

MAGICJACK VOCALTEC LTD  
Form 10-K  
March 16, 2017

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended December 31, 2016

OR

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

For transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-27648

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

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

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

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

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Securities registered pursuant to Section 12(b) of the Act:

Ordinary Shares, No Par Value The NASDAQ Stock Market LLC  
(Title of each class) (Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:

NONE

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

Yes  No

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

Yes  No

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

Yes  No

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

Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition 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  Smaller reporting company

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

Yes  No

The aggregate market value of the ordinary shares held by non-affiliates of the registrant computed by reference to the price of the registrant's Ordinary Shares as of the last business day of the registrant's most recently completed second fiscal quarter (based on the last reported sale price on the Nasdaq Global Stock Market as of such date) was \$63,013,209.

The number of the registrant's ordinary shares outstanding as of February 28, 2017 was 16,050,687.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement related to the 2016 Annual General Meeting of Shareholders filed on March 15, 2017 are incorporated by reference into Part III of this Form 10-K.

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## DEFINITIONS

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

- references to "magicJack VocalTec," the "Company," "we," "us" or "our" are to magicJack VocalTec Ltd., a company organized under the laws of the State of Israel (the "Registrant"), and its subsidiaries;
- references to "common shares", "ordinary shares", "our shares" and similar expressions refer to the Registrant's Ordinary Shares, no par value;
- references to "\$" or "dollars" are to U.S. dollars 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;
- references to the "Companies Law" are to Israel's Companies Law, 5759-1999, as currently amended;
- references to the "Exchange Act" are to the Securities Exchange Act of 1934, as amended;
- references to "NASDAQ" are to the Nasdaq Global Stock Market;
- references to the "SEC" are to the United States Securities and Exchange Commission; and
- references to the "magicJack devices" are to the original magicJack<sup>®</sup>, the magicJack PLUS<sup>™</sup>, the New magicJack PLUS<sup>™</sup> and the magicJackGO and the magicJackEXPRESS<sup>™</sup>.

## USE OF TRADEMARKS

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

## PART I

THIS ANNUAL REPORT ON FORM 10-K CONTAINS HISTORICAL INFORMATION AND FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD-LOOKING STATEMENTS. THE WORDS "ANTICIPATE," "BELIEVE," "ESTIMATE," "EXPECT," "INTEND," "MAY," "PLAN," "PROJECT," "SHOULD" AND SIMILAR EXPRESSIONS, AS THEY RELATE TO MAGICJACK VOCALTEC OR ITS MANAGEMENT, ARE INTENDED TO IDENTIFY FORWARD-LOOKING

STATEMENTS. SUCH STATEMENTS REFLECT THE CURRENT VIEWS AND ASSUMPTIONS OF MAGICJACK VOCALTEC WITH RESPECT TO FUTURE EVENTS AND ARE SUBJECT TO RISKS AND UNCERTAINTIES. MANY FACTORS COULD CAUSE THE ACTUAL RESULTS, PERFORMANCE OR ACHIEVEMENTS TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, PERFORMANCE OR ACHIEVEMENTS THAT MAY BE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS, BOTH REFERENCED AND NOT REFERENCED IN THIS ANNUAL REPORT. SUCH FACTORS INCLUDE, BUT ARE NOT LIMITED TO: THE COMPETITION WE FACE; OUR RELIANCE ON THE MAGICJACK PRODUCT AND RELATED SOFTWARE ACCESS RIGHTS FOR A SUBSTANTIAL PORTION OF OUR REVENUES; OUR ABILITY TO ATTRACT NEW CUSTOMERS AND RETAIN CURRENT CUSTOMERS; OUR ABILITY TO OBTAIN ENOUGH PHONE NUMBERS TO MEET OUR CUSTOMERS' DEMANDS; OUR ABILITY TO SUCCESSFULLY PROTECT OUR PROPRIETARY RIGHTS OR DEFEND OURSELVES AGAINST CLAIMS OF INFRINGEMENT; OUR ABILITY TO DEVELOP AND DEPLOY NEW PRODUCTS; OUR ABILITY TO COMPLY WITH DOMESTIC AND INTERNATIONAL REGULATIONS AND STANDARDS; OUR ABILITY TO ANTICIPATE DEMAND FOR OUR PRODUCTS; DIFFERENCES BETWEEN OUR SERVICES AND TRADITIONAL PHONE SERVICES, INCLUDING 911 SERVICE; OUR ABILITY TO ADAPT TO RAPID CHANGES IN THE MARKET FOR VOICE SERVICES; OUR DEPENDENCE ON KEY SWITCHING ELEMENTS FROM COMPETITORS; UNCERTAINTIES RELATING TO REGULATION OF VOICE-OVER-INTERNET-PROTOCOL SERVICES; CHANGES IN TAX LAWS OR IN OUR TAX STATUS RESULTING IN INCREASED TAX LIABILITY; CURRENTLY PENDING OR FUTURE LITIGATION OR GOVERNMENTAL PROCEEDINGS; SERVER OR SYSTEM FAILURES THAT COULD AFFECT THE QUALITY OR DISRUPT THE SERVICES WE PROVIDE AND OUR ABILITY TO MAINTAIN DATA SECURITY.

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CERTAIN FACTORS THAT MIGHT CAUSE SUCH ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD LOOKING STATEMENTS ARE INCLUDED AND FULLY DESCRIBED IN PART I, ITEM 1A, "RISK FACTORS." SHOULD ONE OR MORE OF THESE RISKS OR UNCERTAINTIES MATERIALIZE, OR SHOULD UNDERLYING ASSUMPTIONS PROVE INCORRECT, ACTUAL RESULTS MAY VARY MATERIALLY FROM THOSE DESCRIBED HEREIN AS ANTICIPATED, BELIEVED, ESTIMATED, EXPECTED, INTENDED, PLANNED OR PROJECTED. MAGICJACK VOCALTEC DOES NOT INTEND OR ASSUME ANY OBLIGATION TO UPDATE THESE FORWARD-LOOKING STATEMENTS. ANY FORWARD-LOOKING STATEMENTS IN THIS ANNUAL REPORT ON FORM 10-K ARE MADE AS OF THE DATE HEREOF, AND WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR REVISE ANY FORWARD-LOOKING STATEMENTS, WHETHER AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE, EXCEPT AS REQUIRED BY LAW.

## ITEM 1. BUSINESS

### Business Overview

magicJack VocalTec Ltd. and its Subsidiaries (the "Company") is a cloud communications leader that is the inventor of the magicJack devices and other magicJack products and services. magicJacks weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source, providing users with complete phone service for home, enterprise and while traveling. The Company charges highly competitive rates for the right to access its servers ("access right"), and the Company's customers then continue to have the ability to obtain free telephone services. The Company currently offers the magicJack GO and magicJack EXPRESS, which are updated versions of the magicJack device that have their own CPU and can connect a regular phone directly to the user's broadband modem/router and function as a standalone phone without using a computer. The magicJack mobile apps are applications that allow users to make and receive telephone calls through their smart phones using their magicJack account. Currently, consumers that do not have a magicJack account can purchase and download the magicJack mobile apps to make telephone calls from anywhere in the world into the U.S. or Canada for free. The mobile apps include the magicApp and the magicJack Connect App, which are available for both iOS and Android. The Company's products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

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

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

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

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

Company to compete long-term in the UCaaS market.

During the first quarter of 2016, the Company created a new subsidiary, magicJack SMB, Inc. (“SMB”). Through this subsidiary, the Company provides easy-to-buy, simple-to-use VoIP services to small to medium sized businesses at competitive prices. The Company began sales of its SMB product during the third quarter of 2016.

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



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

The Company's corporate name is magicJack VocalTec Ltd. for both legal and commercial purposes. The Company is located at 12 Haomanut Street, 2nd Floor, Poleg Industrial Area, Netanya, Israel 4250445 (telephone number +972-9-970-3888). The Company was organized under the laws of the State of Israel in 1989 and is subject to the Israeli Companies Law, or the Companies Law. The Company's subsidiary, YMax Corporation ("YMax", and together with VocalTec, the "Combined Company"), is located at 222 Lakeview Avenue Suite 1600, West Palm Beach, Florida, 33401 (telephone number 561-749-2255).

## Product and Service Offerings

### magicJack Devices

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

### Mobile apps

The magicJack mobile apps are applications that allow users to make and receive telephone calls through their smart phones using their magicJack account. Currently, consumers that do not have a magicJack account can purchase and download the magicJack mobile apps to make telephone calls from anywhere in the world into the U.S. or Canada for free. The magicApp offers a U.S. phone number, unlimited local and long distance calling to the US, Canada, Puerto Rico and the U.S. Virgin Islands, and unlimited text messaging to any U.S. mobile number. The magicApp is available to both iOS and Android users and offers access rights for a monthly or annual fee. In May 2016, we launched the magicJack Connect App for iOS and Android. The magicJack Connect App, also available for both iOS and Android, offers users free worldwide Wi-Fi App-to-App calling & messaging. The magicJack Connect App also offers an unlimited U.S. calling plan which allows subscribers to call the U.S. from anywhere in the world plus receive a U.S. phone number for only \$9.99 per year.

### Access Right Renewals

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

### Other magicJack-Related Products

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

### Prepaid Minutes

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

#### Access and Wholesale Charges

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

#### UCaaS Services and Equipment

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

## Sources of Revenues

The Company generates revenues from the following sources:

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

Access right renewals – represent revenues from customers renewing access rights beyond the initial period included with a magicJack device or mobile app. 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. These revenues also include revenues from access rights granted to paid subscribers of the magicApp and magicJack Connect App, and are recognized ratably over the access right period;

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

magicJack-related products – represent revenues recognized from the sale of other items related to the magicJack devices and access right renewals the Company offers its customers, including: (i) porting fees charged to customers to port their existing phone number to a magicJack device or service, (ii) fees charged for customers to select a custom, vanity or Canadian phone number, (iii) fees charged to customers to change their existing number, (iv) insurance covering the replacement of a damaged or lost device, and (v) sale of battery powerbanks for mobile devices. These revenues are recognized at the time of sale, with the exception of sales of the battery powerbank which are recognized when shipped;

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

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

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

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

Approximately 87% of the Company’s consolidated revenues for the year ended December 31, 2016 and 90% of the Company’s consolidated revenues for the years ended December 31, 2015 and 2014 were derived from sales to customers located in the United States.

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

|   | Year Ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2016                    | 2015      | 2014      |
| Net revenues  |                         |           |           |
| Sale of magicJack devices and initial access rights | \$12,775                | \$15,915  | \$24,564  |
| Access right renewals                               | 58,513                  | 65,761    | 65,542    |
| Shipping and handling                               | 889                     | 794       | 2,085     |
| magicJack-related products                          | 5,435                   | 4,289     | 7,006     |
| Prepaid minutes                                     | 5,677                   | 8,243     | 10,083    |
| Access and wholesale charges                        | 5,021                   | 5,953     | 7,028     |
| UCaaS   | 8,966                   | -         | -         |
| Other   | 122                     | 7         | 14        |
| Total net revenues                                  | \$97,398                | \$100,962 | \$116,322 |

## Research and Development

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

Research and development expenses were \$5.2 million, \$4.5 million and \$5.9 million for the years ended December 31, 2016, 2015 and 2014, respectively. During year ended December 31, 2016, \$1.3 million of research and development expense was related to the SMB segment. The balance of research and development expense was related to the Core Consumer segment. The Company accounts for research and development costs in accordance with the applicable accounting pronouncements described in Note 2, "Summary of Accounting Policies," in the Notes to our Consolidated Financial Statements included in Item 8 herein.

## Markets Where We Compete

The primary market in which the Company currently competes is the United States. As of December 31, 2016, approximately 98% of its property and equipment, net of depreciation, is located in the United States. For the year ended December 31, 2016, approximately 87% of its consolidated revenues were derived from sales to customers located in the United States.

## Business Seasonality

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

## Manufacturing

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

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

## Marketing, Sales and Distribution

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

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

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The new SMB segment has been testing various marketing methods to advertise its new products, primarily through digital channels.

In February 2015, RadioShack Corporation ("RadioShack") filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court of the District of Delaware (the "Bankruptcy Proceeding"). magicJack VocalTec Ltd. (the "Company") was an unsecured creditor of RadioShack in the amount of \$1.3 million in the Bankruptcy Proceeding for inventory purchased in 2014 and did not collect any portion of the amount it was owed. As a result, the Company did not recognize approximately \$125,000 of revenue from these sales in the fourth quarter 2014 nor did it recognize any of the remaining \$1.175 million of deferred revenue in subsequent periods in 2015 due to the uncollectability of such sales. The outstanding amount owed by RadioShack is not included in accounts receivable on the Company's consolidated balance sheets as of December 31, 2016 or December 31, 2015. As no U.S. retail customer, including RadioShack, accounts for more than 10% of the Company's total net revenues, the Company does not believe the Bankruptcy Proceeding of RadioShack, or its potential discontinuance as a going concern, will have a material adverse effect on the Company's results of operations or financial condition.

In the years ended December 31, 2016, 2015 and 2014, sales of the magicJack devices through retail outlets represented approximately 52%, 67% and 72%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 48%, 33% and 28%, respectively, of magicJack devices sold.

For the years ended December 31, 2016, 2015 and 2014, no retailer accounted for more than 10% of operating revenues for the Core Consumer or SMB segments. For the year ended December 31, 2016, two customers accounted for approximately 29% of operating revenues for the Enterprise segment.

#### Competition

The Company's Core Consumer business faces competition from traditional telephone companies, wireless companies, cable companies and alternative voice communication providers. Some of our principal competitors are the traditional telephone service providers, such as AT&T, Inc., CenturyLink, Inc. and Verizon Communications Inc., which provide telephone service based on the public switched telephone network. Some of these traditional providers also have added or are planning to add broadband telephone services to their existing telephone and broadband offerings. The Company also faces, or expects to face, competition from cable companies, such as Cablevision Systems Corp., Charter Communications, Inc., Comcast Corporation, Cox Communications, Inc. and Time Warner Cable (a division of Time Warner Inc.), which have added or are planning to add broadband telephone services to their existing cable television, voice and broadband offerings. Further, wireless providers, including AT&T Mobility, Inc., Sprint Nextel Corporation, T-Mobile USA Inc., Verizon Wireless, Inc. and Clearwire Corporation, offer services that some customers may prefer over wireline-based service. In the future, as wireless companies offer more minutes at lower prices, their services may become more attractive to customers as a replacement for wireline-based service. Some of these providers may be developing a dual mode phone that will be able to use broadband telephone service where broadband access is available and cellular phone service elsewhere, which will pose additional competition to our offerings.

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

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

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

#### Our Competitive Positioning

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

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



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

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

### Intellectual Property

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

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

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

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

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

## Effects of Governmental Regulations

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

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

## Intercarrier Compensation

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

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

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

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

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

## E911 Calling

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

Many state and local governments have sought to impose fees on customers of VoIP providers, or to collect fees from VoIP providers, to support implementation of E911 services in their area. Such fees are often put in terms of a fee placed on monthly bills, or focused on use from a specific location. The application of such fees with respect to magicJack users and the Company is not clear because various statutes and regulation may not cover the Company's services, the Company does not bill its customers monthly, nor does it bill customers at all for telecommunications services. The Company may also not know the end user's location because the magicJack devices and services are nomadic. If fees are owed, they are owed by the end user and not the Company, as most statutes, to the extent they apply, would have the Company act as a billing and collection agent. Should a regulatory authority require payment of money from the Company for such support, magicJack LP may decide to not offer its 911 service in that area or to develop a mechanism to collect fees from its customers, which may or may not be satisfactory to the entity requesting us to be a billing agent. The Company cannot predict whether the collection of such additional fees or limitations on where its services are available would impact customers' interest in purchasing its products.

In 2013 as a result of settlement of litigation, the Company agreed that it would, at least once a year, issue bills for 911 emergency calling services to all U.S. customers who have access to 911 services through their magicJack services, and who have provided a valid address in a U.S. jurisdiction that provides access to 911 services and which is legally empowered to impose 911 charges on such users in accordance with applicable state and/or local law.

Certain E911 regulatory authorities have asserted or may assert in the future that the Company is liable for damages, including end user assessed E911 taxes, surcharges and/or fees, for not having billed and collected E911 fees from its customers in the past or in the future. Although the Company strongly disagrees with these assertions and believes that any such authority's claims are without merit, if a jurisdiction were to prevail, the decision could have an adverse effect on the Company's financial condition and results of operations.

#### Network Neutrality

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

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

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

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

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

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

The FCC also adopted a fourth new rule in the form of a forward-looking standard. This rule is intended to address concerns that may arise with new practices that do not fall within one of the three bright line rules. It will be applied on a case-by-case basis to address questionable practices as they occur that unreasonably interfere with or unreasonably disadvantage the ability of consumers to use or for providers to make available lawful content, applications, services, or devices.

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

However, a decision by a court or the FCC striking down or narrowing the FCC's net neutrality rules could adversely impact the Company's business to the extent legal prohibitions against broadband providers blocking, throttling, or otherwise degrading the quality of the Company's data packets or attempting to extract additional fees from the Company or its customers are eliminated. A court or the FCC also could find that the FCC lacks legal authority to regulate broadband services, which could prevent the FCC from adopting new rules to govern the operating practices of broadband providers.

#### Universal Service Fund ("USF") and Other Funds

The FCC and many PUCs have established USF programs to ensure that affordable telecommunications services are widely available in high cost areas and for low income telephone subscribers and to promote universal availability of modern networks capable of providing voice and broadband service. In addition to USF, the FCC imposes other fees to meet the costs of establishing and maintaining a numbering administration system, to recover the shared costs of long-term number portability, and to contribute to the Telecommunications Relay Services ("TRS") Fund. All telecommunications carriers and other providers are required to contribute to these funds, including interconnected VoIP providers. The FCC and many PUCs have for a number of years been considering substantial changes to the USF system including changes in contribution methodology. Some proposals, if adopted, could have a material adverse effect on the Company.

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

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

#### Customer Privacy and Promotional Activities

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

#### Communications Assistance for Law Enforcement Act ("CALEA")

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

#### Services for the Disabled

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



### Number Portability

The FCC requires interconnected VoIP providers to comply with LNP rules that allow subscribers remaining in the same geographic area to switch from a wireless, wireline or VoIP provider to any other wireless, wireline or VoIP provider and keep their existing phone numbers. The Company provides LNP, even though the Company believes it is not an interconnected VoIP service provider subject to the LNP rules.

### Outage Reporting

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

### Discontinuance of Service Reporting

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

### Annual Traffic and Revenue Reports

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

### Broadband and Telephone Competition Reporting

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

### Effects of State Regulations

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

### Rural Call Completion Reporting

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

## State and Municipal Taxes

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

## Regulatory Environment

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

## Executive Officers of the Registrant

The following sets forth certain information regarding the Company's executive officers as of the filing date of this annual report (unless otherwise indicated):

| NAME            | AGE | POSITION  |
|-----------------|-----|---|
| Don C. Bell III | 47  | President, Chief Executive Officer and Director (effective March 9, 2017) |
| Gerald Vento    | 69  | President, Chief Executive Officer and Director (until March 9, 2017)     |
| Jose Gordo      | 43  | Chief Financial Officer   |

DON C. BELL III, President, Chief Executive Officer & Director Nominee. Mr. Bell was nominated to the Company's Board on December 29, 2016, and was appointed Chief Executive Officer by the Board on March 9, 2017. Prior to joining the Company, he was the owner and general partner of Tidal Capital LLC since April 2011, and President of Trigg Partners since August 2014. He was President and Principal Owner of Tidal Research, LLC from 2007 to 2011. From 2003 to 2006, he served as Senior Vice President of Marketing and Corporate Development at IPC Systems, Inc.

From 2001 to 2003, he was Vice President of Clearwire Technologies. From 1998 to 2001, he was an Investment Banker in the Mergers and Strategic Advisory Department of Goldman Sachs. He is an independent director of Wireless Telecom Group and serves as the chairman of its Compensation Committee and is a member of its Nomination and Governance Committee. He was an independent director of TeleCommunication Systems Inc. from 2015 through its sale to Comtech Telecommunications in 2016, and served as a member of the Compensation Committee and the Nomination and Governance Committee and as Chairman of the Special Committee formed to evaluate and oversee the sales process. Mr. Bell was an independent director of NTS, Inc. from 2012 through the sale of the Company to Tower Three Partners in 2014, and served as a member of the Special Committee formed in connection with such sale. Mr. Bell holds a Master's Degree in Business Administration from The Wharton School, University of Pennsylvania, and graduated from St. John's College with a BA in Classics. Mr. Bell's operating, finance and public director experience in the telecom and technology industry qualify him to serve on the Company's Board of Directors.

GERALD VENTO, President, Chief Executive Officer and Director. Mr. Vento was appointed as the Company's Chief Executive Officer effective as of January 1, 2013. Mr. Vento was appointed to the Company's Board upon the consummation of the business combination between VocalTec and YMax on July 16, 2010, served as Chairman of the Company's Board from April 1, 2012 to December 31, 2012 and was appointed Chief Executive Officer and President effective January 1, 2013. Mr. Vento has served as a Director of YMax since 2008. Mr. Vento previously served as a member of the Board of Managers of Velocity Express, LLC, a privately held transportation and logistics company, from 2009 through 2012, and its CEO and Executive Chairman from 2011 to 2012. Mr. Vento served as the CEO and Executive Chairman of Westec Intelligent Surveillance, a privately held video surveillance security company, from 2004 through 2009, and continued to serve as a director of Westec through 2012. From 1996 to 2002, Mr. Vento served as the Chief Executive Officer of TelCorp PCS Inc. From 1993 to 1995, he served as the Vice Chairman and Chief Executive Officer of Sprint Spectrum/American PCS, L.P., where he oversaw the development of the first PCS network in the United States.

JOSE GORDO, Chief Financial Officer. Mr. Gordo was appointed as the Company's Chief Financial Officer on May 10, 2013. Mr. Gordo joined magicJack in early 2013. In 2011, he co-founded Southcap Partners, a managing general partnership with investments in medium-sized companies. Prior to that, Mr. Gordo was a Managing Director of a private equity firm and was a partner at the national law firm of Akerman LLP, where he specialized in corporate law matters; advising public and private companies and investment firms on mergers & acquisitions and capital markets transactions. He received a J.D. degree from Georgetown University Law Center and a B.A. degree from the University of Miami.

#### Employees

As of December 31, 2016, the Company had 186 full-time employees, of whom 172 were in the United States, 2 were in Poland and 12 were in Israel. The Company's employees are not represented by a labor union. The Company believes that its relations with its employees are good. In Israel, the Company's relations with employees are governed by labor regulations that provide for specific terms of employment between the Company and its employees.

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

#### Available Information

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

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

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

through, such websites.

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## ITEM 1A. RISK FACTORS

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

### RISKS RELATED TO OUR BUSINESS

We have commenced a strategic alternatives process and there can be no assurance that we will be successful in completing a transaction or that any such transaction will yield additional value for our shareholders or that the transaction will not have negative impacts on our business.

On March 15, 2017, we announced that our Board of Directors, working together with our new management team and legal and financial advisors, has commenced a dual track approach to maximize shareholder value through a strategic alternatives process and the execution of a new business strategy. As previously announced, we have received multiple unsolicited offers which are at varying stages of diligence and financing commitment. We plan to continue evaluating and engaging in discussions with the potential buyers we have received offers from as well as proactively seek additional financial and strategic buyers. The strategic alternatives we could pursue include, among other things, the sale of all or part of the company, a merger with another party, or some other strategic transaction. There can be no assurance that the exploration of strategic alternatives will result in a transaction or that any transaction that is agreed to will be completed. Our ability to complete a transaction, if our Board of Directors decides to pursue one, will depend on numerous factors, some of which are outside of our control, including market conditions, interest of third parties in our business, industry trends, and the availability of financing to potential buyers on commercially acceptable terms. Even if a transaction is completed, there can be no assurance that it will be successful or have a positive effect on shareholder value. The Board of Directors may also determine that no transaction is in the best interests of shareholders. Our Board of Directors has not set a timetable for this process. We do not intend to comment further regarding the strategic alternative process, or any specific transaction, until such time as the Board of Directors deems disclosure is appropriate or necessary. Further, it is not certain what impact any potential transaction, or a decision not to pursue any potential transaction, may have on our stock price, operating results, financial condition, liquidity or business prospects.

We may incur substantial costs associated with running our strategic alternatives process, including the cost of legal and financial advisors. The process of evaluating and exploring strategic alternatives may be time consuming and disruptive to our business operations. If we are unable to effectively manage the strategic alternatives process, our business, financial condition, liquidity and results of operations could be materially adversely affected. For example, the process could lead us to lose or fail to attract employees, customers or business partners. Although we have taken steps to address those risks, there can be no assurance that any such losses or distractions will not adversely affect our operations or financial results.

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

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

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

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



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

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

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

Our future growth depends primarily on (1) increased sales of magicJack devices and related products and services, (2) the successful implementation of monetization initiatives for our proprietary mobile apps, the magicApp and the magicJack Connect and (3) the successful integration of the Broadsmart business and implementation of new SOHO initiatives of the new management team. The failure to grow device and related revenues in the Core Consumer business through increased device sales in the future would make us more reliant on other growth initiatives and cause a longer-term decrease in our overall revenues which could have a material adverse effect on our business, results of operations, financial condition and cash flows.

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

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

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

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

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

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

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

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

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

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

The market for the Company's services and products is characterized by rapidly changing enabling technology, frequent enhancements and evolving industry standards. The Company's continued success depends on its ability to accurately anticipate the evolution of new products and technologies and to enhance our existing products and services. Historically, several factors have deterred consumers and businesses from using voice over broadband

service, including security concerns, inconsistent quality of service, increasing broadband traffic and incompatible software products. If the Company is unable to continue to address those concerns and foster greater consumer demand for its products and services, its business and results of operations will be adversely affected.

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

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

The Company invests in the development of new products, services and features with the expectation that it will be able to effectively offer them to consumers and businesses. Accordingly, the Company's inability to successfully commercialize additional products, services and features in the future could have a material adverse effect on its efforts to diversify its product offerings and revenues and ultimately on its business, results of operations, financial condition or cash flows. In addition, the Company cannot assure you that the successful introduction of new products or services will not adversely affect sales of its current products and services.

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

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

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

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

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

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

The Company's means of protecting its proprietary rights may not be adequate and our competitors may independently develop technology that is similar to the Company's. Legal protections afford only limited protection for the Company's technology. The laws of many countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States. Despite its efforts to protect its proprietary rights, unauthorized parties have in the past attempted, and may in the future attempt, to copy aspects of the Company's products or to obtain and use

information that it regards as proprietary. Third parties may also design around the Company's proprietary rights, which may render its protected products less valuable, if the design around is favorably received in the marketplace. In addition, if any of the Company's products or the technology underlying its products is covered by third-party patents or other intellectual property rights, the Company could be subject to various legal actions.

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

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

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

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

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

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

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

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

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

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

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

- the Company's customers may at times experience higher dropped-call rates than they are used to from traditional wireline telephone companies;

- customers who obtain new phone numbers from the Company do not appear in the phone book and their phone numbers are not available through directory assistance services offered by traditional telephone companies;

- the Company's customers cannot accept collect calls;

- the Company's customers cannot reach certain telephone numbers; and

- in the event of a power loss or Internet access interruption experienced by a customer, the Company's service may be interrupted.

