

MAGICJACK VOCALTEC LTD
Form 10-Q
May 11, 2015

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 March 31, 2015

OR

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

For transition period from _____ to _____

Commission file number: 000-27648

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

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

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

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

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of

this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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 17,870,112 ordinary shares with no par value outstanding at April 30, 2015.

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

| | |
|--|----|
| <u>ITEM 1. Financial Statements</u> | |
| <u>Condensed Consolidated Balance Sheets (Unaudited)</u> | 3 |
| <u>Condensed Consolidated Statements of Operations (Unaudited)</u> | 4 |
| <u>Condensed Consolidated Statements of Comprehensive Income (Unaudited)</u> | 5 |
| <u>Condensed Consolidated Statement of Capital Equity (Unaudited)</u> | 6 |
| <u>Condensed Consolidated Statements of Cash Flows (Unaudited)</u> | 7 |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u> | 9 |
| | |
| <u>ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | 22 |
| <u>ITEM 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 30 |
| <u>ITEM 4. Controls and Procedures</u> | 30 |

PART II OTHER INFORMATION

| | |
|--|----|
| <u>ITEM 1. Legal Proceedings</u> | 31 |
| <u>ITEM</u> | |
| <u>1A. Risk Factors</u> | 31 |
| <u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 31 |
| <u>ITEM 3. Defaults Upon Senior Securities</u> | 31 |
| <u>ITEM 4. Mine Safety Disclosures</u> | 31 |
| <u>ITEM 5. Other Information</u> | 31 |
| <u>ITEM 6. Exhibits</u> | 32 |

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 and the magicJackGO.

PART I – FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

| | March 31, 2015 | December 31, 2014 |
|---|-------------------|-------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$82,935 | \$75,945 |
| Investments, at fair value | 367 | 367 |
| Accounts receivable, net of allowance for doubtful accounts and billing adjustments of \$494 and \$1,171, respectively | 2,855 | 3,903 |
| Inventories | 6,856 | 5,635 |
| Deferred costs | 2,463 | 2,765 |
| Prepaid income taxes | 12,508 | 12,513 |
| Deferred tax assets, current | 13,341 | 13,341 |
| Deposits and other current assets | 1,258 | 1,170 |
| Total current assets | 122,583 | 115,639 |
| Property and equipment, net | 3,898 | 3,564 |
| Intangible assets, net | 8,659 | 9,473 |
| Goodwill | 32,304 | 32,304 |
| Deferred tax assets, non-current | 31,908 | 32,510 |
| Deposits and other non-current assets | 741 | 743 |
| Total assets | \$200,093 | \$194,233 |
| LIABILITIES AND CAPITAL EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$2,573 | \$2,879 |
| Income tax payable | 10,254 | 9,197 |
| Accrued expenses and other current liabilities | 7,794 | 8,406 |
| Deferred revenue, current portion | 58,398 | 56,445 |
| Total current liabilities | 79,019 | 76,927 |
| Deferred revenue, net of current portion | 54,520 | 54,782 |
| Other non-current liabilities | 14,877 | 13,438 |
| Total liabilities | 148,416 | 145,147 |
| Commitments and contingencies (Note 9) | | |
| Capital equity | | |
| Ordinary shares, No par value; 100,000 shares authorized; 25,032 shares issued at March 31, 2015 and December 31, 2014, respectively | 111,771 | 111,771 |
| Additional paid-in capital | 11,672 | 10,414 |
| Treasury stock (7,162 and 7,164 shares at March 31, 2015 and December 31, 2014, respectively) | (107,658) | (107,683) |

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| | | |
|--------------------------------------|-----------|-----------|
| Retained earnings | 35,892 | 34,584 |
| Total capital equity | 51,677 | 49,086 |
| Total liabilities and capital equity | \$200,093 | \$194,233 |

See accompanying notes to condensed consolidated financial statements.

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

| | For the Three Months Ended March 31, | |
|---|--|----------|
| | 2015 | 2014 |
| Net revenues | \$25,512 | \$35,313 |
| Cost of revenues | 9,467 | 13,022 |
| Gross profit | 16,045 | 22,291 |
| Operating expenses: | | |
| Marketing | 2,750 | 4,296 |
| General and administrative | 7,700 | 8,650 |
| Research and development | 1,162 | 1,744 |
| Total operating expenses | 11,612 | 14,690 |
| Operating income | 4,433 | 7,601 |
| Other income (expense): | | |
| Interest and dividend income | 11 | 46 |
| Interest expense | (34) | (65) |
| Other income, net | - | 1 |
| Total other expense | (23) | (18) |
| Income before income taxes | 4,410 | 7,583 |
| Income tax expense | 3,102 | 2,264 |
| Net income | \$1,308 | \$5,319 |
| Income per ordinary share: | | |
| Basic | \$0.07 | \$0.30 |
| Diluted | \$0.07 | \$0.30 |
| Weighted average ordinary shares outstanding: | | |
| Basic | 17,868 | 17,827 |
| Diluted | 17,877 | 17,830 |

See accompanying notes to condensed consolidated financial statements.

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

| | For the Three Months Ended March 31, | |
|--|--|---------|
| | 2015 | 2014 |
| Net income | \$1,308 | \$5,319 |
| Other comprehensive income (loss): | | |
| Net unrealized loss on marketable securities | - | (364) |
| Comprehensive income | \$1,308 | \$4,955 |

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 Paid-in Capital | Treasury Stock | | Retained Earnings | Total Capital Equity |
|---|-----------------|-----------|----------------------------------|----------------|--------------|----------------------|----------------------------|
| | Number | Amount | | Number | Amount | | |
| Balance, January 1, 2015 | 25,032 | \$111,771 | \$10,414 | (7,164) | \$(107,683) | \$34,584 | \$49,086 |
| Share-based compensation | - | - | 1,283 | - | - | - | 1,283 |
| Issuance of ordinary shares | - | - | (25) | 2 | 25 | - | - |
| Net income | - | - | - | - | - | 1,308 | 1,308 |
| Balance, March 31, 2015 (unaudited) | 25,032 | \$111,771 | \$11,672 | (7,162) | \$(107,658) | \$35,892 | \$51,677 |

See accompanying notes to condensed consolidated financial statements.

