company's business and operating results may suffer. Furthermore, new regulations, new laws or other factors may cause the Company to lose its ability to maintain certain certifications in various states, which could prevent it from providing telephone numbers to its customers. The Company may, instead, be required to purchase numbers from other CLECs, which would increase its expenses and would negatively impact its results. Moreover, there is no guarantee that the Company would be able to receive or purchase numbers from other CLECs. In such event, the Company would not have numbers to offer prospective customers, which would have a significant negative impact on its business.

If the Company cannot continue to obtain key switching elements from its primary competitors on acceptable terms, it may not be able to offer its local voice and data services on a profitable basis, if at all.

The Company will not be able to provide its local voice and data services on a profitable basis, if at all, unless it is able to obtain key switching elements from some of its primary competitors on acceptable terms. To offer local voice and data services in a market, the Company must connect its servers with other carriers in a specific market. This relationship is governed by an interconnection agreement or carrier service agreement between the Company and that carrier. The Company has such agreements with Verizon, AT&T, XO Communications Services and the CenturyLink network in a majority of its markets. If the Company is unable to continue these relationships, enter into new interconnection agreements or carrier service agreements with additional carriers to other markets or if these providers liquidate or file for bankruptcy, its business and profitability may suffer.

Regulatory initiatives may continue to reduce the maximum rates the Company is permitted to charge long distance service providers for completing calls by their customers to customers served by its servers.

The rates that the Company charges and is charged by service providers for terminating interstate calls by their customers to customers served by its servers, and for transferring calls by its customers onto other carriers, cannot exceed rates determined by regulatory authorities. State regulatory authorities may, in the future, similarly reduce the baseline rates the Company charges for intrastate terminating calls. Such federal or state rate reductions, if enacted, could affect the Company’s revenues and results of operations.

Regulation of broadband telephone services are developing and therefore uncertain; and future legislative, regulatory or judicial actions could adversely impact the Company’s business and expose it to liability.

The current regulatory environment for broadband telephone services is developing and therefore uncertain. Although YMax Communications Corp., one of the Company’s wholly-owned subsidiaries, may be subject to certain regulation as a telecom service provider, it and our other subsidiaries have developed in an environment largely free from government regulation. However, the United States and other countries have begun to assert regulatory authority over broadband telephone service and are continuing to evaluate how broadband telephone service will be regulated in the future. Both the application of existing rules to the Company and its competitors and the effects of future regulatory developments are uncertain. Future legislative, judicial or other regulatory actions could have a negative effect on the Company’s business. If its VoIP telephony service or our other products and services become subject to the rules and regulations applicable to telecommunications providers, if current broadband telephone service rules are clarified and applied to the Company, or if additional rules and regulations applicable specifically to broadband telephone services are adopted, the Company may incur significant compliance costs, and it may have to restructure its service offerings, exit certain markets or start charging for its services at least to the extent of regulatory costs or requirements, any of which could cause its services to be less attractive to customers. The Company has faced, and may continue to face, difficulty collecting such charges from its customers and/or carriers, and collecting such charges may cause it to incur legal fees. The Company may be unsuccessful in collecting all of the regulatory fees owed to it. The imposition of any such additional regulatory fees, charges, taxes and regulations on VoIP communications services could materially increase the Company’s costs and may limit or eliminate its competitive pricing advantages.

Regulatory and governmental agencies may determine that the Company should be subject to rules applicable to certain broadband telephone service providers or seek to impose new or increased fees, taxes, and administrative burdens on broadband telephone service providers. The Company also may change its product and service offerings in a manner that subjects it to greater regulation and taxation. Such obligations could include requirements that the Company contribute directly to federal or state Universal Service Funds. The Company may also be required to meet various disability access requirements, number portability obligations, and interception or wiretapping requirements, such as the Communications Assistance for Law Enforcement Act. The imposition of such regulatory obligations or the imposition of additional federal, state or local taxes on its services could increase the Company’s cost of doing business and limit its growth.

