MAGICJACK VOCALTEC LTD
Form 10-Q
November 10, 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 September 30, 2014

OR

¨ 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 October 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, the New magicJack PLUSTM and the magicJackGO.

PART I – FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

ASSETS	September 30, 2014 (Unaudited)	December 31, 2013
Current assets:		
Cash and cash equivalents	$75,198	$45,997
Marketable securities, at fair value	367	8,782
Accounts receivable, net of allowance for doubtful accounts and billing adjustments of $3,395 and $3,912, respectively	3,142	3,626
Inventories	3,345	4,490
Deferred costs	2,363	4,662
Prepaid income taxes	10,528	11,956
Deferred tax assets, curent	11,259	11,267
Deposits and other current assets	2,659	818
Total current assets	108,861	91,598
Property and equipment, net	3,525	1,959
Intangible assets, net	10,314	15,656
Goodwill	32,304	32,304
Deferred tax assets, non-curent	30,797	29,684
Deposits and other non-current assets	744	693
Total assets	$186,545	$171,894
LIABILITIES AND CAPITAL EQUITY		
Current liabilities:		
Accounts payable	$7,049	$4,237
Accrued expenses and other current liabilities	8,534	9,236
Deferred revenue, current portion	54,748	54,541
Total current liabilities	70,331	68,014
Deferred revenue, net of current portion	58,756	59,951
Other non-current liabilities	6,046	6,487
Total liabilities	135,133	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 September 30, 2014 and December 31, 2013, respectively	111,771	111,744
Additional paid-in capital	9,381	3,692
Accumulated other comprehensive loss	-	(642)
Treasury stock (7,200 and 7,202 shares at September 30, 2014 and December 31, 2013, respectively)	(108,126)	(108,151)

Retained earnings	38,386	30,799
Total capital equity	51,412	37,442
Total liabilities and capital equity	$186,545	$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 September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Net revenues	$25,813	$35,533	$90,606	$105,312
Cost of revenues	9,477	12,134	33,891	35,333
Gross profit	16,336	23,399	56,715	69,979
Operating expenses:				
Marketing	6,244	2,866	15,230	8,437
General and administrative	9,402	6,892	26,721	20,386
Research and development	1,494	990	4,613	3,626
Total operating expenses	17,140	10,748	46,564	32,449
Operating (loss) income	(804)	12,651	10,151	37,530
Other income (expense):				
Gains on investments	-	-	37	722
Interest and dividend income	13	45	108	275
Interest expense	(34)	(65)	(154)	(242)
Fair value loss on common equity put options	-	-	-	(1,047)
Other income, net	1	15	4	16
Total other expense	(20)	(5)	(5)	(276)
(Loss) income before income taxes	(824)	12,646	10,146	37,254
Income tax (benefit) expense	(823)	3,743	2,559	12,257
Net (loss) income	$(1)	$8,903	$7,587	$24,997
Net (loss) income per ordinary share:				
Basic	$(0.00)	$0.48	$0.43	$1.34
Diluted	$(0.00)	$0.48	$0.43	$1.34
Weighted average ordinary shares outstanding:				
Basic	17,832	18,552	17,830	18,596
Diluted	17,832	18,560	17,832	18,604

See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Net (loss) income	$(1)	$8,903	$7,587	$24,997
Other comprehensive income (loss):				
Reclassification of unrealized loss on marketable securities to gains on investments	-	-	642	420
Net unrealized gain (loss) on marketable securities	-	1,204	-	(831)
Comprehensive (loss) income	$(1)	$10,107	$8,229	$24,586

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	-	-	5,714	-	-	-	-	5,714
Issuance of ordinary shares	-	-	(25)	-	2	25	-	-
Release of unrealized loss on marketable securities to gains on investments	-	-	-	642	-	-	-	642
Net income	-	-	-	-	-	-	7,587	7,587
Balance, September 30, 2014 (unaudited)	25,032	$111,771	$ 9,381	$ -	(7,200)	$(108,126)	$38,386	$51,412

See accompanying notes to condensed consolidated financial statements.

