

MAGICJACK VOCALTEC LTD
Form 10-K
March 16, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2017

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.)

12 HAOMANUT STREET, 2ND FLOOR
POLEG INDUSTRIAL ZONE, NETANYA, ISRAEL 4250445
(Address of principal executive offices, including zip code)

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

Securities registered pursuant to Section 12(b) of the Act:
Ordinary Shares, No Par Value The NASDAQ Stock Market LLC
(Title of each class) (Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:
NONE

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Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate 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 No

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Non-accelerated filer

Large accelerated filer Accelerated filer (Do not check if smaller reporting company)

Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

The aggregate market value of the ordinary shares held by non-affiliates of the registrant computed by reference to the price of the registrant's Ordinary Shares as of the last business day of the registrant's most recently completed second fiscal quarter (based on the last reported sale price on the Nasdaq Global Stock Market as of such date) was \$73,697,308.

The number of the registrant's ordinary shares outstanding as of February 28, 2018 was 16,189,894.

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DEFINITIONS

In this annual report on Form 10-K, unless the context otherwise requires:

- references to “magicJack VocalTec,” the “Company,” “we,” “us” or “our” are to magicJack VocalTec Ltd., a company organized under the laws of the State of Israel (the “Registrant”), and its subsidiaries;
- references to “common shares”, “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. All references to “NIS” are to New Israeli Shekels and “PLN” are to Polish Zloty. Except as otherwise indicated, financial statements of, and information regarding, magicJack VocalTec are presented in U.S. dollars;
- references to the “Companies Law” are to Israel’s Companies Law, 5759-1999, as currently amended;
- references to the “Exchange Act” are to the Securities Exchange Act of 1934, as amended;
- references to “NASDAQ” are to the Nasdaq Global Stock Market;
- references to the “SEC” are to the United States Securities and Exchange Commission; and
- references to the “magicJack devices” are to the original magicJack®, the magicJack PLUS™, the New magicJack PLUS™, the magicJackGO and the magicJackEXPRESS™.

USE OF TRADEMARKS

VocalTec, MAGICJACK, MAGICJACK PLUS, MAGICJACK APP, MAGICJACK AMERICA, MAGICAPP & Design, M & App Icon Design, MAGICJACK Sensory/Sound Mark, MAGICJACKGO, MAGICJACK CONNECT and MAGICJACKEXPRESS (stylized) are trademarks of magicJack VocalTec. Trademark applications for MAGICJACK AMERICA, MAGICJACKEXPRESS (stylized), M & App Icon Design, MAGICAPP & Design, and MAGICJACK CONNECT are pending in the United States. Outside the United States, trademark registrations for the MAGICJACK mark have been obtained in Canada, China, the European Union, El Salvador, India, Mexico and Peru. The Company owns Canadian trademark registrations for MAGICJACK PLUS, and MAGICJACK APP, as well as, pending Canadian trademark applications for M & App Icon Design, MAGICAPP & Design, and MAGICJACKEXPRESS (stylized). Additionally, the Company has been granted trademark registrations for M & App Icon Design, MAGICAPP & Design, MAGICJACK AMERICA, MAGICJACKEXPRESS (stylized), and MAGICJACKGO in Mexico. These trademarks are important to our business. Although we have omitted the “®” and “TM” trademark designations for such trademarks in this annual report, all rights to such trademarks are nevertheless reserved.

PART I

This annual report on Form 10-K contains historical information and forward-looking statements within the meaning of section 27A of the Securities Act of 1933, as amended, and section 21E of the Securities Exchange act of 1934, as amended. Actual results could differ materially from those set forth in these forward-looking statements. The words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “plan,” “project,” “should” and similar expressions, as they relate to magicJack VocalTec or its management, are intended to identify forward-looking statements. Such statements reflect the current views and assumptions of magicJack VocalTec with respect to future events and are subject to risks and uncertainties. Many factors could cause the actual results, performance or achievements to be materially different from any future results, performance or achievements that may be expressed or implied by such forward-looking statements, both referenced and not referenced in this annual report. Such factors are set forth under Part I, Item 1A, “Risk Factors,” below. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those expected. Any forward-looking statements in this annual report on Form 10-K are made as of the date hereof, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

ITEM 1. BUSINESS

Business 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. The Company charges highly competitive rates for the right to access its servers (“access right”), and the Company’s customers then continue to have the ability to obtain free telephone services. The Company currently offers the magicJack GO and magicJack EXPRESS, which are updated versions of the magicJack device 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 magicJack mobile apps are applications that allow users to make and receive telephone calls through their smart phones using their magicJack account. Currently, consumers that do not have a magicJack account can purchase and download the magicJack mobile apps to make telephone calls from anywhere in the world into the U.S. or Canada for free. The mobile apps include the magicApp and the magicJack Connect App, which are available for both iOS and Android. 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 Appserver 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 device. The Company also wholesales telephone service to VoIP providers and telecommunication carriers.

The Company’s strategy since 2007 has been to vertically integrate its technology, design and suppliers, and it has completed four acquisitions between 2007 and 2010, including a merger with the company that invented VoIP, in order to implement this strategy.

From 2011 through 2015, the Company has offered several versions of the magicJack device and mobile apps. The device has been progressively upgraded to include superior voice quality, expanded memory and enhanced processing power. The initial access right period for the different versions of the device ranged from three to twelve months.

In March 2016, the Company acquired substantially all of the assets of North American Telecommunications Corporation (dba “Broadsmart”). Broadsmart is a hosted Unified Communication as a Service (“UCaaS”) provider for medium-to-large multi-location enterprise customers. Broadsmart has experience provisioning and delivering complex UCaaS solutions to corporate customers on a nationwide basis. Broadsmart services multi-location, geographically diverse enterprises. With the acquisition of Broadsmart, the Company has diversified its operations into UCaaS targeting high end enterprise customers. This acquisition was intended to position the Company to compete long-term in the UCaaS market.