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

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

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

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

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

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

State and local governments may seek to impose E911 fees.

Many state and local governments have sought to impose fees on customers of VoIP providers, or to collect fees from VoIP providers, to support implementation of E911 services in their area. The application of such fees with respect to magicJack users and the Company is not clear because various statutes and regulations may not cover the Company's



services, the Company does not bill its customers monthly, nor does it bill customers at all for telecommunication services. The Company may also not know the end user's location because the magicJack devices and services are nomadic. Should a regulatory authority require payment of money from the Company for such support, magicJack LP may be required to develop a mechanism to collect fees from its customers, which may or may not be satisfactory to the entity requesting us to be a billing agent. The Company cannot predict whether the collection of such additional fees or limitations on where its services are available would impact customers' interest in purchasing its products.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Since 2008, the Company has experienced periods where it sells a significant number of magicJack device units and where it has significantly increased the number of customers using its products and services. These increases have placed, and the Company's anticipated sales will continue to place, a significant strain on its resources. As a result of these sales, the Company may have to implement new operational and financial systems and procedures and controls, to expand, train and manage its employee base, and to maintain close coordination among its technical, marketing, support and finance staffs. The Company must also continue to attract, retain, and integrate personnel in all aspects of operations. To the extent the Company acquires new businesses, it must also assimilate new operations, technologies and personnel. The Company may be unable to manage its expenses effectively in the future, which may negatively impact its gross profit or operating expenses in any particular quarter.

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

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

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

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

- a reduction in sales or delay in market acceptance of the Company's services;
- product returns, repairs, replacements or sales credits or refunds to the Company's customers;
- loss of existing customers and difficulty in attracting new customers;

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

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

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

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

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

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

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

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

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

- lack of direct control over production capacity and delivery schedules;
- lack of direct control over quality assurance, manufacturing yields and production costs;

·risk of loss of inventory while in transit from China, Hong Kong or Taiwan;

·the risk of currency fluctuation; and

risks associated with international commerce, including unexpected changes in legal and regulatory requirements, changes in tariffs and trade policies, risks associated with the protection of intellectual property, political and economic instability and natural disasters, such as earthquakes, typhoons or tsunamis.

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

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

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

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

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

Many factors out of the Company's control could interfere with its ability to market, license, implement or support its products with any of its channels, which in turn could harm its business. These factors include, but are not limited to, a change in the business strategy of the Company's channels, the introduction of competitive product offerings by other companies that are sold through one or more of its channels, potential contract defaults by one or more of its channels, bankruptcy of one or more distribution channel, or changes in ownership or management of one or more of its channels. For example, in February 2015, RadioShack Corporation, one of the Company's retail customers, filed a voluntary petition in bankruptcy court. The Company was owed \$1.3 million by RadioShack which it did not collect and the Company ceased making sales to RadioShack to limit its exposure. The Company has made limited sales to the RadioShack entity that emerged from the bankruptcy proceedings and terminated its relationship with that entity effective as of October 27, 2016. Some of the Company's competitors may have stronger relationships with its channels than the Company does or offer more favorable terms with respect to their products, and the Company has limited control, if any, as to whether those channels implement its products rather than its competitors' products or whether they devote resources to market and support its competitors' products rather than its offerings. If the Company fails to maintain relationships with these channels, fails to develop new channels, fails to effectively manage, train, or provide incentives to existing channels or if these channels are not successful in their sales efforts, sales of the Company's products may decrease and its operating results would suffer.

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

The Company considers our customer care to be critically important to acquiring and retaining customers. A portion of its customer care is provided by third parties located in the Philippines. This approach exposes the Company to the risk that it may not maintain service quality, control or effective management within these business operations. The increased elements of risk that arise from conducting certain operating processes in some jurisdictions could lead to an increase in reputational risk. Interruptions in the Company's customer care caused by disruptions at its third-party facilities may cause it to lose customers, which could adversely affect its revenue and profitability. If the Company's customer base expands rapidly in the U.S. or abroad, it may not be able to expand its outsourced customer care operations quickly enough to meet the needs of its customer base, and the quality of its customer care will suffer and its access right renewal rate may decrease. As the Company broadens its magicJack offerings and its customers build



increasingly complex home networking environments, it will face additional challenges in training its customer care staff. The Company could face a high turnover rate among its customer service providers. The Company intends to have its customer care provider hire and train customer care representatives in order to meet the needs of a growing customer base. If they are unable to hire, train and retain sufficient personnel to provide adequate customer care, the Company may experience slower growth, increased costs and higher levels of customer attrition, which would adversely affect its business and results of operations.

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

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

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

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

We rely on our management team and any difficulties encountered managing our management transition, the loss of one or more key employees or our inability to attract and retain qualified personnel could harm our business.

Our success and future growth depend on the skills, working relationships and continued services of our management team and other key personnel. On March 15, 2017, we announced that Don Carlos Bell III had been appointed as our new President and Chief Executive Officer and Gerald Vento would continue to serve on our Board of Directors. We also announced that Thomas Fuller was appointed as our EVP of Finance transitioning to the role of Chief Financial Officer in May of 2017, Kristin Beischel was appointed as our EVP and Chief Marketing Officer, Dvir Salomon was elevated to our management team as our EVP and Chief Technology Officer, and Kerrin Parker was appointed as Chief Operating Officer of Broadsmart. Management transitions can be inherently difficult to manage and may cause operational and administrative inefficiencies, added costs, uncertainty and decreased productivity among our employees, increase the likelihood of turnover, and result in the loss of personnel with deep institutional knowledge, which could result in significant disruptions to our operations. In addition, we must successfully integrate the new management team members within our organization in order to achieve our operating objectives, and changes in key management positions may temporarily affect our financial performance and results of operations as new management becomes familiar with our business. The presence of new management team members, and the loss of key personnel, may also impact our ability to attract and retain qualified personnel and could also adversely impact our relationships with customers and vendors, resulting in loss of business and loss of vendor relationships. The uncertainty inherent in our recent management changes could also lead to concerns from current and potential third parties with whom we do business, any of which could damage our business prospects.

The Company may make acquisitions or enter into joint venture arrangements that prove unsuccessful or strain or divert its resources.

The Company has made acquisitions of other companies or assets in its industry and entered into joint venture arrangements. It may consider additional acquisitions or joint ventures in the future that could complement its business, including the acquisition of entities that would expand its service offerings, increase its market share or offer access to other asset classes, technology or service offerings that it does not currently have. The Company has limited experience in completing acquisitions of other businesses or assets. If it does acquire other businesses or assets, it may not be able to successfully integrate these businesses or assets with its own and it may be unable to maintain its standards, controls and policies. The Company may fail in its attempt to integrate acquired companies, businesses, or assets in such a way that it can realize cross-selling opportunities and other synergies. Further, acquisitions may place additional constraints on the Company's resources by diverting the attention of its management from its business

operations. Additionally, the Company may experience difficulties in developing or maintaining controls and procedures related to an acquisition or joint venture arrangement. Through acquisitions or joint venture arrangements, the Company may enter areas in which it has no or limited experience, and an acquisition or joint venture may be unsuccessful in accomplishing the intended benefits of the transaction. In addition, we cannot predict market reactions to any acquisitions or joint venture arrangements. While we will strive to conduct appropriate due diligence in connection with any acquisition or joint venture opportunity, there may be risks or liabilities that such due diligence efforts fail to disclose or that the Company inadequately assesses. The discovery of material liabilities associated with acquisitions or joint venture opportunities, economic risks faced by joint venture partners, or any failure of joint venture partners to perform their obligations could adversely affect our business, results of operations and financial condition. Moreover, any acquisition or joint venture arrangement may result in substantial transaction-related expenses, a potentially dilutive issuance of equity securities, the incurrence of debt or amortization of expenses and related intangible assets, all of which could have an adverse effect on the Company's business and results of operations.

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

Though the Company has been profitable in the last three years, the Company has had net losses in the past, and could have operating losses in the future. Also, the Company's new Enterprise and SMB segments generated operating losses in 2016. Additionally, the Company may incur significant operating and certain capital expenditures as it increases its sales and marketing activities to expand its customer base and increase its research and development activities as it develops new or enhanced technologies and features to improve its services, products and offerings. The Company may also increase its general, administrative and operating functions to support its growing operations. As a result, the Company will need to generate a significant amount of revenues to achieve and maintain profitability. These increased expenses could exceed any revenues the Company may generate. Its efforts to attract new customers and to provide its current communications applications and services to an increased number of customers may be more expensive than the Company currently anticipates. If it does not significantly increase revenues after investing in these efforts, the Company's results from operations would be harmed. The Company cannot assure you that it can sustain or increase profitability on a quarterly or annual basis in the future. Because of its limited operating history and the early stage of the market for some of its products and services, historical trends and expected performance are difficult to analyze. If revenues do not grow, or if operating expenses exceed the Company's expectations or cannot be adjusted accordingly, its business, results of operations and financial condition could be adversely affected.

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

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

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

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

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

The Company could consider expanding its operations internationally and such plans are subject to increased risks which could harm its business, operating results, and financial condition.

The Company has consider expand its operations and markets for its products and services internationally. There are risks inherent in doing business internationally, including:

- evolving or more stringent telecommunication and broadband telephone service standards and requirements of obtaining required permits, licenses and certifications to conduct its business;
- different or more stringent consumer protection, content, data protection, privacy and other laws;
- import or export restrictions, tariffs and changes in trade regulations;
- economic volatility and the global economic slowdown, currency exchange rate fluctuations and inflationary pressures;
- profit repatriation restrictions and foreign currency exchange restrictions;
- laws and business practices that favor local competitors or prohibit foreign ownership of certain businesses;
- credit risk and higher levels of payment fraud;
- longer payment cycles;
- political or social instability; and
- potentially adverse tax developments.

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

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

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

The Company's income tax returns are subject to audit in various jurisdictions throughout the world and its 2010, 2011, 2012 and 2013 U.S. federal income tax returns were audited by the IRS.

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

The Company's consolidated U.S. federal income tax returns for the fiscal years ended December 31, 2010, 2011, 2012, and 2013, were audited by the Internal Revenue Service ("IRS"). While the Company believes that its tax positions were appropriate when reported, the IRS challenged certain of these positions during audit. During 2015, the Company reached a settlement of these issues with the IRS which resulted in the Company being required to pay additional U.S. taxes and interest for the periods under audit. Additionally, the IRS could challenge the Company's tax positions for the current or future periods and while the Company is prepared to vigorously defend any positions challenged, if the Company is unsuccessful in defending them it may be required to pay taxes, interest, fines or penalties, and/or be obligated to pay increased taxes in the future, any of which could have a material adverse effect on the Company's business, financial condition and results of operations.

## RISKS RELATED TO REGULATION IN THE UNITED STATES

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

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

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

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

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

The rates that the Company charges and is charged by service providers for terminating calls by their customers to customers served by its servers, and for transferring calls by its customers onto other carriers, cannot exceed rates determined by regulatory authorities. In 2011, the FCC adopted an order fundamentally overhauling its existing intercarrier compensation ("ICC") rules, which govern payments between carriers for exchange traffic. This order established a new ICC regime that will result in the elimination of virtually all terminating switched access charges and reciprocal compensation payments over a transition period that will end in 2020. The reductions resulting from these new ICC rules have affected and will continue to affect the Company's revenues and results of operations.

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

The current regulatory environment for broadband telephone services is developing and therefore uncertain. Although YMax Communications Corp., one of the Company's wholly-owned subsidiaries, may be subject to certain regulations as a telecom service provider, it and our other subsidiaries operate in an environment largely free from government regulation. However, the United States and other countries have begun to assert regulatory authority over broadband

telephone service and are continuing to evaluate how broadband telephone service will be regulated in the future. Both the application of existing rules to the Company and its competitors and the effects of future regulatory developments are uncertain. Future legislative, judicial or other regulatory actions could have a negative effect on the Company's business. If its VoIP telephony service or our other products and services become subject to the rules and regulations applicable to telecommunications providers, if current broadband telephone service rules are expanded and applied to the Company, or if additional rules and regulations applicable specifically to broadband telephone services are adopted, the Company may incur significant compliance costs, and it may have to restructure its service offerings, exit certain markets or start charging for its services at least to the extent of regulatory costs or requirements, any of which could cause its services to be less attractive to customers. The Company has faced, and may continue to face, difficulty collecting such charges from its customers and/or carriers, and collecting such charges may cause it to incur legal fees. The Company may be unsuccessful in collecting all of the regulatory fees owed to it. The imposition of any such additional regulatory fees, charges, taxes and regulations on VoIP communications services could materially increase the Company's costs and may limit or eliminate its competitive pricing advantages.



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

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

The success of the Company's business relies on customers' continued and unimpeded access to broadband service. Providers of broadband services may be able to block the Company's services or charge their customers more for also using its services, which could adversely affect its revenue and growth.

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

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

In response to the D.C. Circuit's decision, the FCC released an order in March 2015 adopting new net neutrality rules, which were predicated on the FCC's decision to reclassify broadband as a common carrier service under Title II of the Communications Act of 1934 and the exercise of the FCC's authority under Section 706 of the Telecommunications Act of 1996. These new rules prohibit broadband providers from blocking, throttling, or engaging in paid prioritization (including prioritizing content and services of their affiliates). These new rules prohibit broadband providers from unreasonably interfering with or unreasonably disadvantaging the ability of consumers to select, access, and use the lawful content, applications, services, or devices of their choosing; or of edge providers to make

lawful content, applications, services, or devices available to consumers. The FCC also adopted enhanced transparency requirements with which broadband providers must comply. After the FCC's new net neutrality rules went into effect in June 2015, various broadband providers and their trade associations challenged the FCC's decision before the U.S. Court of Appeals for the D.C. Circuit. In June 2016, the D.C. Circuit issued its decision upholding the FCC's rules. Various parties have filed petitions seeking rehearing en banc of the D.C. Circuit's decision, which remain pending, and the current FCC chairman had expressed his intent to revisit the FCC's rules. The Company cannot predict the outcome of these proceedings.

However, a decision by a court or the FCC striking down or narrowing the FCC's net neutrality rules could adversely impact the Company's business to the extent legal prohibitions against broadband providers blocking, throttling, or otherwise degrading the quality of the Company's data packets or attempting to extract additional fees from the Company or its customers are eliminated. A court or the FCC also could find that the FCC lacks legal authority to regulate broadband services, which could prevent the FCC from adopting new rules to govern the operating practices of broadband providers.

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

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

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

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

The Company exchanges calls with other providers pursuant to applicable law and interconnection agreements and other carrier contracts that define the rates, terms, and conditions applicable to such traffic exchange. The calls the Company exchanges originate from and terminate to a customer that uses a broadband Internet connection to access its services and are routed using telephone numbers of the customer's choosing. There is uncertainty, however, with respect to intercarrier compensation for such traffic while rules continue to be challenged in various courts. The FCC Order in November 2011 has asserted its jurisdiction over such traffic. Various state commissions have also issued rulings with respect to the exchange of different categories of traffic under interconnection agreements. To the extent that another provider were to assert that the traffic the Company exchanges with them is subject to higher levels of compensation than the Company, or the third parties terminating the Company's traffic to the PSTN, pay today (if any), or if other providers from whom the Company currently collects compensation for the exchange of such traffic refuse to pay it going forward, the Company may need to seek regulatory relief to resolve such a dispute. Given the recent changes to the intercarrier compensation regime, the Company cannot guarantee that the outcome of any proceeding would be favorable, and an unfavorable ruling could adversely affect the amounts the Company collects and/or pays to other providers in connection with the exchange of its traffic. The FCC clarified in January 2015 that its VoIP symmetry rule does not require a CLEC or its VoIP provider partner to provide the physical last-mile facility to the VoIP provider's end user customers in order to provide the functional equivalent of end office switching, and thus for the CLEC to be eligible to assess access charges for this service. The ruling confirms that the VoIP symmetry rule is technology and facilities neutral and applies regardless of whether a CLEC's VoIP partner is a facilities-based or over-the-top VoIP provider. However, in November 2016, the U.S. Court of Appeals for the D.C. Circuit vacated the FCC's ruling. The Company cannot predict how the D.C. Circuit's decision will affect the amounts the Company collects and/or pays to other providers in connection with the exchange of its traffic.

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

The Company is subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet, e-commerce, and electronic devices. Existing and future laws and regulations may impede the

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

## RISKS RELATED TO THE OPERATION AND SECURITY OF OUR SYSTEM

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

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

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

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

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

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

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

reputation.

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

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

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

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

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

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

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

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

brands, discourage use of its websites, and increase its costs.

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



## RISKS RELATING TO THE COMPANY'S ORDINARY SHARES

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

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

The Company does not anticipate paying cash dividends on its ordinary shares, which could reduce the return on shareholders' investments.

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

We cannot assure our shareholders that share repurchase programs will enhance long-term shareholder value. Share repurchases, if any, could increase the volatility of the price of our ordinary shares.

The Company has done significant stock repurchase programs in the past and could consider such programs in the future. In 2015, our board of directors authorized a share repurchase program. Under the program, we were authorized to repurchase shares of ordinary shares on the open market or in privately negotiated transactions for an aggregate purchase price not to exceed \$20.0 million. We repurchased 2,329,003 ordinary shares and expended \$20.0 million under that repurchase program. Although the Board of Directors authorized this share repurchase program, the share repurchase program did not obligate the Company to repurchase any specific dollar amount or to acquire any specific number of shares. The existence of a share repurchase program could cause our stock price to be higher than it would be in the absence of such a program and could potentially reduce the market liquidity for our stock. The timing and actual number of shares repurchased, if any, will depend on a variety of factors including market and business conditions, the trading price of the Company's ordinary shares, the nature of other investment or strategic opportunities, the rate of dilution of our equity compensation program, the availability of adequate funds, the applicable rules and regulations under Israeli law, the U.S. federal securities laws, and NASDAQ listing standards, and other factors.

Any repurchases of our ordinary shares pursuant to our share repurchase program could affect our stock price and increase its volatility. There can be no assurance that any share repurchases will enhance shareholder value because the market price of our ordinary shares may decline below the levels at which we repurchased shares of stock. Although our share repurchase program is intended to enhance long-term shareholder value, short-term stock price fluctuations could reduce the program's effectiveness. The repurchase program may in the future be limited, suspended or discontinued at any time without prior notice and any such limitation, suspension or discontinuation could cause the market price of our ordinary shares to decline. There can be no assurance that we will repurchase shares of our ordinary shares under our share repurchase program or that any future repurchases will have a positive impact on the trading price of our ordinary shares or earnings per share.



## RISKS RELATING PRIMARILY TO THE COMPANY'S INCORPORATION IN ISRAEL

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

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

Our commercial insurance does not cover losses that may occur as a result of events associated with the security situation in the Middle East. Although the Israeli government currently covers the reinstatement value of direct damages that are caused by terrorist attacks or acts of war, we cannot assure you that this government coverage will be maintained. Any losses or damages incurred by us could have a material adverse effect on our business, operating results and financial condition.

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

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

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

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

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

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

Israeli corporate law regulates mergers, requires that a tender offer be effected when more than a specified percentage of shares in a company are purchased, requires special approvals for certain transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. For instance, subject to various exceptions, the Israeli Companies Law prohibits any acquisition of shares or voting power in a public company that would result in the purchaser holding 25% or more, or more than 45% of the voting power in the company, if there is no other person holding 25% or more, or more than 45% of the voting power in a company, respectively, without conducting a special tender offer. The Israeli Companies Law further provides that a purchase of shares or voting power of a public company or a class of shares of a public company, which will result in the purchaser's holding more than 90% of the company's shares, class of shares or voting rights, is prohibited unless the purchaser conducts a full tender offer for all of the company's shares or class of shares. The purchaser will be allowed to purchase all of the company's shares or class of shares if either (i) the shareholders who do not accept the offer hold less than 5% of the issued and outstanding share capital of the company or of the applicable class, and more than half of the shareholders who do not have a personal interest in the offer accept the offer, or (ii) the shareholders who do not accept the offer hold less than 2% of the issued and outstanding share capital of the company or of the applicable class. At the request of an offeree of a full tender offer which was accepted, the court may determine that the consideration for the shares purchased under the tender offer was lower than their fair value and compel the offeror to pay to the offerees the fair value of the shares as determined by the court.

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

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

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

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

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

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

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

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

Since the Company is incorporated under Israeli law, the rights and responsibilities of its shareholders are governed by the Company's articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in U.S.-based corporations. For example, a shareholder of an Israeli company has a duty to act in good faith and in a customary manner in exercising its rights and performing its obligations towards the company and other shareholders and to refrain from abusing its power in the company, including, among other things, voting at a general meeting of shareholders on certain matters, such as amendments to a company's articles of association, increases in a company's authorized share capital, mergers and acquisitions and

related party transactions requiring shareholder approval. In addition, a shareholder who is aware that it possesses the power to determine the outcome of a shareholder vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness toward the company. There is limited case law available to assist us in understanding the nature of this duty or the implications of these provisions. These provisions may be interpreted to impose additional obligations and liabilities on holders of the Company's ordinary shares that are not typically imposed on shareholders of U.S. corporations.

#### Shareholder Approval of Certain Executive Compensation

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

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

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

The Company's headquarters are located in Netanya, Israel. The Company does not own any of its properties. All of the Company's properties, including the properties utilized by its subsidiaries, are leased. The following table contains additional information about the Company's properties as of March 16, 2017:

| Location               | Principal Use  | Approximate<br>Square Feet | Lease<br>Expiration<br>Date |
|------------------------|--|----------------------------|-----------------------------|
| Netanya, Israel        | Administrative offices, technical team and research and development.                                 | 2,637                      | March<br>2018               |
| West Palm Beach,<br>FL | Executive, administrative offices  | 4,490                      | October<br>2019             |
|                        | Customer service management, warehouse and distribution center.                                      | 10,580                     | July 2019                   |
|                        | Customer care call center.   | 8,405                      | October<br>2019             |
| Plano, TX              | Research and development for the magicJack devices and certain related-products and network support. | 2,334                      | May 2017                    |
| Sunnyvale, CA          | Research and development for the magicJack devices and certain related-products.                     | 1,232                      | June 2017                   |
| Franklin, TN           | Technology management and hosting equipment, servers   | 3,722                      | February<br>2019            |
| Atlanta, GA            | SMB offices.   | 11,268                     | June 2018                   |
| Warsaw, Poland         | Research and development for the magicJack devices and certain related-products.                     | 3,017                      | April 2022                  |

The Company currently pays a total annual rental amount of approximately \$0.9 million for all its facilities. The Company believes that its facilities are suitable for their purposes and sufficient to support its needs through 2017, and that, if necessary, current leases can be renewed or additional facilities can be secured for the Company's anticipated general corporate needs.

## ITEM 3. LEGAL PROCEEDINGS

## 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. For additional information, refer to Note 10, "Commitments and Contingencies," in the Notes to our Consolidated Financial Statements included in Item 8 herein.

On March 11, 2016, a purported class action lawsuit was filed against the Company, its Chief Executive Officer, Gerald Vento ("Mr. Vento"), and its Chief Financial Officer, Jose Gordo ("Mr. Gordo"), in the United States District Court for the Southern District of New York. The complaint alleges that the Company and Messrs. Vento and Gordo made false and misleading statements regarding the financial performance and guidance during the alleged class period of November 12, 2013 to March 12, 2014. The complaint alleges that the Company and Messrs. Vento and Gordo violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The complaint seeks damages, attorneys' fees and costs, and equitable/injunctive relief or such other relief as the court deems proper. The Company cannot estimate the likelihood of liability or the amount of potential damages.

#### ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.



## PART II

ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND  
5. ISSUER PURCHASES OF EQUITY SECURITIES

## Price Range of Ordinary Shares and Dividend Policy

The Company's ordinary shares are quoted on the NASDAQ under the symbol "CALL." The following table sets forth the high and low adjusted closing prices for the Company's ordinary shares as reported on the NASDAQ for the periods indicated, as adjusted to the nearest cent.

|                               |         |        |
|-------------------------------|---------|--------|
| Year Ended December 31, 2016: | High    | Low    |
| Fourth quarter                | \$7.50  | \$5.75 |
| Third quarter                 | \$6.81  | \$5.28 |
| Second quarter                | \$6.70  | \$5.56 |
| First quarter                 | \$9.21  | \$6.30 |
| Year Ended December 31, 2015: |         |        |
| Fourth quarter                | \$11.78 | \$9.06 |
| Third quarter                 | \$9.69  | \$6.77 |
| Second quarter                | \$8.29  | \$6.50 |
| First quarter                 | \$8.54  | \$6.84 |

On March 15, 2017, the last reported sale price of our ordinary shares on the NASDAQ was \$8.17 per share. As of March 15, 2017, there were approximately 107 record holders of our ordinary shares. As of March 15, 2017, approximately 94.5% of our ordinary shares are held in the United States by approximately 83 record holders.

## Dividends

The Company has not paid any cash dividend during the two most recently completed fiscal years. The Company currently intends to retain any earnings for use in its business, for investment in acquisitions and to repurchase shares of its ordinary shares.

## Securities Authorized for Issuance Under Equity Compensation Plans

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 and restricted shares. In April 2014, the shareholders approved amendments to the 2013 Plans at the annual general meeting of shareholders increasing the number of awards available for grant. The aggregate number of shares that may be subject to awards under the 2013 Plans is 3,600,000. The Company had previously granted shares under the VocalTec amended Master Stock Plan (the "2003 Plan") which expired in April 2013. During the year ended December 31, 2016, the Company issued 1,000,000 ordinary share options outside of the 2013 Plans as an inducement for the two founders of Broadsmart to become employed by the Company.

During the year ended December 31, 2016, the Company granted 1,107,040 ordinary share options to its employees and executives with a weighted average exercise price of \$7.09 and 320,305 restricted stock units to its executives, directors and consultants with a weighted average fair value at grant date of \$6.07. During the year ended December 31, 2015, the Company granted 998,614 ordinary share options to its employees and executives with a weighted average exercise price of \$9.33 and 385,852 restricted stock units to its executives, directors and consultants with a weighted average fair value at grant date of \$9.33. During the year ended December 31, 2014, the Company granted

762,500 ordinary share options to its employees and executives with a weighted average exercise price of \$14.71 and 30,500 restricted stock units to its executives, directors and consultants with a weighted average fair value at grant date of \$19.15.

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As of December 31, 2016, there were 3,488,059 ordinary share options outstanding with a weighted average exercise price of \$11.13 under our equity compensation plans, as follows:

| Plan Category  | Number of Securities to be Issued Upon Exercise of Outstanding Options (a) | Weighted Average Exercise Price of Outstanding Options (\$) (b) | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities reflected in Column (a)) (c) |
|--|--|---|---|
| Equity compensation plans approved by security holders (1)     | 2,488,059  | 12.72   | 198,593   |
| Equity compensation plans not approved by security holders (2) | 1,000,000  | 7.18  | n/a   |

(1) Consists of the magicJack Vocaltec Ltd. 2013 Stock Incentive Plan and the magicJack Vocaltec Ltd. 2013 Israeli Stock Incentive Plan as amended.

