

MAGICJACK VOCALTEC LTD  
Form 10-Q  
November 09, 2016

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2016

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 its charter)

STATE OF ISRAEL  
(State or Other Jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

12 HAOMANUT STREET, 1ST 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)

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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,

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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

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

Large Accelerated filer

Accelerated filer

Non-accelerated filer

(do not check if a smaller reporting company)

Smaller reporting company

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

Yes  No

There were 15,896,695 ordinary shares with no par value outstanding at October 31, 2016.

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## DEFINITIONS

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

- references to “magicJack VocalTec,” the “Company,” “we,” “us” or “our” are to magicJack VocalTec Ltd., a company organized under the laws of the State of Israel (the “Registrant”), and its subsidiaries;
- references to “ordinary shares”, “our shares” and similar expressions refer to the Registrant’s Ordinary Shares, no par value;
- references to “\$” or “dollars” are to U.S. dollars and all references to “NIS” are to New Israeli Shekels. Except as otherwise indicated, financial statements of, and information regarding, magicJack VocalTec are presented in U.S. dollars; and
- references to the “magicJack devices” are to the original magicJack®, the magicJack PLUSTM, the New magicJack PLUSTM , the magicJackGO and the magicJackEXPRESSTM.

## PART I – FINANCIAL INFORMATION

## ITEM 1. Financial Statements

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

|   | September<br>30,<br>2016 | December<br>31,<br>2015 |
|---|--------------------------|-------------------------|
| <b>ASSETS</b>   |                          |                         |
| (Unaudited)   |                          |                         |
| Current assets:   |                          |                         |
| Cash and cash equivalents   | \$ 51,526                | \$ 78,589               |
| Investments, at fair value  | 447                      | 367                     |
| Accounts receivable, net of allowance for doubtful accounts and billing adjustments of \$528 and \$455, respectively                                | 2,626                    | 2,925                   |
| Inventories   | 4,463                    | 5,723                   |
| Deferred costs  | 2,316                    | 2,097                   |
| Prepaid income taxes  | 602                      | 2,747                   |
| Receivable from earnout escrow  | 2,000                    | -                       |
| Deposits and other current assets   | 2,508                    | 2,655                   |
| Total current assets  | 66,488                   | 95,103                  |
| Property and equipment, net   | 3,805                    | 3,302                   |
| Intangible assets, net  | 29,924                   | 6,687                   |
| Goodwill  | 47,485                   | 32,304                  |
| Deferred tax assets, non-current  | 30,824                   | 30,689                  |
| Deposits and other non-current assets   | 819                      | 751                     |
| Total assets  | \$ 179,345               | \$ 168,836              |
| <b>LIABILITIES AND CAPITAL EQUITY</b>   |                          |                         |
| Current liabilities:  |                          |                         |
| Accounts payable  | \$ 2,780                 | \$ 1,086                |
| Income tax payable  | 1,764                    | -                       |
| Accrued expenses and other current liabilities  | 7,223                    | 6,284                   |
| Deferred revenue, current portion   | 49,324                   | 52,554                  |
| Total current liabilities   | 61,091                   | 59,924                  |
| Deferred revenue, net of current portion  | 45,811                   | 50,146                  |
| Other non-current liabilities   | 13,451                   | 11,098                  |
| Total liabilities   | 120,353                  | 121,168                 |
| Commitments and contingencies (Note 10)   |                          |                         |
| Capital equity  |                          |                         |
| Ordinary shares, No par value; 100,000 shares authorized; 25,039 and 25,036 shares issued at September 30, 2016 and December 31, 2015, respectively | 111,781                  | 111,773                 |
| Additional paid-in capital  | 15,640                   | 14,573                  |
| Treasury stock (9,179 and 9,426 shares at September 30, 2016 and December 31, 2015, respectively)   | (122,994 )               | (126,772 )              |

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|  |            |            |
|--|------------|------------|
| Retained earnings                                    | 55,046     | 48,094     |
| Total magicJack VocalTec, LTD. shareholders's equity | 59,473     | 47,668     |
| Noncontrolling interest                              | (481 )     | -          |
| Total capital equity                                 | 58,992     | 47,668     |
| Total liabilities and capital equity                 | \$ 179,345 | \$ 168,836 |

See accompanying notes to condensed consolidated financial statements.

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

|  | For the Three Months<br>Ended<br>September 30, |          | For the Nine Months<br>Ended<br>September 30, |          |
|--|--|----------|---|----------|
|  | 2016   | 2015     | 2016  | 2015     |
| Net revenues                                     | \$24,572                                       | \$25,409 | \$73,572                                      | \$76,331 |
| Cost of revenues                                 | 9,509  | 8,225    | 27,556  | 26,361   |
| Gross profit                                     | 15,063   | 17,184   | 46,016  | 49,970   |
| Operating expenses:                              |  |          |   |          |
| Marketing  | 2,680  | 2,357    | 5,659   | 6,940    |
| General and administrative                       | 7,641  | 6,286    | 24,828  | 21,297   |
| Research and development                         | 1,314  | 1,088    | 3,661   | 3,418    |
| Gain on mark-to-market                           | (2,000 )                                       | -        | (2,000 )                                      | -        |
| Total operating expenses                         | 9,635  | 9,731    | 32,148  | 31,655   |
| Operating income                                 | 5,428  | 7,453    | 13,868  | 18,315   |
| Other income (expense):                          |  |          |   |          |
| Interest and dividend income                     | 5  | 6        | 21  | 23       |
| Interest expense                                 | -  | -        | -   | (57 )    |
| Other (expense) income, net                      | (6 )   | 4        | (11 )   | (2 )     |
| Total other (expense) income                     | (1 )   | 10       | 10  | (36 )    |
| Income before income taxes                       | 5,427  | 7,463    | 13,878  | 18,279   |
| Income tax expense                               | 2,205  | 4,152    | 7,407   | 6,708    |
| Net income                                       | 3,222  | 3,311    | 6,471   | 11,571   |
| Net loss attributable to noncontrolling interest | 177  | -        | 481   | -        |
| Net income attributable to common shareholders   | \$3,399  | \$3,311  | \$6,952                                       | \$11,571 |
| Net Income per common share:                     |  |          |   |          |
| Basic  | \$0.21   | \$0.20   | \$0.44  | \$0.66   |
| Diluted  | \$0.21   | \$0.20   | \$0.44  | \$0.66   |
| Weighted average ordinary shares outstanding:    |  |          |   |          |
| Basic  | 15,857   | 16,651   | 15,786  | 17,400   |
| Diluted  | 15,865   | 16,658   | 15,935  | 17,426   |

See accompanying notes to condensed consolidated financial statements.

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

|  | For the Three Months<br>Ended<br>September 30, |         | For the Nine Months<br>Ended<br>September 30, |          |
|--|--|---------|---|----------|
|  | 2016   | 2015    | 2016  | 2015     |
| Net income   | \$3,222  | \$3,311 | \$6,471                                       | \$11,571 |
| Other comprehensive income (loss):                         |  |         |   |          |
| Comprehensive loss attributable to noncontrolling interest | 177  | -       | 481   | -        |
| Comprehensive income attributable to common shareholders   | \$3,399  | \$3,311 | \$6,952                                       | \$11,571 |

See accompanying notes to condensed consolidated financial statements.



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

|  | Ordinary Shares |            | Additional<br>Paid-in<br>Capital | Treasury Stock |             | Retained<br>Earnings | Non<br>controlling<br>Interest | Total<br>Capital<br>Equity |
|--|-----------------|------------|----------------------------------|----------------|-------------|----------------------|--------------------------------|----------------------------|
|  | Number          | Amount     |                                  | Number         | Amount      |                      |                                |                            |
| Balance, January 1,<br>2016                | 25,036          | \$ 111,773 | \$ 14,573                        | (9,426 )       | \$(126,772) | \$ 48,094            | \$ -                           | \$ 47,668                  |
| Exercise of ordinary<br>share options      | 3               | 8          | -                                | -              | -           | -                    | -                              | 8                          |
| Share-based<br>compensation                | -               | -          | 3,169                            | -              | -           | -                    | -                              | 3,169                      |
| Issuance of ordinary<br>shares             | -               | -          | (169 )                           | 14             | 169         | -                    | -                              | -                          |
| Issuance of shares for<br>acquisition      | -               | -          | (1,933 )                         | 233            | 3,609       | -                    | -                              | 1,676                      |
| Net income                                 | -               | -          | -                                | -              | -           | 6,952                | (481 )                         | 6,471                      |
| Balance, September<br>30, 2016 (unaudited) | 25,039          | \$ 111,781 | \$ 15,640                        | (9,179 )       | \$(122,994) | \$ 55,046            | \$ (481 )                      | \$ 58,992                  |

See accompanying notes to condensed consolidated financial statements.

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

|   | For the Nine Months<br>Ended<br>September 30, |           |
|---|---|-----------|
|   | 2016  | 2015      |
| <b>Cash flows from operating activities:</b>                                      |   |           |
| Net income  | \$6,471                                       | \$11,571  |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |           |
| Provision for doubtful accounts and billing adjustments                           | 210   | 70        |
| Share-based compensation  | 3,169   | 3,906     |
| Depreciation and amortization   | 3,510   | 2,877     |
| Gain on mark-to-market  | (2,000 )                                      | -         |
| Impairment of intangible assets   | 498   | -         |
| Increase (release) of uncertain tax positions                                     | 1,548   | (1,124 )  |
| Deferred income tax provision   | 626   | 6,105     |
| Interest expense - non-cash   | -   | 57        |
| Change in operating assets and liabilities  |   |           |
| Accounts receivable   | 656   | 1,265     |
| Inventories   | 1,562   | (605 )    |
| Deferred costs  | (219 )  | 927       |
| Prepaid income taxes  | 2,237   | 5,985     |
| Deposits and other current assets   | (187 )  | (909 )    |
| Other non-current assets  | 28  | (6 )      |
| Accounts payable  | 1,495   | (1,546 )  |
| Income taxes payable  | 1,764   | (873 )    |
| Accrued expenses and other current liabilities                                    | (237 )  | (1,511 )  |
| Deferred revenue  | (7,737 )                                      | (6,869 )  |
| Other non-current liabilities   | (110 )  | 11        |
| Net cash provided by operating activities   | 13,284  | 19,331    |
| <b>Cash flows from investing activities:</b>                                      |   |           |
| Purchase of investments   | (80 )   | -         |
| Purchases of property and equipment   | (256 )  | (548 )    |
| Acquisition of Broadsmart   | (40,019 )                                     | -         |
| Net cash used in investing activities   | (40,355 )                                     | (548 )    |
| <b>Cash flows from financing activities:</b>                                      |   |           |
| Purchase of treasury stock  | -   | (13,565 ) |
| Repurchase of ordinary shares to settle withholding liability                     | -   | (94 )     |
| Payment of other current liabilities  | -   | (1,500 )  |
| Proceeds from exercise of ordinary share options                                  | 8   | -         |
| Net cash provided by (used in) financing activities                               | 8   | (15,159 ) |
| Net (decrease) increase in cash and cash equivalents                              | (27,063 )                                     | 3,624     |
| Cash and cash equivalents, beginning of period                                    | 78,589  | 75,945    |

|  |          |          |
|--|----------|----------|
| Cash and cash equivalents, end of period | \$51,526 | \$79,569 |
|--|----------|----------|

See accompanying notes to condensed consolidated financial statements.

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

|  | For the Nine Months Ended<br>September 30, |          |
|--|--|----------|
|  | 2016                                       | 2015     |
| <b>Supplemental disclosures:</b>                     |  |          |
| Interest paid  | \$ -                                       | \$ -     |
| Income taxes paid                                    | \$ 1,304                                   | \$ 3,318 |
| <b>Non-cash investing and financing activities:</b>  |  |          |
| Ordinary shares issued for acquisition of Broadsmart | \$ 1,676                                   | \$ -     |

See accompanying notes to condensed consolidated financial statements.

## NOTE 1 –DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

### Description of Business

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

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

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

In March 2016, the Company acquired substantially all of the assets of North American Telecommunications Corporation (dba “Broadsmart”). Broadsmart is a leading hosted UCaaS (Unified Communication as a Service) provider for medium-to-large multi-location enterprise customers. Broadsmart has a track record of designing, provisioning and delivering complex UCaaS solutions to blue chip corporate customers on a nationwide basis. Broadsmart has expertise in servicing enterprises with hundreds-to-thousands of locations. With the acquisition of Broadsmart, the Company has diversified its operations into UCaaS targeting high end small-to-medium-sized businesses (SMBs) and enterprise customers. This acquisition has positioned 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. Through this subsidiary, the Company provides easy-to-buy, simple-to-use VoIP services to small businesses at disruptive prices. The Company began sales of its SMB product during the third quarter of 2016.

### Basis of Presentation

The Company’s unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the Company’s unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included. The balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

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

Approximately 90% of the Company's revenues in the Consumer Segment in the three and nine months ended September 30, 2016 and 2015 were from sales to customers located in the United States. The majority of the Company's Consumer Segment revenues recognized were generated from sales of the magicJack product line and from the software access right that accompanies these products, which were \$19.2 million and \$21.8 million for the three months ended September 30, 2016 and 2015, respectively, and \$58.8 million and \$65.6 million for the nine months ended September 30, 2016 and 2015, respectively. The Company's Consumer Segment also provides its customers with the ability to make prepaid calls using the magicJack devices and magicJack APP by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were \$1.4 million and \$2.0 million for the three months ended September 30, 2016 and 2015, respectively, and \$4.6 million and \$6.4 million for the nine months ended September 30, 2016 and 2015, respectively.