The Company offers its products and services in other countries, and therefore could also be subject to regulatory risks in each such foreign jurisdiction, including the risk that regulations in some jurisdictions will prohibit it from providing its services cost-effectively or at all, which could limit its growth. Currently, there are several countries where regulations prohibit the Company from offering service. In addition, because customers can use the Company’s services almost anywhere that a broadband Internet connection is available, including countries where providing broadband telephone service is illegal, the governments of those countries may attempt to assert jurisdiction over the Company. Violations of these laws and regulations could result in fines, criminal sanctions against the Company, its officers or its employees, and prohibitions on the conduct of its business. Any such violations could include prohibitions on the Company’s ability to offer its products and services in one or more countries, could delay or prevent potential acquisitions, expose the Company to significant liability and regulation and could also materially damage its reputation, its brand, its international expansion efforts, its ability to attract and retain employees, its business and its operating results. The Company’s success depends, in part, on its ability to anticipate these risks and manage these difficulties.

The success of the Company’s business relies on customers’ continued and unimpeded access to broadband service. Providers of broadband services may be able to block the Company’s services or charge their customers more for also using its services, which could adversely affect t its revenue and growth.

The Company’s customers must have broadband access to the Internet in order to use its service. Providers of broadband access, some of whom are also competing providers of voice services, may take measures that affect their customers’ ability to use the Company’s service, such as degrading the quality of the data packets they transmit over their lines, giving those packets low priority, giving other packets higher priority than the Company’s, blocking its packets entirely or attempting to charge their customers more for also using its services.

On January 14, 2014, the D.C. Circuit Court of Appeals, in Verizon v. FCC, struck down major portions of the FCC’s 2010 “net neutrality” rules governing the operating practices of broadband Internet access providers. The FCC originally designed the rules to ensure an “open Internet” and included three key requirements for broadband providers: 1) a prohibition against blocking websites or other online applications; 2) a prohibition against unreasonable discrimination among Internet users or among different websites or other sources of information; and 3) a transparency requirement compelling the disclosure of network management policies. The Court struck down the first two requirements, concluding that they constitute “common carrier” restrictions that are not permissible given the FCC’s earlier decision to classify Internet access as an “information service,” rather than a “telecommunications service.” The Court upheld the FCC’s transparency requirement.

The decision affirmatively recognizes the FCC’s jurisdiction over the Internet, based on Section 706 of the Telecommunications Act of 1996. The FCC has announced that it will again propose network neutrality regulations based on this jurisdiction. Legislation in this area is also possible. The Company cannot predict to what extent this decision or future regulatory initiatives may affect its business at this time. While the Company believes that interference with access to its products and services seems unlikely, such broadband Internet access provider interference has occurred, in very limited circumstances, in the U.S., and could result in a loss of existing users and increased costs, and could impair the Company’s ability to attract new users, thereby harming its revenue and growth. On February 19, 2014, the Federal Communications Commission stated it won't appeal the aforementioned court decision regarding net neutrality rules and will try again to craft regulations to ensure open access to the Internet.

The Company may be bound by certain FCC regulations relating to the provision of E911 service, and if it fails to comply with new FCC regulations requiring it to provide E911 emergency calling services, it may be subject to fines or penalties.

In 2005, the FCC issued regulations requiring interconnected voice-over broadband providers to provide E911 services and to notify customers of any differences between the broadband telephone service emergency calling services and those available through traditional telephone providers and obtain affirmative acknowledgments from customers of those notifications. While the Company does not believe the FCC’s rules currently apply to its offering, the FCC could, however, clarify or modify its ruling to obligate the Company to provide E911 services according to its specific requirements. A proposal to broaden those covered by the requirements is currently under consideration by the FCC. According to the FCC’s rules, certain broadband communications companies must offer enhanced emergency calling services, or E911, to all customers located in areas where E911 service is available from their traditional wireline telephone company. E911 service allows emergency calls from customers to be routed directly to an emergency dispatcher in a customer’s registered location and gives the dispatcher automatic access to the customer’s telephone number and registered location information.