(2) Consists of options issued outside of the 2013 Plans as an inducement for the two founders of Broadsmart to become employed by the Company.

Issuer Purchases of Equity Securities

In December 2016, the Company purchased 62,726 of its ordinary shares at \$6.85 per share, for an aggregate purchase price of approximately \$430 thousand, in settlement of the withholding tax liability of certain of its executive officers and other employees on the vesting of restricted stock units.

| Period                               | (a)<br>Total Number of Shares Purchased * | (b)<br>Average Price Paid per Share | (c)<br>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs* | (d)<br>Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Program (in thousands) |
|--------------------------------------|---|-------------------------------------|--|---|
| October 1, 2016 - October 31, 2016   | 0   | \$ -                                | 0  | \$ -  |
| November 1, 2016 - November 30, 2016 | 0   | \$ -                                | 0  | \$ -  |
| December 1, 2016 - December 31, 2016 | 62,726                                    | \$ 6.85                             | 0  | \$ -  |
| Total                                | 62,726                                    |                                     | 0  |   |

The following graph compares the cumulative total shareholder return on the Company's common stock from January 1, 2011 to December 31, 2016 to that of the total return of the Nasdaq Telecom Index and the S&P 500 Index. The comparison assumes \$100 was invested in the Company's common stock on January 1, 2011 and in each of the forgoing indices on January 1, 2011, and assumes the reinvestment of dividends. The graph is furnished and not "filed" with the Securities and Exchange Commission or "soliciting material" under the Securities Exchange Act of 1934 and shall not be incorporated by reference into any such filings, irrespective of any general incorporation contained in such filing.

Comparison of Cumulative Five Year Total Stockholder Return

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## ITEM 6. SELECTED FINANCIAL DATA

The Company's consolidated financial statements are prepared in accordance with United States generally accepted accounting principles ("GAAP") and are presented in U.S. dollars. Information as of December 31, 2016, 2015, 2014, 2013 and 2012 and for each of the years then ended is derived from the Company's audited consolidated financial statements.

The information presented below (in thousands, except earnings per share) is qualified by the more detailed consolidated financial statements set forth elsewhere in this report, and should be read in conjunction with the consolidated financial statements and notes thereto, and with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

|   | Year Ended December 31, |           |           |           |             |
|---|-------------------------|-----------|-----------|-----------|-------------|
|   | 2016                    | 2015      | 2014      | 2013      | 2012        |
| <b>Statement of Operations:</b>   |                         |           |           |           |             |
| Net revenues  | \$97,398                | \$100,962 | \$116,322 | \$143,492 | \$158,362   |
| Cost of revenues (1)  | 36,734                  | 34,142    | 42,541    | 49,094    | 61,325      |
| Gross profit  | 60,664                  | 66,820    | 73,781    | 94,398    | 97,037      |
| Operating expenses (1)  | 46,909                  | 41,477    | 60,217    | 46,952    | 53,472      |
| Operating income  | 13,755                  | 25,343    | 13,564    | 47,446    | 43,565      |
| Interest expense  | -                       | (57 )     | (192 )    | (307 )    | (411 )      |
| Other income (expense), net (2)   | 20                      | 26        | 158       | 9         | 3,736       |
| Income before income taxes  | 13,775                  | 25,312    | 13,530    | 47,148    | 46,890      |
| (Benefit) provision for income taxes  | 8,719                   | 11,802    | 9,745     | (23,163 ) | (8,961 )    |
| Net income  | 5,056                   | 13,510    | 3,785     | 70,311    | 55,851      |
| Net loss attributable to noncontrolling interest                                    | 635                     | -         | -         | -         | -           |
| Net income attributable to magicJack VocalTec Ltd. common shareholders              | \$5,691                 | \$13,510  | \$3,785   | \$70,311  | \$55,851    |
| <b>Income per share attributable to magicJack VocalTec Ltd. common shareholders</b> |                         |           |           |           |             |
| Basic (3)   | \$0.36                  | \$0.80    | \$0.21    | \$3.81    | \$2.80      |
| Diluted (3)   | \$0.35                  | \$0.79    | \$0.21    | \$3.81    | \$2.73      |
| <b>Weighted average ordinary shares outstanding</b>                                 |                         |           |           |           |             |
| Basic   | 15,815                  | 16,975    | 17,831    | 18,468    | 19,916      |
| Diluted   | 16,064                  | 17,045    | 17,868    | 18,476    | 19,985      |
| <b>Balance Sheet Data:</b>  |                         |           |           |           |             |
| Cash and cash equivalents   | \$52,394                | \$78,956  | \$76,312  | \$54,779  | \$38,349    |
| Total assets  | \$174,517               | \$168,836 | \$194,233 | \$171,894 | \$120,767   |
| Property and equipment, net   | \$3,805                 | \$3,302   | \$3,564   | \$1,959   | \$2,348     |
| Goodwill and other identified intangibles, net                                      | \$47,185                | \$38,991  | \$41,777  | \$47,960  | \$48,440    |
| Other non-current liabilities (4)   | \$10,866                | \$11,098  | \$13,438  | \$6,487   | \$3,114     |
| Total capital (deficit) equity  | \$58,200                | \$47,668  | \$49,086  | \$37,442  | \$(24,770 ) |
| Total ordinary shares outstanding, net of treasury shares                           | 16,051                  | 15,610    | 17,868    | 17,827    | 18,709      |
| <b>Other Data:</b>  |                         |           |           |           |             |
| Depreciation of property and equipment  | \$1,191                 | \$799     | \$619     | \$565     | \$538       |
| Amortization of intangible assets   | \$3,542                 | \$2,786   | \$4,168   | \$4,293   | \$2,764     |

|                                     |       |     |         |     |     |
|-------------------------------------|-------|-----|---------|-----|-----|
| Impairment of intangible assets (5) | \$998 | \$- | \$2,500 | \$- | \$- |
|-------------------------------------|-------|-----|---------|-----|-----|

Cost of revenues for the years ended December 31, 2016, 2015 and 2014 included a bonus to employees and outside consultants for services rendered in those years of \$0.3 million, \$0.3 million and \$0.1 million, respectively.

(1) There were no bonus amounts allocated to cost of revenues in 2013 and 2012. Operating expenses for the years ended December 31, 2016, 2015, 2014, 2013 and 2012 included a bonus to employees and outside consultants for services rendered in those years of \$1.6 million, \$1.7 million, \$0.3 million, \$1.4 million and \$4.0 million, respectively.

(2) Other income (expense), net includes gains (losses) on investments, interest and dividend income, fair value gain (loss) on common equity put options and investment advisory fees. Other income for the years ended December 31, 2016, 2015 and 2014 was not significant. Other income in 2013 was primarily related to \$0.3 million in interest and dividend income and \$0.7 million in gains on investments, offset by \$1.0 million in fair value loss on common equity put options. Other income in 2012 was primarily related to \$3.7 million in fair value gain on common equity put options and \$0.8 million in interest and dividend income, partially offset by \$0.7 million in losses on investments.

(3) Refer to Note 14, "Income per Share," in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

(4) As of December 31, 2016, 2015, 2014, 2013 and 2012, this item represents (a) the non-current portion of outstanding indebtedness in connection with an agreement entered during June 2011 for the purchase of certain intangible assets (b) deferred income tax liabilities, non-current, and (c) \$10.4 million, \$10.8 million and \$12.0 million, provision for uncertain tax position recorded in 2016, 2015 and 2014, respectively. Refer to Note 9, "Other Liabilities," and Note 13, "Income Taxes," in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

(5) Impairments of intangible assets for the year ended December 31, 2016 were comprised of an amortizable software license deemed obsolete, certain domain names not subject to amortization that were not renewed, and a trade name not subject to amortization. Impairment of intangible assets for the year ended December 31, 2014 was comprised of a non-compete agreement with the Company's founder and former CEO who passed away during 2014. Refer to Note 6, "Intangible Assets," in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION OF THE COMPANY'S FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH ITS CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES INCLUDED ELSEWHERE IN THIS ANNUAL REPORT ON FORM 10-K. THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. THE COMPANY'S ACTUAL RESULTS MAY DIFFER SIGNIFICANTLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE FUTURE RESULTS TO DIFFER SIGNIFICANTLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED BELOW AND ELSEWHERE IN THIS ANNUAL REPORT, PARTICULARLY THOSE DESCRIBED ABOVE UNDER ITEM 1A, RISK FACTORS.

magicJack VocalTec Ltd. and its Subsidiaries (the "Company") is a cloud communications leader that is the inventor of the magicJack devices and other magicJack products and services. magicJacks weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source, providing users with complete phone service for home, enterprise and while traveling. We charge highly competitive rates for the right to access our servers ("access right"), and our customers then continue to have the ability to obtain free telephone services. We currently offer the magicJack GO and magicJack EXPRESS, which are updated versions of the magicJack device that have their own CPU and can connect a regular phone directly to the user's broadband modem/router and function as a standalone phone without using a computer. The magicJack mobile apps are applications that allow users to make and receive telephone calls through their smart phones using their magicJack account. Currently, consumers that do not have a magicJack account can purchase and download the magicJack mobile apps to make telephone calls from anywhere in the world into the U.S. or Canada for free. The mobile apps include the magicApp and the magicJack Connect App, which are available for both iOS and Android. 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 device. We also wholesale telephone service to VoIP providers and telecommunication 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.

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

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

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

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



## Basis of Presentation

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

We have historically prepared our consolidated financial statements on the basis of being a single reporting entity. Beginning in the first quarter of 2016, with the acquisition of Broadsmart and the internal development of our SMB division, we have been reporting the results of operations for these new business lines as separate Reportable Segments. Refer to Note 16, “Segment Reporting,” in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

Approximately 87% of our consolidated revenues in the year ended December 31, 2016 and 90% of our revenues in the years ended December 31, 2015 and 2014 were derived from sales to customers located in the United States. The majority of our revenues were generated from sales of the magicJack device and from the accompanying software access rights, which were \$77.6 million, \$86.8 million and \$99.2 million for the years ended December 31, 2016, 2015 and 2014, respectively. We also provide our customers the ability to make prepaid calls using a magicJack device or magicJack App by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were \$5.7 million, \$8.2 million and \$10.1 million for years ended December 31, 2016, 2015 and 2014, respectively.

The majority of our Enterprise segment revenues recognized were generated from Broadsmart hosted UCaaS services and sales of hardware and equipment which were \$9.0 million post acquisition for the year ended December 31, 2016. We had no UCaaS revenue from Broadsmart for the years ended December 31, 2015 and 2014, prior to acquisition.

Our SMB segment did not generate significant revenue for the year ended December 31, 2016. There was no revenue for SMB for the years ended December 31, 2015 and 2014.

## Basis of Consolidation

Our consolidated financial statements include the accounts of magicJack VocalTec Ltd. and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, Tiger Jet Network, Inc., VocalTec Communications, LLC (“VocalTec US”, formerly Stratus Telecommunications, LLC), Broadsmart Global, Inc., and magicJack SMB, Inc.. The results of Broadsmart Global, Inc. have been included since March 17, 2016. Refer to Note 15, “Acquisition of Business,” in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details. The results of SMB have been included since the first quarter of 2016. All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period financial statement amounts to conform to the current presentation.

## 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

We recognize revenue in accordance with ASC Topic 605, "Revenue Recognition" ("ASC 605"), which provides authoritative guidance on revenue recognition. For arrangements that include more than one product or service ("deliverables"), we apply Section 25 of ASC 605, "Multiple-Element Arrangements". ASC 605-25 establishes criteria for separating deliverables into different units of accounting and allocating consideration to those units of accounting.

#### Core Consumer Segment

For the Core Consumer business, net revenues consist of revenues 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 related products and services. Revenues are recorded net of sales returns and allowances.

#### magicJack Devices and Access Right Renewals

magicJack devices include an initial access right, which qualify as multiple deliverables per ASC 605-25. Since the device and initial access right are interdependent and not sold separately, they are accounted for as a combined unit of accounting. Direct sales of devices include shipping charges and 30 days to return the device and cancel the service. For retail sales of devices, there is a delay between shipment to the retailer and the ultimate sale to a customer (end-user). Based on sales and inventory data provided by retail partners, our estimate of the delay for the year ending December 31, 2016 was 90 days. We defer revenue recognition on direct sales for the 30 day return period and on retail sales for the delay period, after which we recognize the revenue from device sales and shipping charges, if applicable, ratably over the remaining initial access right period.

Customers may renew access rights for periods ranging from one month to five years. The revenue associated with access right renewals is deferred and recognized ratably over the extended access right period. Revenue from mobile apps is included as part of Access Right Renewals and recognized ratably over the 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 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 also accept returns of battery powerbanks for mobile devices within 30 days of sale. We estimate potential returns under these arrangements at point of sale and re-estimate them on a quarterly basis. For the years ended December 31, 2016, 2015 and 2014, our estimates of returns and actual returns from initial stocking orders have not been materially different.

#### Other magicJack-Related Products

We offer customers other optional products related to their magicJack devices and services, such as insurance, custom or vanity phone numbers, Canadian phone numbers, the ability to either change their existing phone numbers or port them to a magicJack device, and battery powerbanks for mobile devices. These revenues are recognized at the time of sale, with the exception of sales of the battery powerbank which are recognized when shipped.

#### Prepaid Minutes and Access and Wholesale Charges

We generate revenues from sales of prepaid international minutes to customers, fees charged to telecommunication carriers or providers for origination of their calls to 800-numbers, and access fees charged to other telecommunication carriers or providers on a per-minute basis for IXC calls terminated to our end-users. Revenues from access fee charges to other telecommunication 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. Revenues from prepaid minutes and access and wholesale charges are recognized as minutes are used.

## Enterprise Segment

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

UCaaS services and equipment provided by our Broadsmart subsidiary qualify as multiple deliverables per ASC 605-25. Since the equipment and services are sold separately and can be used with other products and services, they are accounted for as separate units of accounting. We recognize revenues from sales of our hosted services in the period the services are provided over the term of the respective customer agreements. Customers are billed monthly in advance for these recurring services and in arrears for one time service charges and other certain usage charges. Revenues from sales of hardware and network equipment are recognized in the period that the equipment is delivered. Revenues from the sale of equipment purchased but not yet delivered and installed is deferred and recognized in the period that the hardware or equipment is put into service.

## SMB Segment

SMB provides phone equipment and services that are interdependent and not sold separately. As such, they are accounted for as a combined unit of accounting under ASC 605-25. Some agreements include a refund period or a promotion for free introductory service. Revenue recognition is deferred for either period, after which we recognize the revenue for the combined unit ratably over the remaining service period. Revenues from this segment were not significant for the year ended December 31, 2016.

## GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired. Goodwill and other identifiable intangible assets with indefinite lives are not amortized to operations, but are instead 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 our market capitalization below its book value.

The valuation methodology we use for assessing potential impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from actual future results, we may record impairment charges in the future.

As part of our annual impairment review for goodwill and other identifiable intangible assets with indefinite lives, performed as of October 1, 2016 (the "Measurement Date"), management determined that there were impairment indicators at the Enterprise Segment. Based on these indicators and the new reporting units for goodwill, we engaged an independent third party to perform a valuation of Broadsmart's intangible assets and a two-step goodwill impairment test for each of our reporting units.

The third party valuation as of October 1, 2016 was used to test the Enterprise segment's identified intangible assets subject to amortization for impairment. Management summed the undiscounted cash flows expected to result from the use of these assets and their eventual disposition used in the third party valuation report and noted that the sum exceeded the carrying amount of the assets, indicating no further impairment testing was necessary for these assets as of October 1, 2016. Refer to Note 6, "Intangible Assets" in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

The third party valuation as of October 1, 2016 determined the fair value of Broadsmart's identified intangible assets not subject to amortization based on the relief from royalty method, which requires an estimate of a reasonable royalty rate, identification of relevant projected revenues and expenses, and selection of an appropriate discount rate. This

valuation yielded an estimated fair value of \$1.7 million for the Broadsmart tradename. This tradename was recorded as an identifiable intangible asset with an indefinite life at a carrying value of \$2.2 million. As a result, an impairment loss of \$0.5 million was recognized in General and Administrative expense for the fourth quarter of 2016 under the Enterprise segment in the statement of operations related to the tradename.

Under the first step of the goodwill test as of October 1, 2016, the fair value of each reporting unit was compared with its carrying value (including goodwill). The fair value was determined based on a discounted future cash-flows approach. The Core Consumer reporting unit passed the first step with fair value in excess of carrying value by approximately 227% and no further testing was required. The SMB segment had no goodwill and no further testing was required. The Enterprise reporting unit did not pass the first step and further testing was required.

Under the second step of the goodwill test as of October 1, 2016, the carrying amount of the Enterprise reporting unit's (Broadsmart's) goodwill was compared to its implied fair value. The implied fair value of goodwill was determined by allocating the fair value of the reporting unit's assets and liabilities in a manner similar to a purchase price allocation with the residual fair value being the implied fair value of goodwill. The fair value of the reporting unit was determined using a discounted cash flow analysis. The Enterprise segment passed the second step with implied fair value of goodwill exceeding carrying value by approximately 35%.

Based on this testing, we determined that there was no impairment of goodwill as of our annual goodwill impairment test date of October 1, 2016. Refer to Note 7, "Goodwill" in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

Management continued to monitor the performance of the Enterprise segment/reporting unit (Broadsmart) and updated its impairment analysis of intangible assets not subject to amortization, goodwill and the identified intangible assets subject to amortization as of December 31, 2016. No further impairment charges were required as a result of this analysis.

Although the acquired Broadsmart business has underperformed compared to our expectations, we believe that the underlying fundamentals of the Broadsmart business and the exhibited market opportunities for growth remain consistent with our understanding and analysis of the business at the time of acquisition. Subsequent to the year ended December 31, 2016, we implemented steps to improve the operating results and bolster integration efforts for the Broadsmart business. In February 2017, we hired a new Chief Operating Officer for Broadsmart to reduce the administrative and organizational duties of Broadsmart's original founders, who continue to be employed by us and are integral to its success, so that they can focus on expanding the customer base. We have also begun to hire additional sales and marketing personnel dedicated to obtaining new business. We believe that the Enterprise reporting unit will eventually perform at originally expected levels but more time is needed to give these integration efforts an opportunity to be successful. If these efforts are not successful, we will need to re-evaluate our forecasts for the Enterprise reporting unit. Further impairments could ensue if Broadsmart continues to perform below expectations.

## INCOME TAXES

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. Our net deferred tax assets consist primarily of foreign net operating loss carryforwards and timing differences between the recognition of income for book and tax purposes. We record a valuation allowance to reduce the net deferred tax assets to the amount that we estimate is more-likely-than-not to be realized. We evaluated the valuation allowance as of December 31, 2016, 2015 and 2014 which resulted in adjustments of (\$1.2 million) to bring the allowance to \$16.3 million, \$1.3 million to bring the allowance to \$17.5 million, and \$1.2 million to bring the allowance to \$16.2 million, respectively. These amounts adjust 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 continue to make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required.

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 where 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 where there is 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. For the year ended December 31, 2016, we recorded a provision for uncertain tax positions of (\$0.3) million. For the year ended December 31, 2015, our provision for uncertain tax positions was reduced by \$10.1 million primarily due to the settlement of the IRS audits for tax years 2010 through 2013. As of December 31, 2016 and 2015, the liability for uncertain tax positions totaled \$10.4 million and \$10.8 million, respectively. The current portion of such liability, if any, has been reflected in income taxes payable. There was no current portion of uncertain tax positions as of December 31, 2016 and 2015, respectively. The noncurrent portion of such liability, \$10.4 million and \$10.8 million as of December 31, 2016 and 2015, respectively, has been reflected in other non-current liabilities.

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

We file U.S. federal and state and foreign income tax returns in jurisdictions with varying statutes of limitations. During fiscal 2013, we received notice that the IRS was going to examine our tax returns for 2010 and 2011. In October 2014, we were informed that the IRS was going to expand its audit to include our 2012 and 2013 tax returns. During 2015, we reached agreement with the IRS on a settlement of all years under audit. The settlement resulted in an increase to the jurisdictional income of the U.S. The additional tax and interest due to the IRS and various state taxing authorities as a result of the increased U.S. jurisdictional income was \$6.8 million and \$0.9 million, respectively. We were able to utilize approximately \$4.2 million of benefits related to other favorable adjustments identified during the exam to satisfy a portion of the federal liability, resulting in net tax and interest paid to the IRS of \$2.6 million. The \$0.9 million state liability is reflected as a reduction to prepaid income taxes in our December 31, 2015 consolidated balance sheets. The increase to the U.S. jurisdictional income resulted in a decrease in our Israeli jurisdictional income. The decrease in Israeli income, in turn, increased our Israeli net operating losses, resulting in a tax benefit of \$5.6 million. For year ended December 31, 2016, we recorded income tax expense of \$8.7 million, which is higher than the expected tax provision of \$4.7 million, using the statutory rate of 34%, due, in part, to the net impact of a decrease in the Israeli corporate tax rate from 26.5% to 23.0% which was effective in December 2016. The decrease in the rate resulted in the need to reduce our Israeli deferred tax assets, primarily net operating loss carryforwards, which resulted in deferred tax expense and a reduction in the value of related deferred tax assets of \$5.2 million. Additionally, the effective tax rate was impacted by decreases to uncertain tax positions of (\$0.8 million), decreases in valuation allowances of (\$1.2 million), and other items of \$0.8 million. The discrete items noted above were partially offset by the lower jurisdictional tax rate charged on the operating income of our Israeli operations. The tax years 2011 through 2016 remain open to examination by other major taxing jurisdictions to which we are subject.



## SHARE-BASED COMPENSATION

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

## BUSINESS TRENDS

Revenues in our Core Consumer segment continued to decline during the year ended December 31, 2016. We remain encouraged by the loyalty of our existing customer base and we continue to undertake efforts to improve our customer renewal rates and limit customer churn. With the launch of magicJack Connect to both iOS and Android customers, we are increasing our efforts to reposition the device with its companion App service. We believe that there will continue to be solid consumer demand for our low priced, unlimited phone service, whether through our magicJack device, our mobile Apps, or a combination of both.

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

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

Although the acquired Broadsmart business has underperformed compared to our expectations, we believe that the underlying fundamentals of the UCaaS business and the exhibited market opportunities for growth remain consistent with our understanding and analysis of the business at the time of acquisition. As a consequence of the underperformance, in 2016 we recognized a \$0.5 million impairment on the Broadsmart trade name. Refer to Note 6, "Intangible Assets" in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details. Subsequent to the year ended December 31, 2016, we implemented steps to improve the operating results and bolster integration efforts for the Broadsmart business. In February 2017, we hired a new Chief Operating Officer for Broadsmart to reduce the administrative and organizational duties of Broadsmart's original founders, so that they can focus on expanding the customer base. We have also begun to hire additional sales and marketing personnel dedicated to obtaining new business. We believe that the business will eventually perform at originally expected levels but more time is needed to give these integration efforts an opportunity to be successful. If these efforts are not successful, we will need to re-evaluate our forecasts for the business. Further impairments could ensue if Broadsmart continues to perform below expectations.

In addition to the Broadsmart acquisition, we are further transitioning towards business customers with the launch of our new SMB segment. We expect that this business line will leverage our core assets and give us the ability to sell services at disruptive pricing to small-to-medium business customers. While we did not recognize significant revenue from SMB in 2016, we believe that in the long term, if we successfully execute on this growth initiative, it has the potential to generate significant shareholder value.

Furthermore, in May 2016, we launched the magicJack Connect App for iOS and Android. The magicJack Connect App offers users free worldwide Wi-Fi App-to-App calling & messaging. The App also offers an unlimited U.S. calling plan which allows subscribers to call the U.S. from anywhere in the world plus receive a U.S. phone number for only \$9.99 per year. With in-App purchase capability, other offers available on the magicJack Connect App include international calling plans for select countries, the ability to purchase local phone numbers from over 40 countries, and the ability to purchase international calling credits for consumers that prefer pay-as-you go options. We are focused on driving sales growth through monetizing magicJack Connect. The magicJack Connect App competes with other large, well-capitalized global companies in the telecom App industry who are introducing low priced consumer offers into the marketplace on an ongoing basis. Accordingly, we cannot assure that the features we are offering for monetization of the magicJack Connect App will be attractive to consumers at the price points we are offering, or at all.

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

In 2017, we intend to focus on launching new services targeting Small Office Home Office (“SOHO”), pursuing a mobile-first, web-first strategy. We believe that because of our vertically integrated operations and CLEC network with significant excess capacity, we can be both competitively price disruptive and profitable at the same time, similar to the historical magicJack Core Consumer business. We believe this strategy leverages existing assets and recent R&D investment, and is a webfocused customer acquisition and UCaaS model. We plan to consolidate operations and to eliminate redundant SMB segment functions in Atlanta. We are also planning on eliminating unproductive or less-promising ventures, including our partnership with Telefonica and the Hotelijack initiative. We have recruited a new executive team to execute this strategy.

While we are excited by the new direction that we are planning for 2017 and the potential inherent in the acquisition of Broadsmart, there can be no assurance that these initiatives will be successful and we cannot predict what impact, if any, these initiatives will ultimately have on our business, results of operations, financial condition or cash flows.

## SIGNIFICANT CHANGES IN FINANCIAL POSITION

The following table presents significant changes in our consolidated balance sheets for the periods indicated (in thousands).

|                                | December 31,<br>2016 | December 31,<br>2015 | December 31,<br>2014 | 2016<br>compared to<br>2015 | 2015<br>compared to<br>2014 |
|--------------------------------|----------------------|----------------------|----------------------|-----------------------------|-----------------------------|
| Cash and cash equivalents      | \$ 52,394            | \$ 78,589            | \$ 75,945            | \$ (26,195 )                | \$ 2,644                    |
| Inventories                    | \$ 4,441             | \$ 5,723             | \$ 5,635             | \$ (1,282 )                 | \$ 88                       |
| Prepaid income taxes           | \$ 527               | \$ 2,747             | \$ 12,513            | \$ (2,220 )                 | \$ (9,766 )                 |
| Deferred tax assets, current   | \$ -                 | \$ -                 | \$ 13,341            | \$ -                        | \$ (13,341 )                |
| Receivable from earnout escrow | \$ 2,000             | \$ -                 | \$ -                 | \$ 2,000                    | \$ -                        |
| Intangible assets, net         | \$ 28,854            | \$ 6,687             | \$ 9,473             | \$ 22,167                   | \$ (2,786 )                 |
| Goodwill                       | \$ 47,185            | \$ 32,304            | \$ 32,304            | \$ 15,181                   | \$ -                        |
| Income tax payable             | \$ 1,527             | \$ -                 | \$ 9,197             | \$ 1,527                    | \$ (9,197 )                 |
| Total deferred revenue         | \$ 92,708            | \$ 102,700           | \$ 111,227           | \$ (9,992 )                 | \$ (8,527 )                 |
| Other non-current liabilities  | \$ 10,866            | \$ 11,098            | \$ 13,438            | \$ (232 )                   | \$ (2,340 )                 |

## YEAR ENDED DECEMBER 31, 2016 COMPARED TO YEAR ENDED DECEMBER 31, 2015

During the year ended December 31, 2016, cash and cash equivalents decreased \$26.2 million, primarily reflecting \$40.0 million used in the acquisition of Broadsmart, partially offset by \$15.3 million provided by operations. A detailed discussion of this change is provided in "Liquidity and Capital Resources".