The majority of the Company's Enterprise Segment revenues recognized were generated from Broadsmart hosted UCaaS services and sales of hardware and equipment which were \$2.8 million and \$6.2 million for the three and nine months ended September 30, 2016, respectively. There was no revenue for Broadsmart for the three and nine months ended September 30, 2015.

The Company's SMB Segment has not generated material revenue for the three and nine months ended September 30, 2016.

#### Basis of Consolidation

The Company's unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries. The results of Broadsmart Global, Inc. have been included since March 17, 2016. Refer to Note 15 – "Acquisition of Business," for further details. All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three and nine months ended September 30, 2016 may not be indicative of the results for the entire year ending December 31, 2016. The interim unaudited condensed consolidated financial statements should be read in conjunction with the Company's financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this report and in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 filed on March 15, 2016.

#### Noncontrolling Interest

During the nine months ended September 30, 2016, the Company formed a new subsidiary and entered into a joint venture with an unrelated third party which resulted in the Company having a 60% controlling interest in the joint venture which anticipates selling a line of high-technology residential consumer products in the fourth quarter of fiscal year 2016. To date the company has spent approximately \$1.2 million dollars funding the operations of this joint venture. The operations of the joint venture for the nine months ended September 30, 2016 have not been significant to the Company's financial statements. The Company's unaudited condensed consolidated financial statements for three and nine months ended September 30, 2016, included an adjustment to comprehensive income attributable to common shareholders of \$177 thousand and \$481 thousand, respectively, to recognize the impact of the noncontrolling interest. The Company is evaluating whether the joint venture will meet the aggregation criteria with the existing commercial segment or be treated as a standalone segment.

#### NOTE 2 – SUMMARY OF ACCOUNTING POLICIES

A summary of significant accounting policies used in preparing the Company's financial statements, including a summary of recent accounting pronouncements that may affect its financial statements in the future, follows:

#### Use of Estimates

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

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

#### Net Revenues

Net revenues consists of revenue from sales of magicJack devices to retailers, wholesalers or directly to customers, access right renewal fees, fees charged for shipping magicJack devices, usage of domestic and international prepaid minutes, access charges to other carriers, recurring sales of the Company's hosted UCaaS voice services, non-recurring sales of equipment related to its UCaaS services and other miscellaneous charges. The Company typically enters into multi-year agreements, typically with durations of three to five years, to provide the hosted voice and other services. The Company earns revenue from the sale of the hardware and network equipment necessary to operate its UCaaS services directly to its customers. All revenue is recorded net of sales returns and allowances.



## Revenue Recognition

### Consumer Segment

#### magicJack Devices and Renewal Access Revenue

The Company recognizes revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of its software to access the Company's servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period. Revenue from the sales of magicAPP and magicJack Connect access rights is recognized ratably over the access right period. The revenue from sales of battery powerbanks is fully recognized in the period of sale. When a discounted battery powerpack is sold as part of a package, revenue is allocated between the package components based on relative fair value.

### Sales Return Policy

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

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. The Company estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the three and nine months ended September 30, 2016 and 2015, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

### Prepaid Minutes and Access and Wholesale Charges

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

### Enterprise Segment

#### Broadsmart/UCaaS Revenue

The Company recognizes revenues from sales of its hosted services in the period the services are provided over the term of the respective customer agreements. Customers are billed monthly in advance for these recurring services and in arrears for one time service charges and other certain usage charges. Revenues from sales of hardware and network equipment are recognized in the period that the equipment is delivered. Revenue from the sale of equipment purchased but not yet delivered and installed is deferred and recognized in the period that the hardware or equipment is put into service.

### SMB Segment

### VoIP Services

The Company provides VoIP services to small businesses. Revenue from this segment is immaterial for the three and nine months ended September 30, 2016.

### Deferred Revenues

Deferred revenues consist of billings and payments for magicJack devices, sales of access rights received in advance of revenue recognition, billings and payments for equipment purchased by customers, but not yet delivered and sales of maintenance services in advance of revenue recognition. The Company bills and collects in advance for magicJack devices, which include the access right for the software to access its servers for an initial access right period in order to obtain free domestic local and long distance broadband telephone service. Equipment revenue is generally recognized upon delivery and maintenance services revenue is generally recognized ratably over the period during which the services are performed. Deferred revenues to be recognized over the next twelve months are classified as current and included in deferred revenue, current portion in the Company's consolidated balance sheets. The remaining amounts are classified as non-current in the consolidated balance sheets and included in deferred revenue, net of current portion.

## Cost of Revenues

### Consumer Segment

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

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were \$0.9 million and \$0.8 million for the three months ended September 30, 2016 and 2015, respectively, and \$2.7 million and \$2.6 million for the nine months ended September 30, 2016 and 2015, respectively.

### Enterprise Segment

Cost of revenues related to the Company's UCaaS services includes direct costs of providing the services, which are expensed as incurred. These costs include charges for access to the public switched telephone network, internet service for its customers, maintenance costs for its software, commissions, credit card charges, contract labor for installation and depreciation and amortization. The Company also incurs costs for hardware and equipment sold to customers along with related shipping and installation costs. Costs are recognized as services are provided.

### SMB Segment

Cost of revenues from this segment is immaterial for the three and nine months ended September 30, 2016.

## Marketing Expenses

Marketing expenses of \$2.7 million and \$2.4 million for the three months ended September 30, 2016 and 2015, respectively, and \$5.7 million and \$6.9 million for the nine months ended September 30, 2016 and 2015, respectively, consist primarily of advertising media buys for television commercials, Internet advertising and print advertising, as well as marketing related personnel costs and other marketing projects including sponsorships. Marketing costs are expensed when incurred. A break-down of marketing expense by category is as follows (in thousands):

|                             | For the Three Months<br>Ended<br>September 30, |          | For the Nine Months<br>Ended<br>September 30, |          |
|-----------------------------|--|----------|---|----------|
|                             | 2016   | 2015     | 2016  | 2015     |
| Advertising media buys      | \$ 1,556                                       | \$ 2,002 | \$ 3,056                                      | \$ 5,165 |
| Marketing personnel related | 668  | 229      | 1,287   | 1,154    |
| Other marketing projects    | 456  | 126      | 1,316   | 621      |
| Total Marketing Expense     | \$ 2,680                                       | \$ 2,357 | \$ 5,659                                      | \$ 6,940 |

## Research and Development Expenses

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

Research and development expenses were \$1.3 million and \$1.1 million for the three months ended September 30, 2016 and 2015, respectively, and \$3.7 million and \$3.4 million for the nine months ended September 30, 2016 and 2015, respectively. During the three and nine months ended September 30, 2016, \$0.4 million and \$0.8 million of research and development expense was related to the SMB Segment. The balance of research and development expense was related to the Consumer Segment.

#### Gain on Mark-to-Market

The acquisition of Broadsmart in March 2016, described in Note 15 – "Acquisition of Business," included an additional contingent payment of \$2.0 million in cash to Todd A. Correll and Thomas J. Tharrington (Messrs. Correll and Tharrington are collectively referred to as the "Seller Shareholders"), if the acquired assets generate 2016 revenues equal to or exceeding \$15.6 million (the "Earnout Payment"). The Earnout Payment will not exceed \$2.0 million. The \$2.0 million Earnout Payment was paid into escrow at the time of closing and included in total consideration of the business acquired. No asset or liability was included in the accompanying Condensed Consolidated Balance Sheet for this item as of March 31, 2016 or June 30, 2016. In the third quarter ended September 30, 2016 management concluded that it was remote that 2016 revenues of the acquired assets would equal or exceed \$15.6 million, and accordingly recorded a \$2.0 million receivable from earnout escrow in the Condensed Consolidated Balance Sheet, with the corresponding income from change in contingent consideration recorded as a reduction of operating expense labeled gain on mark-to-market in the Consolidated Statement of Operations.

#### Earnings per Ordinary Share

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

### Cash and Cash Equivalents

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

### Allowance for Doubtful Accounts and Billing Adjustments

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

### Investments

Investments are held in interest bearing time deposits with terms longer than three months from the date of acquisition.

### Certain Risks and Concentrations

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, investments and accounts receivable. Cash equivalents generally consist of money market instruments and U.S. government notes.

The Company places its cash and cash equivalents in high quality financial institutions and management believes that the Company is not exposed to any significant risk on its cash accounts. The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the Federal Deposit Insurance Corporation or FDIC up to \$250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at each Israeli bank are not insured. The Company has never experienced any losses related to these balances. At September 30, 2016, the Company had cash and cash equivalents totaling \$51.5 million, which included (i) \$50.9 million in U.S. financial institutions, and (ii) \$0.6 million in an Israeli financial institution.

The Company's non-interest bearing cash balances in U.S. banks, which included \$1.9 million in one individual financial institution, were fully insured except for \$83 thousand that exceeded insurance limits at September 30, 2016. The Company had money market accounts with financial institutions with balances totaling approximately \$48.9 million at September 30, 2016.

No telecommunication carrier accounted for more than 10% of gross accounts receivable at September 30, 2016. One telecommunication carrier accounted for approximately 11% of gross accounts receivable at December 31, 2015. For the three and nine months ended September 30, 2016 and 2015, no telecommunications carrier accounted for more than 10% of the Company's total net revenues.

One U.S. retail customer accounted for approximately 13% and 14% of gross accounts receivable at September 30, 2016 and December 31, 2015, respectively. For the three and nine months ended September 30, 2016 and 2015, no retailer accounted for more than 10% of the Company's total net revenues.

### Fair Value

The Company accounts for financial instruments in accordance with ASC Topic 820, "Fair Value Measurements and Disclosures" ("ASC 820"), which provides a framework for measuring fair value and expands required disclosure about fair value measurements of assets and liabilities. ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's judgements about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

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

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

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

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

When available, the Company uses quoted market prices to determine fair value, and it classifies such measurements within Level 1. Fair value measurements are classified according to the lowest level input or value-driver that is significant to the valuation. Fair value includes the consideration of nonperformance risk. Nonperformance risk refers to the risk that an obligation (either by a counterparty or the Company) will not be fulfilled. For the Company's financial assets traded in an active market (Level 1), the nonperformance risk is included in the market price. The Company's assets and liabilities measured on a recurring basis at fair value may include marketable securities and time deposits. As of September 30, 2016 and December 31, 2015, all of them are Level 1 instruments. The fair value of Level 2 securities is estimated based on observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts payable and accrued expenses are expected to approximate fair value because of their immediate availability, near term maturities or potential interest payments at settlement.

#### Inventories

Inventories are stated at the lower of cost or market, with cost primarily determined using the first-in first-out cost method. Inventory is written off at the point it is determined to be obsolete.

#### Property, Equipment and Depreciation Expense

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

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

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management believes there is no impairment of the Company's property or equipment at September 30, 2016.

## Intangible Assets

Identifiable intangible assets are stated at cost. Amortization is computed on identified intangibles subject to amortization using the accelerated and straight-line methods over the estimated useful lives of such assets, which range from one to seventeen years. The costs of developing the Company's intellectual property rights, intellectual property right applications and technology are charged to research and development expense.

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company recognized an impairment loss of \$498 thousand in the three and nine months ended September 30, 2016. Refer to Note 6 – "Intangible Assets" for further details.



## Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired. Goodwill and other intangible assets with indefinite lives are not amortized to operations, but instead are reviewed for impairment at least annually, or more frequently if there is an indicator of impairment. Indicators include, but are not limited to: sustained operating losses or a trend of poor operating performance and a decrease in the Company's market capitalization below its book value. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record impairment charges in the future. With the acquisition of Broadmart in March 2016 and the founding of the SMB business during the first quarter of 2016, management began evaluating each of these new business lines separately and has determined that the Company now has three reportable segments – "Consumer," "Enterprise" and "SMB". Refer to Note 16 - "Segment Reporting" for further details.

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

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

In connection with the Company's annual goodwill impairment analysis, as of October 1, 2015, the annual measurement date, the Company's analysis did not indicate any impairment of goodwill has occurred. Management believes there is no impairment at September 30, 2016.

## Share-based Compensation

Share-based compensation generally consists of option grants or ordinary share and restricted stock units awards to directors, officers, employees or consultants that are measured at grant date, based on the fair value of the award, and are recognized as an expense over the requisite service period.

## Business Combinations

The Company accounts for business combinations using the acquisition method of accounting. The acquisition method of accounting requires that the purchase price, including the fair value of contingent consideration, of the acquisition be allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. Goodwill as of the acquisition date is measured as the excess of consideration transferred over the net of the acquisition date fair values of assets acquired and the liabilities assumed. While the Company uses its best estimates and assumptions as part of the purchase price allocation process to accurately value assets acquired and liabilities assumed at the acquisition date, the Company's estimates are inherently uncertain and subject to

refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, the Company records adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill to the extent the Company identifies adjustments to the preliminary purchase price allocation. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded to the consolidated statements of operations. The Company includes the results of all acquisitions in its Consolidated Financial Statements from the date of acquisition. Acquisition related transaction costs, such as banking, legal, accounting and other costs incurred in connection with an acquisition, are expensed as incurred in general and administrative expense.