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

| | For the Three Months Ended March 31, | |
|---|--|-----------|
| | 2015 | 2014 |
| Cash flows from operating activities: | | |
| Net income | \$ 1,308 | \$ 5,319 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for doubtful accounts and billing adjustments | 33 | 114 |
| Share-based compensation | 1,283 | 2,669 |
| Depreciation and amortization | 1,016 | 1,391 |
| Deferred income tax provision | 602 | 646 |
| Interest expense - non-cash | 34 | 65 |
| Change in operating assets and liabilities | | |
| Accounts receivable | 1,015 | (1,300) |
| Inventories | (1,221) | 1,105 |
| Deferred costs | 302 | 1,353 |
| Deposits and other current assets | (83) | 1,627 |
| Other non-current assets | 2 | (19) |
| Accounts payable | (299) | 1,006 |
| Income taxes payable | 1,057 | (5) |
| Accrued expenses and other current liabilities | (646) | (725) |
| Deferred revenue | 1,691 | 435 |
| Other non-current liabilities | 1,439 | 509 |
| Net cash provided by operating activities | 7,533 | 14,190 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (543) | (1,360) |
| Net cash used in investing activities | (543) | (1,360) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of ordinary share options | - | 16 |
| Net cash provided by (used in) financing activities | - | 16 |
| Net increase in cash and cash equivalents | 6,990 | 12,846 |
| Cash and cash equivalents, beginning of period | 75,945 | 45,997 |
| Cash and cash equivalents, end of period | \$ 82,935 | \$ 58,843 |

See accompanying notes to condensed consolidated financial statements.

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

| | For the Three Months Ended March 31, | |
|---|--|------|
| | 2015 | 2014 |
| Supplemental disclosures: | | |
| Interest paid | \$- | \$- |
| Income taxes paid | \$- | \$5 |
| Non-cash investing and financing activities: | | |
| Property and equipment (acquired but not paid) | \$5 | \$49 |

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 and magicJack GO, which are updated magicJack devices that have their own CPU and can connect a regular phone directly to the user’s broadband modem/router and function as a standalone phone without using a computer. The Company's products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

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

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

Basis of Presentation

The Company’s unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the Company’s unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. 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, 2014 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

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

The Company prepares its unaudited condensed consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of the Company’s revenues in the three months ended March 31, 2015 and 2014 were from sales to customers located in the United States. The majority of the Company’s revenues recognized were

generated from sales of the magicJack product line and from the software access right that accompanies these products, which were \$21.9 million and \$30.8 million for the three months ended March 31, 2015 and 2014, respectively. The Company also provides its customers the ability to make prepaid calls using the magicJack devices and magicJack APP by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were \$2.2 million and \$2.8 million for the three months ended March 31, 2015 and 2014, respectively.

Basis of Consolidation

The Company's unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications, LLC ("VocalTec US", formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, "Dialmaxx"). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three months ended March 31, 2015 may not be indicative of the results for the entire year ending December 31, 2015. 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, 2014 filed on March 16, 2015.

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, the expected forfeitures of ordinary share options and estimates of likely outcomes related to certain contingent liabilities.

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

Net Revenues

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

Revenue Recognition

magicJack Devices Revenue

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

Sales Return Policy

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

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. The Company

estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the three months ended March 31, 2015 and 2014, 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 of \$0 and \$19 thousand for the three months ended March 31, 2015 and 2014, respectively.

Deferred Revenues

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

Cost of Revenues

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

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were \$1.0 million and \$1.2 million for the three months ended March 31, 2015 and 2014, respectively.

Marketing Expenses

Marketing expenses of \$2.8 million and \$4.3 million for the three months ended March 31, 2015 and 2014, respectively, consist primarily of advertising media buys for television commercials, Internet advertising and print advertising, as well as marketing related personnel costs and other marketing projects including sponsorships. Marketing costs are expensed when incurred. A break-down of marketing expense by category is as follows (in thousands):

| | For the Three Months Ended March 31, | |
|-----------------------------|--|----------|
| | 2015 | 2014 |
| Advertising media buys | \$ 1,957 | \$ 2,398 |
| Marketing personnel related | 538 | 964 |
| Other marketing projects | 255 | 934 |
| Total Marketing Expense | \$ 2,750 | \$ 4,296 |

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 \$1.2 million and \$1.7 million for the three months ended March 31, 2015 and 2014, respectively.

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.

Marketable Securities and Other Investments

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

Certain Risks and Concentrations

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

The Company places its cash and cash equivalents in high quality financial institutions and management believes that the Company is not exposed to any significant risk on its cash accounts. The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the Federal Deposit Insurance Corporation or FDIC up to \$250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at each Israeli bank are not insured. The Company has never experienced any losses related to these balances. At March 31, 2015, the Company had cash and cash equivalents totaling \$82.9 million, which included (i) \$82.5 million in U.S. financial institutions, and (ii) \$0.4 million in an Israeli financial institution.

The Company's non-interest bearing cash balances in U.S. banks, which included \$1.6 million in one individual financial institution, were fully insured. The Company had money market accounts with a financial institution with balances totaling approximately \$80.9 million.

No telecommunication carrier accounted for more than 10% of gross accounts receivable at March 31, 2015. One telecommunication carrier accounted for approximately 15% of gross accounts receivable at December 31, 2014. For the three months ended March 31, 2015 and 2014, no telecommunications carrier accounted for more than 10% of the Company's total net revenues.

One U.S. retail customer accounted for approximately 20% and 17% of gross accounts receivable at March 31, 2015 and December 31, 2014, respectively. For the three months ended March 31, 2015 and 2014, 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 March 31, 2015 and December 31, 2014, 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.

In connection with the Company's purchase of certain intangible assets during June 2011, the Company made payments of \$1.5 million in May 2011, May 2012, May 2013 and May 2014, respectively, and is required to make a final non-interest bearing future payment of \$1.5 million on May 31, 2015. The liability for such payments has been discounted at a rate of 10% to a total fair value of \$1.5 million and \$1.4 million included in accrued expenses and other current liabilities at March 31, 2015 and December 31, 2014, respectively. The Company believes that the \$1.5 million carrying value at March 31, 2015 approximates fair value based on observable market inputs other than quoted prices for similar traded debt securities, which are Level 2 instruments. The \$23 thousand unamortized discount at March 31, 2015 is being amortized using the effective interest method and recorded as interest expense in the Company's unaudited condensed consolidated statements of operations.