During the first quarter of 2016, the Company created a new subsidiary, magicJack SMB, Inc. (“SMB”). Through this subsidiary, the Company provides easy-to-buy, simple-to-use VoIP services to small to medium sized businesses at competitive prices. The Company began sales of its SMB product during the third quarter of 2016. During 2017, the Company rolled back its investment in the SMB product and launched the magicJack “Spark” product, a business focused mobile App product.

The Company has historically prepared its consolidated financial statements on the basis of being a single reporting entity. Beginning in the first quarter of 2016, the Company has been reporting the results of operations for these new business lines as separate Reportable Segments – “Core Consumer,” “Enterprise” and “SMB”. These segments are organized by the products and services that are sold and the customers that are served. The Core Consumer segment represents the historical magicJack consumer business. The Enterprise segment includes Broadsmart and the SMB segment includes SMB. Refer to Note 16, “Segment Reporting,” in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

In May 2016, we launched the magicJack Connect App for iOS and Android. The magicJack Connect App offers users free worldwide Wi-Fi App-to-App calling & messaging. The App also offers an unlimited U.S. calling plan which allows subscribers to call the U.S. from anywhere in the world plus receive a U.S. phone number for only \$9.99 per year.

On November 9, 2017, the Company entered into a Merger Agreement with B. Riley Financial, Inc. (“B. Riley”), in which B. Riley proposes to acquire all of the outstanding shares of the Company for \$8.71 per share. The purchase price of \$8.71 per share represents a premium of approximately (i) 18.5% over the closing price of the Company’s ordinary shares on the NASDAQ Global Select Market on March 14, 2017, the last completed trading day prior to the date that the Company announced that it had received unsolicited indications of interest and would be considering its strategic alternatives, (ii) 23.6% over the 90-day average closing price of the Company’s ordinary shares for the period ended November 7, 2017, and (iii) 54.2% over the closing price of the Company’s ordinary shares on November 8, 2017, the last completed trading day prior to the Company’s announcement that it entered into the Merger Agreement. The Transaction is subject to various closing conditions, including Company shareholder approval and regulatory approvals. A Special Meeting of the Shareholders is scheduled for March 19, 2018, to vote on the Transaction. The Company anticipates completing the Transaction in the first half of 2018.

The Company's corporate name is magicJack VocalTec Ltd. for both legal and commercial purposes. The Company is located at 12 Haomanut Street, 2nd Floor, Poleg Industrial Area, Netanya, Israel 4250445 (telephone number +972-9-970-3888). The Company was organized under the laws of the State of Israel in 1989 and is subject to the Israeli Companies Law, or the Companies Law. The Company's subsidiary, YMax Corporation ("YMax", and together with VocalTec, the "Combined Company"), is located at 560 Village Blvd., Suite 120, West Palm Beach, Florida, 33409 (telephone number 561-749-2255).

Product and Service Offerings

magicJack Devices

The magicJack is a VoIP device weighing about one ounce which includes an initial access right period. Customers receive free VoIP phone service for their home, enterprise or while traveling. The Company started selling the magicJack in late 2007. Since that time, the Company has offered several upgraded versions of the device with superior voice quality, expanded memory and enhanced processing power. The initial access right period for the different versions ranges from three to twelve months. The current device available for purchase is the magicJack GO, which includes a twelve month access right period. magicJack devices are sold either directly to customers through our website or through retailers.

Mobile apps

The Company also offers magicJack mobile apps, which are applications that allow users to make and receive telephone calls through their smart phones or devices. The Company currently offers the magicApp, magicJack Connect and magicJack Spark. The magicApp and magicJack Connect are mobile apps available for both iOS and Android. In 2017, the Company launched magicJack Spark on iOS and Android devices. The mobile apps allow customers to place and receive telephone calls in the U.S. or Canada on their mobile devices through either an existing or new magicJack account. The mobile apps also give users the ability to add a second phone number to their smart phone for a monthly or annual fee. Customers may purchase international minutes to place telephone calls through the magicJack device or mobile apps to locations outside of the U.S. and Canada.

Access Right Renewals

Customers who own a magicJack device or mobile app may renew access rights for periods ranging from one month to five years.

Other magicJack-Related Products

The Company offers customers other optional products related to their magicJack devices and services, such as custom or vanity phone numbers, Canadian phone numbers, the ability to either change their existing phone numbers or port them to a magicJack device, and battery powerbanks for mobile devices.

Prepaid Minutes

The Company's customers can purchase international minutes on a prepaid basis.

Access and Wholesale Charges

The Company generates revenues from access fees charged to other carriers, as well as wholesaling telephone service to VoIP providers and telecommunication carriers.

UCaaS Services and Equipment

The Company provides hosted communication services and sells hardware and network equipment that are compatible with the service, through its subsidiary, Broadsmart, which has a track record of provisioning and delivering complex UCaaS solutions to blue chip corporate customers on a nationwide basis.

Sources of Revenues

The Company generates revenues from the following sources:

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

Access right renewals and mobile apps – represent revenues from customers purchasing rights to access our servers beyond the access right period included with a magicJack device or magicJack service. The extended access right ranges from one to five years. These fees charged to customers are initially deferred and recognized as revenue ratably over the extended access right period. Revenues from access rights granted to users of the magicApp, magicJack Connect App and magicJack Spark are recognized ratably over the access right period;

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Shipping and handling – represent charges for shipping and handling fees for magicJack devices shipped directly to customers. The fees are initially deferred and recognized as revenues over the access right period associated with the magicJack device;

magicJack-related products – represent revenues recognized from the sale of other items related to the magicJack devices and access right renewals the Company offers its 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) sale of battery powerbanks for mobile devices. These revenues are recognized at the time of sale, with the exception of sales of the battery powerbank which are recognized when shipped;

Prepaid minutes – represent revenues recognized primarily from the usage and expiration of international prepaid minutes, net of chargebacks. Revenues from prepaid minutes are recognized as minutes are used;

Access and wholesale charges – represent revenues generated from: (i) access fees charged to other telecommunication carriers or providers for Inter-exchange Carriers (“IXC”) calls terminated to the Company’s end-users, and (ii) fees charged to telecommunication 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. Revenues from access and wholesale charges are recognized as minutes are used;

UCaaS – represents revenues recognized from: (i) recurring monthly service revenue from sales of its hosted services - customers are billed monthly in advance for these recurring services and in arrears for one time service charges and other certain usage charges, and (ii) non-recurring revenue from the sale of hardware and network equipment. Revenues for recurring monthly service are recorded in the period the services are provided over the term of the respective customer agreements and revenue from the sale of hardware and network equipment is recognized in the period that the equipment is delivered and put into service; and

Other revenues – represent VoIP services provided to small to medium sized businesses and revenues generated by ancillary revenue sources.