The consequences of failure to comply fully with the FCC's orders currently are unclear. Limitations on the Company's ability to provide E911 service or to comply with changing mandates of the FCC could materially limit its growth and have a material adverse effect on its profitability. The Company could be subjected to various fines and forfeitures. FCC rulings could also subject the Company to greater regulation in some states.

Regulatory rulings and/or carrier disputes could affect the manner in which the Company interconnects and exchanges traffic with other providers and the costs and revenues associated with doing so.

The Company exchanges calls with other providers pursuant to applicable law and interconnection agreements and other carrier contracts that define the rates, terms, and conditions applicable to such traffic exchange. The calls the Company exchanges originate from and terminate to a customer that uses a broadband Internet connection to access its services and are routed using telephone numbers of the customer's choosing. There is uncertainty, however, with respect to intercarrier compensation for such traffic while rules continue to be challenged in various courts. The FCC Order in November 2011 has asserted its jurisdiction over such traffic. Various state commissions have also issued rulings with respect to the exchange of different categories of traffic under interconnection agreements. To the extent that another provider were to assert that the traffic the Company exchanges with them is subject to higher levels of compensation than the Company, or the third parties terminating the Company's traffic to the PSTN, pay today (if any), or if other providers from whom the Company currently collects compensation for the exchange of such traffic refuse to pay it going forward, the Company may need to seek regulatory relief to resolve such a dispute. Given the recent changes to the intercarrier compensation regime, the Company cannot guarantee that the outcome of any proceeding would be favorable, and an unfavorable ruling could adversely affect the amounts the Company collects and/or pays to other providers in connection with the exchange of its traffic.

The Company's business is subject to privacy and online security risks, including security breaches, and it could be liable for such breaches of security. If the Company is unable to protect the privacy of its customers making calls using its service, or information obtained from its customers in connection with their use or payment of its services, in violation of privacy or security laws or expectations, the Company could be subject to liability and damage to its reputation.

Although the Company has developed systems and processes that are designed to protect customer information and prevent fraudulent transactions, data loss and other security breaches, such systems and processes may not be sufficient to prevent fraudulent transactions, data loss and other security breaches. Failure to prevent or mitigate such breaches may adversely affect the Company's operating results.

Customers may believe that using the Company's services to make and receive telephone calls using their broadband connection could result in a reduction of their privacy, as compared to traditional wireline carriers. Additionally, the Company's website, www.magicJack.com, serves as an online sales portal. The Company currently obtains and retains personal information about its website users in connection with such purchases. In addition, the Company obtains personal information about its customers as part of their registration to use its products and services. Federal, state and foreign governments have enacted or may enact laws or regulations regarding the collection and use of personal information.

The Company's businesses involve the storage and transmission of users' proprietary information, and security breaches could expose it to a risk of loss or misuse of this information, litigation, and potential liability. An increasing number of websites, including several other Internet companies, have recently disclosed breaches of their security, some of which have involved sophisticated and highly targeted attacks on portions of their sites. Because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems, change frequently and often are not recognized until launched against a target, the Company may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of its security occurs, the market perception of the effectiveness of the Company’s security measures could be harmed and it could lose users. A party that is able to circumvent the Company’s security measures could misappropriate the Company’s or its users' proprietary information, cause interruption in the Company’s operations, damage its computers or those of its users, or otherwise damage the Company’s reputation and business. Any compromise of the Company’s security could result in a violation of applicable privacy and other laws, significant legal and financial exposure, damage to the Company’s reputation, and a loss of confidence in its security measures, which could harm its business.