During the year ended December 31, 2016, inventories decreased \$1.3 million due to reduced purchases of magicJack devices reflecting lower year-over-year sales volumes.

During the year ended December 31, 2016, prepaid income taxes decreased \$2.2 million, income tax payable increased \$1.5 million and other non-current liabilities decreased \$0.2 million due to recognition of 2016 income taxes.

During the year ended December 31, 2016, receivable from earnout escrow increased \$2.0 million. This item represents amounts placed in escrow as part of the Broadsmart acquisition, as contingent consideration to the sellers if the Broadsmart business generated 2016 revenues equal to or exceeding \$15.6 million (the "Earnout Payment"). The 2016 revenue target was not achieved and the funds are now expected to be returned to us.

During the year ended December 31, 2016, intangible assets increased \$22.2 million. The increase in intangible assets is primarily attributable to \$26.4 million in additions from the acquisition of Broadsmart, partially offset by: (i) amortization expense of \$3.5 million and (ii) impairments of \$1.0 million.

During the year ended December 31, 2016, goodwill increased \$14.9 million due to the acquisition of Broadsmart.

During the year ended December 31, 2016, total deferred revenue decreased \$10.0 million due primarily to the recognition of 2015 deferred revenue exceeding the deferral associated with 2016 sales.

## YEAR ENDED DECEMBER 31, 2015 COMPARED TO YEAR ENDED DECEMBER 31, 2014

During the year ended December 31, 2015, cash and cash equivalents increased \$2.6 million, primarily reflecting \$25.4 million provided by operations, partially offset by \$20.0 million used to repurchase treasury stock as part of our share repurchase program. A detailed discussion of this change is provided in “Liquidity and Capital Resources”.

During the year ended December 31, 2015, prepaid income taxes decreased \$9.8 million, income tax payable decreased \$9.2 million deferred tax assets, current decreased \$13.3 million and other non-current liabilities decreased \$2.3 million reflecting (i) adoption of ASU 2015-17, which requires deferred tax liabilities and assets to be classified as noncurrent in the consolidated balance sheet and (ii) settlement of an IRS audit for the years ended December 31, 2010, 2011, 2012 and 2013.

During the year ended December 31, 2015, intangible assets decreased \$2.8 million due to amortization expense.

During the year ended December 31, 2015, total deferred revenue decreased \$8.5 million due primarily to the recognition of 2014 deferred revenue exceeding the deferral associated with 2015 sales.

## RESULTS OF OPERATIONS

The following table presents our consolidated results of operations for the periods indicated (in thousands, except per share information). The 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. The components of our operating revenue and cost of revenues as presented in the following table are described below the table.

|   | Year ended<br>December 31, |          |          | 2016<br>Compared to |         | 2015<br>Compared to |         |
|---|----------------------------|----------|----------|---------------------|---------|---------------------|---------|
|   | 2016                       | 2015     | 2014     | 2015                |         | 2014                |         |
| Net revenues  |                            |          |          |                     |         |                     |         |
| Sale of magicJack devices and initial access rights | \$12,775                   | \$15,915 | \$24,564 | \$(3,140)           | (19.7)% | \$(8,649)           | (35.2)% |
| Access right renewals                               | 58,513                     | 65,761   | 65,542   | (7,248)             | (11.0)  | 219                 | 0.3     |
| Shipping and handling                               | 889                        | 794      | 2,085    | 95                  | 12.0    | (1,291)             | (61.9)  |
| magicJack-related products                          | 5,435                      | 4,289    | 7,006    | 1,146               | 26.7    | (2,717)             | (38.8)  |
| Prepaid minutes                                     | 5,677                      | 8,243    | 10,083   | (2,566)             | (31.1)  | (1,840)             | (18.2)  |
| Access and wholesale charges                        | 5,021                      | 5,953    | 7,028    | (932)               | (15.7)  | (1,075)             | (15.3)  |
| UCaaS   | 8,966                      | -        | -        | 8,966               | 100.0   | -                   | -       |
| Other   | 122                        | 7        | 14       | 115                 | 1,642.9 | (7)                 | (50.0)  |
| Total net revenues                                  | 97,398                     | 100,962  | 116,322  | (3,564)             | (3.5)   | (15,360)            | (13.2)  |
| Cost of revenues                                    |                            |          |          |                     |         |                     |         |
| Cost of devices and related products                | 8,684                      | 8,320    | 11,068   | 364                 | 4.4     | (2,748)             | (24.8)  |
| Shipping and handling                               | 1,729                      | 1,194    | 1,980    | 535                 | 44.8    | (786)               | (39.7)  |
| Credit card processing fees                         | 1,828                      | 2,260    | 2,473    | (432)               | (19.1)  | (213)               | (8.6)   |
| Network and carrier charges                         | 12,310                     | 15,352   | 19,694   | (3,042)             | (19.8)  | (4,342)             | (22.0)  |
| UCaaS   | 7,224                      | -        | -        | 7,224               | 100.0   | -                   | -       |
| Other   | 4,959                      | 7,016    | 7,326    | (2,057)             | (29.3)  | (310)               | (4.2)   |
| Total cost of revenues                              | 36,734                     | 34,142   | 42,541   | 2,592               | 7.6     | (8,399)             | (19.7)  |
| Gross profit  | 60,664                     | 66,820   | 73,781   | (6,156)             | (9.2)   | (6,961)             | (9.4)   |
| Operating expenses:                                 |                            |          |          |                     |         |                     |         |
| Marketing   | 9,085                      | 9,409    | 20,434   | (324)               | (3.4)   | (11,025)            | (54.0)  |
| General and administrative                          | 34,325                     | 27,547   | 33,912   | 6,778               | 24.6    | (6,365)             | (18.8)  |
| Research and development                            | 5,199                      | 4,521    | 5,871    | 678                 | 15.0    | (1,350)             | (23.0)  |
| Gain on mark-to-market                              | (1,700)                    | -        | -        | (1,700)             | (100.0) | -                   | -       |
| Total operating expenses                            | 46,909                     | 41,477   | 60,217   | 5,432               | 13.1    | (18,740)            | (31.1)  |
| Operating income                                    | 13,755                     | 25,343   | 13,564   | (11,588)            | (45.7)  | 11,779              | 86.8    |
| Other income (expense):                             |                            |          |          |                     |         |                     |         |
| Gains on investments                                | -                          | -        | 37       | -                   | *       | (37)                | *       |
| Interest and dividend income                        | 26                         | 26       | 117      | -                   | *       | (91)                | *       |
| Interest expense                                    | -                          | (57)     | (192)    | 57                  | *       | 135                 | *       |
| Other (expense) income, net                         | (6)                        | -        | 4        | (6)                 | *       | (4)                 | *       |
| Total other (expense) income                        | 20                         | (31)     | (34)     | 51                  | *       | 3                   | *       |
| Income before income taxes                          | 13,775                     | 25,312   | 13,530   | (11,537)            | (45.6)  | 11,782              | *       |
| Income tax expense                                  | 8,719                      | 11,802   | 9,745    | (3,083)             | (26.1)  | 2,057               | *       |
| Net income  | 5,056                      | 13,510   | 3,785    | (8,454)             | (62.6)  | 9,725               | *       |

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|  |         |          |         |            |         |         |   |
|--|---------|----------|---------|------------|---------|---------|---|
| Loss attributable to noncontrolling interest                           | (635 )  | -        | -       | (635 )     | *       | -       | * |
| Net income attributable to magicJack VocalTec Ltd. common shareholders | \$5,691 | \$13,510 | \$3,785 | \$(7,819 ) | (57.9 ) | \$9,725 | * |
| Income per magicJack VocalTec Ltd common share:                        |         |          |         |            |         |         |   |
| Basic  | \$0.36  | \$0.80   | \$0.21  | \$(0.44 )  | (55.0 ) | \$0.59  | * |
| Diluted  | \$0.35  | \$0.79   | \$0.21  | \$(0.44 )  | (55.2 ) | \$0.58  | * |

\* - Not meaningful.

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## Components of Net Revenues

Our net revenues are comprised of the following sources:

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

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

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

magicJack-related products – represent revenues recognized from sale of other items related to the magicJack devices and access right renewals we offer our customers, including: (i) porting fees charged to customers to port their existing phone number to a magicJack device or service, (ii) fees charged for customers to select a custom, vanity or Canadian phone number, (iii) fees charged to customers to change their existing number, (iv) insurance covering the replacement of a damaged or lost device, and (v) sale of battery powerbanks. These revenues are recognized at the time of sale, with the exception of sales of the battery powerbank which are recognized when shipped;

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

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

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

Other revenues – represent VoIP services provided to small to medium sized businesses through the SMB segment and revenues generated by ancillary revenue sources

## Components of Cost of Revenues

Our cost of revenues is comprised of the following components:

Cost of devices and related products – represent the costs of components and manufacturing of the magicJack devices, as well as production, packaging and other inventory-related costs and broker commissions on devices and mobile apps. The costs of the magicJack devices and mobile apps are recognized over the initial three, six or twelve month access right period. The cost of battery powerbanks is expensed as incurred;

Shipping and handling – represent 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 direct customers. These costs are expensed as incurred;



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Credit card processing fees – represent 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 direct to customers through our website. These fees are expensed as incurred;

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

UCaaS – represents the cost of providing the recurring monthly hosted services including, network usage charges, customer internet access, amortization expense and commissions as well as the cost of hardware and network equipment related to non-recurring sales, provided by our Broadsmart subsidiary. These costs are expensed as incurred; and

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

### YEAR ENDED DECEMBER 31, 2016 COMPARED TO YEAR ENDED DECEMBER 31, 2015

#### Net Revenues

Total net revenues were \$97.4 million and \$101.0 million for the years ended December 31, 2016 and 2015, respectively, representing a decrease of \$3.6 million, or 3.5%. The decreases in the components of net revenues were primarily attributable to the following:

- \$7.2 million net decrease in access right renewal and mobile App revenues;
- \$2.6 million decrease in revenues from prepaid minutes resulting from lower usage levels;
- \$3.1 million decrease in magicJack device sales revenues, primarily reflecting lower retail sales volumes; and
- \$0.9 million decrease in revenues from access and wholesale charges.

These decreases in components of net revenues were partially offset by \$9.0 million in sales related to Broadsmart UCaaS revenues and a \$1.1 million increase in revenues from the sale of magicJack-related products.

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

For the years ended December 31, 2016 and 2015, no retailer accounted for more than 10% of net revenues for the Core Consumer segment. For the year ended December 31, 2016, two customers accounted for 29% of net revenue for the Enterprise segment. Revenue for the SMB segment was not significant for the year ended December 31, 2016.

#### Cost of Revenues

Total cost of revenues was \$36.7 million and \$34.1 million for the years ended December 31, 2016 and 2015, respectively, representing an increase of approximately \$2.6 million, or 7.6%. This increase in cost of revenues was primarily attributable to:

- \$7.2 million in Broadsmart UCaaS related cost of goods sold, which included approximately \$2.1 million in depreciation and amortization expense related to acquired assets,

· a \$0.5 million increase in shipping and handling costs reflecting an increase in direct sales volume, and  
· a \$0.4 million increase in the cost of devices and related products due to (a) a \$0.8 million increase in broker commissions, primarily related to the mobile app sales, and (b) a \$0.6 million increase in the cost of powerbanks, partially offset by a \$1.0 million decrease in the cost of magicJack devices.

These increases in components of cost of revenues were partially offset by: (i) a \$3.0 million decrease in network and carrier charges primarily as a result of lower traffic substantially resulting from the elimination of free App users at the end of Q2 2016, (ii) \$2.1 million decrease in other cost of revenues primarily attributable to a decrease in overhead allocation reflecting lower personnel related costs and amortization expense, and (iii) a \$0.4 million decrease in credit card processing fees.

## Operating Expenses

Total operating expenses were \$46.9 million and \$41.5 million for the years ended December 31, 2016 and 2015, respectively, representing an increase of \$5.4 million, or 13.1%. This increase in operating expenses is primarily attributable to:

a \$6.8 million increase in G&A expense due to several factors including: (a) \$6.1 million in costs associated with the SMB segment, (b) \$3.1 million in costs associated with the Broadsmart UCaaS business, (c) \$1.1 million in costs associated with our joint venture, and (c) \$1.0 million impairment of intangible assets; partially offset by cost reductions in the Core Consumer segment totaling \$4.5 million, primarily in the areas of personnel related costs and customer care related costs; and

a \$1.3 million increase in R&D expenses related to the new SMB segment, partially offset by cost reductions of \$0.7 million in the Core Consumer segment.

These increases were partially offset by a \$1.7 million gain on mark-to-market related to the Broadsmart Earnout Payment. There was also a small net decrease of \$0.3 million in consolidated marketing expense. By segment, the changes were a \$4.6 million decrease in the Core Consumer segment due to reduced media buys and personnel related costs, partially offset by the addition of: (a) \$3.5 million in costs associated with the SMB segment, (b) \$0.4 million in costs associated with the Enterprise segment (Broadsmart), and (c) \$0.4 million in costs associated with the “Other” segment.

## Other Income (Expense)

Total other income (expense) was not significant for the years ended December 31, 2016 and 2015.

## Income Taxes

Total income tax expense was \$8.7 million and \$11.8 million for the years ended December 31, 2016 and 2015, respectively. The calculation of our effective income tax rate for the years ended December 31, 2016 and 2015 is as follows (in thousands):

|                              | Year Ended December 31, |           |   |  |
|------------------------------|-------------------------|-----------|---|--|
|                              | 2016                    | 2015      |   |  |
| Income before taxes          | \$ 13,775               | \$ 25,312 |   |  |
| Income tax expense (benefit) | 8,719                   | 11,802    |   |  |
| Effective income tax rate    | 63.30                   | % 46.63   | % |  |

We primarily operate in the U.S. and Israel. Our U.S. operations are subject to a federal statutory income tax rate of 34% in 2016 and 2015 and our Israeli operations are subject to a statutory income tax rate of 25.0% in 2016 and 26.5% in 2015. Our Israeli operations will be subject to a statutory income tax rate of 24.0% in 2017 and 23.0% in 2018. The income tax provision for 2016 and 2015 included items that have resulted in significant variances in our effective tax rate in comparison to statutory rates.

For the year ended December 31, 2016, we recorded an income tax expense of \$8.7 million, which is higher than the expected tax provision of \$4.7 million, using the statutory income tax rate of 34% due, in part, to the net impact of a decrease in the Israeli corporate tax rate from 26.5% to 23.0% which was effective in December 2016. The decrease in the rate resulted in the need to reduce our Israeli deferred tax assets, primarily net operating loss carryforwards, which resulted in deferred tax expense and a reduction in the value of related deferred tax assets of \$5.2 million.

Additionally, the effective tax rate was impacted by increases to uncertain tax positions of (\$0.8 million), decreases in valuation allowances of (\$1.2 million), and other items of \$0.8 million. The items noted above were partially offset by the lower jurisdictional tax rate charged on the operating income of our Israeli operations.

The 2017 estimated annual effective tax rate is expected to approximate 35%, excluding discrete tax items, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

For the year ended December 31, 2015, we recorded income tax expense of \$11.8 million, which differed from the expected provision of \$8.6 million, using the statutory rate of 34%, primarily due to changes in valuation allowances of \$1.3 million established against certain Israeli capital losses and state net operating loss carryforwards, increases to uncertain tax positions of \$0.5 million, a decrease to deferred tax assets associated with expired stock options of \$0.7 million, and other one-time discrete items of \$0.7 million. State income tax (benefit), net of federal tax benefit, is presented in the effective tax rate reconciliation exclusive of changes in valuation allowances on state income tax deferred items.

As of December 31, 2016 and 2015, we had an income tax payable and prepaid income taxes balance of \$1.0 million and \$2.7 million, respectively.

## Noncontrolling Interest

During the year ended December 31, 2016, we formed a new subsidiary and entered into a joint venture with an unrelated third party which resulted in a 60% controlling interest in the joint venture which began selling a line of high-technology residential consumer products in the fourth quarter of fiscal year 2016. To date we have spent approximately \$1.6 million funding the operations of this joint venture. The operations of the joint venture for the year ended December 31, 2016 have not been significant to our financial statements. Our consolidated financial statements for the year ended December 31, 2016, include an adjustment to income attributable to magicJack VocalTec Ltd. common shareholders of \$635 thousand, to recognize the impact of the noncontrolling interest. We have determined that the joint venture does not meet either the aggregation criteria to be combined with the existing Core Consumer segment or the quantitative thresholds to be treated as a separately reportable segment. As such, it is included in "Other" in our segment reconciliation. Refer to Note 16, "Segment Reporting," in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

## Net Income Attributable to Common Shareholders and Income Per Share

As a result of the foregoing items, net income attributable to common shareholders decreased to \$5.7 million in 2016 as compared to \$13.5 million in 2015, primarily as a result of net losses of \$11.0 million, \$2.2 million and \$1.6 million in the SMB, Enterprise and "Other" segments, respectively. The losses were partially offset by an increase in net income of \$7.0 million from the Core Consumer segment and an adjustment of \$0.6 million for the impact of the noncontrolling interest. Income per diluted share attributable to magicJack VocalTec Ltd. common shareholders decreased to \$0.35 per common share in 2016 as compared to \$0.79 per common share in 2015 due to the decrease in net income, partially offset by a decrease of approximately 1.0 million (or 5.8%) in the weighted average number of common shares outstanding in 2016 as compared to 2015 primarily due to our 2015 share repurchase program.

## YEAR ENDED DECEMBER 31, 2015 COMPARED TO YEAR ENDED DECEMBER 31, 2014

### Net Revenues

Total net revenues were \$101.0 million and \$116.3 million for the years ended December 31, 2015 and 2014, respectively, representing a decrease of \$15.4 million, or 13.2%. The decreases in the components of net revenues were primarily attributable to the following:

- a \$8.7 million decrease in revenues recognized for the sale of magicJack devices, primarily as a result of lower unit volume on the sale of magicJack devices;
- a \$1.3 million decrease in shipping and handling revenues primarily as a result of the reduction in unit sales mentioned above;
- a \$2.7 million decrease in other magicJack related products reflecting lower unit sales on the device;
- a \$1.8 million decrease in revenues from prepaid minutes primarily as a result of lower usage of prepaid minutes and;
- a \$1.1 million decrease in access and wholesale charges primarily reflecting lower network traffic.

These decreases in components of net revenues were partially offset by a \$0.2 million increase in access right renewals.

In the years ended December 31, 2015 and 2014, sales of the magicJack devices through retail outlets represented approximately 67% and 72%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales

represented approximately 33% and 28%, respectively, of magicJack devices sold.

For the years ended December 31, 2015 and 2014, no retailer accounted for more than 10% of our total net revenues.

#### Cost of Revenues

Total cost of revenues was \$34.1 million and \$42.5 million for the years ended December 31, 2015 and 2014, respectively, representing a decrease of \$8.4 million, or 19.7%. This decrease in cost of revenues was primarily attributable to:

- a \$3.8 million combined decrease in costs related to the magicJack devices, shipping and handling and credit card processing fees primarily reflecting lower unit sales of the magicJack device;
- a \$4.3 million reduction in network and carrier charges reflecting lower network volume and continuing efforts to negotiate more favorable rates with other carriers and;
- a \$0.3 million decrease in other cost of revenues primarily reflecting lower amortization expense on certain intangible assets.

## Operating Expenses

Total operating expenses were \$41.5 million and \$60.2 million for the years ended December 31, 2015 and 2014, respectively, representing a decrease of \$18.7 million, or 31.1%. This decrease in operating expenses was primarily due to:

a \$11.0 million decrease in marketing-related expense driven by (i) a \$7.2 million decrease in advertising media buys reflecting management's decision not to spend significantly on media buys, (ii) a \$1.2 million decrease in marketing related personnel costs driven by a decrease in head-count, and (iii) a \$2.6 million decrease in sponsorships and other advertising spend reflecting a more conservative approach to our marketing spend in 2015;

a \$6.4 million decrease in general & administrative expenses primarily due to (i) approximately \$5.0 million in lower legal and other professional expenses reflecting less litigation, and the settlement of certain regulatory and tax-related matters and other disputes, (ii) \$1.7 million lower customer care related expenses, and (iii) \$3.4 million in lower amortization expense and lower impairment charges related to the write-off of the \$2.5 million net carrying value associated with a non-compete agreement with our founder and former CEO in 2014 with no comparable expense in 2015. These decreases were partially offset by a \$3.1 increase in personnel related costs primarily reflecting severance expense and higher accrued bonus amounts year-over-year and;

a \$1.4 million decrease in research and development costs primarily reflecting lower personnel related expenses and a decrease in research and development related consulting costs.

Our combined advertising-related expenses decreased by approximately 54% for the year ended December 31, 2015 as compared to December 31, 2014 primarily due to increased advertising efforts in the year ended December 31, 2014 related to the launch of the magicJack GO device and our new advertising campaign and brand refresh. During the year ended December 31, 2015, we reduced our advertising media buys. Advertising-related expenses have varied historically, and may continue to vary from quarter to quarter.

## Other Income (Expense)

Total other expense was not significant for the years ended December 31, 2015 and 2014.

## Income Taxes

Total income tax expense was \$11.8 million and \$9.7 million for the years ended December 31, 2015 and 2014, respectively. The calculation of our effective tax rate for the years ended December 31, 2015 and 2014 was as follows (in thousands):

|                              | Year Ended December 31, |           |
|------------------------------|-------------------------|-----------|
|                              | 2015                    | 2014      |
| Income before taxes          | \$ 25,312               | \$ 13,530 |
| Income tax expense (benefit) | 11,802                  | 9,745     |
| Effective income tax rate    | 46.63 %                 | 72.03 %   |

We primarily operate in the U.S. and Israel. Our U.S. operations are subject to a federal statutory income tax rate of 34%, and our Israeli operations are subject to a statutory income tax rate of 26.5% in 2015 and 2014. The income tax provision for 2015 and 2014 included items that have resulted in significant variances in our effective tax rate in comparison to statutory rates.

For the year ended December 31, 2015, we recorded income tax expense of \$11.8 million, which differed from the expected provision of \$8.6 million, using the statutory rate of 34%, primarily due to changes in valuation allowances of \$1.3 million established against certain Israeli capital losses and state net operating loss carryforwards, increases to uncertain tax positions of \$0.5 million, a decrease to deferred tax assets associated with expired stock options of \$0.7 million, and other one-time discrete items of \$0.7 million. State income tax (benefit), net of federal tax benefit, is presented in the effective tax rate reconciliation exclusive of changes in valuation allowances on state income tax deferred items.

For the year ended December 31, 2014, we recorded income tax expense of \$9.7 million, which differed from the expected tax provision of \$5.0 million, using the statutory rate of 34%, primarily due to an increase in the U.S. uncertain tax positions of \$6.4 million, as well as the effect of changes in the exchange rate on both our net deferred tax assets associated with our Israeli operations of \$2.5 million, and taxable unrealized gains on the Israeli parent's U.S. dollar denominated assets of \$6.4 million. These items were partially offset by an income tax benefit in our foreign taxes associated with expected revisions to jurisdictional income allocations resulting from the IRS audit examination of \$5.3 million, and by the jurisdictional rate differential between the U.S. and Israel of \$3.7 million and an adjustment of our estimate of the required valuation allowance of \$1.2 million. Our Israeli operations resulted in an income tax provision of \$5.2 million, an effective tax rate of 28.9%, and our domestic operations recorded a provision of \$4.5 million for the year ended December 31, 2014.



As of December 31, 2015 and 2014, we had a prepaid income taxes balance of \$2.7 million and \$12.5 million, respectively, which was available to offset potential payments related to the uncertain tax liabilities disclosed above.

#### Net Income Attributable to Ordinary Shareholders and Income Per Share

As a result of the foregoing items, net income attributable to ordinary shareholders increased to \$13.5 million in 2015 as compared to \$3.8 million in 2014. Income per diluted share attributable to ordinary shareholders increased to \$0.79 per ordinary share in 2015 as compared to \$0.21 per ordinary share in 2014 as a result of higher net operating income in 2015 as compared to 2014, and by a decrease of approximately 0.8 million (or 4.6%) in the weighted average number of ordinary shares outstanding in 2015 as compared to 2014 primarily due to our share repurchase program.

#### LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash generated from operations, cash on hand, and investments. As of December 31, 2016, we had cash and cash equivalents of \$52.4 million, investments of \$0.4 million and accounts receivables of \$3.2 million. Accounts payable and income taxes payable at December 31, 2016, were \$2.8 million and \$1.4 million, respectively. During the year ended December 31, 2016 our cash decreased from \$78.6 million as of December 31, 2015 to \$52.4 million as of December 31, 2016, as we made two significant investments in our future to diversify our revenue sources and customer base. Those two investments were the \$40.0 million acquisition of Broadsmart for our Enterprise segment in March 2016 and the year-long development of the SMB segment which resulted in an \$11.0 million investment. These two initiatives are intended to diversify the Company's operations in light of the declining Core Consumer business centered on the magicJack device and related products and services.

During the year ended December 31, 2016, we generated positive operating cash flows of \$15.3 million, as compared to \$25.4 million for the year ended December 31, 2015. The \$10.1 million decrease was primarily attributable to the decrease in net income discussed above, most notably the \$11.0 million investment in the new SMB segment. Net income was \$5.1 million for the year ended December 31, 2016 as compared to a \$13.5 million for the year ended December 31, 2015. We currently believe that available funds and cash flows generated by operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months. If we decide to make future acquisitions, we may require new sources of funding, including 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 on acceptable terms.

#### Cash Flow – Operating Activities

Net cash provided by operating activities was \$15.3 million, \$25.4 million and \$25.0 million for the years ended December 31, 2016, 2015 and 2014, respectively.

During the year ended December 31, 2016, net cash provided by operating activities was primarily attributable to: (i) \$5.1 million of net income; (ii) \$12.7 million in non-cash items consisting primarily of (a) \$4.2 million of share-based compensation expense, (b) \$4.7 million of depreciation and amortization expense, (c) a \$1.0 million impairment of intangible assets, (d) a \$0.3 million increase in uncertain tax positions, and (e) a \$4.4 million decrease in deferred income tax provision, partially offset by a \$1.7 million gain on mark-to-market related to the Broadsmart Earnout Payment; (iii) a \$1.6 million decrease in inventory levels; (iv) a \$2.0 million decrease in prepaid income taxes; (v) a \$1.5 million increase in accounts payable, and (vi) a \$1.5 million increase in income taxes payable. These items were partially offset by: (i) a \$10.2 million decrease in deferred revenue; (ii) a \$1.0 million decrease in accrued expenses and other current liabilities; and (iii) a \$0.4 million increase in deposits and other current assets.