Approximately 86%, 87% and 90% of the Company’s consolidated revenues for the years ended December 31, 2017, 2016 and 2015, respectively, were derived from sales to customers located in the United States.

The following table presents a breakdown of the Company’s net revenues by source for the periods indicated (in thousands).

	Year Ended December 31,		
	2017	2016	2015
Net revenues			
Sale of magicJack devices	\$10,361	\$12,775	\$15,915
Access right renewals	51,925	58,513	65,761
Shipping and handling	1,308	889	794
magicJack-related products	4,730	5,435	4,289
Prepaid minutes	4,441	5,677	8,243
Access and wholesale charges	3,769	5,021	5,953
UCaaS	10,868	8,966	-
Other	591	122	7
Total net revenues	\$87,993	\$97,398	\$100,962

Research and Development

The Company's research and development activities consist primarily of the design and development of its proprietary software used in the magicJack devices, the mobile apps and its servers, as well as the development of new products and applications for use in its VoIP service offerings.

Research and development expenses were \$5.9 million, \$5.2 million, and \$4.5 million for the years ended December 31, 2017, 2016, and 2015, respectively. During the three months ended March 31, 2017, \$0.6 million of research and development expense was related to the SMB segment prior to its being absorbed into the Core Consumer segment. The balance of research and development expense was related to the Core Consumer segment. The Company accounts for research and development costs in accordance with the applicable accounting pronouncements described in Note 2, "Summary of Accounting Policies," in the Notes to our Consolidated Financial Statements included in Item 8 herein.

Markets Where We Compete

The primary market in which the Company currently competes is the United States. As of December 31, 2017, approximately 98% of its property and equipment, net of depreciation, is located in the United States. For the year ended December 31, 2017, approximately 86% of its consolidated revenues were derived from sales to customers located in the United States. The remaining 14% of consolidated revenues were primarily derived from sales in Canada.

Business Seasonality

The Company's revenues are not subject to seasonal fluctuations. However, quarterly revenue amounts are impacted by the timing of customer renewals and the revenues for Broadsmart can be impacted by the timing of non-recurring equipment and other sales.

Manufacturing

In 2006, the Company entered into a manufacturing and supply agreement with a Chinese company to manufacture the magicJack devices. Certain components of the magicJack device are built for the Company, based on the Company's specifications, in Taiwan and Hong Kong and then sent to the Chinese manufacturer in China for final assembly.

The Company's supply chain and third party manufacturing arrangements are structured to allow the Company to control product quality, realize cost efficiencies and minimize the risks associated without having to disclose proprietary technology to multiple outside parties during production. The Company's strategy since 2007 has been to vertically integrate the Company's technology and design suppliers, and the Company has completed three acquisitions since 2007 to implement this strategy. As a result of these strategic acquisitions, the Company controls practically every stage in the design of the Company's products. Certain magicJack device parts are sourced directly by the production facility in China. The Company works closely with our suppliers to plan inventory procurement in quantities that will meet customer demand while minimizing inventory risks. The Company purchases components and sub-assemblies through separate purchase orders and does not currently have any long-term purchase contracts with these suppliers. Prices of our components have not fluctuated significantly in the past three fiscal years.

Marketing, Sales and Distribution

For its Core Consumer business, the Company has relied on various marketing methods to advertise its products, including digital marketing and long and short form television commercials. The Company currently distributes the magicJack devices through retail outlets, including Walmart, Best Buy, Fry's and others, as well as through direct sales via the Company's web-site.

For its Enterprise business, Broadsmart has not historically marketed through traditional advertising channels but has relied on direct sales and a network of strong, established third party re-seller relationships.

In the years ended December 31, 2017, 2016 and 2015, sales of the magicJack devices through retail outlets represented approximately 53%, 52% and 67%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 47%, 48% and 33%, respectively, of magicJack devices sold.

For the years ended December 31, 2017, 2016 and 2015, no retailer accounted for more than 10% of operating revenues for the Core Consumer or SMB segments. For the years ended December 31, 2017 and 2016, two customers accounted for approximately 29% of operating revenues for the Enterprise segment: Advance Auto Parts of 18% and Lewis, Brisbois, Bisgaard & Smith of 11%.

Competition

The Company's Core Consumer business faces competition from traditional telephone companies, wireless companies, cable companies and alternative voice communication providers. Some of our principal competitors are the traditional telephone service providers, such as AT&T, Inc., CenturyLink, Inc. and Verizon Communications Inc., which provide telephone service based on the public switched telephone network. Some of these traditional providers also have 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. Some of these providers may be developing a dual mode phone that will be able to use broadband telephone service where broadband access is available and cellular phone service elsewhere, which will pose additional competition to our offerings.

The Company faces competition on magicJack device sales from Apple, Samsung 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, and Skype, which are other non-interconnected voice providers, 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.

Because most of its customers are purchasing communications services from one or more of these providers, success is dependent upon the Company's ability to attract customers away from their existing providers. The Company competes primarily through the quality and cost structure of its infrastructure and its low pricing.

The Company's new Enterprise segment and SMB business operate in a highly competitive market for business voice services which includes some of the same large competitors as its Core Consumer business (AT&T and Vonage) as well as other smaller competitors such as 8x8, Inc., Ooma, RingCentral, ShoreTel and Inteliquent.

Many of the Company's actual and potential competitors enjoy greater name recognition, longer operating histories, more varied products and services and larger marketing budgets, as well as substantially greater financial, technical and other resources than the Company does. In addition, the Company may also face future competition from new market entrants.