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 at March 31, 2015.

Goodwill

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

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

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

In connection with the Company's annual goodwill impairment analysis, as of October 1, 2014, the annual measurement date, the Company's analysis did not indicate any impairment of goodwill has occurred. Management believes there is no impairment at March 31, 2015.

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.

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the period of enactment. The Company's net deferred tax assets consist primarily of foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its' net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. The Company decreased the valuation allowance by \$0.2 million during the three months ended March 31, 2015. No adjustments were made to the valuation allowance during the three months ended March 31, 2014.

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 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 2015 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 March 31, 2015, the estimated annual effective income tax rate is expected to approximate 30.5%, excluding discrete tax items, which includes federal, foreign, state and local taxes. This rate may fluctuate due to changes in jurisdictional income and to the timing of other discrete period transactions during the remainder of the year.

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. The standard will become effective for the Company with the annual and interim reporting periods beginning after December 15, 2016. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows, and financial statement disclosures.

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

NOTE 3 – INVESTMENTS

Investments consists of time deposits with maturity dates of greater than 90 days totaling \$367 thousand at March 31, 2015, and December 31, 2014.

The fair value of time deposits at March 31, 2015 and December 31, 2014 was determined based on its face value, which approximates its fair value and is a Level 1 input.

There were no realized gain or loss on investments for the three months ended March 31, 2015 and 2014.

NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

| | March 31, 2015 | December 31, 2014 |
|----------------|-------------------|-------------------------|
| Raw materials | \$ 2,821 | \$ 2,793 |
| Finished goods | 4,035 | 2,842 |
| Total | \$ 6,856 | \$ 5,635 |

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished goods are comprised primarily of magicJack devices on hand or in transit to the Company’s distribution center in the United States. The Company wrote-off approximately \$20 thousand of obsolete inventory during the three months ended March 31, 2015. There were no write-downs of obsolete inventory for the three months ended March 31, 2014.

NOTE 5 – PROPERTY AND EQUIPMENT

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

| | Estimated Useful Lives (in years) | March 31, 2015 | December 31, 2014 |
|--|---|-------------------|-------------------------|
| Switches | 3 - 15 | \$ 8,952 | \$ 8,436 |
| Computers | 3 | 2,707 | 2,707 |
| Furniture | 5 | 257 | 257 |
| Leasehold-improvements | * | 701 | 681 |
| Accumulated depreciation and amortization | | (8,719) | (8,517) |
| Total | | \$ 3,898 | \$ 3,564 |

* 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 months ended March 31, 2015 and 2014 was \$0.2 million and \$0.1 million, respectively.

NOTE 6 – INTANGIBLES ASSETS

As of March 31, 2015 and December 31, 2014, the Company had intangible assets with carrying values of \$8.7 million and \$9.5 million, respectively. Identified intangible assets not subject to amortization consisted of tradename and domain names with combined carrying value of \$1.2 million as of March 31, 2015 and December 31, 2014. Identified intangible assets with finite lives subject to amortization consist of the following (in thousands):

| | Estimated Useful Lives (in years) | March 31, 2015 | | | December 31, 2014 | | | | |
|---|---|-----------------------------|-----------------------------|-------|------------------------------|-----------------------------|-----------------------------|-------|------------------------------|
| | | Gross Carrying Amount | Accumulated Amortization | Net | Weighted- Average Life | Gross Carrying Amount | Accumulated Amortization | Net | Weighted- Average Life |
| Technology | 3 - 17 | \$4,930 | \$ (4,322) | \$608 | 5.20 | \$5,221 | \$ (4,554) | \$667 | 5.37 |
| Intellectual property rights | 3 - 17 | 14,161 | (8,314) | 5,847 | 5.48 | 14,161 | (7,713) | 6,448 | 6.70 |
| Covenants not-to-compete and not-to-sue | 2 - 5 | 2,085 | (1,598) | 487 | 1.17 | 2,085 | (1,494) | 591 | 1.42 |
| Tradename | 3 - 6 | 321 | (303) | 18 | 0.75 | 321 | (297) | 24 | 1.00 |
| Customer relationships | 5 - 7 | 500 | (426) | 74 | 2.33 | 750 | (660) | 90 | 2.58 |
| Backlog | 1 | 800 | (800) | - | - | 800 | (800) | - | - |

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| | | | | | | | | |
|-------|----------|--------------|---------|------|----------|--------------|---------|------|
| Other | 470 | (55) | 415 | 3.75 | 470 | (28) | 442 | 4.00 |
| Total | \$23,267 | \$ (15,818) | \$7,449 | | \$23,808 | \$ (15,546) | \$8,262 | |

Amortization expense for the three months ended March 31, 2015 and 2014 was \$0.8 million and \$1.3 million, respectively. Based on the carrying value of identified intangible assets recorded at March 31, 2015, and assuming no subsequent impairment of the underlying assets, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

| Fiscal Year | Amortization Expense |
|--------------------------------------|----------------------|
| Nine months ending December 31, 2015 | \$ 1,920 |
| 2016 | 1,675 |
| 2017 | 1,441 |
| 2018 | 964 |
| 2019 | 558 |
| Thereafter | 891 |
| | \$ 7,449 |

NOTE 7 – DEFERRED COSTS AND REVENUES

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

Deferred revenues are comprised of the following at March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | December 31, 2014 |
|--------------------------------|-------------------|----------------------|
| magicJack devices | \$ 10,741 | \$ 10,619 |
| Access right renewals | 45,140 | 43,231 |
| Prepaid minutes | 2,517 | 2,595 |
| Deferred revenue, current | 58,398 | 56,445 |
| Deferred revenue, non-current* | 54,520 | 54,782 |
| Total deferred revenues | \$ 112,918 | \$ 111,227 |

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

Costs necessary to fulfill the Company's obligations to provide broadband telephone service to new and existing customers who have purchased magicJack devices or access rights to access the Company's servers are expensed as incurred. Such costs were approximately \$4.3 million and \$5.5 million for the three months ended March 31, 2015 and 2014, respectively.

NOTE 8 – OTHER LIABILITIES

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

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Legal Proceedings

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

these matters could have a material adverse effect on the Company's results of operations in a particular fiscal year or quarter.