Currently, a significant number of the Company's users authorize it to bill their credit card accounts directly for all transaction fees charged by the Company. The Company relies on encryption and authentication technology licensed from third parties to provide the security and authentication to effectively secure transmission of confidential information, including customer credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography or other developments may result in the technology used by the Company to protect transaction data being breached or compromised. Non-technical means, for example, actions by a suborned employee, can also result in a data breach.

Possession and use of personal information in conducting the Company's business subjects it to legislative and regulatory burdens that could require notification of data breach, restrict its use of personal information and hinder the Company's ability to acquire new customers or market to existing customers. The Company may incur expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.

Under payment card rules and the Company's contracts with its card processors, if there is a breach of payment card information that the Company stores, it could be liable to the payment card issuing banks for their cost of issuing new cards and related expenses. In addition, if the Company fails to follow payment card industry security standards, even if there is no compromise of customer information, the Company could incur significant fines or lose its ability to give customers the option of using payment cards to fund their payments or pay their fees. If the Company were unable to accept payment cards, its business would be seriously damaged.

The Company's servers are also vulnerable to computer viruses, physical or electronic break-ins, and similar disruptions. The Company may need to expend significant resources to protect against security breaches or to address problems caused by breaches. These issues are likely to become more difficult as the Company expands the number of places where it operates. Security breaches, including any breach by the Company or by parties with which it has commercial relationships that result in the unauthorized release of the Company's users' personal information, could damage its reputation and expose the Company to a risk of loss or litigation and possible liability. The Company's insurance policies carry coverage limits that may not be adequate to reimburse it for losses caused by security breaches.

The Company's users, as well as those of other prominent Internet companies, have been and will continue to be targeted by parties using fraudulent "spoof" and "phishing" emails to misappropriate passwords, credit card numbers, or other personal information or to introduce viruses or other malware through "trojan horse" programs to the Company's users' computers. These emails appear to be legitimate emails sent by magicJack, but direct recipients to fake websites operated by the sender of the email or request that the recipient send a password or other confidential information via email or download a program. Despite the Company's efforts to mitigate "spoof" and "phishing" emails through product improvements and user education, "spoof" and "phishing" remain a serious problem that may damage the Company's brands, discourage use of its websites, and increase its costs.

The Company has a stringent privacy policy covering the information it collects from its customers and has established security features to protect its service. However, the Company's security measures may not prevent security breaches. The Company may need to expend resources to protect against security breaches or to address problems caused by breaches. If unauthorized third parties were able to penetrate its security and gain access to, or otherwise misappropriate, the Company's customers' personal information or be able to access their telephone calls, it could harm the Company's reputation and, therefore, its business and the Company could be subject to liability. Such liability could include claims for misuse of personal information or unauthorized use of credit cards. These claims could result in litigation, the Company's involvement in which, regardless of the outcome, could require it to expend significant financial resources. Internet privacy is a rapidly changing area and the Company may be subject to future requirements and legislation that are costly to implement and negatively impact its results.

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Government regulation is evolving and unfavorable changes could harm the Company's business.

The Company is subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet, e-commerce, and electronic devices. Existing and future laws and regulations may impede the Company's growth. These regulations and laws may cover taxation, privacy, data protection, pricing, content, copyrights, distribution, mobile communications, electronic device certification, electronic waste, electronic contracts and other communications, consumer protection, web services, the provision of online payment services, unencumbered Internet access to the Company's services, the design and operation of websites, and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property ownership, libel, and personal privacy apply to the Internet, e-commerce, digital content and web services. Jurisdictions may regulate consumer-to-consumer online businesses, including certain aspects of the Company's seller programs. Unfavorable regulations and laws could diminish the demand for the Company's products and services and increase its cost of doing business.

RISKS RELATED TO OUR SYSTEM SECURITY

Server failures or system breaches could cause delays or adversely affect the Company's service quality, which may cause it to lose customers and revenue.