Our Competitive Positioning

The Company believes that the key competitive factors in our market include:

- pricing and cost structure;
- ease of initial set-up and use;
- call quality;
- customer care; and
- ease of use and the design of features and capabilities that are attractive to customers.

The Company believes that its large existing user base, competitive pricing, efficient customer acquisition model, low cost service delivery and customer care capabilities, position us well to compete effectively in the future.

Intellectual Property

The Company believes that the improvement of existing products and services, its technologies and the development of new products are important in establishing and maintaining a competitive advantage. The Company believes that the value of its products is dependent, to a certain extent, upon the maintenance of intellectual property rights, the license rights to use certain intellectual property rights, trade secrets or copyright protection of its proprietary software and technologies. The Company relies on a combination of trade secrets, copyrights, trademarks and patents, together with non-disclosure and invention assignment agreements, to establish and protect the technology used in its products.

magicJack VocalTec and its wholly-owned subsidiaries hold numerous patents in the United States and other countries with respect to certain technologies employed and to be employed in its products. In addition, VocalTec or its wholly owned subsidiaries have obtained licenses (in one case, an exclusive license) from other patent owners to use technology protected by those patents.

The Company's U.S. trademark registrations include VocalTec & Design, MAGICJACK, MAGICJACK PLUS, MAGICJACK APP, MAGICJACK Sensory/Sound Mark and MAGICJACKGO. Trademark applications for MAGICJACK AMERICA, MAGICJACKEXPRESS (stylized), M & App Icon Design, MAGICAPP & Design and MAGICJACK CONNECT are pending in the United States. Outside the United States, trademark registrations for the

MAGICJACK house mark have been obtained in Canada, China, the European Union, El Salvador, India, Mexico and Peru. The Company also owns Canadian trademark registrations for MAGICJACK PLUS and MAGICJACK APP, as well as, Canadian trademark applications for M & App Icon Design, MAGICAPP & Design, and MAGICJACKEXPRESS (stylized). Additionally, the Company has been granted trademark registrations for M & App Icon Design, MAGICAPP & Design, MAGICJACK AMERICA, MAGICJACKEXPRESS (stylized), and MAGICJACKGO in Mexico. These trademarks are important to our business. Although we have omitted the “®” and “tm” trademark designations for such trademarks in this annual report, all rights to such trademarks are nevertheless reserved. All other trademarks or registered trademarks used in this Annual Report on Form 10-K are the property of their respective owners.

The Company relies on a combination of patents, copyrights, trademarks and trade secrets, as well as confidentiality agreements, to establish and protect its intellectual property worldwide. The Company has filed numerous foreign and domestic patent right applications directed to its magicJack device and other products with E911 capability, emergency call routing, emergency call location determination, and other technologies. At present, the Company owns seven issued utility patents and two issued design patents in the United States, and it is the licensee (in one case, the exclusive licensee) of several issued U.S. patents. The Company is also actively researching new technologies and improvements to its existing technologies and intends to pursue intellectual property right protection for these technologies to the extent permissible by law and prudent for its business. The patents owned by the Company expire through or by April 2032. Many of the Company's software and communication solutions have been developed internally and are proprietary.

Although the Company does not believe that its products infringe any valid claim of a patent owned by any third party, third parties have asserted infringement and other claims against it from time to time. These claims have been directed at certain basic and fundamental components of the Company's products. There can be no assurance that third parties will not assert such claims against the Company in the future or that such claims will not be successful.

Effects of Governmental Regulations

In the United States, the Company's Enterprise and SMB segments are subject to federal regulation under the rules and regulations of the Federal Communications Commission ("FCC" or the "Commission") and various state and local regulations. The Company believes that, under current regulations, the Company's Core Consumer segment, and its magicJack, LP subsidiary, is not an interconnected VoIP provider subject to those regulations.

The Company provides broadband telephone services using VoIP technology and/or services treated as information services by the FCC. The Company is also licensed as a Competitive Local Exchange Carrier ("CLEC") and is subject to extensive federal and state regulation applicable to CLECs. The FCC has to date asserted limited statutory jurisdiction and regulatory authority over the operations and offerings of certain providers of broadband telephone services, including non-interconnected VoIP. FCC regulations may now, or may in the future, be applied to the Company's broadband telephone operations. Other FCC regulations apply to the Company because it provides international calling capability. Some of the Company's operations are also subject to regulation by state public utility commissions ("PUCs").

Inter-carrier Compensation

On November 18, 2011, the FCC released a Report and Order (the "FCC Order") and Further Notice of Proposed Rulemaking that comprehensively reforms the system under which regulated service providers compensate each other for terminating interstate and intrastate traffic. Regulated service providers are free to negotiate alternative arrangements, but the FCC Order establishes default rates in the absence of agreements between regulated service providers. The rules adopted by the FCC provide for a multiyear transition to a national bill-and-keep framework as the ultimate end state for all telecommunications traffic terminated by a local exchange carrier. Under bill-and-keep, providers do not charge an originating carrier for terminating traffic and instead recover the costs of termination from their own customers.

Pursuant to the FCC Order, rates are lowered for the most common termination functions performed by regulated service providers when exchanging traffic. The transition period depends on the type of regulated service provider. After the relevant transition is complete, service providers will be required to recoup certain termination costs directly from their customers and not from other service providers. As part of this transition, depending on the particular function performed and the type of regulated service provider, the rate for inter- and intrastate traffic was reduced to \$0.0007 per minute effective July 1, 2016 for the most common termination functions performed by price cap regulated service providers and their competitors. Beginning July 1, 2018, these regulated service providers must recover the costs associated with the provision of terminating services from their customers rather than from other

service providers.