During the year ended December 31, 2015, net cash provided by operating activities was primarily attributable to (i) \$13.5 million net income, (ii) \$20.1 million in net non-cash items consisting primarily of, \$5.3 million in share-based compensation related primarily to ordinary share options and restricted stock units issued to executives, \$3.6 million

of depreciation and amortization expense, \$12.9 million in deferred tax expense, \$0.1 million in the provision for billing adjustments, and \$0.1 million in non-cash interest, offset in part by a \$1.8 million decrease in uncertain tax positions, (iii) \$0.7 million decrease in deferred costs related to the magicJack device, (iv) a \$3.1 million decrease in prepaid income taxes, (v) a \$1.6 million increase in accrued bonus, and (vi) \$0.9 million decrease in accounts receivable; offset in part by (i) \$8.5 million decrease in deferred revenues primarily as a result of lower sales of magicJack devices, (ii) \$0.1 million increase in inventories, (iii) \$1.0 million increase in deposits and other current assets, (iv) \$1.8 million decrease in accounts payable, (v) a \$0.9 million decrease in income taxes payable and (vi) \$2.3 million decrease in accrued expenses and other current liabilities.

During the year ended December 31, 2014, net cash provided by operating activities was primarily attributable to (i) \$3.8 million net income, (ii) \$24.8 million in net non-cash items consisting primarily of, \$7.2 million in share-based compensation related primarily to ordinary share options and restricted stock units issued to executives, \$14.2 million increase in uncertain tax positions, \$4.8 million depreciation and amortization expense, \$2.5 million in impairment of intangible assets, \$0.4 million in the provision for billing adjustments, and \$0.2 million in non-cash interest, offset in part by a \$4.4 million deferred tax benefit, (iii) \$1.9 million decrease in deferred costs related to the magicJack device, and (iv) \$0.7 million increase in accounts payable; offset in part by (i) \$3.3 million decrease in deferred revenues as a result of lower sales of magicJack devices, (ii) \$1.1 million increase in inventories, (iii) \$0.9 million increase in deposits and other current assets, (iv) \$0.7 million increase in accounts receivable, and (v) \$0.3 million decrease in accrued expenses and other current liabilities.

#### Cash Flow – Investing Activities

Net cash (used in) provided by investing activities was (\$41.0) million, \$(1.0) million and \$6.4 million for the years ended December 31, 2016, 2015 and 2014, respectively.

Net cash used in investing activities during the year ended December 31, 2016 was primarily attributable to the acquisition of Broadsmart.

Net cash used in investing activities during the year ended December 31, 2015 was attributable \$1.0 million used for purchases of property and equipment.

Net cash provided by investing activities during the year ended December 31, 2014 was primarily attributable to \$9.1 million net proceeds from the sale of investments, partially offset by \$2.2 million used for purchases of property and equipment, and \$0.5 million used for acquisition of certain intangible assets.

#### Cash Flow –Financing Activities

Net cash used in financing activities was \$0.4 million, \$21.7 million and \$1.5 million for the years ended December 31, 2016, 2015 and 2014, respectively.

No significant cash was (used in) or provided by financing activities for the year ended December 31, 2016.

Net cash used in financing activities during the year ended December 31, 2015 primarily consisted of: (i) \$20.0 million in cash used to purchase treasury stock as part of our share repurchase program, (ii) payment of \$1.5 million for the last of five installment payments for the purchase of certain intangible assets in 2011, and (iii) \$0.2 million in cash used to repurchase shares to settle executives' tax withholding liability upon the vesting of restricted stock units during the year.

Net cash used in financing activities for the year ended December 31, 2014 consisted primarily of a payment of \$1.5 million for the fourth of five installment payments for the purchase of certain intangible assets in 2011.

#### Stock Repurchase Program

In the first quarter of 2015, our Board of Directors authorized a stock repurchase program to enable us to purchase our ordinary shares at such times as management deemed appropriate up to a maximum cumulative repurchase authority of \$20.0 million. The objective of our stock repurchase program was to improve stockholders' returns. As of December 31, 2015, we had expended the maximum authorized amount of \$20.0 million for the acquisition of ordinary shares under the 2015 stock repurchase program. All shares purchased, and not yet retired, are recorded as treasury shares. We repurchased 2,329,003 ordinary shares under this program through December 31, 2015. We had no stock repurchase activity in the year ended December 31, 2016.

Our Board of Directors had previously authorized a stock repurchase program to enable us to purchase our ordinary shares at such times as management deemed appropriate up to a maximum cumulative repurchase authority of \$100.0 million. The objective of our stock repurchase program was to improve stockholders' returns. As of December 31, 2014, we had repurchased \$91.3 million of ordinary shares under the previous stock repurchase program, and there was \$8.7 million that remained authorized to purchase ordinary shares pursuant to the stock repurchase program. This program was terminated when our Board of Directors approved the new \$20.0 million program in the first quarter of 2015. All shares purchased, and not yet retired, were recorded as treasury shares. There was no repurchase activity related to our previous stock repurchase program for the years ended December 31, 2016, 2015 or 2014. We repurchased 6,143,731 ordinary shares under this program through December 31, 2015.

We have in the past bought call option contracts and sold put option contracts in connection with our share repurchase program in order to attempt to lower the average share price paid for ordinary shares it purchased. There were no outstanding put option contracts at December 31, 2016 or 2015, and we do not expect to buy call options or sell common equity put options in the future as part of any share repurchase program. We did not purchase any call option contracts or sell any put option contracts during the years ended December 31, 2016 or December 31, 2015.

#### Other Liabilities

As of December 31, 2014, we 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 it made a final non-interest bearing payment of \$1.5 million on May 31, 2015. The liability for such payments was discounted at a rate of 10% to a net present value of \$1.4 million at December 31, 2014. Refer to Note 9, "Other Liabilities," in the Notes to our Consolidated Financial Statements included in Item 8 herein for further details.

#### RECENT ACCOUNTING PRONOUNCEMENTS

Refer to Note 2, "Summary of Accounting Policies," in the Notes to our Consolidated Financial Statements included in Item 8 herein for details.

#### CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

##### Contractual Obligations

The impact that our aggregate contractual obligations as of December 31, 2016 are expected to have on our liquidity and cash flow in future periods is as follows (in thousands):

|                               | Payments Due by Period |                  |           |           |                   |         |
|-------------------------------|------------------------|------------------|-----------|-----------|-------------------|---------|
|                               | Total                  | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years | Other   |
| Operating lease obligations   | \$2,860                | \$ 1,156         | \$ 1,506  | \$ 170    | \$ 28             | \$-     |
| Accrued severance pay (1)     | \$1,038                | \$ 637           | \$ -      | \$ -      | \$ 401            | \$-     |
| Uncertain tax positions (2)   | \$10,435               | \$ -             | \$ 1,176  | \$ 1,211  | \$ -              | \$8,048 |
| Total contractual obligations | \$14,333               | \$ 1,793         | \$ 2,682  | \$ 1,381  | \$ 429            | \$8,048 |

(1)  
As  
of  
December  
31,  
2016,  
we  
had  
\$0.3  
million  
in  
severance  
pay  
funds  
in  
reserve  
to

settle  
such  
liabilities.  
(2) As of  
December  
31, 2016,  
we had  
\$8.0  
million in  
uncertain  
tax  
liabilities  
for which  
the  
Company  
can not  
reliably  
estimate  
the period  
of cash  
settlement.

#### Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements as of December 31, 2016.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Exposure to Interest Rates

The primary objective of the Company's investment activities is to preserve its capital until it is required to fund operations while at the same time maximizing the income the Company receives from its investments without incurring investment market volatility risk. The Company's 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 the Company's cash and cash equivalents. Due to the short-term nature of the Company's cash and cash equivalent holdings, a 10% movement in market interest rates would not materially impact the total fair market value of the Company's portfolio as of December 31, 2016.

Exposure to Exchange Rates

The Company's overseas expenses are incurred primarily in connection with the manufacturing of the magicJack devices and expenses related to its operations in Israel. The majority of the Company's 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 the Company's expenses that are influenced by exchange rate fluctuations, a 10% movement in currency exchange rates would not materially impact the Company's results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
magicJack VocalTec Ltd. and Subsidiaries  
Netanya, Israel

We have audited the accompanying consolidated balance sheets of magicJack VocalTec Ltd. and Subsidiaries (the “Company”) as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income, capital equity and cash flows for each of the three years in the period ended December 31, 2016. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of magicJack VocalTec Ltd. and Subsidiaries at December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), magicJack VocalTec Ltd. and Subsidiaries’ internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control-Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and our report dated March 16, 2017 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP  
Certified Public Accountants  
West Palm Beach, Florida

March 16, 2017

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

|   | December 31, |           |
|---|--------------|-----------|
|   | 2016         | 2015      |
| <b>ASSETS</b>   |              |           |
| Current assets:   |              |           |
| Cash and cash equivalents   | \$52,394     | \$78,589  |
| Investments, at fair value  | 447          | 367       |
| Accounts receivable, net of allowance for doubtful accounts and billing adjustments of \$402 and \$455, respectively                  | 3,171        | 2,925     |
| Inventories, net  | 4,441        | 5,723     |
| Deferred costs  | 2,319        | 2,097     |
| Prepaid income taxes  | 527          | 2,747     |
| Receivable from earnout escrow  | 2,000        | -         |
| Deposits and other current assets   | 1,970        | 2,655     |
| Total current assets  | 67,269       | 95,103    |
| Property and equipment, net   | 3,805        | 3,302     |
| Intangible assets, net  | 28,854       | 6,687     |
| Goodwill  | 47,185       | 32,304    |
| Deferred tax assets   | 26,568       | 30,689    |
| Deposits and other non-current assets   | 836          | 751       |
| Total assets  | \$174,517    | \$168,836 |
| <b>LIABILITIES AND CAPITAL EQUITY</b>   |              |           |
| Current liabilities:  |              |           |
| Accounts payable  | \$2,790      | \$1,086   |
| Income tax payable  | 1,527        | -         |
| Accrued expenses and other current liabilities  | 8,426        | 6,284     |
| Deferred revenue, current portion   | 48,507       | 52,554    |
| Total current liabilities   | 61,250       | 59,924    |
| Deferred revenue, net of current portion  | 44,201       | 50,146    |
| Other non-current liabilities   | 10,866       | 11,098    |
| Total liabilities   | 116,317      | 121,168   |
| Commitments and contingencies (Note 10)   |              |           |
| Capital equity  |              |           |
| Ordinary shares, No par value; 100,000 shares authorized; 25,039 and 25,036 shares issued at December 31, 2016 and 2015, respectively | 111,783      | 111,773   |
| Additional paid-in capital  | 13,567       | 14,573    |
| Treasury stock (8,988 and 9,426 shares at December 31, 2016 and 2015, respectively)   | (120,300)    | (126,772) |
| Retained earnings   | 53,785       | 48,094    |
| Total magicJack VocalTec Ltd. shareholders' equity  | 58,835       | 47,668    |
| Noncontrolling interest   | (635)        | -         |
| Total capital equity  | 58,200       | 47,668    |
| Total liabilities and capital equity  | \$174,517    | \$168,836 |

See accompanying notes to consolidated financial statements.



MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share information)

|   | Year Ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2016                    | 2015      | 2014      |
| Net revenues  | \$97,398                | \$100,962 | \$116,322 |
| Cost of revenues  | 36,734                  | 34,142    | 42,541    |
| Gross profit  | 60,664                  | 66,820    | 73,781    |
| Operating expenses:   |                         |           |           |
| Marketing   | 9,085                   | 9,409     | 20,434    |
| General and administrative  | 34,325                  | 27,547    | 33,912    |
| Research and development  | 5,199                   | 4,521     | 5,871     |
| Gain on mark-to-market  | (1,700 )                | -         | -         |
| Total operating expenses  | 46,909                  | 41,477    | 60,217    |
| Operating income  | 13,755                  | 25,343    | 13,564    |
| Other income (expense):   |                         |           |           |
| Gains on investments  | -                       | -         | 37        |
| Interest and dividend income  | 26                      | 26        | 117       |
| Interest expense  | -                       | (57 )     | (192 )    |
| Other (expense) income, net   | (6 )                    | -         | 4         |
| Total other income (expense)  | 20                      | (31 )     | (34 )     |
| Income before income taxes  | 13,775                  | 25,312    | 13,530    |
| Income tax expense  | 8,719                   | 11,802    | 9,745     |
| Net income  | 5,056                   | 13,510    | 3,785     |
| Net loss attributable to noncontrolling interest                              | 635                     | -         | -         |
| Net income attributable to magicJack VocalTec Ltd. common shareholders        | \$5,691                 | \$13,510  | \$3,785   |
| Income per share attributable to magicJack VocalTec Ltd. common shareholders: |                         |           |           |
| Basic   | \$0.36                  | \$0.80    | \$0.21    |
| Diluted   | \$0.35                  | \$0.79    | \$0.21    |
| Weighted average common shares outstanding:                                   |                         |           |           |
| Basic   | 15,815                  | 16,975    | 17,831    |
| Diluted   | 16,064                  | 17,045    | 17,868    |

See accompanying notes to consolidated financial statements.

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

|  | Year Ended December 31, |          |         |
|--|-------------------------|----------|---------|
|  | 2016                    | 2015     | 2014    |
| Net income   | \$5,056                 | \$13,510 | \$3,785 |
| Other comprehensive income (loss):   |                         |          |         |
| Reclassification of unrealized loss on marketable securities to realized gain on investments | -                       | -        | 642     |
| Comprehensive income   | 5,056                   | 13,510   | 4,427   |
| Comprehensive income attributable to noncontrolling interest                                 | 635                     | -        | -       |
| Comprehensive income attributable to magicJack VocalTec Ltd. common shareholders             | \$5,691                 | \$13,510 | \$4,427 |

See accompanying notes to consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CAPITAL EQUITY  
For the Years Ended December 31, 2016, 2015 and 2014  
(in thousands)

|   | Common Stock |            | Additional<br>Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Treasury Stock |             | Retained<br>Earnings | Noncontrol-<br>ling<br>Interest | Total<br>Capital<br>Equity |
|---|--------------|------------|----------------------------------|---|----------------|-------------|----------------------|---------------------------------|----------------------------|
|   | Number       | Amount     |                                  |   | Number         | Amount      |                      |                                 |                            |
| Balance,<br>December 31,<br>2013  | 25,029       | \$ 111,744 | \$ 3,692                         | \$ (642 )   | (7,202)        | \$(108,151) | \$ 30,799            | \$ -                            | \$ 37,442                  |
| Exercise of<br>ordinary share<br>options  | 3            | 27         | -                                | -   | -              | -           | -                    | -                               | 27                         |
| Share-based<br>compensation   | -            | -          | 7,190                            | -   | -              | -           | -                    | -                               | 7,190                      |
| Issuance of<br>ordinary shares  | -            | -          | (468 )                           | -   | 38             | 468         | -                    | -                               | -                          |
| Release of<br>unrealized loss on<br>marketable<br>securities to gains<br>on investments | -            | -          | -                                | 642   | -              | -           | -                    | -                               | 642                        |
| Net income  | -            | -          | -                                | -   | -              | -           | 3,785                | -                               | 3,785                      |
| Balance,<br>December 31,<br>2014  | 25,032       | 111,771    | 10,414                           | -   | (7,164)        | (107,683)   | 34,584               | -                               | 49,086                     |
| Exercise of<br>ordinary share<br>options  | 4            | 2          | -                                | -   | -              | -           | -                    | -                               | 2                          |
| Share-based<br>compensation   | -            | -          | 5,268                            | -   | -              | -           | -                    | -                               | 5,268                      |
| Issuance of<br>ordinary shares  | -            | -          | (1,109 )                         | -   | 90             | 1,109       | -                    | -                               | -                          |
| Purchase of<br>treasury stock   | -            | -          | -                                | -   | (2,352)        | (20,198 )   | -                    | -                               | (20,198)                   |
| Net income  | -            | -          | -                                | -   | -              | -           | 13,510               | -                               | 13,510                     |
| Balance,<br>December 31,<br>2015  | 25,036       | 111,773    | 14,573                           | -   | (9,426)        | (126,772)   | 48,094               | -                               | 47,668                     |
| Exercise of<br>ordinary share<br>options  | 3            | 10         | -                                | -   | -              | -           | -                    | -                               | 10                         |
| Share-based<br>compensation   | -            | -          | 4,220                            | -   | -              | -           | -                    | -                               | 4,220                      |
|   | -            | -          | (3,293 )                         | -   | 267            | 3,293       | -                    | -                               | -                          |

|                                    |        |            |           |      |         |             |           |           |           |
|------------------------------------|--------|------------|-----------|------|---------|-------------|-----------|-----------|-----------|
| Issuance of ordinary shares        |        |            |           |      |         |             |           |           |           |
| Issuance of shares for acquisition | -      | -          | (1,933 )  | -    | 233     | 3,609       | -         | -         | 1,676     |
| Purchase of treasury stock         | -      | -          | -         | -    | (62 )   | (430 )      | -         | -         | (430 )    |
| Net income                         | -      | -          | -         | -    | -       | -           | 5,691     | (635 )    | 5,056     |
| Balance, December 31, 2016         | 25,039 | \$ 111,783 | \$ 13,567 | \$ - | (8,988) | \$(120,300) | \$ 53,785 | \$ (635 ) | \$ 58,200 |

See accompanying notes to consolidated financial statements.

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

|   | Year Ended December 31, |          |          |
|---|-------------------------|----------|----------|
|   | 2016                    | 2015     | 2014     |
| Cash flows from operating activities:   |                         |          |          |
| Net income  | \$5,056                 | \$13,510 | \$3,785  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |          |          |
| Provision for doubtful accounts and billing adjustments                           | 203                     | 81       | 444      |
| Share-based compensation  | 4,220                   | 5,268    | 7,190    |
| Depreciation and amortization   | 4,733                   | 3,585    | 4,823    |
| Gain on mark-to-market  | (1,700 )                | -        | -        |
| Impairment of intangible assets   | 998                     | -        | 2,464    |
| (Decrease) increase of uncertain tax positions                                    | (315 )                  | (1,789 ) | 14,166   |
| Deferred income tax provision (benefit)   | 4,418                   | 12,863   | (4,423 ) |
| Interest expense - non-cash   | -                       | 57       | 192      |
| Gains on investments  | -                       | -        | (37 )    |
| Change in operating assets and liabilities, net of business acquisitions          |                         |          |          |
| Accounts receivable   | 118                     | 897      | (721 )   |
| Inventories   | 1,584                   | (88 )    | (1,145 ) |
| Deferred costs  | (222 )                  | 668      | 1,897    |
| Deposits and other current assets   | 2,366                   | 2,125    | (933 )   |
| Other non-current assets  | 11                      | (8 )     | (50 )    |
| Accounts payable  | 1,522                   | (1,782 ) | 651      |
| Income taxes payable  | 1,527                   | (873 )   | -        |
| Accrued expenses and other current liabilities                                    | 966                     | (679 )   | (287 )   |
| Deferred revenue  | (10,164)                | (8,527 ) | (3,265 ) |
| Other non-current liabilities   | (71 )                   | 56       | 274      |
| Net cash provided by operating activities   | 15,250                  | 25,364   | 25,025   |
| Cash flows from investing activities:   |                         |          |          |
| Proceeds from sales of investments  | -                       | -        | 9,094    |
| Purchases of marketable securities  | (80 )                   | -        | -        |
| Purchases of property and equipment   | (605 )                  | (1,024 ) | (2,213 ) |
| Acquisition of intangible assets  | (321 )                  | -        | (485 )   |
| Acquisition of Broadsmart, net of cash acquired                                   | (40,019)                | -        | -        |
| Net cash (used in) provided by investing activities                               | (41,025)                | (1,024 ) | 6,396    |
| Cash flows from financing activities:   |                         |          |          |
| Purchase of treasury stock  | -                       | (20,000) | -        |
| Repurchase of ordinary shares to settle withholding liability                     | (430 )                  | (198 )   | -        |
| Proceeds from exercise of ordinary share options                                  | 10                      | 2        | 27       |
| Payment of other current liabilities  | -                       | (1,500 ) | (1,500 ) |
| Net cash used in financing activities   | (420 )                  | (21,696) | (1,473 ) |
| Net (decrease) increase in cash and cash equivalents                              | (26,195)                | 2,644    | 29,948   |
| Cash and cash equivalents, beginning of year                                      | 78,589                  | 75,945   | 45,997   |
| Cash and cash equivalents, end of year  | \$52,394                | \$78,589 | \$75,945 |



See accompanying notes to consolidated financial statements.

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MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

(in thousands)

|   | Year Ended December 31, |          |        |
|---|-------------------------|----------|--------|
|   | 2016                    | 2015     | 2014   |
| Supplemental disclosures:                         |                         |          |        |
| Income taxes paid                                 | \$ 1,495                | \$ 5,213 | \$ 279 |
| Non-cash investing and financing activities:      |                         |          |        |
| Property and equipment (acquired but not paid)    | \$ 182                  | \$ -     | \$ 11  |
| Ordinary shares issued for purchase of Broadsmart | \$ 1,676                | \$ -     | \$ -   |

See accompanying notes to consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES  
NOTES TO 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 to access its servers (“access right”), and the Company's customers then continue to have the ability to obtain free telephone services. The Company currently offers the magicJack GO and magicJack EXPRESS, which are updated versions of the magicJack device that have their own CPU and can connect a regular phone directly to the user’s broadband modem/router and function as a standalone phone without using a computer. The magicJack mobile apps are applications that allow users to make and receive telephone calls through their smart phones using their magicJack account. Currently, consumers that do not have a magicJack account can purchase and download the magicJack mobile apps to make telephone calls from anywhere in the world into the U.S. or Canada for free. The mobile apps include the magicApp and the magicJack Connect App, which are available for both iOS and Android. The Company's products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

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

The Company was incorporated in the State of Israel in 1989 and is domiciled in Netanya, Israel, with executive and administrative offices in West Palm Beach, Florida, technology management offices in Franklin, Tennessee, and research and development offices in Plano, Texas, and Sunnyvale, California. In addition, the Company’s Consumer business has a warehouse and customer care call center in West Palm Beach, Florida. Broadsmart’s offices are located in Fort Lauderdale, Florida and the SMB Division’s offices are in Alpharetta, Georgia.

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

During the first quarter of 2016, the Company created a new subsidiary, magicJack SMB, Inc. (“SMB”). Through this subsidiary, the Company provides easy-to-buy, easy to install and simple-to-use VoIP services to small to medium sized businesses at competitive prices. The Company began sales of its SMB product during the third quarter of 2016.

Basis of Presentation

The Company's consolidated financial statements are prepared in conformity with United States generally accepted accounting principles (“GAAP”). 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 the Company's consolidated operations are conducted. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in currencies other than dollars, including Israeli New Shekel (“NIS”), are re-measured in dollars and any gains or losses are recognized in the Company's earnings in the period they occur.

We have historically prepared our consolidated financial statements on the basis of being a single reporting entity. Beginning in the first quarter of 2016, with the acquisition of Broadsmart and the internal development of our SMB division, we have been reporting the results of operations for these new business lines as separate Reportable Segments. Approximately 87% of the Company's consolidated revenues in the year ended December 31, 2016 and 90% of the Company's revenues in the years ended December 31, 2015 and 2014 were from sales to customers located in the United States.

## Basis of Consolidation

The Company's consolidated financial statements include the accounts of magicJack VocalTec Ltd. 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), Broadsmart Global, Inc. ("Broadsmart"), and magicJack SMB, Inc.. The results of Broadsmart Global, Inc. have been included since March 17, 2016. Refer to Note 15, "Acquisition of Business," for further details. The results of SMB have been included since the first quarter of 2016. All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior periods consolidated financial statement amounts to conform to the current presentation.

## Noncontrolling Interest

During the year ended December 31, 2016, the Company formed a new subsidiary and entered into a joint venture with an unrelated third party which resulted in the Company having a 60% controlling interest in the joint venture which began selling a line of high-technology residential consumer products in the fourth quarter of fiscal year 2016. To date the Company has spent approximately \$1.6 million funding the operations of this joint venture. The operations of the joint venture for the year ended December 31, 2016 have not been significant to the Company's financial statements. The Company's consolidated financial statements for the year ended December 31, 2016, include an adjustment to income attributable to magicJack VocalTec Ltd. common shareholders of \$635 thousand, to recognize the impact of the noncontrolling interest. The Company has determined that the joint venture does not meet either the aggregation criteria to be combined with the existing Core Consumer segment or the quantitative thresholds to be treated as a separate reportable segment. As such, it is included in the "Other" category of the Company's segment reconciliation. Refer to Note 16, "Segment reporting," for further details.

## NOTE 2 – SUMMARY OF ACCOUNTING POLICIES

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

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

|                              | Year Ended December 31, |           |           |
|------------------------------|-------------------------|-----------|-----------|
|                              | 2016                    | 2015      | 2014      |
| Net revenues                 |                         |           |           |
| Sale of magicJack devices    | \$12,775                | \$15,915  | \$24,564  |
| Access right renewals        | 58,513                  | 65,761    | 65,542    |
| Shipping and handling        | 889                     | 794       | 2,085     |
| magicJack-related products   | 5,435                   | 4,289     | 7,006     |
| Prepaid minutes              | 5,677                   | 8,243     | 10,083    |
| Access and wholesale charges | 5,021                   | 5,953     | 7,028     |
| UCaaS                        | 8,966                   | -         | -         |
| Other                        | 122                     | 7         | 14        |
| Total net revenues           | \$97,398                | \$100,962 | \$116,322 |

## Revenue Recognition

The Company recognizes revenue in accordance with ASC Topic 605, "Revenue Recognition" ("ASC 605"), which provides authoritative guidance on revenue recognition. For arrangements that include more than one product or service (deliverables), the Company applies Section 25 of ASC 605, "Multiple-Element Arrangements". ASC 605-25 establishes criteria for separating deliverables into different units of accounting and allocating consideration to those units of accounting.

## Core Consumer Segment

### magicJack Devices Revenue and Renewal Access Revenue

magicJack devices include an initial access right, which qualify as multiple deliverables per ASC 605-25. Since the device and initial access right are interdependent and not sold separately, they are accounted for as a combined unit of accounting. Direct sales of devices include shipping charges and 30 days to return the device and cancel the service. For retail sales of devices, there is a delay between shipment to the retailer and the ultimate sale to a customer (end-user). Based on sales and inventory data provided by retail partners, the Company's estimate of the delay for the year ended December 31, 2016 was 90 days. The Company defers revenue recognition on direct sales for the 30 day return period and on retail sales for the delay period, after which the Company recognizes the revenue from device sales ratably over the remaining initial access right period.

Customers may renew access rights for periods ranging from one month to five years. The revenue associated with access right renewals is deferred and recognized ratably over the extended access right period. Revenue from the sales of magicApp and magicJack Connect App access rights is recognized ratably over the 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 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 also accepts returns of battery powerbanks for mobile devices within 30 days of sale. The Company estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the years ended December 31, 2016, 2015 and 2014, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

#### Other magicJack-Related Products

The Company offers customers other optional products related to their magicJack devices and services, such as insurance, custom or vanity phone numbers, Canadian phone numbers, the ability to either change their existing phone numbers or port them to a magicJack device, and battery powerbanks for mobile devices. These revenues are recognized at the time of sale, with the exception of sales of the battery powerbank which are recognized when shipped.



### Prepaid Minutes and Access and Wholesale Charges

The Company generates revenues from the sales of prepaid international minutes to customers, 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 or negotiated contract rates, less a provision for billing adjustments. Revenues from prepaid minutes and access and wholesale charges are recognized as minutes are used.