In operating its servers, the Company may be unable to connect and manage a large number of customers or a large quantity of traffic at high speeds. Any failure or perceived failure to achieve or maintain high-speed data transmission could significantly reduce demand for the Company's services and adversely affect its operating results. In addition, computer viruses, break-ins, human error, natural disasters and other problems may disrupt the Company's servers. The system security and stability measures the Company implements may be circumvented in the future or otherwise fail to prevent the disruption of its services. The costs and resources required to eliminate computer viruses and other security problems may result in interruptions, delays or cessation of services to the Company's customers, which could decrease demand, decrease the Company's revenue and slow its planned expansion.

Hardware and software failures, delays in the operation of the Company's computer and communications systems or the failure to implement system enhancements may harm its business.

The Company's success depends on the efficient and uninterrupted operation of its software and communications systems. A failure of its servers could impede the delivery of services, customer orders and day-to-day management of the Company's business and could result in the corruption or loss of data. Despite any precautions the Company may take, damage from fire, floods, hurricanes, power loss, telecommunications failures, computer viruses, break-ins and similar events at its various facilities could result in interruptions in the flow of data to the Company's servers and from its servers to the Company's customers. In addition, any failure by the Company's computer environment to provide its required telephone communications capacity could result in interruptions in the Company's service. Additionally, significant delays in the planned delivery of system enhancements and improvements, or inadequate performance of the systems once they are completed, could damage the Company's reputation and harm its business. Finally, long-term disruptions in infrastructure caused by events such as natural disasters, the outbreak of war, the escalation of hostilities, and acts of terrorism (particularly involving cities in which it has offices) could adversely affect the Company's businesses. Although the Company maintains general liability insurance, including coverage for errors and omissions, this coverage may be inadequate, or may not be available in the future on reasonable terms, or at all. The Company cannot assure you that this policy will cover any claim against it for loss of data or other indirect or consequential damages and defending a lawsuit, regardless of its merit, could be costly and divert management's attention. In addition to potential liability, if the Company experiences interruptions in its ability to supply its services, its reputation could be harmed and the Company could lose customers.

The Company’s service requires an operative broadband connection, and if the adoption of broadband does not progress as expected, the market for its services will not grow and the Company may not be able to grow its business and increase its revenue.

Use of the Company’s service requires that the user be a subscriber to an existing broadband Internet service, most typically provided through a cable or digital subscriber line, or DSL, connection. Although the number of broadband subscribers in the U.S. and worldwide has grown significantly over the last five years, this service has not yet been adopted by all consumers and is not available in every part of the United States and Canada, particularly rural locations. If the adoption of broadband services does not continue to grow, the market for the Company’s services may not grow.

RISKS RELATING TO THE COMPANY’S ORDINARY SHARES

If securities or industry analysts do not publish research or reports about the Company’s business, if they adversely change their recommendations regarding the Company’s ordinary shares or if the Company’s operating results do not meet their expectations, the market price of the Company’s ordinary shares could decline.

The trading market for the Company’s ordinary shares will be influenced by the research and reports that industry or securities analysts publish about it or its business. If one or more of these analysts cease coverage of the Company or fail to publish reports on it regularly, the Company could lose visibility in the financial markets, which in turn could cause the price of the Company’s ordinary shares or trading volume in its ordinary shares to decline. Moreover, if one or more of the analysts who cover the Company downgrades the Company’s ordinary shares or if its operating results do not meet their expectations, the market price of the Company’s ordinary shares could decline.

The Company does not anticipate paying cash dividends on its ordinary shares, which could reduce the return on your investment.

The Company has never declared or paid cash dividends on its ordinary shares and does not expect to do so in the foreseeable future. The Company currently intends to retain its future earnings, if any, to fund the development and growth of its business and to repurchase its ordinary shares not for retirement. In addition, terms of any future debt agreements may preclude the Company from paying cash dividends. Accordingly, any return on your investment must come from an increase in the trading price of the Company’s ordinary shares.