The FCC Order also establishes new rules concerning traffic exchanged over Public Switch Telephone Network (“PSTN”) facilities that originates or terminates in Internet Protocol format, referred to as “VoIP-PSTN” traffic. As with traditional and wireless telecommunications traffic, regulated service providers will ultimately be required to recoup all costs associated with terminating such traffic from their customers. But as part of the transition to that end point, the FCC Order adopts a VoIP-PSTN specific framework for compensation between regulated service providers, establishing two rates for such traffic: toll and local. The toll rate will match the relevant interstate access rate for traditional telecommunications traffic and the local rate will match the reciprocal compensation rate associated with traditional telecommunications traffic. Further, the FCC Order allows regulated service providers to tariff charges associated with handling VoIP-PSTN traffic in a manner consistent with the FCC’s rules, which took effect on December 29, 2011.

The FCC Order broadly reformed the system of default rates that apply to payments between regulated service providers going forward, but did not resolve past disputes. While the rates for termination of VoIP-PSTN traffic are ultimately reduced, the FCC’s ruling may provide the certainty needed to collect interstate access charges for such traffic during the transition to bill-and-keep. To the extent that another provider were to assert that the traffic we exchange with them is subject to higher levels of compensation than we, or the third parties terminating our traffic to the PSTN, pay today (if any), our termination costs could initially increase, but ultimately will be reduced as the intercarrier compensation system transitions to bill-and-keep.

The FCC clarified in January 2015 that its VoIP symmetry rule does not require a CLEC or its VoIP provider partner to provide the physical last-mile facility to the VoIP provider's end user customers in order to provide the functional equivalent of end office switching, and thus for the CLEC to be eligible to assess access charges for this service. The ruling confirms that the VoIP symmetry rule is technology and facilities neutral and applies regardless of whether a CLEC's VoIP partner is a facilities-based or over-the-top VoIP provider. However, in November 2016, the U.S. Court of Appeals for the D.C. Circuit vacated the FCC's ruling. The Company cannot predict how the D.C. Circuit's decision will affect the amounts the Company collects and/or pays to other providers in connection with the exchange of its traffic.

E911 Calling

The FCC has required providers of interconnected VoIP services to provide 911 emergency calling capabilities to their customers. While the Company believes it is not an interconnected VoIP provider as currently defined by the FCC and thus is not subject to the FCC's 911 rules, it nevertheless provides some 911 capability for its customers. In September 2010, the FCC released a nationwide industry "Notice of Inquiry" seeking additional comments on a number of issues including, but not limited to, whether nomadic interconnected VoIP providers should be required to offer automatic location information of their users without customers providing location information. The FCC also sought comment on how far it can extend E911 obligations to other types of companies including device manufacturers, software developers and others. In July 2011, the FCC released a Second Further Notice of Proposed Rulemaking, seeking comment on various issues including (i) whether to apply the FCC's 911 rules to "outbound-only" interconnected VoIP services (i.e., services that support outbound calls to the PSTN but not inbound voice calling from the PSTN); (ii) whether to develop a framework for ensuring that all covered VoIP providers can provide automatic location information for VoIP 911 calls; and (iii) whether to revise the FCC's definition of interconnected VoIP service to require an "Internet connection" rather than a broadband connection, and to "define connectivity in terms of the ability to terminate calls to all or substantially all United States E.164 telephone numbers." As part of the same release, the FCC included a Notice of Proposed Rulemaking that sought comment on whether any amendment of the definition of interconnected VoIP service should be limited to 911 purposes, or should apply more broadly to other contexts. In September 2011, the FCC released a Notice of Proposed Rulemaking seeking comment on what role the FCC should play to facilitate the implementation of "next generation" 911 capabilities, including, for example, the short-term implementation of text-to-911 solutions; the prioritization of 911 traffic, especially during times of natural and manmade disasters; long-term implementation of IP-based alternatives for delivering text, photos, videos, and other data to 911; and the path towards integration and standardization of IP-based text-to-911. At this time, the Company cannot predict the outcome of these proceedings nor can it predict their potential impact on its business. The Company's VoIP E911 services are more limited than the 911 services offered by traditional wireline telephone companies. These limitations may cause significant delays, or even failures, in callers' receipt of emergency assistance.

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. Such fees are often put in terms of a fee placed on monthly bills, or focused on use from a specific location. 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 telecommunications services. The Company may also not know the end user's location because the magicJack devices and services are nomadic. If fees are owed, they are owed by the end user and not the Company, as most statutes, to the extent they apply, would have the Company act as a billing and collection agent. Should a regulatory authority require payment of money from the Company for such support, magicJack LP may decide to not offer its 911 service in that area or 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 2013 as a result of settlement of litigation, the Company agreed that it would, at least once a year, issue bills for 911 emergency calling services to all U.S. customers who have access to 911 services through their magicJack services, and who have 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. Although the Company strongly disagrees with these assertions and believes that any such authority's claims are without merit, if a jurisdiction were to prevail, the decision could have an adverse effect on the Company's financial condition and results of operations.

Network Neutrality

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 rule compelling the disclosure of specific information about the broadband service, including network management policies. The Court struck down the first two rules, 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 rule.

In response to the D.C. Circuit's decision, the FCC released an order in March 2015 adopting new net neutrality rules. In doing so, the FCC reclassified broadband Internet access - the retail broadband service mass-market customers buy from cable, phone, and wireless providers - as a telecommunications service regulated under Title II of the Communications Act of 1934, although the FCC agreed to forbear from many requirements of Title II. Significantly, these rules applied equally to fixed and mobile broadband networks.

The FCC adopted three new bright-line rules as follows:

No Blocking: Broadband providers may not block access to legal content, applications, services, or non-harmful devices.

No Throttling: Broadband providers may not impair or degrade lawful Internet traffic on the basis of content, applications, services, or non-harmful devices.

No Paid Prioritization: Broadband providers may not favor some lawful Internet traffic over other lawful traffic in exchange for consideration of any kind - in other words, no "fast lanes." This rule also banned Internet Service Providers (ISPs) from prioritizing content and services of their affiliates.

The FCC also adopted a fourth "general conduct" rule in the form of a forward-looking standard. This rule was intended to address concerns that may arise with new practices that do not fall within one of the three bright line rules by prohibiting questionable practices that unreasonably interfered with or unreasonably disadvantage the ability of consumers to use or for providers to make available lawful content, applications, services, or devices. The FCC also adopted enhanced transparency requirements with which broadband providers must comply.