Acquisition-related integration costs which do not meet the criteria of discontinued operations include: (i) costs associated with exit or disposal activities, (ii) costs for employee, lease and contract terminations, (iii) facility closing costs, and other costs associated with exit activities. Acquisition-related integration costs also include expenses directly related to integrating and reorganizing acquired businesses, employee retention costs, recruiting costs, certain moving costs, certain duplicative costs during integration and asset impairments. These costs are expensed as incurred in general and administrative expense.

## Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted tax rates or tax laws are included in the provision for income taxes in the period of enactment. The Company's net deferred tax assets consist primarily of foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. The Company increased the valuation allowance by \$0.3 million and decreased the valuation allowance by \$0.2 million during the three and nine months ended September 30, 2016, respectively. The Company decreased the valuation allowance by \$0.7 million and \$0.1 million during the three and nine months ended September 30, 2015, respectively.

The Company assesses its income tax positions and records tax benefits for all years subject to examination based upon its evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where there is a greater than 50% likelihood that a tax benefit will be sustained, the Company has recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that the Company estimates there is a 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. The Company revised its liability for uncertain tax positions by an increase of \$0.3 million and \$1.5 million in the three and nine months ended September 30, 2016, respectively, due primarily to an increase in uncertain tax positions related to various state issues and the revaluation impact of certain Israeli uncertain tax positions. The Company revised its liability for uncertain tax positions by a net decrease of \$7.9 million in the nine months ended September 30, 2015, due primarily to the effective settlement of various positions taken in connection with U.S. federal income tax years 2010 through 2013 which were examined by the Internal Revenue Service ("IRS").

The Company records its income tax expense for interim financial statements by using an estimated annual effective income tax rate based on its expected annual results after consideration of permanent nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2016 and changes in other deferred tax assets and liabilities are recognized during interim periods based on an annual forecast as of the interim reporting date. At September 30, 2016, the estimated annual effective income tax rate is expected to approximate 34.7%, excluding discrete tax items, which includes federal, foreign, state and local taxes. This rate may fluctuate due to changes in jurisdictional income and to the timing of other discrete period transactions during the remainder of the year.

## Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." The standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. On July 9, 2015, the FASB deferred the effective dates of the standard by one year. As a result, the standard will be effective for annual and interim periods beginning after December 15, 2017. Companies may adopt the standard as early as the original effective date (i.e. annual reporting periods beginning after December 15, 2016). Early adoption prior to that date is not permitted. The standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or a modified retrospective adoption, meaning the standard is applied only to the most current period presented. In March 2016, the FASB issued ASU 2016-08 to provide clarification regarding the application of the principal-versus-agent guidance. In April 2016, the FASB issued ASU 2016-10 to clarify the guidance for identifying

performance obligations and accounting for licenses of intellectual property. In May 2016, the FASB also issued ASU 2016-12, which provides narrow scope improvements and technical expedients on assessing collectibility, presentation of sales taxes, evaluating contract modifications and completed contracts at transition and the disclosure requirement for the effect of the accounting change for the period of adoption. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows, and financial statement disclosures.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory". This ASU applies to inventory that is measured using first-in, first-out ("FIFO") or average cost. Under the updated guidance, an entity should measure inventory that is within scope at the lower of cost and net realizable value, which is the estimated selling prices in the ordinary course of business, less reasonably predicable costs of completion, disposal and transportation. Subsequent measurement is unchanged for inventory that is measured using last-in, last-out ("LIFO"). This ASU is effective for annual and interim periods beginning after December 15, 2016, and should be applied prospectively with early adoption permitted at the beginning of an interim and annual reporting period. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows.

In November 2015, the FASB issued ASU No. 2015-17, “Balance Sheet Classification of Deferred Taxes”. ASU 2015-17 requires deferred tax liabilities and assets to be classified as noncurrent in the consolidated balance sheet. The standard is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for financial statements that have not been previously issued. The ASU may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company adopted ASU 2015-17 on a prospective basis in the fourth quarter of 2015. Prior periods were not retrospectively adjusted.

In February 2016, the FASB issued ASU 2016-02, “Leases”. ASU 2016-02 requires that long-term lease arrangements be recognized on the balance sheet. The standard is effective for interim and annual periods beginning after December 15, 2018, and early adoption is permitted. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows.

In March 2016, the FASB issued ASU 2016-09, “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting”. ASU 2016-09 simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for the Company beginning January 1, 2018 for both interim and annual reporting periods. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments”. ASU 2016-15 reduces the diversity of how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, Statement of Cash Flows, and other Topics. The standard is effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The ASU should be applied retrospectively to all periods presented. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows.

#### NOTE 3 – INVESTMENTS

Investments consist of time deposits with maturity dates of greater than 90 days totaling \$447 thousand and \$367 thousand at September 30, 2016 and December 31, 2015, respectively.

The fair value of time deposits at September 30, 2016 and December 31, 2015 was determined based on its face value, which approximates its fair value and is a Level 1 input.

There was no realized gain or loss on investments for the three and nine months ended September 30, 2016 and September 30, 2015.

#### NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

|               | September<br>30,<br>2016 | December<br>31,<br>2015 |
|---------------|--------------------------|-------------------------|
| Raw materials | \$ 1,535                 | \$ 1,498                |

|                |          |          |
|----------------|----------|----------|
| Finished goods | 2,928    | 4,225    |
| Total          | \$ 4,463 | \$ 5,723 |

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished goods are comprised primarily of magicJack devices on hand or in transit to the Company's distribution center in the United States and customer equipment. The Company wrote-off approximately \$146 thousand and \$0 (Zero) of obsolete inventory during the three months ended September 30, 2016 and September 30, 2015, respectively and \$229 thousand and \$102 thousand of obsolete inventory during the nine months ended September 30, 2016 and September 30, 2015, respectively.

## NOTE 5 – PROPERTY AND EQUIPMENT

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

|                          | Estimated<br>Useful<br>Lives<br>(in years) | September<br>30,<br>2016 | December<br>31,<br>2015 |
|--------------------------|--|--------------------------|-------------------------|
| Switches                 | 3 - 15                                     | \$ 9,537                 | \$ 8,606                |
| Computers                | 3  | 2,806                    | 2,707                   |
| Furniture                | 5 - 7                                      | 249                      | 257                     |
| Leasehold-improvements   | *  | 828                      | 701                     |
| Accumulated depreciation |  | (9,615 )                 | (8,969 )                |
| Total                    |  | \$ 3,805                 | \$ 3,302                |

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

Depreciation expense for the three and nine months ended September 30, 2015 was \$0.2 and \$0.6, respectively. Depreciation expense for 2016 by segment is as follows (in thousands):

|                      | For the Three Months ended September 30,<br>2016 |            |       |              |
|----------------------|--|------------|-------|--------------|
|                      | Consumer   | Enterprise | SMB   | Consolidated |
| Depreciation expense | \$ 264   | \$ 50      | \$ 17 | \$ 331       |

|                      | For the Nine Months ended September 30,<br>2016 |            |       |              |
|----------------------|---|------------|-------|--------------|
|                      | Consumer  | Enterprise | SMB   | Consolidated |
| Depreciation expense | \$ 725  | \$ 114     | \$ 20 | \$ 859       |

## NOTE 6 – INTANGIBLE ASSETS

As of September 30, 2016 and December 31, 2015, the Company had intangible assets with carrying values of \$29.9 million and \$6.7 million, respectively. Identified intangible assets not subject to amortization consisted of tradename and domain names with combined carrying value of \$3.2 million and \$1.2 million as of September 30, 2016 and December 31, 2015, respectively. Identified intangible assets with finite lives subject to amortization consist of the following (in thousands):

|                                    |  | September 30, 2016          |                             |       |                              | December 31, 2015           |                             |       |                              |
|------------------------------------|--|-----------------------------|-----------------------------|-------|------------------------------|-----------------------------|-----------------------------|-------|------------------------------|
|                                    | Estimated<br>Useful<br>Lives (in<br>years) | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net   | Weighted-<br>Average<br>Life | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net   | Weighted-<br>Average<br>Life |
| Technology                         | 3 - 17                                     | \$3,110                     | \$ (2,810 )                 | \$300 | 4.64                         | \$4,930                     | \$ (4,497 )                 | \$433 | 4.83                         |
| Intellectual<br>property<br>rights | 3 - 17                                     | 14,162                      | (10,501 )                   | 3,661 | 4.98                         | 14,161                      | (9,623 )                    | 4,538 | 5.36                         |

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|                               |        |          |              |          |       |          |              |         |      |
|-------------------------------|--------|----------|--------------|----------|-------|----------|--------------|---------|------|
| Covenants                     |        |          |              |          |       |          |              |         |      |
| not-to compete and not-to-sue | 2 - 5  | 2,185    | (2,101 )     | 84       | 3.42  | 2,085    | (1,911 )     | 174     | 0.42 |
| Tradename                     | 3 - 6  | 131      | (131 )       | -        | -     | 321      | (321 )       | -       | -    |
| Customer                      |        |          |              |          |       |          |              |         |      |
| relationships                 | 5 - 16 | 22,600   | (1,750 )     | 20,850   | 10.25 | 500      | (500 )       | -       | -    |
| Backlog                       | 1      | 800      | (800 )       | -        | -     | 800      | (800 )       | -       | -    |
| Software                      |        |          |              |          |       |          |              |         |      |
| License                       | 10     | 885      | (58 )        | 827      | 9.50  | -        | -            | -       | -    |
| Process                       |        |          |              |          |       |          |              |         |      |
| know how                      | 5      | 1,100    | (60 )        | 1,040    | 6.33  | -        | -            | -       | -    |
| Other                         |        | -        | -            | -        | -     | 470      | (138 )       | 332     | 3.00 |
| Total                         |        | \$44,973 | \$ (18,211 ) | \$26,762 |       | \$23,267 | \$ (17,790 ) | \$5,477 |      |



Amortization expense for the three and nine months ended September 30, 2015 was \$0.7 and \$2.3, respectively. Amortization expense for 2016 by segment is as follows (in thousands):

|                      | For the Three Months ended September 30,<br>2016 |            |      |              |
|----------------------|--|------------|------|--------------|
|                      | Consumer   | Enterprise | SMB  | Consolidated |
| Amortization expense | \$ 364   | \$ 633     | \$ - | \$ 997       |

|                      | For the Nine Months ended September 30,<br>2016 |            |      |              |
|----------------------|---|------------|------|--------------|
|                      | Consumer  | Enterprise | SMB  | Consolidated |
| Amortization expense | \$ 1,267  | \$ 1,384   | \$ - | \$ 2,651     |

During the three and nine months ended September 30, 2016, impairment losses of \$0.5 million were recognized in General and Administrative expense under the Consumer segment in the statement of operations. The impairments were comprised of: (i) a Telecom license included in the “Other” category of amortizable intangible assets for \$249 thousand (net of accumulated amortization) deemed obsolete, and (ii) domain names not subject to amortization for \$249 thousand that were not renewed.

Based on the carrying value of identified intangible assets recorded at September 30, 2016, and assuming no subsequent impairment of the underlying assets, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

| Fiscal Year                           | Amortization<br>Expense |
|---------------------------------------|-------------------------|
| Three months ending December 31, 2016 | \$ 981                  |
| 2017                                  | 3,871                   |
| 2018                                  | 3,335                   |
| 2019                                  | 3,112                   |
| 2020                                  | 2,862                   |
| Thereafter                            | 12,601                  |
|                                       | \$ 26,762               |

#### NOTE 7 – GOODWILL

The changes in the carrying amount of goodwill for the nine months ended September 30, 2016, are as follows (in thousands):

|  | Nine Months Ended September 30, 2016 |            |     |              |
|--|--------------------------------------|------------|-----|--------------|
|  | Consumer                             | Enterprise | SMB | Consolidated |
| Balance, beginning of period                     | \$32,304                             | \$-        | \$- | \$32,304     |
| Goodwill acquired with<br>Broadsmart acquisition | -                                    | 15,181     | -   | 15,181       |
| Balance, end of period                           | \$32,304                             | \$15,181   | \$- | \$47,485     |



## NOTE 8 – DEFERRED COSTS AND REVENUES

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

Deferred revenues are comprised of the following at September 30, 2016 and December 31, 2015 (in thousands):

|                                | September 30,<br>2016 | December 31,<br>2015 |
|--------------------------------|-----------------------|----------------------|
| magicJack devices              | \$ 8,065              | \$ 9,352             |
| Access right renewals          | 38,318                | 40,677               |
| Prepaid minutes                | 2,621                 | 2,525                |
| Other                          | 320                   | -                    |
| Deferred revenue, current      | 49,324                | 52,554               |
| Deferred revenue, non-current* | 45,811                | 50,146               |
| Total deferred revenues        | \$ 95,135             | \$ 102,700           |

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

Costs necessary to fulfill the Company's obligations to provide broadband telephone service to new and existing customers who have purchased magicJack devices or access rights to access the Company's servers are expensed as incurred. Such costs were approximately \$2.9 million and \$3.7 million for the three months ended September 30, 2016 and 2015, respectively, and approximately \$9.6 million and \$11.9 million for the nine months ended September 30, 2016 and 2015, respectively.

## NOTE 9 – OTHER LIABILITIES

In the prior year, the Company had an outstanding indebtedness in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets, which was secured only by such intangible assets. The Company made a final non-interest bearing annual payment of \$1.5 million in May 2015. As of September 30, 2016 and December 31, 2015, no amounts were included in the Company's condensed consolidated balance sheet.