In April 2015 the Company engaged in mediation to settle a dispute for legal fees incurred in relation to the hiring of an employee whose employment by the Company would allegedly violate confidentiality obligations of the employee. The Company agreed to pay approximately \$0.7 million to settle the dispute and the amount is included in accrued expenses and other current liabilities on the Company's Condensed Consolidated Balance Sheet as of March 31, 2015.

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

NOTE 10 –TREASURY STOCK

The Company's Board of Directors authorized a stock repurchase program to enable the Company to purchase its ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of \$100 million. The primary objective of the Company's stock repurchase program is to improve stockholders' returns. The Company expended \$91.3 million under its repurchase program through March 31, 2015 and there was \$8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased and not yet retired, are recorded as treasury stock. The Company repurchased 6,143,731 ordinary shares under this program through March 31, 2015.

During the first quarter of 2015, the Company's Board of Directors authorized a new share repurchase program under which the company may repurchase up to \$20.0 million of its outstanding common stock from time to time on the open market or in privately negotiated transactions. The remaining \$8.7 million remaining under the company's prior \$100 million repurchase program has been terminated.

The Company issued 2,015 of its ordinary shares held as treasury stock with a cost of \$25 thousand, or \$12.32 per share, to a director as a result of restricted stock units that were granted in mid-2013, which vested during the three months ended March 31, 2015. Refer to Note 11, "Share-Based Compensation" for further details.

The changes in treasury stock during the three months ended March 31, 2015 are as follows (in thousands, except for number of shares):

| | Three Months Ended | |
|---|--------------------|------------|
| | March 31, 2015 | |
| | Number | Amount |
| Balance, beginning of period | 7,164,260 | \$ 107,683 |
| Ordinary shares issued due to vesting of restricted stock units | (2,015) | (25) |
| Balance, end of period | 7,162,245 | \$ 107,658 |

NOTE 11 – SHARE-BASED COMPENSATION

The Company has granted ordinary share options, issued restricted stock units and ordinary shares as an alternative or supplement to the compensation of its executives, employees, directors and outside consultants. The Company's share-based compensation program is a long-term retention program intended to attract and reward talented executives, employees and outside consultants, and align their interests with stockholders. The Company is currently granting share-based awards under the magicJack Vocaltec Ltd. 2013 Stock Incentive Plan and the magicJack Vocaltec Ltd. 2013 Israeli Stock Incentive Plan (together, the "2013 Plans"). In July 2013, the shareholders approved the 2013 Plans at the annual general meeting of shareholders to allow grants of ordinary share options, restricted stock units and ordinary shares. In April 2014, the shareholders approved amendments to the 2013 Plans increasing the number of share based awards available for grant. As of March 31, 2015, 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. 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.

18

The Company's share-based compensation expense for ordinary share options, issued restricted stock units and ordinary shares for the three months ended March 31, 2015 and 2014 was as follows (in thousands):

| | Three Months Ended March 31, | |
|------------------------|---------------------------------|----------|
| | 2015 | 2014 |
| Ordinary share options | \$ 997 | \$ 2,439 |
| Restricted stock units | 286 | 230 |
| Ordinary shares | - | - |
| | \$ 1,283 | \$ 2,669 |

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

| | Three Months Ended March 31, | |
|----------------------------|---------------------------------|----------|
| | 2015 | 2014 |
| Cost of revenues | \$ 31 | \$ 225 |
| Marketing | 194 | 712 |
| General and administrative | 852 | 1,471 |
| Research and development | 206 | 261 |
| | \$ 1,283 | \$ 2,669 |

Ordinary Share Options

Ordinary share options granted under the 2013 Plans have a five-year life and vest over a period of 24 to 36 months beginning at the date of grant. The 2013 Plans, 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, 2014, and three months ended March 31, 2015 (aggregate intrinsic value in thousands):

| Date of Grant | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value * |
|----------------------|----------------------|--|---|-----------------------------------|
| January 1, 2014 | 1,285,207 | \$ 14.95 | 4.41 | \$ - |
| Granted | 762,500 | \$ 14.71 | | |
| Exercised | (3,820) | \$ 7.33 | | |
| Expired or cancelled | (30) | \$ 147.55 | | |
| December 31, 2014 | 2,043,857 | \$ 14.87 | 3.80 | \$ - |
| Granted | - | \$ - | | |
| Exercised | - | \$ - | | |
| Forfeited | (85,000) | \$ 17.28 | | |
| Expired or cancelled | - | \$ - | | |
| | 1,958,857 | \$ 14.77 | 3.53 | \$ - |

Outstanding at March 31, 2015
(unaudited)

Vested at March 31, 2015

| | | | | |
|-------------|---------|----------|------|------|
| (unaudited) | 968,728 | \$ 14.89 | 3.39 | \$ - |
|-------------|---------|----------|------|------|

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

Share-based compensation expense recognized for ordinary share options was approximately \$1.0 million and \$2.4 million for the three months ended March 31, 2015 and 2014, respectively. The total intrinsic value of ordinary share options exercised during the three months ended March 31, 2015 and 2014 was \$0 and \$17 thousand, respectively. As of March 31, 2015, there was approximately \$4.9 million of unrecognized share-based compensation expense related to unvested ordinary share options, which is expected to be recognized over a weighted average period of 1.32 years.

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's expected stock price volatility over the term of the awards, assumed employee exercise behaviors, risk-free interest rate and expected dividends. For purposes of valuing ordinary share options, the Company used historical volatility at the date of grant. The approximate risk-free interest rate was based on the U.S. Treasury yield for comparable periods. As the Company does not have historical data available regarding employee exercise patterns, it did not anticipate any forfeiture of the ordinary share options granted and the expected term of the ordinary share options was calculated using the simplified method in accordance with SAB No. 107, "Share Based Payment." The Company does not expect to pay dividends on its ordinary shares in the foreseeable future. Accordingly, the Company used a dividend yield of zero in its option pricing model. The weighted average fair value of ordinary share options granted during the three months ended March 31, 2015 and 2014 was \$0 and \$5.71, and was measured at the date of grant using the following assumptions:

| | Three Months Ended | |
|--------------------------|--------------------|----------------|
| | March 31, | |
| | 2015 | 2014 |
| Expected term (in years) | - | 3.2 - 3.5 |
| Dividend yield | - | 0.00 % |
| Expected volatility | - | 57.2% to 57.3% |
| Risk free interest rate | - | 1.44% to 1.64% |
| Forfeiture rate | - | 0.00 % |