After the FCC's new net neutrality rules went into effect in June 2015, various broadband providers and their trade associations challenged the FCC's decision before the U.S. Court of Appeals for the D.C. Circuit. In June 2016, the D.C. Circuit issued its decision upholding the FCC's rules. The D.C. Circuit also denied various parties have filed petitions seeking rehearing en banc of the D.C. Circuit court's decision. Various parties have sought review by the United States Supreme Court of the D.C. Circuit's decision, which remains pending, and the current FCC chairman had expressed his intent to revisit the FCC's rules. The Company cannot predict the outcome of these proceedings.

In December 2017, the FCC adopted its "Restoring Internet Freedom Order," which: 1) restored the classification of broadband Internet access services as unregulated information services, ending Title II regulation of these services; 2) eliminated the FCC's three "bright-line" net neutrality rules; 3) eliminated the FCC's "general conduct" rule; and 4) adopted a new transparency rule. The "Restoring Internet Freedom Order" has been published in the Federal Register and will take effect on April 23, 2018, except for the new transparency rule, which will not take effect until approved by the Office of Management and Budget.

Multiple parties have filed petitions seeking judicial review of the "Restoring Internet Freedom Order," which have been consolidated and assigned for hearing by the United States Court of Appeals for the Ninth Circuit (which may be asked to transfer the case to the D.C. Circuit). The Company cannot predict how these challenges will be resolved. However, a decision by a court upholding the FCC decision to eliminate legal prohibitions against broadband providers blocking, throttling, or otherwise degrading the quality of the Company's data packets or attempting to extract additional fees from the Company or its customers could adversely impact the Company's business. A court also could find that the FCC lacks legal authority to regulate broadband services, which could prevent a future FCC from adopting new rules to govern the operating practices of broadband providers.

Universal Service Fund ("USF") and Other Funds

The FCC and many PUCs have established USF programs to ensure that affordable telecommunications services are widely available in high cost areas and for low income telephone subscribers and to promote universal availability of modern networks capable of providing voice and broadband service. In addition to USF, the FCC imposes other fees to meet the costs of establishing and maintaining a numbering administration system, to recover the shared costs of

long-term number portability, and to contribute to the Telecommunications Relay Services (“TRS”) Fund. All telecommunications carriers and other providers are required to contribute to these funds, including interconnected VoIP providers. The FCC and many PUCs have for a number of years been considering substantial changes to the USF system including changes in contribution methodology. Some proposals, if adopted, could have a material adverse effect on the Company.

On Thursday, December 14, 2017, the Federal Communications Commission voted 3-2 to reverse its 2015 order classifying the provision of broadband internet access services as a “telecommunication service” subject to Title II of the Communications Act of 1934, and restoring the classification of broadband internet access services as an “information service” under Title I of the Communications Act. This reclassification moves the provision of broadband internet services from treatment as a utility (with greater governmental oversight over the provision of the utility’s services) to treatment as another offering by a telecommunications service provider.

The December 14, 2017 Order consequentially rescinds the rules prohibiting blocking of lawful internet content and applications, throttling or degrading lawful internet traffic, and paid prioritization of certain internet traffic. These three prohibitions form the core of the “net neutrality” rules – essentially, the rules that required all internet traffic to be treated equally.

The order was made public on January 4, 2018, and the Company anticipates that various state attorneys general and others who want to reverse the repeal will challenge the FCC’s decision. The repeal itself is not yet final since it takes effect 60 days after publication in the Federal Register.

The FCC has also indicated its intent to reexamine the current USF contribution methodology, which may include requiring contributions based on revenues from broadband and other Internet Protocol-based services. The Company cannot predict how any changes to the current USF contribution methodology may affect its business at this time.

On February 3, 2015, the FCC released a policy statement for a new methodology for calculating forfeitures for violations of the USF and other federal program payment rules. Under the new treble damages methodology, each violator’s apparent base forfeiture liability will be three times its delinquent debts to the USF, TRS fund, Local Number Portability (“LNP”) fund, North American Numbering Plan (“NANP”) fund, and regulatory fee programs. As before, each single failure to pay a federal program assessment constitutes a separate violation that continues until the assessment is fully paid. The methodology will be used in future enforcement actions, although a group of industry trade associations have petitioned the Commission for review and a stay of this methodology. At this time the Company cannot predict the impact, if any, this policy statement will have on the Company’s operations in the event the Company is found to have violated the Communications Act or FCC rules.

Customer Privacy and Promotional Activities

The Company is subject to various federal and state laws and regulations seeking to protect the privacy of customers’ personal information that restrict the Company’s ability to use such information for marketing and promotional purposes. The FCC limits telephone companies’ and interconnected VoIP providers’ use of customer proprietary network information (“CPNI”) such as telephone calling records without customer approval, and requires those companies to protect CPNI from disclosure. Federal and state laws also limit the Company’s and other companies’ ability to contact customers and prospective customers by telemarketing, email or fax to advertise services.

Communications Assistance for Law Enforcement Act (“CALEA”)

In September 2005, the FCC concluded that interconnected VoIP service providers must comply with the CALEA and configure their network and services to support law enforcement activity in the area of wiretaps and call records. The Company provides CALEA-compliant services even though the Company believes it is not an interconnected VoIP provider subject to CALEA.

Services for the Disabled

Interconnected VoIP providers and manufacturers of specially designed equipment used to provide those services must take steps to ensure that individuals with disabilities, including hearing impaired and other disabled persons, have reasonable access to their services, if such access is readily achievable. The Company believes it is not an interconnected VoIP provider as currently defined by the FCC.

Number Portability

The FCC requires interconnected VoIP providers to comply with LNP rules that allow subscribers remaining in the same geographic area to switch from a wireless, wireline or VoIP provider to any other wireless, wireline or VoIP

provider and keep their existing phone numbers. The Company provides LNP, even though the Company believes it is not an interconnected VoIP service provider subject to the LNP rules.