RISKS RELATING PRIMARILY TO THE COMPANY’S INCORPORATION IN ISRAEL

The Company has operations located in Israel, and therefore its results may be adversely affected by political, economic and military conditions in Israel.

The Company’s business and operations will be directly influenced by the political, economic and military conditions affecting Israel at any given time. A change in the security and political situation in Israel could have a material adverse effect on the Company’s business, operating results and financial condition. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, including Hezbollah in Lebanon and Hamas in the Gaza Strip. In the last few years, these conflicts involved missile strikes against civilian targets in various parts of Israel and negatively affected business conditions in Israel. In addition, political uprisings and conflicts in various countries in the Middle East, including Egypt and Syria, are affecting the political stability of those countries. It is not clear how this instability will develop and how it will affect the political and security situation in the Middle East.

Furthermore, several countries, principally in the Middle East, restrict doing business with Israel and Israeli companies, and additional countries may impose restrictions on doing business with Israel and Israeli companies if hostilities in the region continue or intensify. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, operating results and financial condition.

The tax benefits and other incentives available to us require us to continue to meet various conditions and may be terminated or reduced in the future, which could increase our costs and taxes.

The Israeli government currently provides major tax and capital investment incentives to domestic companies, as well as grant and loan programs relating to research and development and marketing and export activities. In recent years, the Israeli Government has reduced the benefits available under these programs and the Israeli Governmental authorities have indicated that the government may in the future further reduce or eliminate the benefits of those programs. The Company currently takes advantage of these programs. There is no assurance that such benefits and programs would continue to be available to the Company in the future. If such benefits and programs were terminated or further reduced, it could have an adverse effect on the Company’s business, operating results and financial condition.

The Company's operations could be disrupted as a result of the obligation of its personnel to perform military service

Several of the Company's employees reside in Israel and may be required to perform annual military reserve duty and may be called for active duty under emergency circumstances at any time. The Company's operations could be disrupted by the absence for a significant period of time of one or more of these employees due to military service. Any such disruption could adversely affect the Company's business, results of operations and financial condition.

Provisions of Israeli law and the Company's Articles of Association may prevent or make it difficult for the Company to be acquired and adversely affect the market price of its ordinary shares.

Israeli corporate law regulates mergers, requires that a tender offer be effected when more than a specified percentage of shares in a company are purchased, requires special approvals for certain transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions.

Furthermore, Israeli tax considerations may make potential transactions unappealing to the Company or to its shareholders, especially for those shareholders whose country of residence does not have a tax treaty with Israel which exempts such shareholders from Israeli tax. With respect to mergers, Israeli tax law allows for tax deferral in certain circumstances but makes the deferral contingent on the fulfillment of a number of conditions, including, in some cases, a holding period of two years from the date of the transaction during which sales and dispositions of shares of the participating companies are restricted. Moreover, with respect to certain share swap transactions, the tax deferral is limited in time, and when such time expires, the tax becomes payable even if no disposition of the shares has occurred.

Certain provisions of our Articles of Association, or the Articles, may have the effect of rendering more difficult or discouraging an acquisition of the Company deemed undesirable by its Board of Directors. These provisions include a requirement that most of amendments of the Company's Articles must be approved by the holders of not less than seventy-five percent (75%) of the voting power represented at the meeting in person or by proxy and voting thereon.

These provisions of Israeli law and the Company's Articles and could have the effect of delaying or preventing an acquisition of the Company or changes in control, some of which could be deemed by certain shareholders to be in their best interests and which could affect the price some investors are willing to pay for the Company's ordinary shares.

It may be difficult to pursue an action in the U.S. or to enforce a U.S. judgment, including actions or judgments based upon the civil liability provisions of the U.S. federal securities laws, against the Company and its executive officers and directors, or to assert U.S. securities law claims in Israel.