Restricted Stock Units

The Company may also award non-vested restricted stock units to its executives, employees, directors and outside consultants under the 2013 Plan, which may vest based on service or a combination of service and other conditions, such as market. 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 three months ended March 31, 2015 and 2014, 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 three months ended March 31, 2015:

| | Number of | Fair Value |
|------------------------------|-----------|---------------|
| | Shares | at Grant Date |
| December 31, 2014 | 147,264 | \$ 15.05 |
| Granted | - | \$ - |
| Vested | (2,015) | \$ 14.42 |
| Forfeited | - | \$ - |
| Non-vested at March 31, 2015 | 145,249 | \$ 15.06 |

Share-based compensation expense recognized for restricted stock units was approximately \$0.3 million and \$0.2 million for the three months ended March 31, 2015 and 2014, respectively. As of March 31, 2015, there was \$1.2 million in unrecognized share-based compensation costs related to restricted stock units. The unrecognized

share-based compensation expense is expected to be recognized over a weighted average period of 0.91 years.

NOTE 12 – INCOME TAXES

Total income tax expense was \$3.1 million and \$2.3 million for the three months ended March 31, 2015 and 2014, respectively. The principal components of our income taxes for the three months ended March 31, 2015 and 2014 are the following (in thousands):

| | Three Months Ended March 31, | | | |
|----------------------------|---------------------------------|---------|------|---------|
| | 2015 | | 2014 | |
| Income before income taxes | \$ | 4,410 | \$ | 7,583 |
| Income tax expense | | 3,102 | | 2,264 |
| Effective income tax rate | | 70.34 % | | 29.86 % |

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 26.5% that is lower than the Company's U.S. federal income tax rate which is 35% as of March 31, 2015.

For the three months ended March 31, 2015, the Company recorded income tax expense of \$3.1 million, which is higher than the expected tax provision of \$1.5 million, using the statutory rate of 35%, due, in part, to the net impact of increases resulting from the changes in the exchange rate on both the Company's net deferred tax assets associated with the Israeli operations with a tax effect of \$0.6 million, and the taxable unrealized gains on revaluation of foreign currency rates on the Israeli parent's U.S. dollar denominated assets, primarily on the intercompany receivable, with a tax effect of \$0.9 million and the tax effect of various other items totaling \$0.1 million. The Company revised its liability for uncertain tax positions by a net increase of \$1.3 million in the three months ended March 31, 2015.

Subsequent to March 31, 2015, the Company signed documents prepared by the Internal Revenue Service to settle the income tax examinations for the tax years 2010 through 2013. Please see additional disclosure in Note 14, "Subsequent Events."

NOTE 13 – INCOME PER SHARE

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

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

| | Three Months Ended March 31, | |
|--|------------------------------|----------|
| | 2015 | 2014 |
| | (in thousands) | |
| Numerator: | | |
| Net income | \$ 1,308 | \$ 5,319 |
| Denominator: | | |
| Denominator for basic net income per share - weighted average ordinary shares outstanding | 17,868 | 17,827 |
| Effect of dilutive options to purchase ordinary shares | 7 | - |
| Effect of dilutive options or restricted stock units vesting, exercised or expired during the period | 2 | 3 |
| Denominator for diluted net income per share - weighted average ordinary shares outstanding | 17,877 | 17,830 |
| Net income per ordinary share attributable to shareholders | | |

| | | |
|---------|---------|---------|
| Basic | \$ 0.07 | \$ 0.30 |
| Diluted | \$ 0.07 | \$ 0.30 |

For the three months ended March 31, 2015 and 2014, 2,097,356 and 296,031 outstanding ordinary share options and restricted stock units, respectively, were excluded from the earnings per share calculation because they would be anti-dilutive.

NOTE 14 – SUBSEQUENT EVENTS

IRS Settlement

As of April 30, 2015, the Company signed documents prepared by the Internal Revenue Service (“IRS”) to settle the income tax examinations for the tax years 2010 through 2013. The IRS's formal execution of these documents is pending. Upon settlement, the Company owed \$2.6 million, which was paid on May 1, 2015 and was previously provided for in the Company's condensed consolidated financial statements. Federal interest due is subject to final IRS computation, but is estimated to be approximately \$0.4 million. State taxes, interest and penalties due are estimated to be approximately \$0.7 million. The Company believes it has fully accrued for any probable liability resulting from the examination and will adjust the estimated accruals to final settled amounts, once those matters are fully finalized.

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 March 31, 2015 and for the three month periods ended March 31, 2015 and 2014, as well as our Annual Report on Form 10-K for the year ended December 31, 2014. 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, 2014 filed on March 16, 2015.

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 and magicJack GO, 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, a softphone company, and the developer and provider of the magicJack product line. We also wholesale telephone services to VoIP providers and telecommunications carriers.

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

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

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, 2014. The balance sheet at December 31, 2014 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 prepare our unaudited condensed consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of our revenues in the three months ended March 31, 2015 and 2014 were derived from sales to customers located in the United States.

Basis of Consolidation

Our consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications LLC (“VocalTec US”, formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, “Dialmaxx”). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three months ended March 31, 2015 may not be indicative of the results for the entire year ending December 31, 2015. 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, 2014 filed on March 16, 2015.

Use of Estimates

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

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

CRITICAL ACCOUNTING POLICIES

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

REVENUE RECOGNITION

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

magicJack Devices Revenue

We recognize revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of our software to access

our servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period.

Sales Return Policy

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

Returns from retailers are accepted on an authorized basis for devices deemed defective. We may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. We estimate potential returns under these arrangements at point of sale and re-estimate potential returns on a quarterly basis. For the three months ended March 31, 2015 and 2014, our estimates of returns and actual returns from initial stocking orders have not been materially different.

Prepaid Minutes and Access and Wholesale Charges

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

INCOME TAXES

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. Our net deferred tax assets consist of primarily foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. We record a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. We evaluated the valuation allowance as of December 31, 2014, which resulted in adjustments of \$1.2 million to bring the allowance to \$16.2 million, an amount which reduces the net deferred tax assets to the amount that will more-likely-than-not be realized. We periodically review the composition of our net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required. We decreased the valuation allowance by \$0.2 million during the three months ended March 31, 2015, due to the utilization of previously reserved net-operating-loss carry-forwards in our 2013 U.S. tax filings.