Outage Reporting

In 2012, the FCC adopted a Report and Order requiring interconnected VoIP providers to report significant service outages to the FCC. The Report and Order defines outage reporting for interconnected VoIP service, establishes reporting criteria and thresholds, and discusses how the reporting process should work, what information should be reported, and confidential treatment of the outage reports. The Company believes it is not an interconnected VoIP provider subject to the outage reporting rules.

Discontinuance of Service Reporting

The FCC requires interconnected VoIP providers to file an application with the Commission and obtain approval prior to discontinuing, reducing, or impairing service. The Company believes it is not an interconnected VoIP provider subject to the service discontinuance rules.

Annual Traffic and Revenue Reports

In January 2013, the FCC extended annual traffic and revenue reporting requirements to non-interconnected VoIP service providers. Carriers engaged in providing international telecommunications service, and companies engaged in providing VoIP service connected to the PSTN, between the United States and any foreign point are required to file a report with the Commission showing revenues, payouts, and traffic for international telecommunications service and VoIP service connected to the PSTN provided during the preceding calendar year. The FCC is considering eliminating or narrowing its current international traffic reporting requirements. At this time the Company cannot predict the impact, if any, that these reporting requirements will have on the Company's operations.

Broadband and Telephone Competition Reporting

Interconnected VoIP service providers, facilities-based providers of broadband connections to end user locations, providers of wired or fixed wireless local exchange telephone service, and facilities-based providers of mobile telephony service are required to submit to the FCC on an annual basis a Broadband and Telephone Competition Report. Through the report the FCC collects information to analyze the deployment of broadband infrastructure and competition. The Company believes it is not an interconnected VoIP provider subject to submitting a Broadband and Telephone Competition Report.

Effects of State Regulations

The Company has been, and will continue to be, subject to a number of PUC and other state regulations that govern the terms and conditions of the Company's offerings, including billing practices, 911 fees, distribution of telephone numbers, customer disputes and other consumer protection matters. The Company cannot predict the outcome of current or future proceedings, nor can it predict the potential impact on the Company's business.

Rural Call Completion Reporting

To the extent a covered provider makes the initial long-distance path choice for more than 100,000 domestic retail subscriber lines, the provider is subject to the FCC's record retention and reporting requirements. Specifically, the provider must record and retain information about call attempts to rural operating company numbers ("OCN"s) and must submit certified reports for call attempts to both rural and non-rural OCNs. The FCC's Wireline Competition Bureau has clarified that: (1) covered providers may not count unanswered call attempts as answered calls under the FCC's data retention and reporting rules; and (2) the explanatory notes in Appendix C of the FCC's Order that describe "answered" calls and "busy," "ring no answer," and "unassigned number" call attempts are intended to serve as examples rather than exclusive definitions. As part of their quarterly reports to the FCC, covered providers should explain the method they used to identify these call attempt categories. The Company is currently collecting and reporting the required data. At this time, the Company cannot predict the impact, if any, that these reporting requirements will have on the Company's operations.

State and Municipal Taxes

The Company believes that it files all required state and municipal tax returns and pays all required state and municipal taxes (such as sales, excise, utility, and ad valorem taxes), fees and surcharges. The Company's Enterprise

and SMB segments remit state and municipal taxes as required in the states where they are registered to do business. The Company believes that its Core Consumer segment is exempt from certain taxes, fees and surcharges because it does not charge for telephone services or render bills to its customers. The Company's Core Consumer segment remits sales tax in Florida on sales of magicJack units because of the personnel, property and activities of its magicJack LP subsidiary that are in Florida. Certain states and municipalities may disagree with the Company's policies regarding the Core Consumer business and may believe it should be remitting taxes for past or future sales on certain items or services. Although the Company strongly disagrees and believes any possible claims are without merit, if a state or municipality were to prevail, the decision could have an adverse effect on the Company's financial condition and results of operation. magicJack LP does not have activities or have representation in any other states. However, many states are changing their statutes and interpretations thereof as part of new streamlined sales tax initiatives to collect sales taxes from nonresident vendors that sell merchandise over the Internet to in state customers. The Company's Core Consumer segment may at some time be required to collect and remit sales taxes to states other than Florida. The Company's Core Consumer business may also become required to pay other taxes, fees and surcharges to a large number of states and municipalities as a result of statutory changes in the basis on which such taxes, fees and surcharges are imposed. In the event that the Company's Core Consumer segment is required to collect sales taxes or other taxes from direct sales for states other than Florida on the sale of magicJack devices or on the renewal of our service offerings, the Company will bill and collect such taxes from our customers. The Company will examine any future fees and surcharges imposed as a result of statutory changes and determine on a case by case basis whether to bill its customers or increase the initial or access right sales prices to cover the additional fees and surcharges.

Regulatory Environment

In addition to the foregoing regulations to which the Company may be subject directly, changes to FCC and PUC regulations could affect the services, and the terms and conditions of service, the Company is able to provide. Moreover, changes to any regulations to which the Company is subject directly or indirectly could create uncertainty in the marketplace that could reduce demand for its services, increase the cost of doing business as a result of costs of litigation or increased service delivery cost or could in some other manner have a material adverse effect on the Company's business, financial condition or results of operations. Any new legislation or regulation, or the application of laws or regulations from jurisdictions whose laws do not currently apply to the Company's business, could have a material adverse effect on its business.

Employees

As of December 31, 2017, the Company had 136 full-time employees, of whom 116 were in the United States, 9 were in Poland and 11 were in Israel. The Company's employees are not represented by a labor union. The Company believes that its relations with its employees are good. In Israel, the Company's relations with employees are governed by labor regulations that provide for specific terms of employment between the Company and its employees.

Neither the Company's employees nor the Company are parties to any collective bargaining agreements, except for provisions of such agreements that are applicable to the industry in which the Company is engaged by virtue of expansion orders of the Israeli Ministry of Labor and Welfare issued under applicable Israeli laws.