## NOTE 10 – COMMITMENTS AND CONTINGENCIES

## Legal Proceedings

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

quarter.

On March 11, 2016, a purported class action lawsuit was filed against the Company, its Chief Executive Officer, Gerald Vento ("Mr. Vento"), and its Chief Financial Officer, Jose Gordo ("Mr. Gordo"), in the United States District Court for the Southern District of New York. The complaint alleges that the Company and Messrs. Vento and Gordo made false and misleading statements regarding the financial performance and guidance during the alleged class period of November 12, 2013 to March 12, 2014. The complaint alleges that the Company and Messrs. Vento and Gordo violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The complaint seeks damages, attorneys' fees and costs, and equitable/injunctive relief or such other relief as the court deems proper. The Company intends to vigorously defend itself against it and the Company does not believe that the outcome of this legal proceeding will have a material adverse effect on the Company's business, operating results, financial condition or cash flows. Because the case is at a preliminary stage, the Company cannot estimate the likelihood of liability or the amount of potential damages, if any.

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

#### NOTE 11 –TREASURY STOCK

On March 17, 2016, the Company issued 233,402 of its ordinary shares held as treasury stock with a cost of \$3.6 million, or \$15.46 per shares, as part of the consideration paid for the Broadsmart acquisition. Refer to Note 15 - "Acquisition of Business" for further details. In March 2016, the Company issued 2,016 of its ordinary shares held as treasury shares with a cost of \$25 thousand, or \$12.24 per share, to a Board member as a result of restricted stock units, that were issued in mid-2013, vesting. In addition, in April 2016, the Company issued 9,336 of its ordinary shares held as treasury shares with a cost of \$115 thousand, or \$12.31 per share, to Board members as a result of restricted stock units that were issued in mid-2014, vesting. In August 2016, the Company issued 2,333 of its ordinary shares held as treasury shares with a cost of \$29 thousand, or \$12.33 per share, to a Board member as a result of vesting.

The changes in treasury stock during the nine months ended September 30, 2016 are as follows (in thousands, except for number of shares):

|  | Nine Months Ended<br>September 30, 2016 |            |
|--|---|------------|
|  | Number                                  | Amount     |
| Balance, beginning of period                                       | 9,426,399                               | \$ 126,772 |
| Ordinary shares issued for<br>Broadsmart acquisition               | (233,402 )                              | (3,609 )   |
| Ordinary shares issued due to<br>vesting of restricted stock units | (13,685 )                               | (169 )     |
| Balance, end of period   | 9,179,312                               | \$ 122,994 |

#### NOTE 12 – SHARE-BASED COMPENSATION

The Company has granted ordinary share options, issued restricted stock units and ordinary shares as an alternative or supplement to the compensation of its executives, employees, directors and outside consultants. The Company's share-based compensation program is a long-term retention program intended to attract and reward talented executives, employees and outside consultants, and align their interests with stockholders. The Company is currently granting share-based awards under the magicJack VocalTec Ltd. 2013 Stock Incentive Plan and the magicJack VocalTec Ltd. 2013 Israeli Stock Incentive Plan (together, the "2013 Plans"). In July 2013, the shareholders approved the 2013 Plans at the annual general meeting of shareholders to allow grants of ordinary share options, restricted stock

units and ordinary shares. In April 2014, the shareholders approved amendments to the 2013 Plans increasing the number of share based awards available for grant. As of September 30, 2016, the aggregate number of shares subject to awards under the 2013 Plans, as amended, is 3,600,000. The Company had previously granted shares under the VocalTec amended Master Stock Plan (the “2003 Plan”) which expired in April 2013. During the nine months ended September 30, 2016, the Company issued 1,000,000 ordinary share options outside of the 2013 Plans as an inducement for the two founders of Broadsmart to become employed by the Company. Share-based awards are generally exercisable or issuable upon vesting. The Company’s policy is to recognize compensation expense for awards with only service conditions and a graded vesting on a straight-line basis over the requisite vesting period for the entire award.

The Company's share-based compensation expense for ordinary share options and issued restricted stock units for the three and nine months ended September 30, 2016 and 2015 was as follows (in thousands):

|                        | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|------------------------|-------------------------------------|----------|------------------------------------|----------|
|                        | 2016                                | 2015     | 2016                               | 2015     |
| Ordinary share options | \$ 408                              | \$ 945   | \$ 1,866                           | \$ 3,085 |
| Restricted stock units | 511                                 | 261      | 1,303                              | 821      |
|                        | \$ 919                              | \$ 1,206 | \$ 3,169                           | \$ 3,906 |

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

|                            | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|----------------------------|-------------------------------------|----------|------------------------------------|----------|
|                            | 2016                                | 2015     | 2016                               | 2015     |
| Cost of revenues           | \$ 24                               | \$ 30    | \$ 53                              | \$ 46    |
| Marketing                  | 49                                  | 101      | 125                                | 442      |
| General and administrative | 820                                 | 995      | 2,839                              | 3,051    |
| Research and development   | 26                                  | 80       | 152                                | 367      |
|                            | \$ 919                              | \$ 1,206 | \$ 3,169                           | \$ 3,906 |

The decrease in share-based compensation for the three and nine months ended September 30, 2016, is due primarily to the expense associated with previous awards being fully amortized exceeding the expense associated with new awards.

#### Ordinary Share Options

Ordinary share options granted under the 2013 Plans have a five-year life and typically vest over a period of 36 months beginning at the date of grant. The 2013 Plans, as amended, currently allow for a maximum term of five years for awards granted. The following table provides additional information regarding ordinary share options issued, outstanding and exercisable for the year ended December 31, 2015, and nine months ended September 30, 2016 (aggregate intrinsic value in thousands):

| Date of Grant        | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value * |
|----------------------|----------------------|--|---|-----------------------------------|
| January 1, 2015      | 2,043,857            | \$14.87                                  | 3.80  | \$-                               |
| Granted              | 998,614              | \$9.33                                   |   |                                   |
| Exercised            | (4,250 )             | \$0.57                                   |   |                                   |
| Forfeited            | (247,257 )           | \$14.42                                  |   |                                   |
| Expired or cancelled | (263,537 )           | \$12.67                                  |   |                                   |
| December 31, 2015    | 2,527,427            | \$12.98                                  | 3.61  | \$-                               |
| Granted              | 1,107,040            | \$7.09                                   |   |                                   |

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|   |            |         |      |     |
|---|------------|---------|------|-----|
| Exercised                                     | (1,900 )   | \$3.75  |      |     |
| Forfeited                                     | (34,740 )  | \$8.83  |      |     |
| Expired or cancelled                          | (102,500 ) | \$13.59 |      |     |
| Outstanding at September 30, 2016 (unaudited) | 3,495,327  | \$11.16 | 3.36 | \$- |
| Vested at September 30, 2016 (unaudited)      | 1,311,082  | \$15.53 | 1.89 | \$- |

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



Share-based compensation expense recognized for ordinary share options was approximately \$0.4 million and \$0.9 million for the three months ended September 30, 2016 and 2015, respectively and approximately \$1.9 million and \$3.1 million for the nine months ended September 30, 2016 and 2015, respectively. The total intrinsic value of ordinary share options exercised during the nine months ended September 30, 2016 and 2015 was \$6 thousand and \$0, respectively. As of September 30, 2016, there was approximately \$3.9 million of unrecognized share-based compensation expense related to unvested ordinary share options, which is expected to be recognized over a weighted average remaining period of 2.43 years.

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's expected stock price volatility over the term of the awards, assumed employee exercise behaviors, risk-free interest rate and expected dividends. For purposes of valuing ordinary share options, the Company used historical volatility at the date of grant. The approximate risk-free interest rate was based on the U.S. Treasury yield for comparable periods. The Company has experienced forfeitures in the past and estimates a forfeiture rate for awards issued when deemed applicable. The expected term of the ordinary share options was calculated using the simplified method in accordance with SAB No. 107, "Share Based Payment." The Company does not expect to pay dividends on its ordinary shares in the foreseeable future. Accordingly, the Company used a dividend yield of zero in its option pricing model. The Company granted 1,107,040 ordinary share options during the nine months ended September 30, 2016 with a weighted average fair value of \$2.75. There were no ordinary share options granted during the nine months ended September 30, 2015. The grants were measured using the following assumptions:

|                          | Nine Months Ended September |      |
|--------------------------|-----------------------------|------|
|                          | 30,                         |      |
|                          | 2016                        | 2015 |
| Expected term (in years) | 3.50                        | -    |
| Dividend yield           | 0.00 %                      | -    |
| Expected volatility      | 52.15% to                   | -    |
|                          | 52.47%                      |      |
| Risk free interest rate  | 0.95% to                    | -    |
|                          | 1.13%                       |      |
| Forfeiture rate          | 0.00 %                      | -    |

#### Restricted Stock Units

The Company may also award non-vested restricted stock units to its executives, employees, directors and outside consultants under the 2013 Plans, which may vest based on service or a combination of service and other conditions, such as market share price. The compensation expense for the award will be recognized assuming that the requisite service is rendered regardless of whether the market conditions are achieved. Each non-vested stock unit, upon vesting, represents the right to receive one ordinary share of the Company. During the nine months ended September 30, 2016 the Company granted 295,305 restricted stock units under the 2013 Plans, as amended. During the nine months ended September 30, 2015, the Company did not grant any restricted stock units under the 2013 Plans, as amended.

The following table summarizes the Company's restricted stock unit activity for the nine months ended September 30, 2016:

Average

|                                  | Number of<br>Shares | Fair Value<br>at Grant<br>Date |
|----------------------------------|---------------------|--------------------------------|
| December 31, 2015                | 443,102             | \$ 10.20                       |
| Granted                          | 295,305             | \$ 6.07                        |
| Vested                           | (13,681 )           | \$ 18.60                       |
| Forfeited                        | (9,903 )            | \$ 7.96                        |
| Non-vested at September 30, 2016 | 714,823             | \$ 8.37                        |

Share-based compensation expense recognized for restricted stock units was approximately \$0.5 million and \$0.3 million for the three months ended September 30, 2016 and 2015, respectively, and was approximately \$1.3 million and \$0.8 million for the nine months ended September 30, 2016 and 2015, respectively. As of September 30, 2016, there was approximately \$3.5 million in unrecognized share-based compensation costs related to restricted stock units. The unrecognized share-based compensation expense is expected to be recognized over a weighted average remaining period of 1.10 years.

## NOTE 13 – INCOME TAXES

Total income tax expense was \$2.2 million and \$4.2 million for the three months ended September 30, 2016 and 2015, respectively, and \$7.4 million and \$6.7 million for the nine months ended September 30, 2016 and 2015, respectively. The principal components of the Company's income taxes for the three and nine months ended September 30, 2016 and 2015 are the following (in thousands):

|                            | Three Months Ended |         | Nine Months Ended |          |
|----------------------------|--------------------|---------|-------------------|----------|
|                            | September 30,      |         | September 30,     |          |
|                            | 2016               | 2015    | 2016              | 2015     |
| Income before income taxes | \$5,427            | \$7,463 | \$13,878          | \$18,279 |
| Income tax expense         | 2,205              | 4,152   | 7,407             | 6,708    |
| Effective income tax rate  | 40.63              | % 55.63 | % 53.37           | % 36.70  |

The Company primarily operates in the U.S. and Israel, and the Company's Israeli operations are subject to a statutory income tax rate of 25.0% that is lower than the Company's U.S. federal income tax rate which is 35% as of September 30, 2016.

For the nine months ended September 30, 2016, the Company recorded income tax expense of \$7.4 million, which is higher than the expected tax provision of \$4.9 million, using the statutory rate of 35%, due, in part, to the net impact of a decrease in the Israeli corporate tax rate from 26.5% to 25.0% which was effective in January 2016. The decrease in the rate resulted in the Company needing to reduce its Israeli deferred tax assets, primarily net operating loss carryforwards, which resulted in deferred tax expense and a reduction in the value of related deferred tax assets of \$1.4 million. Additionally, the effective tax rate was impacted by increases to uncertain tax positions of \$1.0 million and other items of \$0.1 million. The discrete items noted above were partially offset by the lower jurisdictional tax rate charged on the operating income of the Company's Israeli operations.

## NOTE 14 – INCOME PER SHARE

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

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

|   | Three Months Ended |         | Nine Months Ended |          |
|---|--------------------|---------|-------------------|----------|
|   | September 30,      |         | September 30,     |          |
|   | 2016               | 2015    | 2016              | 2015     |
| Numerator:  | (in thousands)     |         |                   |          |
| Net income attributable to common shareholders        | \$3,399            | \$3,311 | \$6,952           | \$11,571 |
| Denominator:  |                    |         |                   |          |
| Denominator for basic net income per share - weighted |                    |         |                   |          |

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|  |        |        |        |        |
|--|--------|--------|--------|--------|
| average ordinary shares outstanding  | 15,857 | 16,651 | 15,786 | 17,400 |
| Effect of dilutive options to purchase ordinary shares   | 6      | 7      | 141    | 7      |
| Effect of dilutive options or restricted stock units vesting, exercised or expired during the period | 2      | -      | 8      | 19     |
| Denominator for diluted net income per share - weighted average ordinary shares outstanding          | 15,865 | 16,658 | 15,935 | 17,426 |
| Net income per common share attributable to shareholders   |        |        |        |        |
| Basic  | \$0.21 | \$0.20 | \$0.44 | \$0.66 |
| Diluted  | \$0.21 | \$0.20 | \$0.44 | \$0.66 |

For the three months ended September 30, 2016 and 2015, 3,835,350 and 1,900,519 outstanding ordinary share options and restricted stock units, respectively, were excluded from the earnings per share calculation because they would be anti-dilutive. For the nine months ended September 30, 2016 and 2015, 2,836,850 and 1,900,519 outstanding ordinary share options and restricted stock units, respectively, were excluded from the earnings per share calculation because they would be anti-dilutive.