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 a net increase of \$1.3 million in the three months ended March 31, 2015.

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 2015 and certain other deferred tax assets were recognized for financial reporting purposes at December 31, 2014. At March 31, 2015, the estimated annual effective income tax rate is expected to approximate 30.5%, 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.

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 items to enable a more meaningful discussion of our operations.

| | Three Months Ended March 31, | | 2015 Compared to 2014 | |
|-----------------------------------|---------------------------------|-----------------|-----------------------------|----------------|
| | 2015 | 2014 | | |
| Net Revenues | | | | |
| Sale of magicJack devices | \$ 3,384 | \$ 11,982 | \$ (8,598) | (71.8)% |
| Access right renewals | 17,075 | 15,406 | 1,669 | 10.8 |
| Shipping and handling | 188 | 874 | (686) | (78.5) |
| magicJack-related products | 1,217 | 2,497 | (1,280) | (51.3) |
| Prepaid minutes | 2,234 | 2,828 | (594) | (21.0) |
| Access and wholesale charges | 1,410 | 1,722 | (312) | (18.1) |
| Other | 4 | 4 | - | - |
| Total Net Revenue | 25,512 | 35,313 | (9,801) | (27.8) |
| Cost of Revenues | | | | |
| Cost of magicJack devices | 2,147 | 4,459 | (2,312) | (51.9) |
| Shipping and handling | 296 | 373 | (77) | (20.6) |
| Credit card processing fees | 677 | 782 | (105) | (13.4) |
| Network and carrier charges | 4,339 | 5,547 | (1,208) | (21.8) |
| Other | 2,008 | 1,861 | 147 | 7.9 |
| Total Cost of Revenues | 9,467 | 13,022 | (3,555) | (27.3) |
| Gross Profit | 16,045 | 22,291 | (6,246) | (28.0) |
| Operating expenses: | | | | |
| Marketing | 2,750 | 4,296 | (1,546) | (36.0) |
| General and administrative | 7,700 | 8,650 | (950) | (11.0) |
| Research and development | 1,162 | 1,744 | (582) | (33.4) |
| Total operating expenses | 11,612 | 14,690 | (3,078) | (21.0) |
| Operating income | 4,433 | 7,601 | (3,168) | (41.7) |
| Other income (expense): | | | | |
| Interest and dividend income | 11 | 46 | (35) | * |
| Interest expense | (34) | (65) | 31 | * |
| Other income, net | - | 1 | (1) | * |
| Total other expense | (23) | (18) | (5) | * |
| Income before income taxes | 4,410 | 7,583 | (3,173) | (41.8) |
| Income tax expense | 3,102 | 2,264 | 838 | * |
| Net income | \$ 1,308 | \$ 5,319 | \$ (4,011) | (75.4) |

* - Not meaningful.

Components of Net Revenues

Our net revenues are comprised of the following sources:

- Sales of the magicJack devices – represents revenues recognized from sales of the magicJack devices to retailers, wholesalers, or direct to customers, net of returns, over the period associated with the initial six or twelve months access right period. These revenues are recorded net of sales allowance, chargebacks, retailer discounts and advertising allowances;
- Access right renewals – represents revenues from customers purchasing rights to access our servers beyond the initial access right period included with a magicJack device or magicJack service. The extended access right ranges from one month to five years. These fees charged to customers are initially deferred and recognized as revenue ratably over the extended access right period;

- Shipping and handling – represents charges for shipping and handling fees for magicJack devices shipped directly to customers. The fees are initially deferred and recognized as revenues over the initial six or twelve months access right period associated with the magicJack device;
- magicJack-related products – represents revenues recognized from the sale of other items related to the magicJack devices and access right renewals we offer our customers, including: (i) porting fees charged to customers to port their existing phone number to a magicJack device or service, (ii) fees charged for customers to select a custom, vanity or Canadian phone number, (iii) fees charged to customers to change their existing number, and (iv) insurance covering the replacement of a damaged or lost device;
- Prepaid minutes – represents revenues recognized primarily from the usage and expiration of international prepaid minutes, net of chargebacks;
- Access and wholesale charges – represents revenues generated from: (i) access fees charged to other telecommunication carriers or providers for Inter-exchange Carriers (“IXC”) calls terminated to our end-users, and (ii) fees charged to telecommunications carriers or providers for origination of calls to their 800-numbers. These revenues are recorded based on rates set forth in the respective state and federal tariffs or negotiated contract rates, less provisions for billing adjustments; and
 - Other – represents primarily revenues generated by ancillary revenue sources.

Components of Cost of Revenues

Our cost of revenues is comprised of the following components:

- Cost of magicJack devices 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 six or twelve months access right period;
- Shipping and handling – represents freight, postage and other transportation costs related to: (i) transportation of the magicJack devices from the manufacturer to our warehouse and distribution center, and (ii) freight, shipping and handling fees incurred to ship the magicJack devices to retailers and directly to customers. These costs are expensed as incurred;
- Credit card processing fees – represents transaction and other fees incurred as a result of accepting credit card payments for sales of magicJack devices, access right renewals, shipping and handling charges, magicJack related products and prepaid minutes sold directly to customers through our website. These fees are expensed as incurred;
- Network and carrier charges – represents facilities charges to establish and maintain our network as well as network usage fee charges from other telecommunications carriers. These rates or charges are based upon commercial agreements or applicable state and/or federal tariffs. These charges are expensed as incurred; and
- Other 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 sources we ceased selling.

THREE MONTHS ENDED MARCH 31, 2015 COMPARED TO THREE MONTHS ENDED MARCH 31, 2014

Net Revenues

Total net revenue was \$25.5 million and \$35.3 million for the three months ended March 31, 2015 and 2014, respectively, representing a decrease of \$9.8 million, or 27.8%. The decrease in the components of net revenues was primarily attributable to the following:

- \$8.6 million decrease in revenues from the sale of magicJack devices primarily reflecting lower price points and lower unit sales volumes;
 - \$1.3 million decrease in magicJack related product revenue reflecting lower volumes;
 - \$0.7 million decrease in shipping and handling revenue reflecting the lower sales volumes;

- \$0.6 million decrease in revenues from prepaid minutes resulting from lower usage levels; and
- \$0.3 million decrease in access and wholesale charges.