### Enterprise Segment

UCaaS services and equipment sales related to the Broadsmart subsidiary qualify as multiple deliverables per ASC 605-25. Since the equipment and services are sold separately and can be used with other products and services, they are accounted for as separate units of accounting. The Company recognizes revenues from sales of its hosted services in the period the services are provided over the term of the respective customer agreements. Customers are billed monthly in advance for these recurring services and in arrears for one time service charges and other certain usage charges. Revenues from sales of hardware and network equipment are recognized in the period that the equipment is delivered. Revenue from the sale of equipment purchased but not yet delivered and installed is deferred and recognized in the period that the hardware or equipment is put into service.

### SMB Segment

SMB provides phone equipment and services that are interdependent and not sold separately. As such they are accounted for as a combined unit of accounting under ASC 605-25. Some agreements include a refund period or a promotion for free introductory service. Revenue recognition is deferred for either period, after which the Company recognizes the revenue for the combined unit ratably over the remaining service period. Revenue from this segment was not significant for the year ended December 31, 2016.

### Deferred Revenues

Deferred revenues for the Core Consumer segment consist primarily of billings and payments for magicJack devices and access rights renewals received in advance of revenue recognition. The Company bills and collects in advance for magicJack devices, which include an initial access right period, and access right renewals. The Company recognizes revenue from device sales and access right renewals ratably over the access right period, as described above.

For the Enterprise segment, deferred revenue consists of hardware or equipment purchased but not yet delivered and installed. The Company recognizes revenue from UCaaS hardware or equipment sales in the period they are put into service.

For the SMB segment, deferred revenue consists of billings and payments for phone equipment and services received in advance of revenue recognition. Customers are billed in advance on a monthly or annual basis. The Company recognizes revenue from SMB phone equipment and services ratably over the service period. Deferred revenue from this segment was not significant for the year ended December 31, 2016.

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

### Core Consumer Segment

Cost of revenues for the Core Consumer segment include 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 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 \$3.6 million, \$3.5 million and \$4.5 million for the years ended December 31, 2016, 2015 and 2014, respectively.

## Enterprise Segment

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

## SMB Segment

Cost of revenues for the SMB segment include direct costs of providing the services, which are expensed as incurred, and costs for phone equipment, which are recognized ratably over the service period. Cost of revenues from this segment were not significant for the year ended December 31, 2016.

## Marketing Expenses

Marketing expenses of \$9.1 million, \$9.4 million and \$20.4 million for the years ended December 31, 2016, 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 expenses by category is as follows (in thousands):

|                             | Year Ended December 31, |         |          |
|-----------------------------|-------------------------|---------|----------|
|                             | 2016                    | 2015    | 2014     |
| Advertising media buys      | \$5,139                 | \$6,698 | \$13,922 |
| Marketing personnel related | 2,037                   | 1,487   | 2,663    |
| Other marketing projects    | 1,909                   | 1,224   | 3,849    |
| Total marketing expenses    | \$9,085                 | \$9,409 | \$20,434 |

Marketing expense for the year ended December 31, 2016 by segment is as follows (in thousands):

|                   | For the Year ended December 31,<br>2016 |            |       |       |              |
|-------------------|---|------------|-------|-------|--------------|
|                   | Consumer                                | Enterprise | SMB   | Other | Consolidated |
| Marketing expense | \$4,768                                 | 380        | 3,497 | 440   | \$ 9,085     |

## 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 costs.

Research and development expenses were \$5.2 million, \$4.5 million and \$5.9 million for the years ended December 31, 2016, 2015 and 2014, respectively. During the year ended December 31, 2016, \$1.3 million of research and development expense was related to the SMB segment. The balance of research and development expense was related to the Core Consumer segment.

### Gain on Mark-to-Market

The acquisition of Broadsmart in March 2016, described in Note 15, "Acquisition of Business," included an additional contingent payment of \$2.0 million in cash to Todd A. Correll and Thomas J. Tharrington (Messrs. Correll and Tharrington are collectively referred to as the "Seller Shareholders"), if the acquired assets generate 2016 revenues equal to or exceeding \$15.6 million (the "Earnout Payment"). The Earnout Payment will not exceed \$2.0 million. The \$2.0 million Earnout Payment was paid into escrow at the time of closing. With the help of a third party valuation firm, the value of this contingent consideration was determined to be \$1.7 million which was included in total consideration of the business acquired. In the third quarter ended September 30, 2016, management concluded that it was remote that 2016 revenues of the acquired assets would equal or exceed \$15.6 million, and accordingly recorded a \$2.0 million receivable from earnout escrow in the consolidated balance sheets. Corresponding income of \$1.7 million from change in contingent consideration was recorded as a reduction of operating expense labeled gain on mark-to-market in the consolidated statements of operations.

### Earnings per Common Share

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

### Cash and Cash Equivalents

The Company considers all highly-liquid financial instruments 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 telecommunication carriers and are common in the telecommunication industry. The changes in allowance for doubtful accounts and billing adjustments for the years ended December 31, 2016, 2015 and 2014 are as follows (in thousands):

|   | Year Ended December 31, |         |          |
|---|-------------------------|---------|----------|
|   | 2016                    | 2015    | 2014     |
| Balance, beginning of period                | \$455                   | \$1,171 | \$3,912  |
| Change in provision for doubtful accounts   | 214                     | 75      | 271      |
| Change in provision for billing adjustments | (12 )                   | 6       | 174      |
| Recoveries                                  | -                       | (10 )   | (350 )   |
| Write-offs                                  | (255 )                  | (787 )  | (2,836 ) |
| Balance, end of period                      | \$402                   | \$455   | \$1,171  |

The Company settled certain carrier receivable disputes during the years ended December 31, 2016, 2015 and 2014, which resulted in the write-offs of approximately \$0.3 million, \$0.8 million and \$2.8 million, respectively, of accounts receivables the Company had previously reserved.

#### Interest and Dividend Income

Interest and dividends earned on the Company's investments are accrued as income when earned.

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## 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.

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 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 December 31, 2016, the Company had cash and cash equivalents totaling \$52.4 million, which included (i) \$51.8 million in U.S. banks, and (ii) \$0.6 million in foreign financial institutions.

The Company's non-interest bearing cash balances in U.S. banks, which included \$1.9 million in one individual financial institution, were fully insured, except for \$26 thousand that exceeded insurance limits at December 31, 2016. The Company had money market accounts with financial institutions with balances totaling approximately \$49.7 million.

For the Core Consumer segment, no telecommunication carriers accounted for more than 10% of the segment's gross accounts receivable at December 31, 2016. One telecommunication carrier accounted for approximately 11% of the segment's gross accounts receivable at December 31, 2015. For the years ended December 31, 2016, 2015 and 2014, no telecommunication carrier accounted for more than 10% of the segment's total operating revenue.

For the Core Consumer segment, three customers accounted for approximately 34% of the segment's gross accounts receivable at December 31, 2016. One customer accounted for approximately 14% of the segment's gross accounts receivable at December 31, 2015. For the years ended December 31, 2016, 2015 and 2014, no retailer accounted for more than 10% of the segment's total operating revenues.

For the Enterprise segment, no customer accounted for more than 10% of gross accounts receivable at December 31, 2016. For the year ended December 31, 2016, two customers accounted for approximately 29% of the segment's total operating revenues.

For the SMB segment, accounts receivable and revenues were not significant for the year ended December 31, 2016.

## 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 assumptions 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 December 31, 2016 and 2015, all of them are Level 1 instruments, except for debt securities, which are Level 2 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 of 2011, 2012, 2013, 2014 and 2015, respectively. The liability for such payments was discounted at a rate of 10% to a total fair value of \$1.4 million at December 31, 2014, with \$1.4 million included in accrued expenses and other current liabilities at December 31, 2014 in the Company's consolidated balance sheets. The Company believes that the \$1.4 million carrying value approximated fair value based on observable market inputs other than quoted prices for similar traded debt securities, which are Level 2 instruments. The \$0.1 million unamortized discount at December 31, 2014 was amortized using the effective interest method and recorded as interest expense in the Company's 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 are accounted for under ASC 350 and consist primarily of servers, computer hardware, furniture, and leasehold improvements. Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives, which range from three to fifteen years. Leasehold improvements are depreciated 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. Refer to Note 5, "Property and Equipment" for further details.

The Company reviews property and equipment for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss is based on the fair value of the asset compared to its carrying value. Property and equipment to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

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."

#### Intangible Assets

Identifiable intangible assets are stated at cost and accounted based on whether the useful life of the asset is definite or indefinite. Identified intangible assets with definite useful lives are amortized using the accelerated and straight-line methods over their estimated useful lives, which range from one to seventeen years. 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.

The Company reviews definite lived intangible assets subject to amortization for possible impairment using a three-step approach. Under the first step, management determines whether an indicator of impairment is present (a "Triggering Event"). If a Triggering Event has occurred, the second step is to test for recoverability based on a comparison of the asset's carrying amount with the sum of the undiscounted cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the undiscounted cash flows is less than the carrying amount of the asset, the third step is to recognize an impairment loss for the excess of the asset's carrying amount over its fair value. Intangible assets subject to amortization to be disposed of are reported at the lower of carrying amount or fair

value less costs to sell.

The Company recognized impairment charges of \$1.0 million on intangible assets during the year ended December 31, 2016. In the year ended December 31, 2015, there were no deemed impairments of assets. In the year ended December 31, 2014, the Company recorded an impairment charge of \$2.5 million in intangible assets. Refer to Note 6, "Intangible Assets" for further details.

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The costs of developing the Company's intellectual property rights, intellectual property right applications and technology are charged to research and development expense as incurred.

## Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired in a business combination. Goodwill is not amortized to operations, but instead is reviewed for impairment at least annually, or more frequently if there is an indicator of impairment. Indicators include, but are not limited to: sustained operating losses or a trend of poor operating performance and a decrease in the Company's market capitalization below its book value. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record impairment charges in the future. With the acquisition of Broadsmart in March 2016 and the founding of the SMB business during the first quarter of 2016, management began evaluating each of these new business lines separately and has allocated goodwill between the three reporting units that correspond to the reportable segments – "Consumer," "Enterprise" and "SMB". Refer to Note 7, "Goodwill" and Note 16, "Segment Reporting" for further details.

The Company may utilize a qualitative assessment to determine if it is "more-likely-than-not" that the fair value of 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 in 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). Fair value of the reporting unit is determined using a discounted cash flow analysis. 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. 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 performed as of October 1, the annual measurement date, there is no impairment of such assets as of and for the years ended December 31, 2016, 2015 and 2014. Refer to Note 7, "Goodwill" for further details.

## Share-based Compensation

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

## Business Combinations

The Company accounts for business combinations under ASC 805, using the acquisition method of accounting. The acquisition method of accounting requires that the purchase price, including the fair value of contingent consideration, of the acquisition be allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. Goodwill as of the acquisition date is measured as the excess of consideration transferred over the net of the acquisition date fair values of assets acquired and the liabilities assumed. While the

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

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

## Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. The Company's net deferred tax assets consist primarily of foreign net operating loss carryforwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required.

The Company 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 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 where there is 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements.

## Comprehensive Income

Comprehensive income attributable to common shareholders, as defined, includes all changes in equity (net assets) during a period from non-owner sources. The differences between net income and comprehensive income attributable to common shareholders are due to reclassification of unrealized gain or loss on marketable securities to realized gain or loss on investments and losses attributable to noncontrolling interest.

## Treasury Stock

The Company presents the cost of repurchasing treasury shares as a reduction in capital equity.

## Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." The standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. On July 9, 2015, the FASB deferred the effective dates of the standard by one year. As a result, the standard will be effective for annual and interim periods beginning after December 15, 2017. Companies may adopt the standard as early as the original effective date (i.e. annual reporting periods beginning after December 15, 2016). Early adoption prior to that date is not permitted. The standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or a modified retrospective adoption, meaning the standard is applied only to the most current period presented. In March 2016, the FASB issued ASU 2016-08 to provide clarification regarding the application of the principal-versus-agent guidance. In April 2016, the FASB issued ASU 2016-10 to clarify the guidance for identifying performance obligations and accounting for licenses of intellectual property. In May 2016, the FASB also issued ASU 2016-12, which provides narrow scope improvements and technical expedients on assessing collectibility, presentation of sales taxes, evaluating contract modifications and completed contracts at transition and the disclosure requirement for the effect of the accounting change for the period of adoption. In December 2016, the FASB issued ASU 2016-20 which makes minor corrections and improvements to certain narrow aspects of the guidance. The Company has internally performed a preliminary review of the new guidance and plan to engage consultants to document the appropriate revenue recognition for its various products and services.

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

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

In March 2016, the FASB issued ASU 2016-09, “Improvements to Employee Share-Based Payment Accounting”. ASU 2016-09 simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. The standard is effective for annual periods beginning after December 15, 2016 for both interim and annual reporting periods. The Company will adopt ASU 2016-09 on a prospective basis in the first quarter of 2017. Prior periods were not retrospectively adjusted.

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

In October 2016, the FASB issued ASU 2016-16, “Intra-Entity Transfers of Assets Other than Inventory”. ASU 2016-16 requires an entity to recognize the income tax consequences of intra-entity transfers of assets other than inventory when the transfer occurs. The standard is effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The ASU should be applied retrospectively as an adjustment to retained earnings. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows.

#### NOTE 3 – INVESTMENTS

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

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

There was no realized gain or loss on investments for the years ended December 31, 2016 and 2015. Gains on investments for the year ended December 31, 2014 were \$37 thousand, and included reclassification of unrealized loss on marketable securities from other comprehensive loss to gains on investments of \$0.6 million.

#### NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

|                | December 31, |         |
|----------------|--------------|---------|
|                | 2016         | 2015    |
| Raw materials  | \$1,455      | \$1,498 |
| Finished goods | 2,986        | 4,225   |
| Total          | \$4,441      | \$5,723 |

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished products are comprised primarily of magicJack devices on hand or in transit to the Company's distribution center in the United States and equipment held for sale to customers for the Enterprise segment. The Company wrote-off approximately \$499 thousand of obsolete inventory during each of the years ended December 31, 2016 and 2015. Inventory write-offs are reflected in cost of revenues in the accompanying consolidated statements of operations.

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## NOTE 5 – PROPERTY AND EQUIPMENT

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

|                          | Estimated<br>Useful Lives<br>(in years) | December 31, |         |
|--------------------------|---|--------------|---------|
|                          |   | 2016         | 2015    |
| Switches                 | 3 - 15                                  | \$9,699      | \$8,606 |
| Computers                | 3                                       | 2,866        | 2,707   |
| Furniture                | 5 - 7                                   | 269          | 257     |
| Leasehold-improvements   | *                                       | 893          | 701     |
| Accumulated depreciation |   | (9,922)      | (8,969) |
| Total                    |   | \$3,805      | \$3,302 |

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

Depreciation expense for years ended December 31, 2016, 2015 and 2014 was \$1.2 million, \$0.8 million and \$0.6 million, respectively. Refer to Note 16, “Segment Reporting” for further details.

## NOTE 6 – INTANGIBLE ASSETS

As of December 31, 2016 and 2015, the Company had intangible assets with carrying values of \$28.9 million and \$6.7 million, respectively. The March 2016 acquisition of Broadsmart included the addition of \$26.4 million in intangible assets. Refer to Note 15, “Acquisition of Business” for further details. Identified intangible assets consist of the following (in thousands):

|   | Estimated<br>Useful Lives<br>(in years) | December 31, 2016           |                             |       | Weighted-<br>Average<br>Life | December 31, 2015           |                             |       | Weighted-<br>Average<br>Life |
|---|---|-----------------------------|-----------------------------|-------|------------------------------|-----------------------------|-----------------------------|-------|------------------------------|
|   |   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net   |                              | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net   |                              |
| Technology                                    | 3 - 17                                  | \$3,110                     | \$(2,854)                   | \$256 | 4.71                         | \$4,930                     | \$(4,497)                   | \$433 | 4.83                         |
| Intellectual<br>property rights               | 3 - 17                                  | 14,162                      | (10,794)                    | 3,368 | 4.87                         | 14,161                      | (9,623)                     | 4,538 | 5.36                         |
| Covenants not-to<br>compete and<br>not-to sue | 2 - 5                                   | 2,185                       | (2,107)                     | 78    | 3.17                         | 2,085                       | (1,911)                     | 174   | 0.42                         |

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|   |        |          |             |          |      |          |             |         |      |
|---|--------|----------|-------------|----------|------|----------|-------------|---------|------|
| Tradename                                     | 3 - 6  | 131      | (131 )      | -        | 0.00 | 321      | (321 )      | -       | -    |
| Customer relationships                        | 5 - 10 | 22,600   | (2,249 )    | 20,351   | 9.21 | 500      | (500 )      | -       | -    |
| Backlog                                       | 1      | 800      | (800 )      | -        | 0.00 | 800      | (800 )      | -       | -    |
| Software license                              | 10     | 1,207    | (80 )       | 1,127    | 8.00 | -        | -           | -       | -    |
| Process know how                              | 5      | 1,100    | (87 )       | 1,013    | 6.08 | -        | -           | -       | -    |
| Other   |        | -        | -           | -        | 0.00 | 470      | (138 )      | 332     | 3.00 |
| Intangible assets subject to amortization     |        | \$45,295 | \$(19,102 ) | \$26,193 |      | \$23,267 | \$(17,790 ) | \$5,477 |      |
| Tradename                                     |        | \$2,600  | \$-         | \$2,600  | N/A  | \$900    | \$-         | \$900   | N/A  |
| Domain names                                  |        | 61       | -           | 61       | N/A  | 310      | -           | 310     | N/A  |
| Intangible assets not subject to amortization |        | \$2,661  | \$-         | \$2,661  |      | \$1,210  | \$-         | \$1,210 |      |
| Total intangible assets                       |        | \$47,956 | \$(19,102 ) | \$28,854 |      | \$24,477 | \$(17,790 ) | \$6,687 |      |

Amortization expense for the years ended December 31, 2016, 2015 and 2014 was \$3.5 million, \$2.8 million and \$4.2 million, respectively. Refer to Note 16, "Segment Reporting" for further details.

The Company's annual impairment testing for indefinite-lived intangible assets, performed as of October 1, 2016 (the "Measurement Date"), compared the fair value of the assets to their carrying value. The Company engaged an independent third party to perform a valuation of certain intangible assets in order to determine if there was potential impairment.

The fair value of indefinite-lived intangible assets was determined based on the relief from royalty method, which requires an estimate of a reasonable royalty rate, identification of relevant projected revenues and expenses, and selection of an appropriate discount rate. The third party valuation yielded an estimated fair value of \$1.7 million for the Broadsmart tradename. This tradename was recorded as an identifiable intangible asset with an indefinite life at a carrying value of \$2.2 million. As a result, an impairment loss of \$0.5 million was recognized in General and Administrative expense during the fourth quarter under the Enterprise segment in the statement of operations related to the tradename.

Due to impairment indicators at the Enterprise Segment, as of October 1, 2016 management tested that segment's identified intangible assets subject to amortization for impairment. Management summed the undiscounted cash flows expected to result from the use of these assets and their eventual disposition used in the third party valuation report and noted that the sum exceeded the carrying amount of the assets, indicating no further impairment testing was necessary for these assets as of October 1, 2016.

Management continued to monitor the performance of the Enterprise segment (Broadsmart) and updated its impairment analysis of the indefinite lived intangible assets and identified intangible assets subject to amortization as of December 31, 2016. No further impairment charges were required as a result of this analysis.

Although the acquired Broadsmart business has underperformed compared to our expectations, management believes that the underlying fundamentals of the Broadsmart business and the exhibited market opportunities for growth remain consistent with its understanding and analysis of the business at the time of acquisition. Subsequent to the year ended December 31, 2016, management implemented steps to improve the operating results and bolster integration efforts for the Broadsmart business. In February 2017, the Company hired a new Chief Operating Officer for Broadsmart to reduce the administrative and organizational duties of Broadsmart's original founders, who continue to be employed by the Company and are integral to its success, so that they can focus on expanding the customer base. The Company has also begun to hire additional sales and marketing personnel dedicated to obtaining new business. Management believes that the Enterprise segment will eventually perform at originally expected levels but more time is needed to give these integration efforts an opportunity to be successful. If these efforts are not successful, management will need to re-evaluate its forecasts for the Enterprise segment. Further impairments could ensue as a result of Broadsmart's continued operating results performing below expectations.

In the third quarter ended September 30, 2016, impairment charges of \$0.5 million on identified intangible assets were recognized in general and administrative expense under the Core Consumer segment in the consolidated statement of operations. The impairments were comprised of: (i) a Telecom license included in the "Other" category of amortizable intangible assets for \$249 thousand (net of accumulated amortization) deemed obsolete, and (ii) domain names not subject to amortization for \$249 thousand that were not renewed.

In the year ended December 31, 2014, due to the passing of the Company's founder and former CEO in July 2014, the Company recorded an impairment charge of \$2.5 million included in general and administrative expense related to the write-off of \$2.5 million net carrying value associated with the non-compete agreement with the Company's founder and former CEO included in intangible assets.

Based on the carrying value of identified intangible assets subject to amortization recorded at December 31, 2016, and assuming no subsequent impairment of the underlying assets, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

| Fiscal Year | Amortization Expense |
|-------------|----------------------|
| 2017        | \$ 3,885             |
| 2018        | 3,456                |
| 2019        | 3,198                |
| 2020        | 2,872                |
| 2021        | 2,538                |
| Thereafter  | 10,244               |
|             | \$ 26,193            |

NOTE 7 – GOODWILL

With the acquisition of Broadsmart in March 2016 and the founding of the SMB business during the first quarter of 2016, management began evaluating each of these new business lines separately and has assigned goodwill to the three reporting units that correspond to the reportable segments – “Consumer,” “Enterprise” and “SMB”. Refer to Note 15, “Acquisition of Business” and Note 16, “Segment Reporting” for further details.

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The changes in the carrying amount of goodwill for the year ended December 31, 2016, by reporting unit are as follows (in thousands):

|  | Year Ended December 31, 2016 |            |      |       | Consolidated |
|--|------------------------------|------------|------|-------|--------------|
|  | Consumer                     | Enterprise | SMB  | Other |              |
| Balance, beginning of period                     | \$32,304                     | \$ -       | \$ - | \$ -  | \$ 32,304    |
| Goodwill acquired with<br>Broadsmart acquisition | -                            | 14,881     | -    | -     | 14,881       |
| Balance, end of period                           | \$32,304                     | \$ 14,881  | \$ - | \$ -  | \$ 47,185    |

There were no changes in goodwill during the years ended December 31, 2015 and 2014.

In accordance with ASC 350, as of October 1, 2016 (the “Measurement Date”), the Company engaged an independent third party to perform a two-step goodwill impairment test for all of its reporting units in order to determine on an individual reporting unit basis if there was potential impairment.

The application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Significant judgment, and the use of significant estimates and assumptions, is required to estimate the fair value of reporting units, including estimating future cash flows, future market conditions, and determining the appropriate discount rates, growth rates, and operating margins, among others.

The discounted cash flow analyses factor in assumptions on revenue and expense growth rates. These estimates are based upon the Company’s historical experience, best estimates of future activity, and a cost structure necessary to achieve the related revenues.

Additionally, these discounted cash flow analyses factor in expected amounts of working capital and weighted average cost of capital. The Company believes the assumptions are reasonable, however, there can be no assurance that its estimates and assumptions made for purposes of the goodwill impairment testing, at the annual Measurement Date, will prove to be accurate predictions of the future. Changes in these estimates and assumptions as previously noted, could result in the need to conduct additional goodwill impairment tests in the future and could ultimately result in an impairment charge. In addition, a change in the Company’s reporting units could materially affect the determination of the fair value for each reporting unit, which could trigger impairment in the future. The Company will continue to review its results against forecasts and assess its assumptions to ensure they continue to be appropriate.

Under the first step, the fair value of each reporting unit was compared with its carrying value (including goodwill). The fair value was estimated based on the Income Approach which utilizes a discounted future cash-flows model. The discount rate used was determined to be commensurate with the risk inherent in the Company’s current business. A Market Approach was not used given that management does not believe that the near-term performance of the reporting units is indicative of expected long-term performance based on the following:

- The Core Consumer segment is expected to experience declining revenues throughout the projection period.

- The SMB segment is not profitable during the projection period and revenues are too uncertain to apply a meaningful multiple. Given the speculative nature of this start-up reporting unit, it would be difficult to assign a value. For start-up entities with a speculative forecast, it is not uncommon to utilize a net asset approach.

·Company management expects the Enterprise segment to increase in size and revenue over the projection period.

Based on management's evaluation and the results of Step One of the third party testing, the Company determined that:

·For the Core Consumer segment, the estimated fair value of the reporting unit exceeded its carrying value by approximately 227% and no further testing was required.

·The SMB segment has no goodwill, therefore no further testing was required.

·For the Enterprise segment, the estimated fair value of the reporting unit did not exceed its carrying value and further testing was required.

Under Step Two, the carrying amount of the Enterprise reporting unit's goodwill was compared to the implied fair value of that goodwill. The implied fair value of goodwill was 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's goodwill. Fair value of the reporting unit is estimated using a discounted cash flow analysis. As a result of the allocation, less value was attributed to the other identifiable intangible assets and the residual fair value of goodwill exceeded its carrying value by approximately 35% and no goodwill impairment was recognized.

Management continued to monitor the performance of the Enterprise reporting unit (Broadsmart) and updated its goodwill impairment as of December 31, 2016. No further impairment charges were required as a result of this analysis.

For the years ended December 31, 2015 and 2014, the Company operated as a single segment with a single reporting unit and its market capitalization exceeded its carrying value, so no further testing was required.

#### NOTE 8 – DEFERRED COSTS AND REVENUES

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

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

|                                | December 31, |           |
|--------------------------------|--------------|-----------|
|                                | 2016         | 2015      |
| magicJack devices              | \$7,962      | \$9,352   |
| Access right renewals          | 37,323       | 40,677    |
| Prepaid minutes                | 2,851        | 2,525     |
| Other                          | 371          | -         |
| Deferred revenue, current      | 48,507       | 52,554    |
| Deferred revenue, non-current* | 44,201       | 50,146    |
| Total deferred revenues        | \$92,708     | \$102,700 |

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

Deferred revenues as of December 31, 2016 are expected to be recognized in future years as follows (in thousands):

| Fiscal Year | Estimated<br>Recognition of<br>Deferred Revenues |
|-------------|--|
| 2017        | \$ 48,507  |
| 2018        | 18,361   |
| 2019        | 12,023   |
| 2020        | 7,399  |
| 2021        | 3,467  |
| Thereafter  | 2,951  |
|             | \$ 92,708  |

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 are expensed as incurred. Such costs were approximately \$12.3 million, \$15.4 million and \$19.7 million for the years ended December 31, 2016, 2015 and 2014, respectively.

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## NOTE 9 – OTHER LIABILITIES

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

As of December 31, 2016 and 2015, the Company had recorded a non-current liability for uncertain tax positions of \$10.4 million and \$10.8 million, respectively.

## NOTE 10 – COMMITMENTS AND CONTINGENCIES

### Legal Proceedings

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

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

### Tax Contingencies

The Company believes that it files all required tax returns and pays all required federal, state and municipal taxes (such as sales, excise, utility, and ad valorem taxes), fees and surcharges. The Company is the subject of inquiries and examinations by various 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.