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

	For the Nine Months Ended September 30, 2014	For the Nine Months Ended September 30, 2013
Cash flows from operating activities:		
Net income	$7,587	$24,997
Adjustments to reconcile net income to net cash provided by operating activities:		
Recovery for doubtful accounts and billing adjustments	(64)	(3,827)
Share-based issuances and compensation	5,714	1,631
Depreciation and amortization	3,811	3,496
Impairment of intangible asset	2,464	-
Increase of uncertain tax position	351	-
Deferred income tax provision (benefit)	(1,105)	70
Interest expense - non-cash	154	242
Gains on investments	(37)	(722)
Fair value loss on common equity put options	-	1,047
Change in operating assets and liabilities:		
Accounts receivable	548	5,642
Inventories	1,145	775
Deferred costs	2,299	(151)
Prepaids and other current assets	(437)	(39)
Deposits and other non-current assets	(51)	126
Accounts payable	2,809	(288)
Accrued expenses and other current liabilities	(694)	(1,830)
Deferred revenue	(988)	(2,347)
Other non-current liabilities	-	19
Net cash provided by operating activities	23,506	28,841
Cash flows from investing activities:		
Proceeds from sales of investments	9,094	12,622
Purchases of property and equipment	(1,911)	(84)
Acquisition of intangible assets	(15)	(117)
Net cash provided by investing activities	7,168	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	29,201	34,058
Cash and cash equivalents, beginning of period	45,997	18,959
Cash and cash equivalents, end of period	$75,198	$53,017

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 Nine Months Ended September 30, 2014	2013
Supplemental disclosures:		
Interest paid	$-	$-
Income taxes paid	$165	$12,578
Non-cash investing and financing activities:		
Property and equipment (acquired but not paid)	$103	$-
Intangible assets (acquired through financing)	$470	$-
Accrued expenses and other current liabilities	$(573)	$-

See accompanying notes to condensed consolidated financial statements.

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, provides 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 nine months ended September 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 $21.7 million and $30.9 million for the three months ended September 30, 2014 and 2013, respectively, and $77.7 million and $91.3 million for the nine months ended September 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 $2.5 million and $3.2 million for the three months ended September 30, 2014 and 2013, respectively, and $8.0 million and $9.6 million for the nine months ended September 30, 2014 and 2013, respectively.

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

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 nine months ended September 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 magicJacks, 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 nine months ended September 30, 2014 and 2013, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

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

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 and 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 $0.4 million for the three months ended September 30, 2014 and 2013, respectively, and $55 thousand and $2.4 million for the nine months ended September 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 $1.1 million and $1.5 million for the three months ended September 30, 2014 and 2013, respectively, and $3.5 million and $4.0 million for the nine months ended September 30, 2014 and 2013, respectively.

Marketing Expenses

Marketing expenses of $6.2 million and $2.9 million for the three months ended September 30, 2014 and 2013, respectively, and $15.2 million and $8.4 million for the nine months ended September 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 (in thousands):

	For the Three Months Ended	For the Nine Months Ended

	September 30,		September 30,	
	2014	2013	2014	2013
Advertising media buys	$ 4,297	$ 2,408	$ 9,795	$ 6,997
Marketing personnel related	596	35	2,176	63
Other marketing projects	1,351	423	3,259	1,377
Total Marketing Expense	$ 6,244	$ 2,866	$ 15,230	$ 8,437

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

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 $1.5 million and $1.0 million for the three months ended September 30, 2014 and 2013, respectively, and $4.6 million and $3.6 million for the nine months ended September 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. The Company has never experienced any losses related to these balances. At September 30, 2014, the Company had cash and cash equivalents totaling $75.2 million, which included (i) $74.6 million in U.S. financial institutions, and (ii) $0.6 million in an Israeli financial institution.

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

The Company’s non-interest bearing cash balances in U.S. banks, which included $1.4 million in one individual financial institution, were fully insured. The Company had money market accounts with a brokerage institution with balances totaling approximately $73.2 million.

Two telecommunications carriers accounted for approximately 25% and 11% of gross accounts receivable at September 30, 2014, respectively, and one telecommunications carrier accounted for approximately 28% at December 31, 2013. For the three and nine months ended September 30, 2014 and 2013, no telecommunications carrier accounted for more than 10% of the Company’s total net revenues.

One U.S. retail customer accounted for approximately 10% of gross accounts receivable at December 31, 2013. For the three and nine months ended September 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 and common equity put options in the Company's own stock. As of September 30, 2014 and December 31, 2013, all of the Company’s financial assets 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 September 30, 2014 and December 31, 2013, respectively with $1.4 million and $1.5 million included in accrued expenses and other current liabilities at September 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 September 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 September 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.

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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 September 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 September 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. Management believes there is no impairment at September 30, 2014.

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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 primarily of 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. The Company decreased the valuation allowance by $0.3 million during the three and nine months ended September 30, 2014. No adjustments were made to the valuation allowance during the three and nine months ended September 30, 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 the Company estimates 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 the Company estimates 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 consideration 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 September 30, 2014, the estimated annual effective income tax rate is expected to approximate 26.7%, 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 September 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):

	September 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 September 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 September 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 September 30, 2014 and 2013 was $0, and did not include any reclassification of unrealized gain (loss) on marketable securities from other comprehensive gains (losses) on investments. Gains on investments for the nine months ended September 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 $0.4 million, respectively. During the nine months ended September 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 the specific identification method.