These decreases in components of net revenue were partially offset by a \$1.7 million increase in access right renewal revenues reflecting higher average renewal rates, a higher number of devices on renewal and the impact of e-mail marketing to expiring customers.

For the three months ended March 31, 2015 and 2014, sales of the magicJack devices through retail outlets represented approximately 66% and 69%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 34% and 31%, respectively, of magicJack devices sold. For the three months ended March 31, 2015 and 2014, 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 \$13.0 million for the three months ended March 31, 2015 and 2014, respectively, representing a decrease of approximately \$3.6 million, or 27.3%. This decrease in cost of revenues was primarily attributable to: (i) a \$2.3 million decrease in the cost of magicJack devices resulting primarily from lower device sales volumes; (ii) a \$1.2 million decrease in network and carrier charges primarily as a result of better negotiated rates with other carriers, and (iii) a \$0.2 million combined decrease in shipping and handling costs and credit card processing fees as a result of lower sales volumes.

These decreases in cost of revenues were partially offset by a \$0.1 million increase in overhead allocation.

Operating Expenses

Total operating expenses were \$11.6 million and \$14.7 million for three months ended March 31, 2015 and 2014, respectively, representing a decrease of \$3.1 million, or 21.0%. This decrease in operating expenses is attributable to: (i) a \$1.5 million decrease in marketing expense reflecting reduced media buys and marketing related spends as well as lower personnel related costs; (ii) a \$1.0 million decrease in G&A expense due to several factors including lower legal fees, lower amortization expense as the non-compete with the Company's founder was impaired in 2014 and lower personnel related costs; and (iii) a \$0.6 million decrease in R&D expenses related to lower costs related to R&D and lower personnel related costs.

Income Taxes

Total income tax expense was \$3.1 million and \$2.3 million for the three months ended March 31, 2015 and 2014, respectively. The principal components of our income taxes for the three months ended March 31, 2015 and 2014 are the following (in thousands):

| | Three Months Ended | |
|----------------------------|--------------------|----------|
| | March 31, | |
| | 2015 | 2014 |
| Income before income taxes | \$ 4,410 | \$ 7,583 |
| Income tax expense | 3,102 | 2,264 |
| Effective income tax rate | 70.34 % | 29.86 % |

We primarily operate in the U.S. and Israel, and our Israeli operations are subject to a statutory income tax rate of 26.5% that is lower than our U.S. federal income tax rate which is 35% as of March 31, 2015.

For the three months ended March 31, 2015, we recorded income tax expense of \$3.1 million, which is higher than the expected tax provision of \$1.5 million, using the statutory rate of 35%, due, in part, to the net impact of increases resulting from the changes in the exchange rate on both our net deferred tax assets associated with the Israeli operations with a tax effect of \$0.6 million, and the taxable unrealized gains on revaluation of foreign currency rates on the Israeli parent's U.S. dollar denominated assets, primarily on the intercompany receivable, with a tax effect of \$0.9 million and the tax effect of various other items totaling \$0.1 million.

The 2015 estimated annual effective tax rate is expected to approximate 30.5%, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

Subsequent to March 31, 2015, we signed documents prepared by the Internal Revenue Service to settle the income tax examinations for the tax years 2010 through 2013. Please see additional disclosure in Note 14, "Subsequent Events."

Net income

As a result of the foregoing items, net income decreased to \$1.3 million in the three months ended March 31, 2015, as compared to \$5.3 million in the three months ended March 31, 2014. Net income per diluted share decreased to \$0.07 per ordinary share for the three months ended March 31, 2015, as compared to \$0.30 per ordinary share in the prior year comparable period primarily as a result of decreased profitability.

BUSINESS TRENDS

Renewal revenues remained strong during the three months ended March 31, 2015, increasing more than 10% over the same quarter in the prior year. We are encouraged by the loyalty of our existing customer base and we will continue to undertake efforts to improve our customer renewal rates. Direct and retail device sales declined during the three months ended March 31, 2015. In an effort to strengthen device sales to new customers, we continue to reposition the device with its companion service, the magicAPP, and we are continuing our efforts to expand device sales to new markets. We believe that there will continue to be solid consumer demand for our low priced, unlimited phone service, whether through our magicJack device, our magicAPP, or a combination of both, in the United States and international markets.

With the release of the upgraded magicAPP product to iOS customers in April 2015, we are now offering monthly and annual subscription services for the magicAPP and providing our customers the ability to purchase international prepaid minutes directly from the app. We are focused on driving sales growth through monetizing the magicAPP and integrating the full range of our product offerings including the sale of international prepaid minutes. We will be expanding the service to Android users later in 2015. However, there are factors that could materially adversely affect our growth strategy to integrate the device with the APP and monetize the magicAPP, including that we have not previously generated any material revenues from the magicAPP as it has been a free service to date, and the redeveloped magicAPP will compete with other large, well-capitalized global companies in the telecom APP industry who are introducing low priced consumer offers into the marketplace on an ongoing basis. We cannot assure that the features we are offering for monetization of the magicAPP will be attractive to consumers at the price points we are offering, or at all.

Furthermore, we are working with Telefonica to expand distribution of our product into Latin American markets. As a first step, the Company intends to introduce the magicJackGo into Mexico. Unlike the magicJackGo in the United States, the device sold in Mexico will not include free access to the magicApp. Instead, the Company is marketing a standalone mobile App subscription service called "magicJack America." magicJack America is a monthly subscription service that, in addition to App-to-App calling and messaging, will allow subscribers in Mexico to make and receive unlimited calls to and from any phone in the United States and Canada. An Android and iOS version of magicJack America are currently available, and will be marketed to Android and Apple users throughout Mexico.

The Company plans an incremental roll-out of magicJackGo devices in Mexico during the second half of 2015, with the objective of developing a broader distribution channel in Latin America. Any unsold devices may be returned by Telefonica to the Company. Progress on the launch of our relationship with Telefonica has been slower than anticipated. There can be no assurance that the launch in Mexico or any Central or South American country will be successful and the Company cannot predict what impact, if any, the arrangement with Telefonica will ultimately have on its business, results of operations, financial condition or cash flows.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash generated from operations and cash on hand and investments. As of March 31, 2015, we had cash and cash equivalents of \$82.9 million, marketable securities of \$0.4 million and accounts

receivables of \$2.9 million. Our accounts payable at March 31, 2015 was \$2.6 million.