#### Regulation

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

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

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

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

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

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

E911 Calling - The FCC has required providers of interconnected VoIP services to provide 911 emergency calling capabilities to their customers. While the Company believes it is not an interconnected VoIP provider as currently defined by the FCC and thus is not subject to the FCC's 911 rules, it nevertheless provides some 911 capability for its customers. In September 2010, the FCC released a nationwide industry "Notice of Inquiry" seeking additional comments on a number of issues including, but not limited to, whether nomadic interconnected VoIP providers should

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

Many state and local governments have sought to impose fees on customers of VoIP providers, or to collect fees from VoIP providers, to support implementation of E911 services in their area. Such fees are often put in terms of a fee placed on monthly bills, or focused on use from a specific location. The application of such fees with respect to magicJack users and the Company is not clear because various statutes and regulation may not cover the Company's services, the Company does not bill its customers monthly, nor does it bill customers at all for telecommunications services. The Company may also not know the end user's location because the magicJack devices and services are nomadic. If fees are owed, they are owed by the end user and not the Company, as most statutes, to the extent they apply, would have the Company act as a billing and collection agent. Should a regulatory authority require payment of money from the Company for such support, magicJack LP may decide to not offer its 911 service in that area or to develop a mechanism to collect fees from its customers, which may or may not be satisfactory to the entity requesting us to be a billing agent. The Company cannot predict whether the collection of such additional fees or limitations on where its services are available would impact customers' interest in purchasing its products.

In 2013 as a result of settlement of litigation, the Company agreed that it would, at least once a year, issue bills for 911 emergency calling services to all U.S. customers who have access to 911 services through their magicJack services, and who have provided a valid address in a U.S. jurisdiction that provides access to 911 services and which is legally empowered to impose 911 charges on such users in accordance with applicable state and/or local law.

Certain E911 regulatory authorities have asserted or may assert in the future that the Company is liable for damages, including end user assessed E911 taxes, surcharges and/or fees, for not having billed and collected E911 fees from its customers in the past or in the future. Although the Company strongly disagrees with these assertions and believes that any such authority's claims are without merit, if a jurisdiction were to prevail, the decision could have an adverse effect on the Company's financial condition and results of operations.

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

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

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

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

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

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

The FCC also adopted a fourth new rule in the form of a forward-looking standard. This rule is intended to address concerns that may arise with new practices that do not fall within one of the three bright line rules. It will be applied on a case-by-case basis to address questionable practices as they occur that unreasonably interfere with or unreasonably disadvantage the ability of consumers to use or edge providers to make available lawful content, applications, services, or devices.

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

However, a decision by a court or the FCC striking down or narrowing the FCC's net neutrality rules could adversely impact the Company's business to the extent legal prohibitions against broadband providers blocking, throttling, or otherwise degrading the quality of the Company's data packets or attempting to extract additional fees from the Company or its customers are eliminated. A court or the FCC also could find that the FCC lacks legal authority to regulate broadband services, which could prevent the FCC from adopting new rules to govern the operating practices of broadband providers.

Universal Service Fund ("USF") and Other Funds - The FCC and many PUCs have established USF programs to ensure that affordable telecommunications services are widely available in high cost areas and for low income telephone subscribers and to promote universal availability of modern networks capable of providing voice and broadband service. In addition to USF, the FCC imposes other fees to meet the costs of establishing and maintaining a numbering administration system, to recover the shared costs of long-term number portability, and to contribute to the Telecommunications Relay Services (TRS) Fund. All telecommunications carriers and other providers are required to contribute to these funds, including interconnected VoIP providers. The FCC and many PUCs have for a number of years been considering substantial changes to the USF system including changes in contribution methodology. Some proposals, if adopted, could have a material adverse effect on the Company.

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

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

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

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

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

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

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

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

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



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

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

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

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

State and Municipal Taxes - The Company believes that it files all required state and municipal tax returns and pays all required state and municipal taxes (such as sales, excise, utility, and ad valorem taxes), fees and surcharges. The Company's Enterprise and SMB segments remit state and municipal taxes as required in the states where they are registered to do business. The Company believes that its Core Consumer segment is exempt from certain taxes, fees and surcharges because it does not charge for telephone services or render bills to its customers. The Company's Core Consumer segment remits sales tax in Florida on sales of magicJack units because of the personnel, property and activities of its magicJack LP subsidiary that are in Florida. Certain states and municipalities may disagree with the Company's policies regarding the Core Consumer business and may believe it should be remitting taxes for past or future sales on certain items or services. Although the Company strongly disagrees and believes any possible claims are without merit, if a state or municipality were to prevail, the decision could have an adverse effect on the Company's financial condition and results of operation. magicJack LP does not have activities or have representation in any other states. However, many states are changing their statutes and interpretations thereof as part of new streamlined sales tax initiatives to collect sales taxes from nonresident vendors that sell merchandise over the Internet to in state customers. The Company's Core Consumer segment may at some time be required to collect and remit sales taxes to states other than Florida. The Company's Core Consumer segment may also become required to pay other taxes, fees and surcharges to a large number of states and municipalities as a result of statutory changes in the basis on which such taxes, fees and surcharges are imposed. In the event that the Company's Core Consumer segment is

required to collect sales taxes or other taxes from direct sales for states other than Florida on the sale of magicJack devices or on the renewal of our service offerings, the Company will bill and collect such taxes from our customers. The Company will examine any future fees and surcharges imposed as a result of statutory changes and determine on a case by case basis whether to bill its customers or increase the initial or access right sales prices to cover the additional fees and surcharges.

#### Regulatory Environment

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

## Operating leases

Minimum annual commitments under non-cancellable operating leases as of December 31, 2016 are as follows (in thousands):

| Fiscal Year | Estimated Rent<br>Payments |
|-------------|----------------------------|
| 2017        | \$ 1,156                   |
| 2018        | 924                        |
| 2019        | 582                        |
| 2020        | 85                         |
| 2021        | 85                         |
| Thereafter  | 28                         |
|             | \$ 2,860                   |

Rent expense for the Company's real property leases were \$0.9 million, \$0.8 million and \$0.9 million for the years ended December 31, 2016, 2015 and 2014, respectively, and are included in general and administrative expense in the accompanying Consolidated Statements of Operations.

## NOTE 11 –TREASURY STOCK

The Company's Board of Directors authorized a stock repurchase program to enable it to purchase its ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of \$100.0 million as of December 31, 2014. The objective of the Company's stock repurchase program was to improve stockholders' returns. The Company expended \$91.3 million under its repurchase program through December 31, 2014, and there was \$8.7 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased, not yet retired, are recorded as treasury shares. The Company repurchased 6,143,731 ordinary shares under this program through December 31, 2014.

During the first quarter of 2015, the Company's Board of Directors authorized a new share repurchase program under which the Company could 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 was terminated. During the year ended December 31, 2015, the Company expended the maximum \$20.0 million under the newly authorized amount. The Company repurchased 2,329,003 ordinary shares under this program through December 31, 2015.

During the year ended December 31, 2016, no new share repurchase programs were authorized.

In December 2016, the Company issued 203,618 of its ordinary shares held as treasury shares with a cost of \$2.5 million, or \$12.32 per share, to two of its executive officers and certain other employees as a result of restricted stock units vesting. In October 2016, the Company issued 50,600 of its ordinary shares held as treasury shares with a cost of \$623 thousand, or \$12.32 per share, to certain of its employees as a result of the vesting of restricted stock units and the exercise of options. In August 2016, the Company issued 2,333 of its ordinary shares held as treasury shares with a cost of \$29 thousand, or \$12.33 per share, to a Board member as a result of vesting. In addition, in April 2016, the Company issued 9,336 of its ordinary shares held as treasury shares with a cost of \$115 thousand, or \$12.31 per share, to Board members as a result of restricted stock units that were issued in mid-2014, vesting. In March 2016, the Company issued 2,016 of its ordinary shares held as treasury shares with a cost of \$25 thousand, or \$12.24 per share, to a Board member as a result of restricted stock units, that were issued in mid-2013, vesting. On March 17, 2016, the Company issued 233,402 of its ordinary shares held as treasury stock with a cost of \$3.6 million, or \$15.46 per shares, as part of the consideration paid for the Broadsmart acquisition. Refer to Note 15, "Acquisition of Business" for further details.

In December 2016, the Company purchased 62,726 of its ordinary shares at \$6.85 per share, for an aggregate purchase price of approximately \$430 thousand, in settlement of the withholding tax liability of certain of its executive officers and other employees on the vesting of restricted stock units.

On December 31, 2015, the Company issued 53,419 of its ordinary shares held as treasury shares with a cost of \$0.7 million, \$12.32 per share (and fair value of \$0.5 million, \$9.45 per share), to its executive officers as a result of restricted stock units, that were issued in mid-2013, vesting. In June 2015, the Company issued 24,410 of its ordinary shares held as treasury shares with a cost of \$301 thousand, \$12.32 per share (and fair value of \$188 thousand, \$7.70 per share), to a former Executive Officer as a result of restricted stock units, that were issued in late-2013, vesting in accordance with a separation agreement. In May 2015, the Company issued 834 of its ordinary shares held as treasury shares with a cost of \$10 thousand, \$12.32 per share (and fair value of \$6 thousand, \$7.09 per share), to a Consultant as a result of restricted stock units, that were issued in mid-2014, vesting. In April 2015, the Company issued 9,336 of its ordinary shares held as treasury shares with a cost of \$115 thousand, \$12.32 per share (and fair value of \$64 thousand, \$6.87 per share), to Board members as a result of restricted stock units, that were issued in mid-2014, vesting. In March 2015, the Company issued 2,015 of its ordinary shares held as treasury shares with a cost of \$25 thousand, \$12.24 per share (and fair value of \$14 thousand, \$6.99 per share), to a Board member as a result of restricted stock units, that were issued in mid-2013, vesting.

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In June 2015, the Company repurchased 12,161 of its ordinary shares at \$7.70 per share, for an aggregate purchase price of approximately \$94 thousand, and in December 2015 the Company purchased 10,989 of its ordinary shares at \$9.45 per share, for an aggregate purchase price of approximately \$104 thousand, in settlement of the withholding tax liability of certain of its executive officers on the vesting of restricted stock units.

On December 31, 2014, the Company issued 35,967 of its ordinary shares held as treasury shares with a cost of \$0.4 million, \$12.32 per share (and fair value of \$0.3 million, \$8.12 per share), to its executive officers as a result of restricted stock units, that were issued in mid-2013, vesting. In March 2014, the Company issued 2,015 of its ordinary shares held as treasury shares with a cost of \$24 thousand, \$12.24 per share (and fair value of \$42 thousand, \$20.71 per share), to a Board member as a result of restricted stock units, that were issued in mid-2013, vesting.

The changes in treasury stock during the years ended December 31, 2016, 2015 and 2014 are as follows (in thousands, except for number of shares):

|  | Year Ended December 31, |           |           |           |           |           |
|--|-------------------------|-----------|-----------|-----------|-----------|-----------|
|  | 2016                    |           | 2015      |           | 2014      |           |
|  | Number                  | Amount    | Number    | Amount    | Number    | Amount    |
| Balance, beginning of period                                       | 9,426,399               | \$126,772 | 7,164,260 | \$107,683 | 7,202,242 | \$108,151 |
| Ordinary shares issued for<br>Broadsmart acquisition               | (233,402 )              | (3,609 )  | -         | -         | -         | -         |
| Ordinary shares purchased through<br>the stock repurchase program  | -                       | -         | 2,329,003 | 20,000    | -         | -         |
| Ordinary shares issued to settle<br>withholding liability          | 62,726                  | 430       | 23,150    | 198       | -         | -         |
| Ordinary shares issued due to<br>vesting of restricted stock units | (267,903 )              | (3,293 )  | (90,014 ) | (1,109 )  | (37,982 ) | (468 )    |
| Balance, end of period   | 8,987,820               | \$120,300 | 9,426,399 | \$126,772 | 7,164,260 | \$107,683 |

NOTE 12 – SHARE-BASED COMPENSATION

The Company has granted ordinary share options, issued restricted stock units and ordinary shares as an alternative or supplement to the compensation of its executives, employees, directors and outside consultants. The Company's share-based compensation program is a long-term retention program intended to attract and reward talented executives, employees and outside consultants, and align their interests with shareholders. 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") which were approved by shareholders in July 2013 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 December 31, 2016, the aggregate number of shares subject to awards under the 2013 Plans is 3,600,000. The Company had previously granted shares under the VocalTec amended Master Stock Plan (the "2003 Plan") which expired in April 2013. During the year ended December 31, 2016, the Company issued 1,000,000 ordinary share options outside of the 2013 Plans as an inducement for the two founders of Broadsmart to become employed by the Company. As of December 31, 2016, there are 198,593 awards available for grant under the 2013 Plans. Share-based awards are generally exercisable or issuable upon vesting. The Company's policy is to recognize compensation expense for awards with only service conditions and a graded vesting on a straight-line basis over the requisite vesting period for the entire award.

The Company's share-based compensation expense consisting of ordinary share options, issued restricted stock units and ordinary shares for the years ended December 31, 2016, 2015 and 2014 was as follows (in thousands):

Year Ended December 31,

|                        | 2016     | 2015     | 2014     |
|------------------------|----------|----------|----------|
| Ordinary share options | \$ 2,138 | \$ 4,108 | \$ 6,072 |
| Restricted stock units | 2,082    | 1,160    | 1,118    |
|                        | \$ 4,220 | \$ 5,268 | \$ 7,190 |

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The detail of total share-based compensation recognized by income statement classification is as follows (in thousands):

|                            | Year Ended December 31, |         |         |
|----------------------------|-------------------------|---------|---------|
|                            | 2016                    | 2015    | 2014    |
| Cost of revenues           | \$ 76                   | \$ 76   | \$ 465  |
| Marketing                  | 146                     | 551     | 1,594   |
| General and administrative | 3,755                   | 4,194   | 4,166   |
| Research and development   | 243                     | 447     | 965     |
|                            | \$4,220                 | \$5,268 | \$7,190 |

The decreases in share-based compensation for the years ended December 31, 2016 and 2015, are due primarily to the expense associated with previous awards being fully amortized exceeding the expense associated with new award grants.

#### Ordinary Share Options

Ordinary share options granted under the 2013 Plans have a five-year life and vest over a period of 24 to 37 months beginning at the date of grant. The 2013 Plans currently allow for a maximum term of five years for awards granted. The following table provides additional information regarding ordinary share options issued, outstanding and exercisable for years ended December 31, 2016, 2015 and 2014 (aggregate intrinsic value in thousands):

| Date of Grant        | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value * |
|----------------------|-------------------|---------------------------------|--|-----------------------------|
| January 1, 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              | 998,614           | \$ 9.33                         |  |                             |
| Exercised            | (4,250 )          | \$ 0.57                         |  |                             |
| Forfeited            | (247,257 )        | \$ 14.42                        |  |                             |
| Expired or cancelled | (263,537 )        | \$ 12.67                        |  |                             |
| December 31, 2015    | 2,527,427         | \$ 12.98                        | 3.61   | \$ -                        |
| Granted              | 1,107,040         | \$ 7.09                         |  |                             |
| Exercised            | (2,500 )          | \$ 3.96                         |  |                             |
| Forfeited            | (34,740 )         | \$ 8.83                         |  |                             |

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|   |            |          |      |    |   |
|---|------------|----------|------|----|---|
| Expired or cancelled                                  | (109,168 ) | \$ 13.57 |      |    |   |
| December 31, 2016                                     | 3,488,059  | \$ 11.13 | 3.11 | \$ | - |
| Vested at December 31, 2016                           | 1,310,482  | \$ 15.54 | 2.63 | \$ | - |
| Exercisable at December 31, 2016 and expected to vest | 1,310,482  | \$ 15.54 | 2.63 | \$ | - |

\* The aggregate intrinsic value is the difference between the estimated market value for the Company's common stock and the exercise price of the outstanding stock options on the respective dates.

Share-based compensation expense recognized for ordinary share options was approximately \$2.1 million, \$4.1 million and \$6.1 million for the years ended December 31, 2016, 2015 and 2014, respectively. The total intrinsic value of ordinary share options exercised during the years ended December 31, 2016, 2015 and 2014 was \$7 thousand, \$14 thousand and \$42 thousand, respectively. As of December 31, 2016, there was approximately \$2.1 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 2.19 years.



The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's expected stock price volatility over the term of the awards, assumed employee exercise behaviors, risk-free interest rate and expected dividends. For purposes of valuing ordinary share options, the Company used historical volatility at the date of grant. The approximate risk-free interest rate was based on the U.S. Treasury yield for comparable periods. The Company has experienced forfeitures in the past and estimates a forfeiture rate for awards issued when deemed applicable. Due to the small sample size, historical share option exercise experience is not considered representative of future activity. Therefore, the expected term of the ordinary share options was calculated using the simplified method in accordance with section 10-S99 of ASC Topic 718, "Compensation - Stock Compensation" ("ASC 718"). 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 years ended December 31, 2016, 2015 and 2014 was \$2.75, \$3.60 and \$6.22, and was measured at the date of grant using the following assumptions:

|                          | Year Ended December 31, |        |                  |
|--------------------------|-------------------------|--------|------------------|
|                          | 2016                    | 2015   | 2014             |
| Expected term (in years) | 3.5                     | 3.5    | 3.2 - 3.5        |
| Dividend yield           | 0.0 %                   | 0.0 %  | 0.0 %            |
|                          | 52.2 %                  |        |                  |
|                          | to                      |        |                  |
| Expected volatility      | 52.5 %                  | 51.8 % | 57.2 % to 58.8 % |
|                          | 0.95 %                  |        |                  |
|                          | to                      |        |                  |
| Risk free interest rate  | 1.13 %                  | 1.29 % | 1.07 % to 1.64 % |
| Forfeiture rate          | 0.0 %                   | 20.0 % | 0.0 %            |

#### Restricted Stock Units

The Company may also award non-vested restricted stock units to its executives, employees, directors and outside consultants under the 2013 Plans, which may vest based on service or a combination of service and other conditions, such as market share price. The compensation expense for the award will be recognized assuming that the requisite service is rendered regardless of whether the market conditions are achieved. Each non-vested stock unit, upon vesting, represents the right to receive one ordinary share of the Company. During the year ended December 31, 2016, the Company granted 320,305 restricted stock units under the 2013 Plans, as amended. During the year ended December 31, 2015 the Company granted certain officers 385,852 service based restricted stock units under the 2013 Plans. During the year ended December 31, 2014 the Company granted certain officers, directors and consultants 30,500 service-based restricted stock units under the 2013 Plans.

The following table summarizes the Company's restricted stock unit activity for the year ended December 31, 2016, 2015 and 2014:

| Number of | Average Fair |
|-----------|--------------|
|-----------|--------------|

|                                 | Shares     | Value at Grant Date |
|---------------------------------|------------|---------------------|
| January 1, 2014                 | 154,746    | \$ 14.08            |
| Granted                         | 30,500     | \$ 19.15            |
| Vested                          | (37,982 )  | \$ 14.42            |
| Forfeited                       | -          | \$ -                |
| Non-vested at December 31, 2014 | 147,264    | \$ 15.05            |
| Granted                         | 385,852    | \$ 9.33             |
| Vested                          | (90,014 )  | \$ 13.13            |
| Forfeited                       | -          | \$ -                |
| Non-vested at December 31, 2015 | 443,102    | \$ 10.20            |
| Granted                         | 320,305    | \$ 6.07             |
| Vested                          | (267,300 ) | \$ 8.11             |
| Forfeited                       | (14,022 )  | \$ 7.40             |
| Non-vested at December 31, 2016 | 482,085    | \$ 7.70             |

During the years ended December 31, 2016, 2015 and 2014, the Company recognized \$2.1 million, \$1.2 million and \$1.1 million in share-based compensation expense related to restricted stock units. As of December 31, 2016, there was \$2.0 million in unrecognized share-based compensation costs related to restricted stock units. The unrecognized share-based compensation expense is expected to be recognized over a weighted average period of 1.22 years.

The Company recorded share-based compensation costs from ordinary share options and restricted stock units, related deferred tax assets and tax benefits of \$4.2 million, \$5.7 million and \$2.2 million, respectively, in 2016, \$5.3 million, \$4.7 million and \$1.8 million, respectively, in 2015 and \$7.2 million, \$4.2 million and \$1.6 million, respectively, in 2014.

## NOTE 13 – INCOME TAXES

The information in this note is on a consolidated basis, but uses the United States as the primary taxing authority as the Company's primary operations are in the United States. The parent Company is an Israeli company, whose primary taxable income is from the provision, directly or indirectly through its affiliates, of telecommunication services.

## Components of Income Before Tax Expense

The components of income (loss) before income tax expense are as follows (in thousands):

|               | Year Ended December 31, |          |           |
|---------------|-------------------------|----------|-----------|
|               | 2016                    | 2015     | 2014      |
| United States | \$8,513                 | \$18,343 | \$(4,510) |
| Foreign       | 5,262                   | 6,969    | 18,040    |
|               | \$13,775                | \$25,312 | \$13,530  |

## Components of Income Tax Provision

The components of the income tax provision (benefit) in 2016, 2015 and 2014 are as follows (in thousands):

|                                      | Year Ended December 31, |          |          |
|--------------------------------------|-------------------------|----------|----------|
|                                      | 2016                    | 2015     | 2014     |
| Current:                             |                         |          |          |
| Federal                              | \$3,666                 | \$8,951  | \$-      |
| State                                | 949                     | 76       | 2        |
| Foreign                              | -                       | -        | -        |
| Current provision                    | 4,615                   | 9,027    | 2        |
| Deferred:                            |                         |          |          |
| Federal                              | (637 )                  | 7,203    | (1,774 ) |
| State                                | (59 )                   | 604      | (165 )   |
| Foreign                              | 5,114                   | 5,056    | (2,484 ) |
| Deferred (benefit) provision         | 4,418                   | 12,863   | (4,423 ) |
| Uncertain tax positions              | (314 )                  | (10,088) | 14,166   |
| Total income tax (benefit) provision | \$8,719                 | \$11,802 | \$9,745  |



## Effective Tax Rate Reconciliation

The following is a reconciliation of the Company's estimated annual effective income tax rate to the U.S. federal statutory rate for the years ended December 31, 2016, 2015 and 2014:

|  | Year Ended December 31, |         |         |
|--|-------------------------|---------|---------|
|  | 2016                    | 2015    | 2014    |
| Federal tax at statutory rate                  | 34.00%                  | 34.00%  | 34.00 % |
| State and local taxes, net of federal          | 1.00                    | 5.18    | 3.16    |
| Taxable gains from revaluation                 | 0.00                    | 0.00    | 45.01   |
| Effect of exchange rate on deferred taxes      | 0.00                    | 1.39    | 18.84   |
| Foreign results at rates other than domestic   | (5.65 )                 | (1.08 ) | (27.08) |
| Uncertain tax positions                        | (5.79 )                 | 2.00    | 47.60   |
| Anticipated benefit on increase in foreign NOL | 0.00                    | 0.00    | (38.77) |
| Expiration of stock options                    | 1.16                    | 2.73    | 0.00    |
| Noncontrolling interest                        | 1.57                    | 0.00    | 0.00    |
| Israeli tax rate changes                       | 38.13                   | 0.00    | 0.00    |
| Deferred tax charges on intercompany sales     | 2.16                    | 0.00    | 0.00    |
| Return-to-provision adjustments                | 5.25                    | 0.00    | 0.00    |
| Other  | 0.36                    | (2.66 ) | 0.63    |
| Valuation allowance                            | (8.89 )                 | 5.07    | (11.36) |
| Effective tax rate                             | 63.30%                  | 46.63%  | 72.03 % |

The Company operates in the U.S. and Israel. Its U.S. operations are subject to a federal statutory income tax rate of 34% in 2016, 2015 and 2014 and its Israeli operations are subject to statutory income tax rates of 25.0% in 2016 and 26.5% in 2015 and 2014. The Israel operations will be subject to statutory income tax rates of 24% in 2017 and 23% in 2018. The income tax provision for 2016, 2015, and 2014 included items that have resulted in significant variances in the Company's effective tax rate in comparison to statutory rates.

For the year ended December 31, 2016, the Company recorded income tax expense of \$8.7 million, which is higher than the expected tax provision of \$4.7 million, using the statutory rate of 34%, due, in part, to the net impact of a decrease in the Israeli corporate tax rate from 26.5% to 23.0% which was effective in December 2016. The decrease in the rate resulted in the Company needing to reduce its Israeli deferred tax assets, primarily net operating loss carryforwards, which resulted in deferred tax expense and a reduction in the value of related deferred tax assets of \$5.2 million. Additionally, the effective tax rate was impacted by increases to uncertain tax positions of (\$0.8 million), decreases in valuation allowances of (\$1.2 million) and other items of \$0.8 million. The discrete items noted above were partially offset by the lower jurisdictional tax rate charged on the operating income of the Company's Israeli operations.

For the year ended December 31, 2015, the Company recorded income tax expense of \$11.8 million, which differed from the expected provision of \$8.6 million, using the statutory rate of 34%, primarily due to changes in valuation allowances of \$1.3 million established against certain Israeli capital losses and state net operating loss carryforwards, increases to uncertain tax positions of \$0.5 million, a decrease to deferred tax assets associated with expired stock options of \$0.7 million, and other one-time discrete items of \$0.7 million. State income tax expense, net of federal tax benefit, is presented in the effective tax rate reconciliation exclusive of changes in valuation allowances on state income tax deferred items.

For the year ended December 31, 2014, the Company recorded income tax expense of \$9.7 million, which differed from the expected tax provision of \$5.0 million, using the statutory rate of 34%, primarily due to an increase in the

U.S. uncertain tax positions of \$6.4 million, as well as the effect of changes in the exchange rate on both the Company's net deferred tax assets associated with its Israeli operations of \$2.5 million, and taxable unrealized gains on the Israeli parent's U.S. dollar denominated assets of \$6.4 million. These items were partially offset by an income tax benefit in the Company's foreign taxes associated with expected revisions to jurisdictional income allocations resulting from the IRS audit examination of \$5.3 million, and by the jurisdictional rate differential between the U.S. and Israel of \$3.7 million and an adjustment of our estimate of the required valuation allowance of \$1.2 million. The Company's Israeli operations resulted in an income tax provision of \$5.2 million, an effective tax rate of 28.9%, and its domestic operations recorded a provision of \$4.5 million for the year ended December 31, 2014.

The effective tax rate in the future may be affected by the realization of previously unrecognized deferred tax assets being recovered from future taxable income, the mix of foreign sourced versus domestic income and the effect of any significant changes in foreign currency rates.