Available Information

The Company's annual report on Form 10-K (or Form 20-F for prior years), quarterly reports on Form 10-Q, current reports on Form 8-K (or Form 6-K for filings up to December 31, 2011), Proxy Statements, specialized disclosure reports on Form SD, as well as any amendments to those reports, will be provided in electronic format, free of charge, upon request, as soon as reasonably practicable after they are filed with or furnished to the SEC. You can learn more about the Company by reviewing its SEC filings under the "Financial Information" tab on its web site at <http://www.vocaltec.com>. The investor relations section of our website also includes charters for our audit committee and compensation committee of our board of directors, as well as our code of ethics that applies to all of our employees, officers and directors, including our chief executive officer and our chief financial officer.

The SEC also maintains a website at <http://www.sec.gov> that contains reports, proxy statements and other information about SEC registrants, including magicJack VocalTec. You may also obtain these materials at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

References to the Company's website and the SEC's website in this report are provided as a convenience and do not constitute, and should not be viewed as, incorporation by reference of the information contained on, or available through, such websites.

ITEM 1A. RISK FACTORS

The following are certain risks to which our business operations are subject. Any of these risks could have an adverse effect on the Company's business, financial condition, cash flow, results of operations or future performance. These risks could also cause our actual results to differ materially from those indicated in the forward looking statements contained herein and elsewhere. The risks described below are not the only risks we face. Additional risks not currently known to us or those we currently deem to be immaterial may also materially and adversely affect our business, financial condition, cash flows, results of operations or future performance.

RISKS RELATED TO OUR BUSINESS

We are in the process of executing a strategic alternatives process and have entered into an Agreement and Plan of Merger with B. Riley Financial, Inc., but the transaction requires the satisfaction of certain conditions including approval of shareholders as well as regulatory approval both in the United States and Israel, and there can be no assurance that we will be successful in obtaining the requisite approvals and completing the transaction or that the transaction will yield additional value for our shareholders or that the transaction will not have negative impacts on our business.

On November 9, 2017, we entered into an Agreement and Plan of Merger with B. Riley Financial, Inc. There can be no assurance that the transaction will be finalized, as it is subject to the satisfaction of certain conditions including approval by our shareholders, approval by government regulators in the United States and Israel and other specific conditions as outlined in the Merger Agreement.

We have incurred, and may continue to incur, substantial costs associated with running our strategic alternatives process, including the cost of legal and financial advisors. The process has been time consuming and disruptive to our business operations. If we are unable to effectively manage the strategic alternatives process, our business, financial condition, liquidity and results of operations could be materially adversely affected.

The market in which the Company participates is highly competitive and if the Company 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 offer broadband telephone services to their existing cable television and broadband offerings. Further, wireless providers, including AT&T Mobility, Inc., Sprint Corporation, T-Mobile USA Inc., and Verizon Wireless, Inc. 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 broadband or wireline-based phone 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, Ooma, and Skype, which is another

non-interconnected voice provider, and may face competition from other large, well-capitalized Internet companies. In addition, the Company competes with independent broadband telephone service providers.

Increased competition may result in our competitors using aggressive business tactics, including providing financial incentives to customers, selling their products or services at a discount or loss, offering products or services similar to our products and services on a bundled basis at a discounted rate or no charge, announcing competing products or services combined with aggressive marketing efforts, and asserting intellectual property rights or claims, irrespective of their validity.

We believe that some of our existing competitors may choose to consolidate or may be acquired in the future. Additionally, some of our competitors may enter into alliances or joint ventures with each other or establish or strengthen relationships with other third parties. Any such consolidation, acquisition, alliance, joint venture or other relationship could adversely affect our ability to compete effectively, lead to pricing pressure, our loss of market share and could harm our business, results of operations and financial condition.

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 and related products and services, (2) the successful implementation of monetization initiatives for our proprietary mobile apps, the magicApp, magicJack Connect and magicJack Spark and (3) the successful integration of the Broadsmart business and implementation of the new Small Office Home Office (“SOHO”) initiatives of the new management team. The failure to grow device and related revenues in the Core Consumer business through increased device sales in the future would make us more reliant on other growth initiatives and cause a longer-term decrease in our overall revenues which could have a material adverse effect on our business, results of operations, financial condition and 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 the Company 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, and 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.

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 subscriber agreement that ranges generally from one month 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 subscriber agreement after their initial term period expires, and these agreements 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 retaining customers for renewals. The Company may not be able to accurately predict future trends in customer renewals, and its customers' 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 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 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 products, services and enhancements. The introduction of new products or 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 products or services, enhance its existing products or services to anticipate and meet customer preferences or sell its products and services into new markets, the Company's revenue and results of operations would be adversely affected.

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 and businesses. Accordingly, the Company's inability to successfully commercialize additional products, services and features in the future 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. In addition, 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.

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.

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.

While the Company has new products currently in development or beta versions currently in testing, its continued ability to adapt to a changing business environment will be a significant factor in maintaining or improving its competitive position and its prospects for growth. Factors resulting in potential 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

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 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 the Company's 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. 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.

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 periods of 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 products must comply with various domestic and international regulations and standards and failure to do so could have an adverse effect on its business, operating results and financial condition.

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

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 devices 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 regulations 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 for its Core Consumer business 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 all of its users, it does not believe that it is required by regulations to do so for its Core Consumer business. The Company may, in the future, decide to discontinue providing such services for its Core Consumer business. Discontinuing such services may adversely affect customer demand, may result in fines by the FCC and may affect the Company's revenues.

The success of the Company's business is dependent on cost-effective marketing and its growth may be adversely 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 maintain and/or 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.

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 card 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 periods of rapid growth in the past. If it fails to manage future growth effectively, the Company may be unable to maintain high levels of service or address competitive challenges adequately.

Since 2008, the Company has experienced periods where it sells a significant number of magicJack device units and where it has 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 could 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 could experience interruptions in the future as a result of these types of problems. Interruptions could 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 products, 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 the Company's 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 the Company's 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; earthquakes, typhoons, tsunamis, fires, floods, or other natural disasters; 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 devices, 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 the Company's 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