## NOTE 15 – ACQUISITION OF BUSINESS

### Broadsmart

On March 15, 2016, the Company entered into an Asset Purchase Agreement, dated as of March 15, 2016 (the "Agreement") with Todd A. Correll, Thomas J. Tharrington (Messrs. Correll and Tharrington are collectively referred to as the "Seller Shareholders"), North American Telecommunications Corporation d/b/a Broadsmart (the "Seller" and collectively with the "Seller Shareholders," referred to as the "Seller Parties"). The Agreement provided that, upon the terms and subject to the conditions set forth in the Agreement, the Company will acquire all of the Seller's assets, properties and rights of whatever kind, tangible and intangible, other than certain excluded assets and excluded liabilities under the terms of the Agreement.

The Agreement provided that the Company would acquire substantially all of the assets and assume certain liabilities of the Seller in exchange for approximately \$38.0 million in cash, plus unregistered ordinary shares of the Company worth \$1.8 million, valued based on the average of the previous 30 days stock price, subject to certain adjustments, including an adjustment for working capital and indebtedness. The Agreement also provided for an additional contingent payment of up to \$200,000 in cash to the Seller Shareholders in the event that certain two individuals currently employed by the Seller fail to accept the Company's employment offer within thirty days of the completion of the acquisition (the contingent payment is \$100,000 in the event that one of the two individuals fails to accept such employment offer). This amount is included in accrued expenses and other current liabilities in the accompanying Condensed Consolidated Balance Sheet. Lastly, the Seller Shareholders will receive an additional contingent payment of \$2.0 million in cash if the acquired assets generate 2016 revenues equal to or exceeding \$15.6 million (the "Earnout Payment"). The Earnout Payment will not exceed \$2.0 million. The \$2.0 million Earnout Payment was paid into escrow at the time of closing and included in total consideration of the business acquired. No asset or liability was included in the accompanying Condensed Consolidated Balance Sheet for this item as of March 31, 2016 or June 30, 2016. In the third quarter ended September 30, 2016 management concluded that it was remote that 2016 revenues of the acquired assets would equal or exceed \$15.6 million, and accordingly recorded a \$2.0 million receivable from earnout escrow in deposits and other current assets in the Condensed Consolidated Balance Sheet, with the corresponding income from change in contingent consideration recorded as a reduction of operating expense labeled gain on mark-to-market in the Consolidated Statement of Operations.

The terms of the Agreement provided for the Company to place \$3.0 million of the cash consideration at the closing in escrow with an escrow agent. The purpose of the escrow is to cover any indemnification claims by the Company against the Seller Parties. Under the terms of the Agreement, the Seller Parties are not liable to the Company and its affiliates until the aggregate amount of all losses in respect of indemnification exceeds \$400,000 (the "Basket") and in such case the Seller Parties shall be liable only for all losses in excess of the Basket up to a cap of \$3.0 million and excluding any individual loss that is less than or equal to \$7,500. Certain fundamental representations and warranties, the post-closing covenants and certain other specified obligations of the Seller Parties are outside of the Basket, cap and individual loss limitations. The Company, at this time, does not estimate any liability in excess of the Basket and therefore no asset or liability are included in the accompanying Condensed Consolidated Balance Sheet for this item.

On March 17, 2016, the Company completed the acquisition of substantially all of the assets and assumed certain liabilities of Broadsmart upon the terms and conditions of the Agreement.

The Company issued 233,402 shares of the Company's ordinary shares from treasury stock with a fair value of \$1.7 million based on closing market price per share as of the date of the acquisition to the Seller in satisfaction of the stock consideration provided in the Agreement. The Company also granted stock options to each of the Seller Shareholders to purchase 500,000 shares of the Company's ordinary shares in conjunction with each of them entering into an employment agreement with the Company which is considered compensation expense. The stock options shall

vest as follows: 50% will vest in even annual increments over the next three-year period if the Seller Shareholders remain employed with the Company as of each respective vesting date, and 50% will vest over the next three-year period if Broadsmart achieves certain designated revenue and EBITDA targets. The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The Agreement also provided for an additional contingent payment of up to \$1.0 million in cash from the Seller Shareholders to certain two non-shareholders currently employed by the Seller Shareholders in the event those two individuals accept the Company's employment offer and remain employed by the Company through and including December 15, 2016. No expense has been recorded for this as no agreement has been reached on employment offers with the two non-shareholders.

Broadsmart is a leading hosted UCaaS (Unified Communication as a Service) provider for medium-to-large multi-location enterprise customers. Broadsmart has a track record of designing, provisioning and delivering complex UCaaS solutions to blue chip corporate customers on a nationwide basis. Broadsmart has expertise in servicing enterprises with hundreds-to-thousands of locations. With the acquisition of Broadsmart, the Company has diversified its operations into UCaaS targeting high end SMB and enterprise customers. This acquisition has positioned the Company to compete long-term in the UCaaS market.

The Company incurred \$0.8 million in acquisition related transaction costs, which are included in general and administrative expense in the accompanying Condensed Consolidated Statements of Operations.

The results of operations of the Broadsmart business and the estimated fair values of the assets acquired and liabilities assumed have been included in our consolidated financial statements since the date of the acquisition.

The acquisition was accounted for using the acquisition method of accounting under which assets and liabilities of Broadsmart were recorded at their respective fair values including an amount for goodwill representing the difference between the acquisition consideration and the fair value of the identifiable net assets. The Company expects this goodwill to be deductible for tax purposes. The goodwill attributable to the acquisition has been recorded as a non-current asset and is not amortized, but is subject to an annual review for impairment.

The acquisition price was allocated to the tangible and identified intangible assets acquired and liabilities assumed as of the closing date. The fair values assigned to tangible and identifiable intangible assets acquired and liabilities assumed are based on management's estimates and assumptions. The estimated fair values of assets acquired and liabilities assumed are considered preliminary and are based on the most recent information available. The Company believes that the information provides a reasonable basis for assigning the fair values of assets acquired and liabilities assumed. Thus, the provisional measurements of fair value set forth below are subject to change. The Company expects to finalize the valuation as soon as practicable, but not later than one year from the acquisition date.

The table below summarizes the Broadsmart assets acquired and liabilities assumed as of March 17, 2016 (in thousands):

|  | Estimated<br>Fair Value |
|--|-------------------------|
| <b>Assets</b>                                  |                         |
| Current assets:                                |                         |
| Accounts receivable                            | \$ 567                  |
| Inventories                                    | 302                     |
| Deposits and other current assets              | 143                     |
| Total current assets                           | 1,012                   |
| Property and equipment                         | 355                     |
| Intangible assets                              | 26,385                  |
| Deposits and other non-current assets          | 96                      |
| Total assets acquired                          | 27,848                  |
| <b>Liabilities</b>                             |                         |
| Current liabilities:                           |                         |
| Accrued expenses and other current liabilities | 900                     |
| Deferred revenue                               | 172                     |
| Total current liabilities                      | 1,072                   |
| Other non-current liabilities                  | 62                      |
| Total liabilities assumed                      | 1,134                   |
| Net identifiable assets acquired               | 26,714                  |
| Goodwill                                       | 15,181                  |
| Total purchase price                           | \$ 41,895               |

The intangible assets as of the closing date of the acquisition included:

|                        | Amount    |
|------------------------|-----------|
| Customer relationships | \$ 22,100 |
| Non-compete agreements | 100       |
| Tradename              | 2,200     |

|                  |           |
|------------------|-----------|
| Process know how | 1,100     |
| Software license | 885       |
|                  | \$ 26,385 |

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Indications of fair value of the intangible assets acquired in connection with the acquisition were determined using either the income, market or replacement cost methodologies. The intangible assets are being amortized over periods which reflect the pattern in which economic benefits of the assets are expected to be realized. The customer relationships are being amortized on an accelerated basis over an estimated useful life of sixteen years and the non-compete agreements, process know how and software license are being amortized on a straight-line basis over four years, five years and ten years, respectively. Tradename is not subject to amortization but is subject to an annual review for impairment.

The excess of purchase price over the fair value amounts assigned to the assets acquired and liabilities assumed represents the amount of goodwill resulting from the acquisition. The Company expects this goodwill to be deductible for tax purposes. The goodwill attributable to the acquisition has been recorded as a non-current asset and is not amortized, but is subject to an annual review for impairment. The Company believes the factors that contributed to goodwill include synergies that are specific to the Company's consolidated business, the acquisition of a talented workforce that provides the Company with expertise in the small and medium business market, as well as other intangible assets that do not qualify for separate recognition.

#### Pro Forma Financial Information

The following table presents the unaudited pro forma combined results of operations of the Company and Broadsmart for the three and nine months ended September 30, 2016 and 2015 as if the acquisition of Broadsmart had occurred on January 1, 2015. The pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of 2015.

|              | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--------------|-------------------------------------|-----------|------------------------------------|-----------|
|              | 2016                                | 2015      | 2016                               | 2015      |
| Net revenues | \$ 24,572                           | \$ 28,432 | \$ 76,113                          | \$ 85,587 |
| Net Income   | \$ 3,218                            | \$ 3,189  | \$ 6,878                           | \$ 11,279 |

The pro forma results are based on estimates and assumptions, which the Company believes are reasonable. The pro forma results include adjustments primarily related to amortization of acquired intangible assets, depreciation, interest expense, and transaction costs expensed during the period.

#### NOTE 16 – SEGMENT REPORTING

Operating segments are defined under U.S. GAAP as components of an enterprise for which separate financial information is available and evaluated regularly by a company's chief operating decision makers in deciding how to allocate resources and assess performance.

Historically, the Company has not had separate operating segments. However, with the acquisition of Broadsmart in March, refer to Note 15 – “Acquisition of Business,” for further details, and the founding of the SMB business during the first quarter of 2016, management will be evaluating each of these new business lines separately and has determined that the Company now has three reportable segments – “Consumer,” “Enterprise” and “SMB”. These segments are organized by the products and services that are sold and the customers that are served. The Company measures and evaluates its reportable segments based on revenues and gross profit margins. The Company's segments and their principal activities consist of the following:

#### Consumer

This operating segment represents a vertically integrated group of companies, a micro-processor chip design company, an appserver and session border controller company, a wholesale provider of VoIP services, a softphone company, the developer and provider of the magicJack device, and a wholesaler of telephone service to VoIP providers and telecommunication carriers. This segment represents the historical magicJack consumer business.

magicJack is a cloud communications leader that is the inventor of the magicJack devices and other magicJack products and services. magicJack'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.

#### Enterprise

This operating segment includes Broadsmart. Broadsmart is a leading hosted UCaaS (Unified Communication as a Service) provider for medium-to-large multi-location enterprise customers. Broadsmart has a track record of designing, provisioning and delivering complex UCaaS solutions to blue chip corporate customers on a nationwide basis. Broadsmart has expertise in servicing enterprises with hundreds-to-thousands of locations.

#### SMB

Through this operating segment, started during the first quarter of 2016, the Company provides VoIP services to small businesses. The Company began sales of its SMB segment in the third quarter of 2016.