Certain of the Company's directors are not residents of the United States and certain of their assets and the Company's assets are located outside the United States. Without consent to service of process, additional procedures may be necessary to serve individuals who are not U.S. residents. Therefore, it may be difficult to serve process on those directors who are not U.S. residents in order to commence any lawsuit against them before a U.S. court, including an action based on the civil liability provisions of U.S. federal securities laws.

An investor also may find it difficult to enforce a U.S. court judgment in an Israeli court, including a judgment based on federal securities laws. An Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel.

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An investor may also find it difficult to bring an original action in an Israeli court to enforce liabilities based upon the U.S. federal securities laws against the Company, or against its directors and officers. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws and rule that Israel is not the most appropriate forum in which to bring such a claim. In addition, even if an Israeli court agrees to hear such a claim, it may determine that Israeli law, and not U.S. law, is applicable to the claim. If U.S. law is found to be applicable, the content of applicable U.S. law must be proved as a fact, which can be a time-consuming and costly process.

Your rights and responsibilities as a shareholder will be governed by Israeli law, which differs in some respects from the rights and responsibilities of shareholders of U.S. companies.

Since the Company is incorporated under Israeli law, the rights and responsibilities of its shareholders are governed by The Company's articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in U.S.-based corporations. For example, a shareholder of an Israeli company has a duty to act in good faith and in a customary manner in exercising its rights and performing its obligations towards the company and other shareholders and to refrain from abusing its power in the company, including, among other things, voting at a general meeting of shareholders on certain matters, such as amendments to a company's articles of association, increases in a company's authorized share capital, mergers and acquisitions and related party transactions requiring shareholder approval. In addition, a shareholder who is aware that it possesses the power to determine the outcome of a shareholder vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness toward the company. There is limited case law available to assist us in understanding the nature of this duty or the implications of these provisions. These provisions may be interpreted to impose additional obligations and liabilities on holders of the Company's ordinary shares that are not typically imposed on shareholders of U.S. corporations.

Shareholder Approval of Certain Executive Compensation

Under the Companies Law, arrangements between a public company and a director as to the terms of his office, and an arrangement with a director regarding compensation for non-directorial duties in a public company, require the approval of the compensation committee followed by the approval of the board of directors and the shareholders of the company. Therefore, compensation payable to the Company's executive officers who also serve on its board of directors requires approval of the Company's compensation committee, board of directors and shareholders.

A recent amendment to the Companies Law requires shareholder approval for chief executive officer compensation including (i) the vote of at least a majority of the shares held by shareholders who are not controlling shareholders or have a personal interest in the proposal (shares held by abstaining shareholders shall not be taken into account); or (ii) that the aggregate number of shares voting against the proposal held by such shareholders does not exceed 2% of the Company's voting shareholders ("Special Majority"). These Special Majority requirements under the Companies Law may make it difficult for the Company to hire or retain executives and/or directors.

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

Our Board of Directors previously authorized a stock repurchase program to enable us to purchase our ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of $100 million as of June 30, 2014. The objective of our stock repurchase program is to improve stockholders' returns. We expended $91.3 million under our repurchase program through June 30, 2014. There were no purchases during the three months ended June 30, 2014. At June 30, 2014, we had authority to purchase the remaining $8.7 million in ordinary shares pursuant to the stock repurchase program. All shares repurchased are recorded as treasury stock.

ITEM 3. Defaults Upon Senior Securities

Not applicable.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

31.1	Certification of CEO of magicJack VocalTec Ltd. required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934.
31.2	Certification of CFO of magicJack VocalTec Ltd. required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934.
32.1	Certification of CEO of magicJack VocalTec Ltd. required by Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934.
32.2	Certification of CFO of magicJack VocalTec Ltd. required by Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934

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.

	magicJack VocalTec Ltd. (Registrant)
Dated: August 11, 2014	By: /s/ Gerald Vento Gerald Vento President and Chief Executive Officer
Dated: August 11, 2014	By: /s/ Jose Gordo Jose Gordo Chief Financial Officer