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NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

	September 30, 2014	December 31, 2013
Raw materials	$ 1,356	$ 1,266
Finished goods	1,989	3,224
Total	$ 3,345	$ 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. The Company wrote-off approximately $42 thousand of obsolete inventory during the three and nine months ended September 30, 2014. There were no write-downs of obsolete inventory for the three and nine months ended September 30, 2013.

NOTE 5 – PROPERTY AND EQUIPMENT

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

	Estimated Useful Lives (in years)	September 30, 2014	December 31, 2013
Switches	3 - 15	$ 8,437	$ 7,099
Computers	3 - 10	2,507	2,370
Furniture	3 - 5	257	160
Leasehold-improvements	*	670	228
Accumulated depreciation and amortization		(8,346)	(7,898)
Total		$ 3,525	$ 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 September 30, 2014 and 2013 was $0.2 million and $0.1 million, respectively. Depreciation expense for the nine months ended September 30, 2014 and 2013 was $0.4 million and $0.4 million, respectively.

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NOTE 6 – INTANGIBLES ASSETS

As of September 30, 2014 and December 31, 2013, the Company had intangible assets with carrying values of $10.3 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 September 30, 2014 and December 31, 2013. Identified intangible assets with finite lives subject to amortization consist of the following (in thousands):

	Estimated Useful Lives (in years)	September 30, 2014 Gross Carrying Amount	Accumulated Amortization	Net	Weighted-Average Life	December 31, 2013 Gross Carrying Amount	Accumulated Amortization	Net	Weighted-Average Life
Technology	3 - 17	$ 5,221	$ (4,479)	$ 742	5.56	$ 5,221	$ (4,254)	$ 967	6.19
Intellectual property rights	3 - 17	14,161	(7,105)	7,056	5.46	14,161	(5,280)	8,881	5.69
Covenants not-to-compete and not-to-sue	2 - 5	2,085	(1,390)	695	1.67	5,781	(1,385)	4,396	1.97
Tradename	3 - 6	321	(291)	30	1.25	321	(274)	47	2.00
Customer relationships	5 - 7	750	(640)	110	2.83	750	(581)	169	3.58
Software license	4- 5	470	-	470	4.25	-	-	-	-
Backlog	1	800	(800)	-	-	800	(800)	-	-
Total		$ 23,808	$ (14,705)	$ 9,103		$ 27,034	$ (12,574)	$ 14,460	

Amortization expense for the three months ended September 30, 2014 and 2013 was $0.8 million. Amortization expense for the nine months ended September 30, 2014 and 2013 was $3.4 million and $3.1 million, respectively. Due to the passing of the Company's founder and former CEO in July 2014, the Company recorded an impairment charge of $2.5 million included in general and administrative expense related to the write-off of $2.5 million net carrying value associated with the non-compete agreement with the Company's founder and former CEO included in intangible assets. Amortization expense for the nine months ended September 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 September 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

Three months ending December 31, 2014	$	841
2015		2,733
2016		1,675
2017		1,441
2018		964
Thereafter		1,449
	$	9,103

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.

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

	September 30, 2014	December 31, 2013
magicJack devices	$ 7,579	$ 14,855
Access right renewals	43,325	37,108
Prepaid minutes	2,362	2,578
Other	1,482	-
Deferred revenue, current	54,748	54,541
Deferred revenue, non-current*	58,756	59,951
Total deferred revenues	$ 113,504	$ 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 $4.7 million and $5.2 million for the three months ended September 30, 2014 and 2013, respectively, and approximately $15.3 million and $16.5 million for the nine months ended September 30, 2014 and 2013, respectively.

NOTE 8 – OTHER LIABILITIES

As of September 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 September 30, 2014 and December 31, 2013, respectively, with $1.4 million and $1.5 million included in accrued expenses and other current liabilities at September 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.

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.

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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. 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 September 30, 2014. At September 30, 2014, there was remaining $8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased and 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 September 30, 2014 and December 31, 2013. The Company did not repurchase any shares in the three and nine months ended September 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 nine months ended September 30, 2013. The Company has not repurchased any shares subsequent to September 30, 2014.

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 nine months ended September 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 nine months ended September 30, 2013.

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

	Nine Months Ended September 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 September 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.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Ordinary share options	$ 1,176	$ 883	$ 4,882	$ 883
Restricted stock units	286	348	832	348
Ordinary shares	-	-	-	400
	$ 1,462	$ 1,231	$ 5,714	