Operating segment information for the three and nine months ended September 30, 2016 is summarized as follows (in thousands):

|                              | For the Three Months ended September 30, 2016 |            |            |              |              |
|------------------------------|---|------------|------------|--------------|--------------|
|                              | Consumer                                      | Enterprise | SMB        | Intercompany | Consolidated |
| Net revenues                 | \$21,625                                      | \$2,862    | \$19       | \$ 66        | \$ 24,572    |
| Cost of revenues             | 7,213   | 2,264      | 32         | -            | 9,509        |
| Gross profit (loss)          | 14,412  | 598        | (13 )      | 66           | 15,063       |
| Marketing                    | 1,587   | 67         | 1,026      | -            | 2,680        |
| General and administrative   | 5,242   | 795        | 1,538      | 66           | 7,641        |
| Research and development     | 913   | -          | 401        | -            | 1,314        |
| Gain on mark-to-market       | (2,000 )                                      | -          | -          | -            | (2,000 )     |
| Operating expenses           | 5,742   | 862        | 2,965      | 66           | 9,635        |
| Operating income (loss)      | 8,670   | (264 )     | (2,978 )   | -            | 5,428        |
| Interest and dividend income | (5 )  | -          | -          | -            | (5 )         |
| Other expenses, net          | 6   | -          | -          | -            | 6            |
| Income tax expense (benefit) | 3,424   | (99 )      | (1,120 )   | -            | 2,205        |
| Net income (loss)            | \$5,245                                       | \$(165 )   | \$(1,858 ) | \$ -         | \$ 3,222     |

|                              | For the Nine Months ended September 30, 2016 |            |            |              |              |
|------------------------------|--|------------|------------|--------------|--------------|
|                              | Consumer                                     | Enterprise | SMB        | Intercompany | Consolidated |
| Net revenues                 | \$67,178                                     | \$6,309    | \$19       | \$ 66        | \$ 73,572    |
| Cost of revenues             | 22,517                                       | 4,993      | 46         | -            | 27,556       |
| Gross profit (loss)          | 44,661                                       | 1,316      | (27 )      | 66           | 46,016       |
| Marketing                    | 4,115  | 144        | 1,400      | -            | 5,659        |
| General and administrative   | 18,010                                       | 2,168      | 4,584      | 66           | 24,828       |
| Research and development     | 2,895  | -          | 766        | -            | 3,661        |
| Gain on mark-to-market       | (2,000 )                                     | -          | -          | -            | (2,000 )     |
| Operating expenses           | 23,020                                       | 2,312      | 6,750      | 66           | 32,148       |
| Operating income (loss)      | 21,641                                       | (996 )     | (6,777 )   | -            | 13,868       |
| Interest and dividend income | (21 )  | -          | -          | -            | (21 )        |
| Other expenses, net          | 11   | -          | -          | -            | 11           |
| Income tax expense (benefit) | 10,104                                       | (354 )     | (2,343 )   | -            | 7,407        |
| Net income (loss)            | \$11,547                                     | \$(642 )   | \$(4,434 ) | \$ -         | \$ 6,471     |

|                      | For the Nine Months ended September 30, 2016 |            |            |              |              |
|----------------------|--|------------|------------|--------------|--------------|
|                      | Consumer                                     | Enterprise | SMB        | Intercompany | Consolidated |
| Total assets         | \$140,645                                    | \$44,495   | \$(5,795 ) | \$ -         | \$ 179,345   |
| Capital expenditures | \$141  | \$8        | \$107      | \$ -         | \$ 256       |
| Goodwill             | \$32,304                                     | \$15,181   | \$-        | \$ -         | \$ 47,485    |



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

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited condensed consolidated financial statements as of September 30, 2016 and for the three month and nine month periods ended September 30, 2016 and 2015, as well as our Annual Report on Form 10-K for the year ended December 31, 2015. This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, the accuracy of which involves risk and uncertainties. We use words such as "anticipates," "believes," "plans," "expects," "future," "intends," "estimates," "projects," and similar expressions to identify forward-looking statements. Readers should not place undue reliance on these forward-looking statements, which apply only as of the date of this report. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons. Factors that might cause or contribute to such differences include, but are not limited to, those discussed under the section titled "Risk Factors" of our Form 10-K for the year ended December 31, 2015 filed on March 15, 2016.

### 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. magicJack devices weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source and provide users with complete phone service for home, enterprise and while traveling. We charge our customers highly competitive rates for the right (the "access right") to access our servers, and our customers then continue to have the ability to obtain free telephone services. We also provide additional products and services, which include voice apps on smart phones, as well as the magicJack PLUS, 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. Our products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

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

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

During September 2011, we began promoting the magicJack APP that can be used to make or receive telephone calls between two computers or between the customer's computer and a public switch telephone network. The customer can use a headphone or a computer's speakers and microphone to make and receive telephone calls. In September 2011, the magicJack APP also became available for the iPhone, iPad and iPod Touch. In August 2012, the magicJack APP became available for Android phones. In June 2013, we introduced the New magicJack PLUS. This new device has superior voice quality, expanded memory and enhanced processing power. The New magicJack PLUS includes a six-month right to access our servers in order to make and receive telephone calls for free. In July 2014, we introduced the magicJack GO which includes a twelve month right to access our servers. In April 2015, we released an update to the magicAPP to iOS customers and in July 2015 the updated magicAPP was made available to Android users. The magicAPP offers a US number, unlimited local and long distance calling to the US, Canada, Puerto Rico and the US Virgin Islands, and unlimited text messaging to any US mobile number. The magicAPP offers access to our servers on

a monthly or annual basis. In May 2015, we introduced the magicJack EXPRESS which includes a three month right to access our servers.

In March 2016, we acquired substantially all of the assets of North American Telecommunications Corporation (dba "Broadsmart"). Broadsmart is a leading hosted UCaaS (Unified Communication as a Service) provider for medium-to-large multi-location enterprise customers. Broadsmart has a track record of designing, provisioning and delivering complex UCaaS solutions to blue chip corporate customers on a nationwide basis. Broadsmart has expertise in servicing enterprises with hundreds-to-thousands of locations. With the acquisition of Broadsmart, we have diversified our operations into UCaaS targeting high end SMB and enterprise customers. This acquisition has positioned us to compete long-term in the UCaaS market.

During the first quarter of 2016, we created a new subsidiary, magicJack SMB, Inc. Through this subsidiary, we intend to provide easy-to-buy, simple-to-use VoIP services to small businesses at disruptive prices. We began sales of our SMB product in the third quarter of 2016.

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.

## Basis of Presentation

Our unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, our unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in our Annual Report on Form 10-K for the year ended December 31, 2015. The balance sheet at December 31, 2015 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included.

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

We have historically prepared our consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of our revenues in the three and nine months ended September 30, 2016 and 2015 were derived from sales to customers located in the United States. Beginning in the first quarter of 2016, with the acquisition of Broadsmart and the internal development of our SMB division, we are reporting the results of operations for these new business lines as separate business segments.

## Basis of Consolidation

Our consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries. The results of Broadsmart Global, Inc. have been included since March 17, 2016. Refer to Note 15 – “Acquisition of Business,” for further details. All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the nine months ended September 30, 2016 may not be indicative of the results for the entire year ending December 31, 2016. The interim unaudited condensed consolidated financial statements should be read in conjunction with our financial statements and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in this report and in our Annual Report on Form 10-K for the year ended December 31, 2015 filed on March 15, 2016.

## Use of Estimates

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

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



## CRITICAL ACCOUNTING POLICIES

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

### REVENUE RECOGNITION

#### Consumer Segment

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

#### magicJack Devices and Renewal Access Revenue

We recognize revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of our software to access our servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period. Revenue from the sales of magicAPP and magicJack Connect access rights is recognized ratably over the access right period. The revenue from sales of battery powerbanks is fully recognized in the period of sale. When a discounted battery powerpack is sold as part of a package, revenue is allocated between the package components based on relative fair value.

#### Sales Return Policy

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

Returns from retailers are accepted on an authorized basis for devices deemed defective. We may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. We estimate potential returns under these arrangements at point of sale and re-estimate potential returns on a quarterly basis. For the three and nine months ended September 30, 2016 and 2015, our estimates of returns and actual returns from initial stocking orders have not been materially different.

#### Prepaid Minutes and Access and Wholesale Charges

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

#### Enterprise Segment

For the Enterprise business, net revenues consist of revenues from the sale of hosted services, usage charges, hardware and network equipment sales, and other one-time miscellaneous service charges.

#### Broadsmart/UCaaS Revenue

The Company recognizes revenues from sales of its hosted services in the period the services are provided over the term of the respective customer agreements. Customers are billed monthly in advance for these recurring services and in arrears for one time service charges and other certain usage charges. Revenues from sales of hardware and network equipment are recognized in the period that the equipment is delivered. Revenue from the sale of equipment purchased but not yet delivered and installed is deferred and recognized in the period that the hardware or equipment is put into service.

#### SMB Segment

#### VoIP Services

The Company provides VoIP services to small businesses. Revenue from this segment is immaterial for the three and nine months ended September 30, 2016.

## INCOME TAXES

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. Our net deferred tax assets consist primarily of foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. We record a valuation allowance to reduce the net deferred tax assets to the amount that we estimate is more-likely-than-not to be realized. We periodically review the composition of our net deferred tax assets and related valuation allowances and make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required. We increased the valuation allowance by \$0.3 million and increased the valuation allowance by \$0.2 million during the three and nine months ended September 30, 2016, respectively. We decreased the valuation allowance by \$0.7 million and \$0.1 million for the three and nine months ended September 30, 2015, respectively.

We assess our income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting date. For those tax positions that we estimate there is a greater than 50% likelihood that a tax benefit will be sustained, we have recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that we estimate there is a 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. We revised our liability for uncertain tax positions by an increase of \$0.3 million and \$1.5 million during the three and nine months ended September 30, 2016, respectively, due primarily to an increase in uncertain tax positions related to various state issues and the revaluation impact of previously recorded Israeli uncertain tax positions. We revised our liability for uncertain tax positions by a net decrease of \$7.9 million during the three and nine months ended September 30, 2015, due primarily to the effective settlement of various positions taken in connection with U.S. federal income tax years 2010 through 2013 which were examined by the IRS.

We record our income tax expense for interim financial statements by using an estimated annual effective income tax rate based on our expected annual results after elimination of nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2016 and changes in other deferred tax assets and liabilities are recognized during interim periods based on annual forecasts as of the interim reporting date. At September 30, 2016, the estimated annual effective income tax rate is expected to approximate 34.7%, excluding discrete tax items, which includes federal, foreign, and state and local taxes. This rate may fluctuate due to changes in our jurisdictional income and due to the timing of other discrete period transactions during the remainder of the year.

## SHARE-BASED COMPENSATION

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

## SIGNIFICANT CHANGES IN FINANCIAL POSITION

The following table presents significant changes in our unaudited condensed consolidated balance sheets for the nine months ended September 30, 2016 (in thousands).

|                                | September<br>30,<br>2016<br>(Unaudited) | December<br>31,<br>2015 | Change      |
|--------------------------------|---|-------------------------|-------------|
| Cash and cash equivalents      | \$ 51,526                               | \$ 78,589               | \$(27,063 ) |
| Prepaid income taxes           | \$ 602                                  | \$ 2,747                | \$(2,145 )  |
| Receivable from earnout escrow | \$ 2,000                                | \$ -                    | \$ 2,000    |
| Intangible assets, net         | \$ 29,924                               | \$ 6,687                | \$ 23,237   |
| Goodwill                       | \$ 47,485                               | \$ 32,304               | \$ 15,181   |
| Income tax payable             | \$ 1,764                                | \$ -                    | \$ 1,764    |
| Total deferred revenue         | \$ 95,135                               | \$ 102,700              | \$(7,565 )  |
| Other non-current liabilities  | \$ 13,451                               | \$ 11,098               | \$ 2,353    |

During the nine months ended September 30, 2016, cash and cash equivalents decreased \$27.1 million, primarily reflecting cash used in the acquisition of Broadsmart. A detailed discussion of this change is provided in “Liquidity and Capital Resources”.

During the nine months ended September 30, 2016, prepaid income taxes decreased \$2.1 million, income tax payable increased \$1.8 million and other non-current liabilities increased \$2.4 million due to recognition of 2016 income taxes.

During the nine months ended September 30, 2016, receivable from earnout escrow increased \$2.0 million related to the Broadsmart Earnout Payment.

During the nine months ended September 30, 2016, intangible assets increased \$23.2 million. The increase in intangible assets is primarily attributable to \$26.4 million in additions from the acquisition of Broadsmart, partially offset by: (i) amortization expense of \$2.7 million and (ii) impairment of \$0.5 million.

During the nine months ended September 30, 2016, goodwill increased \$15.2 million due to the acquisition of Broadsmart.

During the nine months ended September 30, 2016, total deferred revenue decreased \$7.6 million due primarily to the recognition of 2015 deferred revenue exceeding the deferral associated with 2016 sales.