During the three months ended March 31, 2015, we generated positive operating cash flows of \$7.5 million, as compared to \$14.2 million for the three months ended March 31, 2014. The \$6.7 million decrease was primarily due to lower sales of magicJack devices and magicJack related products in the three months ended March 31, 2015, partially offset by lower operating costs and by increased revenues from access right renewals. Net income was \$1.3 million for the three months ended March 31, 2015 as compared to \$5.3 million for the three months ended March 31, 2014. We currently believe that available funds and cash flows generated by operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months. If we decide to make future acquisitions, we may require new sources of funding, including additional debt, equity financing or some combination thereof. There can be no assurances that we will be able to secure additional sources of funding or that such additional sources of funding will be available to us on acceptable terms.

Cash Flow – Operating Activities

Net cash provided by operating activities was \$7.5 million and \$14.2 million for the three months ended March 31, 2015 and 2014, respectively.

During the three months ended March 31, 2015, net cash provided by operating activities was primarily attributable to: (i) \$1.3 million of net income, (ii) \$3.0 million in non-cash items consisting primarily of \$1.3 million of stock-based compensation expense, \$1.0 million of depreciation and amortization expense, and \$0.6 million increase in deferred income tax provision, (iii) a \$0.3 million decrease in deferred costs, (iv) a \$1.0 million decrease in accounts receivable, (v) a \$1.7 million increase in deferred revenue, (vi) a \$1.4 million increase in other non-current liabilities and (vii) a \$1.1 million increase in income taxes payable. These items were partially offset by: (i) a \$1.2 million increase in inventory levels (ii) a \$0.6 million decrease in accrued expenses, and (iii) a \$0.3 million decrease in accounts payable.

During the three months ended March 31, 2014, net cash provided by operating activities was primarily attributable to: (i) \$5.3 million of net income, (ii) \$4.9 million in non-cash items consisting of \$2.7 million of stock-based compensation expense, \$1.4 million for depreciation and amortization expense, a \$0.6 million increase in our deferred tax provision and a \$0.1 million provision for billing adjustments, (iii) \$1.6 million decrease in prepaid taxes, (iv) \$1.3 million decrease in deferred costs, (v) a \$1.1 million decrease in inventory levels, (vi) a \$1.0 million decrease in accounts payable, (vii) \$0.4 million increase in deferred revenue primarily associated with access right renewals, and (viii) a \$0.5 million increase in other non-current liabilities. These items were partially offset by a \$1.3 million decrease in accounts receivable and a \$0.7 million decrease in accrued bonuses reflecting payment of 2013 annual bonus amounts.

Cash Flow – Investing Activities

Net cash used in investing activities was \$0.5 million and \$1.4 million for the three months ended March 31, 2015, and 2014, respectively, and was attributable to purchases of equipment and leasehold improvements primarily due to upgrades to our data storage facility.

Cash Flow –Financing Activities

Net cash provided by financing activities during the three months ended March 31, 2014 consisted of \$16 thousand in proceeds from exercise of stock options.

Stock Repurchase Program

Our Board of Directors authorized a stock repurchase program to enable us to purchase our ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of \$100.0 million. The primary objective of our stock repurchase program is to improve stockholders' returns. We expended \$91.3 million under our repurchase program through March 31, 2015 and there was \$8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased and not yet retired, are recorded as treasury stock. The Company repurchased 6,143,731 ordinary shares under this program through March 31, 2015.

During the first quarter of 2015, the Company's Board of Directors authorized a new share repurchase program under which the company may repurchase up to \$20.0 million of its outstanding common stock from time to time on the open market or in privately negotiated transactions. The remaining \$8.7 million remaining under the company's prior \$100 million repurchase program has been terminated.

Other Liabilities

As of March 31, 2015, we had outstanding indebtedness in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets, and secured only by such intangible assets, under which we are required to make a final non-interest bearing future annual payment of \$1.5 million on May 31, 2015. The liability for such payments has been discounted at a rate of 10% to a net present value of \$1.5 million at March 31, 2015. Refer to Note 8, "Other Liabilities," in the Notes to our unaudited condensed consolidated financial statements included in Item 1 for further details.

Off – Balance Sheet Arrangements

We had no off-balance sheet arrangements as of March 31, 2015.

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 March 31, 2015.

Exposure to Exchange Rates

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

Exposure to Equity and Derivative Prices

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

Our Investments

As a result of us investing our excess cash, we are also subject to equity price risk with respect to long or short positions in financial instruments such as equity securities, which may include call option and put option contracts. While our ultimate potential loss with respect to these contracts is determined from the movement of the underlying security or index between the contract inception date and expiration date, the change in fair value of the derivative contracts is also affected by changes in other factors such as interest rates, expected dividend rates and the remaining duration of the contract. At March 31, 2015, we did not have any short positions in put option contracts or long positions in call option contracts.

Our Stock Repurchase Program

We have sold put option contracts in connection with our share repurchase program in order to lower the average price paid for ordinary shares we purchase. Option contracts are sensitive to expiration dates of contracts and fluctuations in the sale price of our ordinary shares, which are in turn sensitive to various factors, including but not limited to: (i) our financial performance and (ii) fluctuations in the overall U.S. and foreign stock markets and economies. At March 31, 2015, we did not have any outstanding put option contracts.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

During the quarter ended March 31, 2015, there were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

Legal Proceedings

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

ITEM 1A. Risk Factors

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, 2014.

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

Our Board of Directors previously authorized a stock repurchase program to enable us to purchase our ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of \$100 million. The objective of our stock repurchase program is to improve stockholders’ returns. We expended \$91.3 million under our repurchase program through March 31, 2015 and there was \$8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. The Company repurchased 6,143,731 ordinary shares under this program through March 31, 2015. There were no purchases during the three months ended March 31, 2015. All shares repurchased are recorded as treasury stock.

During the first quarter of 2015, the Company’s Board of Directors authorized a new share repurchase program under which the company may repurchase up to \$20.0 million of its outstanding common stock from time to time on the open market or in privately negotiated transactions. The remaining \$8.7 million remaining under the company’s prior \$100 million repurchase program has been terminated. There were no purchases under the new share repurchase program during the three months ended March 31, 2015.

ITEM 3. Defaults Upon Senior Securities

Not applicable.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

None.

31

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: May 11, 2015

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

Dated: May 11, 2015

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

33