## RESULTS OF OPERATIONS

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

|                                 | Three Months Ended<br>September 30, |               | 2016<br>Compared to |                | Nine Months Ended<br>September 30, |               | 2016<br>Compared to |               |
|---------------------------------|-------------------------------------|---------------|---------------------|----------------|------------------------------------|---------------|---------------------|---------------|
|                                 | 2016                                | 2015          | 2015                |                | 2016                               | 2015          | 2015                |               |
| <b>Net Revenues</b>             |                                     |               |                     |                |                                    |               |                     |               |
| Sale of magicJack devices       | \$2,849                             | \$4,466       | \$(1,617 )          | (36.2 ) %      | \$9,641                            | \$12,087      | \$(2,446 )          | (20.2 )       |
| Access right renewals           | 14,456                              | 16,199        | (1,743 )            | (10.8 )        | 44,464                             | 49,814        | (5,350 )            | (10.7 )       |
| Shipping and handling           | 228                                 | 208           | 20                  | 9.6            | 609                                | 628           | (19 )               | (3.0 )        |
| magicJack-related products      | 1,638                               | 905           | 733                 | 81.0           | 4,082                              | 3,032         | 1,050               | 34.6          |
| Prepaid minutes                 | 1,390                               | 2,042         | (652 )              | (31.9 )        | 4,606                              | 6,416         | (1,810 )            | (28.2 )       |
| Access and wholesale charges    | 1,158                               | 1,589         | (431 )              | (27.1 )        | 3,898                              | 4,347         | (449 )              | (10.3 )       |
| Broadsmart                      | 2,830                               | -             | 2,830               | *              | 6,243                              | -             | 6,243               | *             |
| Other                           | 23                                  | -             | 23                  | *              | 29                                 | 7             | 22                  | *             |
| <b>Total Net Revenue</b>        | <b>24,572</b>                       | <b>25,409</b> | <b>(837 )</b>       | <b>(3.3 )</b>  | <b>73,572</b>                      | <b>76,331</b> | <b>(2,759 )</b>     | <b>(3.6 )</b> |
| <b>Cost of Revenues</b>         |                                     |               |                     |                |                                    |               |                     |               |
| Cost of magicJack devices       | 2,325                               | 1,957         | 368                 | 18.8           | 6,450                              | 6,117         | 333                 | 5.4           |
| Shipping and handling           | 481                                 | 310           | 171                 | 55.2           | 1,310                              | 911           | 399                 | 43.8          |
| Credit card processing fees     | 441                                 | 490           | (49 )               | (10.0 )        | 1,405                              | 1,711         | (306 )              | (17.9 )       |
| Network and carrier charges     | 2,866                               | 3,697         | (831 )              | (22.5 )        | 9,601                              | 11,863        | (2,262 )            | (19.1 )       |
| Broadsmart                      | 2,264                               | -             | 2,264               | *              | 4,993                              | -             | 4,993               | *             |
| Other                           | 1,132                               | 1,771         | (639 )              | (36.1 )        | 3,797                              | 5,759         | (1,962 )            | (34.1 )       |
| <b>Total Cost of Revenues</b>   | <b>9,509</b>                        | <b>8,225</b>  | <b>1,284</b>        | <b>15.6</b>    | <b>27,556</b>                      | <b>26,361</b> | <b>1,195</b>        | <b>4.5</b>    |
| <b>Gross Profit</b>             | <b>15,063</b>                       | <b>17,184</b> | <b>(2,121 )</b>     | <b>(12.3 )</b> | <b>46,016</b>                      | <b>49,970</b> | <b>(3,954 )</b>     | <b>(7.9 )</b> |
| <b>Operating expenses:</b>      |                                     |               |                     |                |                                    |               |                     |               |
| Marketing                       | 2,680                               | 2,357         | 323                 | 13.7           | 5,659                              | 6,940         | (1,281 )            | (18.5 )       |
| General and administrative      | 7,641                               | 6,286         | 1,355               | 21.6           | 24,828                             | 21,297        | 3,531               | 16.6          |
| Research and development        | 1,314                               | 1,088         | 226                 | 20.8           | 3,661                              | 3,418         | 243                 | 7.1           |
| Gain on mark-to-market          | (2,000 )                            | -             | (2,000 )            | *              | (2,000 )                           | -             | (2,000 )            | *             |
| <b>Total operating expenses</b> | <b>9,635</b>                        | <b>9,731</b>  | <b>(96 )</b>        | <b>(1.0 )</b>  | <b>32,148</b>                      | <b>31,655</b> | <b>493</b>          | <b>1.6</b>    |

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|                              |         |         |          |         |         |          |            |         |
|------------------------------|---------|---------|----------|---------|---------|----------|------------|---------|
| Operating income             | 5,428   | 7,453   | (2,025 ) | (27.2 ) | 13,868  | 18,315   | (4,447 )   | (24.3 ) |
| Other income (expense):      |         |         |          |         |         |          |            |         |
| Interest and dividend income | 5       | 6       | (1 )     | *       | 21      | 23       | (2 )       | *       |
| Interest expense             | -       | -       | -        | *       | -       | (57 )    | 57         | *       |
| Other (expense) income, net  | (6 )    | 4       | (10 )    | *       | (11 )   | (2 )     | (9 )       | *       |
| Total other income (expense) | (1 )    | 10      | (11 )    | *       | 10      | (36 )    | 46         | *       |
| Income before income taxes   | 5,427   | 7,463   | (2,036 ) | (27.3 ) | 13,878  | 18,279   | (4,401 )   | (24.1 ) |
| Income tax expense           | 2,205   | 4,152   | (1,947 ) | (46.9 ) | 7,407   | 6,708    | 699        | 10.4    |
| Net income                   | \$3,222 | \$3,311 | \$(89 )  | (2.7 )  | \$6,471 | \$11,571 | \$(5,100 ) | (44.1 ) |

\* - Not meaningful.

## Components of Net Revenues

Our net revenues are comprised of the following sources:

- Sales of the magicJack devices – represents revenues recognized from sales of the magicJack devices to retailers, wholesalers, or direct to customers, net of returns, over the period associated with the initial three, six or twelve months access right period. These revenues are recorded net of sales allowance, chargebacks, retailer discounts and advertising allowances;
- Access right renewals – represents revenues from customers purchasing rights to access our servers beyond the initial access right period included with a magicJack device or magicJack service. The extended access right ranges from one to five years. These fees charged to customers are initially deferred and recognized as revenue ratably over the extended access right period. These revenues also include revenues from access rights granted to paid subscribers of the magicAPP and are recognized ratably over the access right period;
- Shipping and handling – represents charges for shipping and handling fees for magicJack devices shipped directly to customers. The fees are initially deferred and recognized as revenues over the initial three, six or twelve months access right period associated with the magicJack device;
- magicJack-related products – represents revenues recognized from the sale of other items related to the magicJack devices and access right renewals we offer our customers, including: (i) porting fees charged to customers to port their existing phone number to a magicJack device or service, (ii) fees charged for customers to select a custom, vanity or Canadian phone number, (iii) fees charged to customers to change their existing number, (iv) insurance covering the replacement of a damaged or lost device, and (v) sale of battery powerbanks;
- Prepaid minutes – represents revenues recognized primarily from the usage and expiration of international prepaid minutes, net of chargebacks;
- Access and wholesale charges – represents revenues generated from: (i) access fees charged to other telecommunication carriers or providers for IXC calls terminated to our end-users, and (ii) fees charged to telecommunications carriers or providers for origination of calls to their 800-numbers. These revenues are recorded based on rates set forth in the respective state and federal tariffs or negotiated contract rates, less provisions for billing adjustments;
- Broadsmart/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
  - Other – represents primarily revenues generated by ancillary revenue sources.

## Components of Cost of Revenues

Our cost of revenues is comprised of the following components:

- Cost of magicJack devices sold – represents the costs of components and manufacturing of the magicJack devices, as well as broker commissions, production, packaging, and other inventory-related costs. The cost of components and

manufacturing of the magicJack devices is recognized from sales of the magicJack devices to retailers, wholesalers, or direct to customers over the period associated with the initial three, six or twelve months access right period. The cost of battery powerbanks is fully recognized in the period of sale;

- Shipping and handling – represents freight, postage and other transportation costs related to: (i) transportation of the magicJack devices from the manufacturer to our warehouse and distribution center, and (ii) freight, shipping and handling fees incurred to ship the magicJack devices to retailers and directly to customers. These costs are expensed as incurred;
- Credit card processing fees – represents transaction and other fees incurred as a result of accepting credit card payments for sales of magicJack devices, access right renewals, shipping and handling charges, magicJack related products and prepaid minutes sold directly to customers through our website. These fees are expensed as incurred;
- Network and carrier charges – represents facilities charges to establish and maintain our network as well as network usage fee charges from other telecommunications carriers. These rates or charges are based upon commercial agreements or applicable state and/or federal tariffs. These charges are expensed as incurred;
- Broadsmart/UCaaS – represents the cost of providing the recurring monthly hosted services including, network usage charges, customer internet access, amortization expense and commissions as well as the cost of hardware and network equipment related to non-recurring sales. These costs are expensed as incurred; and
- Other cost of revenues – represents allocation of personnel-related costs, amortization and depreciation expense related to assets employed in generating our revenues, as well as costs from discontinued revenue sources.



THREE MONTHS ENDED SEPTEMBER 30, 2016 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2015

Net Revenues

Total net revenue was \$24.6 million and \$25.4 million for the three months ended September 30, 2016 and 2015, respectively, representing a decrease of \$0.8 million, or 3.3%. The decrease in the components of net revenues was primarily attributable to the following:

- \$1.6 million decrease in revenues from the sale of magicJack devices primarily reflecting lower retail sales volume;
- \$1.7 million decrease in access right renewal revenues; and
- \$0.7 million decrease in revenues from prepaid minutes resulting from lower usage levels;

These decreases in components of net revenue were partially offset by \$2.8 million of revenue for Broadsmart for the three months ended September 30, 2016, and a \$0.7 million increase in revenues from the sale of magicJack related products.

For the three months ended September 30, 2016 and 2015, sales of the magicJack devices through retail outlets represented approximately 56% and 68%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 44% and 32%, respectively, of magicJack devices sold. For the three months ended September 30, 2016 and 2015, no retailer accounted for more than 10% of the Company's total net revenue.

Cost of Revenues

Total cost of revenues was \$9.5 million and \$8.2 million for the three months ended September 30, 2016 and 2015, respectively, representing an increase of approximately \$1.3 million, or 15.6%. This increase in cost of revenues was primarily attributable to: (i) \$2.3 million in Broadsmart related cost of goods sold which included approximately \$0.8 million in depreciation and amortization expense related to acquired assets, (ii) a \$0.2 million increase in shipping and handling costs reflecting an increase in direct sales volume, and (iii) a \$0.4 million increase in the cost of magicJack devices. These increases in components of cost of revenues were partially offset by: (i) a \$0.8 million decrease in network and carrier charges primarily as a result of lower traffic substantially resulting from the elimination of free app users at the end of Q2 2016, and (ii) \$0.6 million decrease in other cost of revenues primarily attributable to a decrease in overhead allocation reflecting lower personnel related costs.

Operating Expenses

Total operating expenses were \$9.6 million and \$9.7 million for three months ended September 30, 2016 and 2015, respectively, representing a decrease of \$0.1 million, or 1.0%. This change in operating expenses is primarily attributable to: (i) a \$1.4 million increase in General and Administrative ("G&A") expense due to several factors including: (a) \$1.5 million in costs associated with the investment in the SMB segment, (b) \$0.8 million in costs associated with Broadsmart, and (c) \$0.5 million impairment of intangible assets; partially offset by cost reductions in the core Consumer segment totaling \$1.4 million, primarily in the areas of personnel related costs and customer care costs; (ii) a \$0.3 million increase in marketing expense; and (iii) a \$0.2 million increase in Research and Development ("R&D") expense; offset by a \$2.0 million gain on mark-to-market related to the Broadsmart Earnout Payment.

Income Taxes

Total income tax expense was \$2.2 million and \$4.2 million for the three months ended September 30, 2016 and 2015, respectively. The principal components of our income taxes for the three months ended September 30, 2016 and 2015

are the following (in thousands):

|                            | Three Months Ended<br>September 30, |          |
|----------------------------|-------------------------------------|----------|
|                            | 2016                                | 2015     |
| Income before income taxes | \$ 5,427                            | \$ 7,463 |
| Income tax expense         | 2,205                               | 4,152    |
| Effective income tax rate  | 40.63 %                             | 55.63 %  |

We primarily operate in the U.S. and Israel, and our Israeli operations are subject to a statutory income tax rate of 25.0% that is lower than our U.S. federal income tax rate which is 35% as of September 30, 2016.

For the three months ended September 30, 2016, we recorded an income tax expense of \$2.2 million, which is higher than the expected tax provision of \$1.9 million, using the statutory income tax rate of 35% primarily due to increases to uncertain tax positions, and other various discrete items totaling \$0.3 million. The discrete items noted above were partially offset by the lower jurisdictional tax rate charged on the operating income of the Company's Israeli operations.

The 2016 estimated annual effective tax rate is expected to approximate 34.7%, excluding discrete tax items, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

#### Net income

As a result of the foregoing items, net income slightly decreased to \$3.2 million in the three months ended September 30, 2016, as compared to net income of \$3.3 million in the three months ended September 30, 2015. Net income per diluted share increased to \$0.21 per ordinary share for the three months ended September 30, 2016, as compared to \$0.20 per ordinary share in the prior year comparable period primarily as a result of a \$2.0 million gain on mark-to-market related to the Broadsmart Earnout Payment, partially offset by decreased profitability reflecting lower revenues and higher cost of revenues and operating expenses. The increase in net income per diluted share was also attributable to a reduction in the number of diluted shares outstanding reflecting the impact of our 2015 share-buy-back program.

#### NINE MONTHS ENDED SEPTEMBER 30, 2016 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2015

##### Net Revenues

Total net revenue was \$73.6 million and \$76.3 million for the nine months ended September 30, 2016 and 2015, respectively, representing a decrease of \$2.8 million, or 3.6%. The decrease in the components of net revenues was primarily attributable to the following:

- \$5.4 million decrease in access right renewal revenues;
- \$1.8 million decrease in revenues from prepaid minutes resulting from lower usage levels; and
- \$2.5 million decrease in magicJack device sales revenues, primarily reflecting lower retail sales volumes.

These decreases in components of net revenue were partially offset by \$6.2 million in sales related to Broadsmart and a \$1.1 million increase in revenues from the sale of magicJack-related products.

For the nine months ended September 30, 2016 and 2015, sales of the magicJack devices through retail outlets represented approximately 54% and 68%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 46% and 32%, respectively, of magicJack devices sold. For the nine months ended September 30, 2016 and 2015, no retailer accounted for more than 10% of the Company's total net revenue.

##### Cost of Revenues

Total cost of revenues was \$27.6 million and \$26.4 million for the nine months ended September 30, 2016 and 2015, respectively, representing an increase of approximately \$1.2 million, or 4.5%. This increase in cost of revenues was

primarily attributable to: (i) \$5.0 million in Broadsmart related cost of goods sold which included approximately \$1.5 million in depreciation and amortization expense related to acquired assets, (ii) a \$0.4 million increase in shipping and handling costs reflecting an increase in direct sales volume, and (iii) a \$0.3 million increase in the cost of magicJack devices. These increases in components of cost of revenues were partially offset by: (i) a \$2.3 million decrease in network and carrier charges primarily as a result of lower traffic substantially resulting from the elimination of free app users at the end of Q2 2016, (ii) \$2.0 million decrease in other cost of revenues primarily attributable to a decrease in overhead allocation reflecting lower personnel related costs, and (iii) a \$0.3 million decrease in credit card processing fees.

## Operating Expenses

Total operating expenses were \$32.1 million and \$31.7 million for the nine months ended September 30, 2016 and 2015, respectively, representing an increase of \$0.5 million, or 1.6%. This increase in operating expenses is primarily attributable to: (i) a \$3.5 million increase in G&A expense due to several factors including: (a) \$4.6 million in costs associated with the investment in the SMB segment, (b) \$2.2 million in costs associated with Broadsmart, and (c) \$0.5 million impairment of intangible assets; partially offset by cost reductions in the core Consumer segment totaling \$3.8 million, primarily in the areas of personnel related costs, legal costs, and customer care related costs; and (ii) a \$0.2 million increase in R&D expenses primarily related to the new SMB segment. These increases were partially offset by a \$1.3 million decrease in marketing expense reflecting reduced media buys and a \$2.0 million gain on mark-to-market related to the Broadsmart Earnout Payment.

## Income Taxes

Total income tax expense was \$7.4 million and \$6.7 million for the nine months ended September 30, 2016 and 2015, respectively. The principal components of our income taxes for the nine months ended September 30, 2016 and 2015 are the following (in thousands):

|                            | Nine Months Ended<br>September 30, |           |
|----------------------------|------------------------------------|-----------|
|                            | 2016                               | 2015      |
| Income before income taxes | \$ 13,878                          | \$ 18,279 |
| Income tax expense         | 7,407                              | 6,708     |
| Effective income tax rate  | 53.37 %                            | 36.70 %   |

We primarily operate in the U.S. and Israel, and our Israeli operations are subject to a statutory income tax rate of 25.0% that is lower than our U.S. federal income tax rate which is 35% as of September 30, 2016.

For the nine months ended September 30, 2016, we recorded an income tax expense of \$7.4 million, which is higher than the expected tax provision of \$4.9 million, using the statutory income tax rate of 35% due, in part, to the net impact of a decrease in the Israeli corporate tax rate from 26.5% to 25.0% which was effective in January 2016. The decrease in the rate resulted in the Company needing to reduce its Israeli deferred tax assets, primarily net operating loss carryforwards, which resulted in discrete tax expense and a reduction in the value of related deferred tax assets of \$1.4 million. Additionally, the effective tax rate was impacted by increases to uncertain tax positions of \$1.0 million and other items of \$0.1 million. The items noted above were partially offset by the lower jurisdictional tax rate charged on the operating income of the Company's Israeli operations.

The 2016 estimated annual effective tax rate is expected to approximate 34.7%, excluding discrete tax items, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

## Net income

As a result of the foregoing items, net income decreased to \$6.5 million in the nine months ended September 30, 2016, as compared to net income of \$11.6 million in the nine months ended September 30, 2015. Net income per diluted share decreased to \$0.44 per ordinary share for the nine months ended September 30, 2016, as compared to \$0.66 per ordinary share in the prior year comparable period primarily as a result of decreased profitability reflecting lower

revenues and higher operating and income tax expense which was partially offset by a reduction in the number of diluted shares outstanding reflecting the impact of our 2015 share-buy-back program.

#### BUSINESS TRENDS

Revenues in our consumer segment continued to decline during the three and nine months ended September 30, 2016. We remain encouraged by the loyalty of our existing customer base and we continue to undertake efforts to improve our customer renewal rates and limit customer churn. We are also maintaining our efforts to expand device sales to new markets, and with the launch of magicJack Connect to both iOS and Android customers, we are increasing our efforts to reposition the device with its companion app service. We believe that there will continue to be solid consumer demand for our low priced, unlimited phone service, whether through our magicJack device, our magicJack Connect APP, or a combination of both, in the United States and international markets.

On March 17, 2016, we completed the acquisition of substantially all of the assets of Broadsmart. In connection with the acquisition, we formed a new subsidiary, Broadsmart Global, Inc. Broadsmart has a track record of designing, provisioning and delivering complex Unified Communication as a Service (UCaaS) solutions to blue chip corporate customers on a nationwide basis. It has expertise in servicing enterprises with hundreds-to-thousands of locations. The business has been highly profitable, having generated approximately \$13 million in revenues. We believe that if we successfully execute, there is significant growth potential for Broadsmart in the UCaaS space.

The two founders of Broadsmart have remained with the business as CEO and President, respectively, of Broadsmart Global, Inc. With the acquisition of Broadsmart, we are diversifying beyond our core business into UCaaS targeting high end SMB and enterprise customers. Broadsmart has demonstrated that they know how to sell and service large enterprise customers with complex needs at thousands of locations in multiple geographies. We intend to fully support them in maximizing their promising pipeline for new business and are exploring opportunities for Broadsmart to realize synergies by leveraging magicJack's proprietary low cost infrastructure.

In addition to the Broadsmart acquisition, we are further transitioning towards business customers with the launch of our new SMB subsidiary in the fourth quarter of 2015. We began making investments in the new SMB business during the first quarter of 2016. In total, we plan to invest approximately \$10 million dollars in this new initiative during fiscal year 2016. We expect that this business line will leverage our core assets and give us the ability to sell these services at disruptive pricing to small-to-medium business customers. While we are not forecasting significant revenue from our SMB business in 2016, we believe that in the long term, if we successfully execute on this growth initiative, it has the potential to generate significant shareholder value.

Furthermore, 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. With in-app purchase capability, other offers available on the magicJack Connect app include international calling plans for select countries, the ability to purchase local phone numbers from over 40 countries, and the ability to purchase international calling credits for consumers that prefer pay-as-you go options. We are focused on driving sales growth through monetizing magicJack Connect. The magicJack Connect APP competes with other large, well-capitalized global companies in the telecom APP industry who are introducing low priced consumer offers into the marketplace on an ongoing basis. Accordingly, we cannot assure that the features we are offering for monetization of the magicJack Connect APP will be attractive to consumers at the price points we are offering, or at all.

On the international front, although progress on the development of our relationship with Telefonica has been slower than anticipated, in February 2016 our continuing efforts resulted in the test launch of a new Mexico-based service offering named "Call U.S.". The new service is being offered through Movistar, Telefonica's mobile operator in Mexico, and is being made available to Movistar's customers throughout Mexico, enabling them to purchase a U.S. phone number through which they can receive unlimited inbound calls from friends, relative or business contacts based in the United States. The service is integrated with Telefonica's existing Movistar systems allowing customers to pay through the same channels that they currently use to pay for their core Movistar wireless service.

With the acquisition of Broadsmart, the investment in the magicJack SMB business and the continued efforts in improving and promoting the magicJack Connect App, we have taken significant steps to diversify our business from the consumer segment and into the SMB and UCaaS space, with magicJack SMB targeting smaller businesses and Broadsmart serving medium to large enterprises.

While we are pleased with the launch of the organic initiatives described above and the acquisition of Broadsmart, there can be no assurance that these initiatives will be successful and we cannot predict what impact, if any, these initiatives will ultimately have on our business, results of operations, financial condition or cash flows.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash generated from operations, cash on hand and investments. As of September 30, 2016, we had cash and cash equivalents of \$51.5 million, investments of \$0.4 million, net accounts receivable of \$2.6 million and receivable from earnout escrow of \$2.0 million. Our accounts payable at September 30, 2016 was \$2.8 million.

During the nine months ended September 30, 2016, we generated positive operating cash flows of \$13.3 million, as compared to \$19.3 million for the nine months ended September 30, 2015. The \$6.0 million decrease was primarily due to lower sales in the core magicJack business during the nine months ended September 30, 2016, and higher general and administrative expenses, primarily reflecting investments in the SMB business segment and transaction related costs for the Broadsmart acquisition which were partially offset by lower marketing expenditures and positive net cash flows from the Broadsmart operations. Net income was \$6.5 million for the nine months ended September 30, 2016 as compared to \$11.6 million for the nine months ended September 30, 2015. We currently believe that available funds and cash flows generated by operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months. If we decide to make future acquisitions, we may require new sources of funding, including debt, equity financing or some combination thereof. There can be no assurances that we will be able to secure additional sources of funding or that such additional sources of funding will be available to us on acceptable terms.



#### Cash Flow – Operating Activities

Net cash provided by operating activities was \$13.3 million and \$19.3 million for the nine months ended September 30, 2016 and 2015, respectively.

During the nine months ended September 30, 2016, net cash provided by operating activities was primarily attributable to: (i) \$6.5 million of net income; (ii) \$7.6 million in non-cash items consisting primarily of (a) \$3.2 million of stock-based compensation expense, (b) \$3.5 million of depreciation and amortization expense, (c) a \$0.5 million impairment of intangible assets, (d) a \$1.5 million increase in uncertain tax positions, and (e) a \$0.6 million increase in deferred income tax provision, partially offset by a \$2.0 million gain on mark-to-market related to the Broadsmart Earnout Payment; (iii) a \$0.7 million decrease in accounts receivable; (iv) a \$1.6 million decrease in inventory levels; (v) a \$2.2 million decrease in prepaid income taxes; (vi) a \$1.5 million increase in accounts payable, and (vii) a \$1.8 million increase in income taxes payable. These items were partially offset by: (i) a \$7.8 million decrease in deferred revenue; (ii) a \$0.2 million decrease in accrued expenses and other current liabilities; (iii) a \$0.2 million increase in deposits and other current assets; (iv) a \$0.1 million decrease in other non-current liabilities, and (v) a \$0.2 million increase in deferred costs.

During the nine months ended September 30, 2015, net cash provided by operating activities was primarily attributable to: (i) \$11.6 million of net income, (ii) \$11.9 million in non-cash items consisting primarily of \$3.9 million of stock-based compensation expense, \$2.9 million of depreciation and amortization expense, and a \$6.1 million increase in deferred income tax provision, partially offset by a \$1.1 million release of the uncertain tax positions, (iii) a \$0.9 million decrease in deferred costs, (iv) a \$1.3 million decrease in accounts receivable, and (v) a \$6.0 million decrease in prepaid income taxes. These items were partially offset by: (i) a \$6.9 million decrease in deferred revenue, (ii) a \$0.6 million increase in inventory levels, (iii) a \$0.9 million decrease in income taxes payable, (iv) a \$1.6 million decrease in accounts payable, (v) a \$0.9 million increase in deposits and other current assets, and (vi) a \$1.5 million decrease in accrued expenses and other current liabilities.

#### Cash Flow – Investing Activities

Net cash used in investing activities was \$40.4 million and \$0.5 million for the nine months ended September 30, 2016, and 2015, respectively.

Net cash used in investing activities during the nine months ended September 30, 2016 was primarily attributable to the acquisition of Broadsmart.

Net cash used in investing activities during the nine months ended September 30, 2015 was attributable to purchases of equipment and leasehold improvements primarily due to upgrades to our data storage facility.

#### Cash Flow – Financing Activities

No significant cash was (used in) or provided by financing activities for the nine months ended September 30, 2016. Net cash used in financing activities was \$15.2 million for the nine months ended September 30, 2015.

Net cash used in financing activities during the nine months ended September 30, 2015 primarily consisted of \$13.6 million in cash used to purchase 1,720,390 ordinary shares at an average price of \$7.88 per share as part of our share repurchase program and a \$1.5 million annual payment in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets.

#### Other Liabilities

As of September 30, 2016, we no longer have any outstanding indebtedness classified as other Liabilities. In the nine months ended September 30, 2015, in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets, and secured only by such intangible assets, the Company made the final non-interest bearing annual payment of \$1.5 million in May 2015.

#### Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements as of September 30, 2016.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

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

Exposure to Interest Rates

The primary objective of our investment activities is to preserve our capital until it is required to fund operations while at the same time maximizing the income we receive from our investments without incurring investment market volatility risk. Our investment income is sensitive to the general level of United States interest rates. In this regard, changes in the United States interest rates affect the interest earned on our cash and cash equivalents. Due to the short-term nature of our cash and cash equivalent holdings, a 10% movement in market interest rates would not materially impact the total fair value of our portfolio as of September 30, 2016.

Exposure to Exchange Rates

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

Exposure to Equity and Derivative Prices

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

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2016, there were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

Legal Proceedings

We are subject to various legal proceedings and claims, including intellectual property claims, contractual and commercial disputes, employment claims, state and local tax matters and other matters which arise in the ordinary course of business. Our policy is to vigorously defend any legal proceedings. Management regularly evaluates the status of legal proceedings in which we are involved in order to assess whether a loss is probable or there is a reasonable possibility that a loss or additional loss may have been incurred and to determine if accruals are appropriate. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on our business, operating results, financial condition or cash flows. However, an unexpected adverse resolution of one or more of these matters could have a material adverse effect on our results of operations in a particular fiscal year or quarter. For additional information, refer to Note 10, “Commitments and Contingencies,” in the Notes to our unaudited condensed consolidated financial statements included in Item 1 herein for further details.

ITEM 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015.

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

Not applicable.

ITEM 3. Defaults Upon Senior Securities

Not applicable.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

Not applicable.

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ITEM 6. Exhibits

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

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

magicJack VocalTec Ltd.  
(Registrant)

Dated: November 9, 2016

By: /s/ Gerald Vento  
Gerald Vento  
President and Chief Executive Officer

Dated: November 9, 2016

By: /s/ Jose Gordo  
Jose Gordo  
Chief Financial Officer