## Components of Deferred Income Tax

The significant components of estimated deferred income tax assets and liabilities as of December 31, 2016 and 2015 are as follows (in thousands):

|   | December 31, |           |
|---|--------------|-----------|
|   | 2016         | 2015      |
| Deferred tax assets:                        |              |           |
| Deferred revenue, net of deferred costs     | \$ 1,043     | \$ 1,925  |
| Domestic net operating loss carryforwards   | 1,214        | 803       |
| Foreign net operating loss carryforwards    | 30,103       | 36,662    |
| Basis difference in intangible assets       | 5,343        | 3,467     |
| Allowance for doubtful accounts             | 91           | 59        |
| Currently non-deductible expenses and other | 2,914        | 2,593     |
| Capital loss carryforwards                  | 1,413        | 1,644     |
| Stock based compensation                    | 2,198        | 1,792     |
| Foreign tax credit carryforward             | 1,558        | 1,075     |
| Total deferred tax assets                   | 45,877       | 50,020    |
| Deferred tax liabilities:                   |              |           |
| Basis difference in goodwill                | (2,079 )     | (953 )    |
| Basis difference in fixed assets            | (911 )       | (834 )    |
| Total deferred tax liabilities              | (2,990 )     | (1,787 )  |
| Valuation allowance                         | (16,319)     | (17,544)  |
| Net deferred taxes                          | \$ 26,568    | \$ 30,689 |

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

## Valuation Allowance

At December 31, 2016 and 2015, the Company had valuation allowances related to deferred tax assets associated with net operating losses of an inactive foreign subsidiary, foreign capital and revaluation losses, unrealized gains on prior year transactions associated with the Company's common equity put options, and domestic state net operating losses. These deferred tax assets do not meet the more likely than not threshold that they will be realized.

More broadly, the Company's assessment for the years ended December 31, 2016, 2015 and 2014 considered the following positive and negative evidence.

## Positive evidence

The Company has generated cumulative pre-tax income in the U.S and Israel of \$22.3 million and \$30.3 million, respectively, for the three year period ended December 31, 2016, and has utilized some of its available tax assets to

reduce the tax liabilities that would have otherwise arisen in those periods.

The U.S. and Israel require approximately \$15.4 million and \$85.2 million in future taxable income, respectively, to realize the deferred tax assets at December 31, 2016. The Company's Israeli net operating loss carryforwards are not subject to expiration and its financial performance has continued to generate pre-tax operating income despite challenging macroeconomic conditions.

#### Negative evidence

At December 31, 2016, the negative evidence consists primarily of the Company's history of significant pre-tax losses dating back to years prior to 2010. In total, the U.S. group of companies has approximately \$0.6 million of state deferred tax assets, before application of valuation allowances, related to \$13.7 million of state net operating losses which expire over periods ranging through 2036. The Israeli group of companies has approximately \$30.1 million of deferred tax assets, before application of valuation allowances, related to \$130.6 million of net operating loss carryforwards, which has accumulated over many years. Of the total Israeli group combined net operating losses, \$51.2 million are limited in use as these net operating losses relate to specific subsidiaries, which are currently inactive and a valuation allowance remains against those losses. The Company believes that the combined impact of a number of Company specific and industry specific developments over recent years makes it unlikely that the repeated annual losses incurred prior to the year ended December 31, 2012 would recur.



In addition, the Company considered negative evidence in connection with various industry specific factors. The market in which the Company participates is highly competitive and could be impacted by changes in technology. If the Company does not compete effectively, its operating results may be harmed by loss of market share and revenues. The Company may also face difficulty in attracting new customers, and if it fails to attract new customers, its business and results of operations may suffer. The Company also relies on independent retailers to sell the magicJack devices, and disruption to these channels would harm its business.

After consideration of both the positive and negative evidence, the Company believes that its positive evidence is strong. The operating profits in recent years compared to the historical operating losses prior to 2012 is an objectively verifiable piece of positive evidence and is the result of a number of factors, which have been present to a greater or lesser extent in prior years, but have only recently gathered sufficient weight to deliver consistent taxable profits. A key consideration in the Company's analysis was that the unlimited carryforward periods of its Israel net operating losses make the realization of those assets less sensitive to variations in the Company's projections of future taxable income than would otherwise be the case if the carryforward periods were time limited.

Valuation allowances of \$16.3 million, \$17.5 million and \$16.2 million at December 31, 2016, 2015 and 2014, respectively, were provided for deferred tax assets associated with net operating losses of an inactive foreign subsidiary, foreign capital and revaluation losses, unrealized gains on prior year transactions associated with the Company's common equity put options, and domestic state net operating losses.

The reconciliation of the valuation allowance for the years ended December 31, 2016 and 2015 is as follows (in thousands):

|                                    | Years Ended December 31, |           |
|------------------------------------|--------------------------|-----------|
|                                    | 2016                     | 2015      |
| Balance, beginning of period       | \$ 17,544                | \$ 16,230 |
| Changes to the valuation allowance | (1,225 )                 | 1,314     |
| Balance, end of period             | \$ 16,319                | \$ 17,544 |

#### Uncertain Tax Positions

The Company reassesses 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 it is more-likely-than-not that a tax benefit will be sustained, the Company has recorded the largest amount of tax benefit with a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more-likely-than-not that a tax benefit will be sustained, no tax benefit has been recognized in the Company's consolidated financial statements.

The Company files U.S. federal and state and foreign income tax returns in jurisdictions with varying statutes of limitations. During 2013, the Company received notice that the IRS was going to examine its tax returns for 2010 and 2011. In October 2014, the Company was informed by the IRS that it was going to expand its audit to include the Company's 2012 and 2013 tax returns. During 2015, the Company reached agreement with the IRS on a settlement of all years under audit. The settlement resulted in an increase to the jurisdictional income of the U.S. The additional tax

and interest due to the IRS and various state taxing authorities as a result of the increased U.S. jurisdictional income was \$6.8 million and \$0.9 million, respectively. The Company was able to utilize approximately \$4.2 million of benefits related to other favorable adjustments identified during the exam to satisfy a portion of the federal liability, resulting in net tax and interest paid to the IRS of \$2.6 million. The \$0.9 million state liability is reflected as a reduction to prepaid income taxes in the Company's December 31, 2015 consolidated balance sheets. The increase to the U.S. jurisdictional income resulted in a decrease in the Company's Israeli jurisdictional income. The decrease in Israeli income, in turn, increased the Company's Israeli net operating losses, resulting in a tax benefit of \$5.6 million. The tax years 2010 through 2016 remain open to examination by other major taxing jurisdictions to which the Company is subject.

A reconciliation of the gross amounts of unrecognized tax benefits, excluding accrued interest and penalties, is as follows (in thousands):

|  | Years Ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2016                     | 2015     | 2014     |
| Unrecognized tax benefits, opening balance                   | \$9,929                  | \$18,860 | \$5,677  |
| Gross increases (decreases) - tax positions in prior periods | (356 )                   | (1,030 ) | 6,978    |
| Gross increases - tax positions in current period            | 79                       | 5        | 6,205    |
| Settlements  | (516 )                   | (7,906 ) | -        |
| Lapse of statute of limitations                              | -                        | -        | -        |
| Unrecognized tax benefits, ending balance                    | \$9,136                  | \$9,929  | \$18,860 |

All amounts in the reconciliation above are reported on a gross basis and do not reflect a federal tax benefit on state income taxes. The Company does not anticipate a significant reduction in unrecognized tax benefits within the next twelve months due to lapse of statute of limitation.

As of December 31, 2016, 2015 and, 2014, there were \$8.3 million, \$9.2 million and \$12.5 million of unrecognized tax benefits, respectively, that if recognized, would favorably affect the Company's annual effective tax rate. The Company recognizes interest and penalties accrued related to unrecognized tax benefits as income tax expense as a component of the income tax (benefit) expense in the Company's consolidated statements of operations and the corresponding liability is included in income taxes payable and other non-current liabilities in its consolidated balance sheets.

As of December 31, 2016, 2015 and 2014, \$10.4 million, \$10.8 million and \$11.4 million, respectively, was included in other non-current liabilities in the Company's consolidated balance sheets for uncertain tax positions. As of December 31, 2016 and 2015 nothing and as of December 31, 2014, \$7.5 million was included in income taxes payable in the Company's consolidated balance sheets for uncertain tax positions. The amount of accrued interest and penalties recognized by the Company in the years ended December 31, 2016, 2015 and 2014 was \$2.1 million, \$1.6 million and \$0.7 million, respectively.

#### NOTE 14 – INCOME PER SHARE

Net income per share– basic, is calculated by dividing net income attributable to the Company's common shareholders by the weighted average number of ordinary shares outstanding during each period. Net income– diluted, is computed using net income per share attributable to the Company's common shareholders, and dividing it 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.

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):

|  | Year Ended December 31, |          |         |
|--|-------------------------|----------|---------|
|  | 2016                    | 2015     | 2014    |
| Numerator:                                     |                         |          |         |
| Net income attributable to common shareholders | \$5,691                 | \$13,510 | \$3,785 |
| Denominator:                                   |                         |          |         |

|   |        |        |        |
|---|--------|--------|--------|
| Denominator for basic net income per share - weighted average common shares outstanding       | 15,815 | 16,975 | 17,831 |
| Effect of dilutive options and/or restricted stock units to purchase common shares            | -      | 2      | -      |
| Effect of dilutive options and/or restricted stock units exercised or expired during the year | 249    | 68     | 37     |
| Denominator for diluted net income per share - weighted average common shares outstanding *   | 16,064 | 17,045 | 17,868 |
| Net income per common share:  |        |        |        |
| Basic   | \$0.36 | \$0.80 | \$0.21 |
| Diluted   | \$0.35 | \$0.79 | \$0.21 |

\* Options to purchase 2,402,427 ordinary shares and 299,137 restricted stock units outstanding during the year ended December 31, 2016 were not included in the calculation of diluted earnings per share because their respective exercise prices were greater than the average market price of the ordinary shares and their inclusion in the calculation would be antidilutive. Options to purchase 2,524,927 ordinary shares and 443,102 restricted stock units outstanding during the year ended December 31, 2015 were not included in the calculation of diluted earnings per share because their respective exercise prices were greater than the average market price of the ordinary shares and their inclusion in the calculation would be antidilutive. Options to purchase 2,037,107 ordinary shares and 147,264 restricted stock units outstanding for the year ended December 31, 2014 were not included in the calculation of diluted earnings per ordinary share because their exercise prices were greater than the average market price of the ordinary shares and their inclusion would have been antidilutive.

## NOTE 15 – ACQUISITION OF BUSINESS

## Broadsmart

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

The Company acquired substantially all of the assets and assumed certain liabilities of the Seller in exchange for approximately \$38.0 million in cash, plus unregistered ordinary shares of the Company worth \$1.8 million, valued based on the average of the previous 30 days stock price, subject to certain adjustments, including an adjustment for working capital and indebtedness. The Agreement also provided for an additional contingent payment of up to \$200,000 in cash to the Seller Shareholders in the event that certain two individuals currently employed by the Seller fail to accept the Company's employment offer (the contingent payment is \$100,000 in the event that one of the two individuals fails to accept such employment offer). This amount was included in consideration and was recorded as accrued expenses and other current liabilities in the accompanying consolidated balance sheets as of December 31, 2016. Lastly, the Seller Shareholders would receive an additional contingent payment of \$2.0 million in cash if the acquired assets generated 2016 revenues equal to or exceeding \$15.6 million (the "Earnout Payment"). The \$2.0 million Earnout Payment was paid into escrow at the time of closing. With the help of a third party valuation firm, the value of this contingent consideration was determined to be \$1.7 million which was included in total consideration of the business acquired. In the third quarter ended September 30, 2016 management concluded that it was remote that 2016 revenues of the acquired assets would equal or exceed \$15.6 million, and accordingly recorded a \$2.0 million receivable from earnout escrow in the consolidated balance sheets. Corresponding income of \$1.7 million from change in contingent consideration was recorded as a reduction of operating expense labeled gain on mark-to-market in the consolidated statement of operations.

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

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

The Company issued 233,402 shares of the Company's ordinary shares from treasury stock with a fair value of \$1.7 million based on closing market price per share as of the date of the acquisition to the Seller in satisfaction of the stock consideration provided in the Agreement. The Company also granted stock options to each of the Seller Shareholders to purchase 500,000 shares of the Company's ordinary shares in conjunction with each of them entering into an employment agreement with the Company which is considered compensation expense. The stock options shall vest as follows: 50% will vest in even annual increments over the next three-year period if the Seller Shareholders remain employed with the Company as of each respective vesting date, and 50% will vest over the next three-year period if Broadsmart achieves certain designated revenue and EBITDA targets. The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The Agreement also provided for an additional

contingent payment of up to \$1.0 million in cash from the Seller Shareholders to certain two non-shareholders currently employed by the Seller Shareholders in the event those two individuals accept the Company's employment offer and remain employed by the Company through and including December 15, 2016. No expense has been recorded for this as no agreement has been reached on employment offers with the two non-shareholders.

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

The Company incurred \$0.8 million in acquisition related transaction costs, which are included in general and administrative expense in the accompanying consolidated statements of operations.

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

The acquisition was accounted for using the acquisition method of accounting under which assets and liabilities of Broadsmart were recorded at their respective fair values including an amount for goodwill representing the difference between the acquisition consideration and the fair value of the identifiable net assets. The Company expects this goodwill to be deductible for tax purposes. The goodwill attributable to the acquisition has been recorded as a non-current asset and is not amortized, but is subject to an annual review for impairment. Refer to Note 7, “Goodwill” for further details. The acquisition price was allocated to the tangible and identified intangible assets acquired and liabilities assumed as of the closing date. The fair values assigned to tangible and identifiable intangible assets acquired and liabilities assumed are based on management’s estimates and assumptions. The Company finalized the valuation as of December 31, 2016.

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

|  | Estimated Fair Value |
|--|----------------------|
| Assets   |                      |
| Current assets:                                |                      |
| Accounts receivable                            | \$ 567               |
| Inventories                                    | 302                  |
| Deposits and other current assets              | 143                  |
| Total current assets                           | 1,012                |
| Property and equipment                         | 355                  |
| Intangible assets                              | 26,385               |
| Deposits and other non-current assets          | 96                   |
| Total assets acquired                          | 27,848               |
| Liabilities                                    |                      |
| Current liabilities:                           |                      |
| Accrued expenses and other current liabilities | 900                  |
| Deferred revenue                               | 172                  |
| Total current liabilities                      | 1,072                |
| Other non-current liabilities                  | 62                   |
| Total liabilities assumed                      | 1,134                |
| Net identifiable assets acquired               | 26,714               |
| Goodwill                                       | 14,881               |
| Total purchase price                           | \$ 41,595            |

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

|                         | Amount    |
|-------------------------|-----------|
| Customer relations hips | \$ 22,100 |
| Non-compete agreements  | 100       |
| Tradename               | 2,200     |
| Process know how        | 1,100     |
| Software license        | 885       |
|                         | \$ 26,385 |

Indications of fair value of the intangible assets acquired in connection with the acquisition were determined using either the income, market or replacement cost methodologies. The intangible assets are being amortized over periods which reflect the pattern in which economic benefits of the assets are expected to be realized. The customer relationships are being amortized on an accelerated basis over an estimated useful life of ten years and the non-compete agreements, process know how and software license are being amortized on a straight-line basis over four years, five years and ten years, respectively. Tradename is not subject to amortization but is subject to an annual review for impairment. An impairment charge of \$0.5 million was recognized on the tradename during the year ended December 31, 2016. Refer to Note 6, "Intangible Assets" for further details.



## Pro Forma Financial Information

The following table presents the unaudited pro forma combined results of operations of the Company and Broadsmart for the years ended December 31, 2016 and 2015 as if the acquisition of Broadsmart had occurred on January 1, 2015. The pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of 2015.

|              | Year Ended<br>December 31, |           |
|--------------|----------------------------|-----------|
|              | 2016                       | 2015      |
| Net revenues | \$99,938                   | \$113,525 |
| Net income   | \$5,407                    | \$13,305  |

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

## NOTE 16 – SEGMENT REPORTING

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

Historically, the Company has not had separate reportable segments. However, with the acquisition of Broadsmart in March 2016, refer to Note 15, "Acquisition of Business," for further details, and the founding of the SMB business during the first quarter of 2016, management evaluated each of these new business lines separately and determined that the Company now has three reportable segments – "Core Consumer," "Enterprise" and "SMB". These segments are organized by the products and services that are sold and the customers that are served. The below table includes an "Other" segment to capture the Company's interest in a joint venture that does not meet either the aggregation criteria to be combined with the existing Core Consumer segment or the quantitative thresholds to be treated as a reportable segment. The Company measures and evaluates its reportable segments based on revenues and gross profit margins. The Company's segments and their principal activities consist of the following:

## Core Consumer

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

magicJack is a cloud communications leader that is the inventor of the magicJack devices and other magicJack products and services. magicJack's products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make

free calls back to the United States and Canada from anywhere legally permitted in the world.

#### Enterprise

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

## SMB

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

## Other

This segment includes the Company's 60% controlling interest in a joint venture which began selling a line of high-technology residential consumer products in the fourth quarter of fiscal year 2016. The Company's consolidated financial statements for the year ended December 31, 2016, include an adjustment to comprehensive income attributable to common shareholders of \$635 thousand, to recognize the impact of the noncontrolling interest. The Company has determined that the joint venture does not meet either the aggregation criteria to be combined with the existing Core Consumer segment or the quantitative thresholds to be treated as a reportable segment. As such, it is included in the "Other" segment.

Selected information for the year ended December 31, 2016 is presented by Reportable Segment below (in thousands):

|                                   | For the Year ended December 31, 2016 |             |             |            |              |              |
|-----------------------------------|--------------------------------------|-------------|-------------|------------|--------------|--------------|
|                                   | Core                                 |             |             |            |              |              |
|                                   | Consumer                             | Enterprise  | SMB         | Other      | Intercompany | Consolidated |
| Net revenues                      | \$88,315                             | 9,043       | 105         | 13         | (78 )        | \$ 97,398    |
| Cost of revenues                  | 29,250                               | 7,224       | 179         | 81         | -            | 36,734       |
| Gross profit (loss)               | 59,065                               | 1,819       | (74 )       | (68 )      | (78 )        | 60,664       |
| Marketing                         | 4,768                                | 380         | 3,497       | 440        | -            | 9,085        |
| General and administrative        | 23,584                               | 3,641       | 6,102       | 1,076      | (78 )        | 34,325       |
| Research and development          | 3,859                                | 22          | 1,313       | 5          | -            | 5,199        |
| Gain on mark-to-market            | (1,700 )                             | -           | -           | -          | -            | (1,700 )     |
| Operating expenses                | 30,511                               | 4,043       | 10,912      | 1,521      | (78 )        | 46,909       |
| Operating income (loss)           | 28,554                               | (2,224 )    | (10,986)    | (1,589)    | -            | 13,755       |
| Interest and dividend income      | (26 )                                | -           | -           | -          | -            | (26 )        |
| Other expenses, net               | 6                                    | -           | -           | -          | -            | 6            |
| Income (loss) before income taxes | \$28,574                             | \$ (2,224 ) | \$ (10,986) | \$ (1,589) | \$ -         | \$ 13,775    |

|                      | For the Year ended December 31, 2016 |            |         |       |              |              |
|----------------------|--------------------------------------|------------|---------|-------|--------------|--------------|
|                      | Core                                 |            |         |       |              |              |
|                      | Consumer                             | Enterprise | SMB     | Other | Intercompany | Consolidated |
| Goodwill             | \$32,304                             | 14,881     | -       | -     | -            | \$ 47,185    |
| Total assets         | \$142,870                            | 40,839     | (9,447) | 255   | -            | \$ 174,517   |
| Capital expenditures | \$511                                | 431        | 220     | 23    | -            | \$ 1,185     |
| Depreciation expense | \$994                                | 155        | 40      | 2     | -            | \$ 1,191     |
| Amortization expense | \$1,604                              | 1,938      | -       | -     | -            | \$ 3,542     |

## NOTE 17 – SUBSEQUENT EVENTS

On January 3, 2017, the Company received a letter from the staff of the Listing Qualifications Department of The Nasdaq Global Stock Market ("NASDAQ") notifying the Company that the Company no longer complies with NASDAQ Listing Rule 5620(a) for continued listing due to its failure to hold its 2016 annual meeting of shareholders

within twelve months of the end of the Company's fiscal year ended December 31, 2015. The Company's last annual meeting of shareholders was held on July 8, 2015. As a result, as of January 3, 2017, the Company had 45 calendar days to submit a plan to regain compliance. If NASDAQ accepts the Company's plan, NASDAQ can grant an exception of up to 180 calendar days from the fiscal year ended December 31, 2016, or until June 29, 2017, to regain compliance. The Company submitted a plan of compliance and supplemental materials to NASDAQ on February 17, 2017 and February 27, 2017. On March 3, 2017, NASDAQ notified the Company that it had granted an extension to the Company to regain compliance with the rule by holding the annual meeting of shareholders on or before June 29, 2017. The Company anticipates holding its 2016 annual shareholders meeting on April 19, 2017.

As previously disclosed, the Company had a 60% controlling interest in a joint venture which began selling a line of high-technology residential consumer products in the fourth quarter of fiscal year 2016. As of December 31, 2016, the Company had invested a total of approximately \$1.5 million in this joint venture. In the first quarter of 2017, the Company determined that it would not make any further investments in this joint venture. As a result of the Company's decision not to further invest, under the original terms of the joint venture, the Company's ownership interest was automatically reduced to 36%. Because the joint venture constitutes a variable interest entity of the Company, the results of the joint venture will continue to be consolidated on the Company's financial statements.

As previously announced in January 2017, Keith Reed, the Senior Vice President and General Manager of SMB, departed the Company effective February 3, 2017 and the Company announced a new direction and anticipated operating efficiencies for the SMB unit. As a result, the Company has made the decision to significantly reduce the staff of the SMB subsidiary and refocus the direction of the business. The Company plans to continue to sell the product and report SMB as a reportable segment going forward, but has plans to make significant changes to the marketing and sales approaches on a going forward basis.

As previously disclosed in December 2016, the Board of Directors of the Company approved, subject to shareholder approval at the 2016 annual shareholders meeting, an extension of the term of Gerald Vento's employment agreement with the Company under the terms of his Executive Employment Agreement with the Company dated January 1, 2013, as amended by Amendment to Executive Employment Agreement, dated as of July 15, 2015 (collectively, the "Vento Employment Agreement") such that Mr. Vento would continue to serve as the Company's President and Chief Executive Officer through the earlier of June 30, 2017 or the date the Company hired a President and Chief Executive Officer to replace Mr. Vento (the "Second Amendment"). In March 2017, the Company announced that it had appointed Don Carlos Bell III as President and Chief Executive Officer of the Company to succeed Mr. Vento as President and Chief Executive Officer, effective as of March 9, 2017. Mr. Bell has agreed to defer negotiation of his compensation in exchange for serving as the Company's President and Chief Executive Officer pending his election as a director of the Company at the 2016 annual shareholders meeting. Mr. Vento will remain on the Board of Directors of the Company and will serve as a consultant to the Company effective as of March 10, 2017 on the terms previously disclosed in the Form 8-K filed on January 5, 2017 in connection with the Second Amendment. Compensation in connection with Mr. Vento's extension of employment under the Second Amendment and his services as a consultant will not be paid until shareholder approval is received at the 2016 annual shareholders meeting, at which time all accrued compensation will be paid to Mr. Vento.

The Company filed its definitive proxy statement for its 2016 annual shareholders meeting on March 15, 2017. The Company's 2016 annual shareholders meeting will be held on April 19, 2017 at 10:00 a.m. Eastern Daylight Time at the offices of the Company located at 222 Lakeview Avenue, Suite 1600, West Palm Beach, Florida 33401 unless otherwise adjourned or postponed.

## MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES

## SUPPLEMENTAL FINANCIAL INFORMATION

## SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly financial results for the years ended December 31, 2016 and 2015 were as follows (in thousands, except per share data):

|   | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total Year |
|---|------------------|-------------------|------------------|-------------------|------------|
| 2016  |                  |                   |                  |                   |            |
| Net revenues  | \$23,699         | \$25,301          | \$24,572         | \$23,826          | \$ 97,398  |
| Gross profit  | 15,490           | 15,463            | 15,063           | 14,648            | 60,664     |
| Operating income (loss) (2)   | 4,234            | 4,206             | 5,428            | (113 )            | 13,755     |
| Net income (loss)   | 734              | 2,515             | 3,222            | (1,415 )          | 5,056      |
| Net income (loss) attributable to magicJack VocalTec Ltd<br>common shareholders | 734              | 2,819             | 3,399            | (1,261 )          | 5,691      |
| Earnings per magicJack VoalTec Ltd common share: (1)                            |                  |                   |                  |                   |            |
| Basic   | 0.05             | 0.18              | 0.21             | (0.08 )           | 0.36       |
| Diluted   | 0.05             | 0.18              | 0.21             | (0.08 )           | 0.35       |

|                                  | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total Year |
|----------------------------------|------------------|-------------------|------------------|-------------------|------------|
| 2015                             |                  |                   |                  |                   |            |
| Net revenues                     | \$25,512         | \$25,410          | \$25,409         | \$24,631          | \$ 100,962 |
| Gross profit                     | 16,045           | 16,741            | 17,184           | 16,850            | 66,820     |
| Operating income                 | 4,433            | 6,429             | 7,453            | 7,028             | 25,343     |
| Net income                       | 1,308            | 6,952             | 3,311            | 1,939             | 13,510     |
| Earnings per ordinary share: (1) |                  |                   |                  |                   |            |
| Basic                            | 0.07             | 0.39              | 0.20             | 0.12              | 0.80       |
| Diluted                          | 0.07             | 0.39              | 0.20             | 0.15              | 0.79       |

(1) The sum of quarterly earnings per ordinary share amounts may not add to the annual earnings per ordinary share amount due to the weighting of ordinary shares and equivalent ordinary shares outstanding during each of the respective periods.

(2) During the third quarter of 2016, the Company recognized a \$2.0 million gain on mark-to-market related to the Broadsmart Earnout and a \$0.5 million loss on impairment of intangible assets. During the fourth quarter of 2016, the Company reduced the gain on mark-to-market by \$0.3 million and recognized a \$0.5 million loss on impairment of intangible assets.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2016, our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15(b) promulgated under the Securities Exchange Act of 1934, as amended, or the Exchange Act. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that, as of December 31, 2016, our disclosure controls and procedures were effective in ensuring that material information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, including ensuring that such material information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rule 13a – 15(f). Our internal control system was designed to provide reasonable assurance to our management and the Board of Directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2016. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, in Internal Control—Integrated Framework (the 2013 COSO framework). Based on our assessment we believe that, as of December 31, 2016, our internal control over financial reporting is effective based on those criteria. The effectiveness of our internal control over financial reporting as of December 31, 2016 has been audited by BDO USA, LLP, an independent registered public accounting firm, as stated in their report which appears below.

Management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Broadsmart Global, Inc., which was acquired on March 16, 2016, and which is included in the consolidated balance sheets of magicJack Vocaltec, Ltd. and Subsidiaries as of December 31, 2016, and the related consolidated statements of operations and comprehensive income, capital equity, and cash flows for the year then ended. Broadsmart Global, Inc. constituted 6.6% and 17.4% of total assets and net assets, respectively, as of December 31, 2016, and 9.3% and (44.0)% of revenues and net income, respectively, for the year then ended. Management did not assess the effectiveness of internal control over financial reporting of Broadsmart Global, Inc. because of the timing of the acquisition which was completed on March 16, 2016.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
magicJack VocalTec Ltd. and Subsidiaries  
Netanya, Israel

We have audited magicJack VocalTec Ltd. and Subsidiaries' (the Company) internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). magicJack VocalTec, Ltd.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Item 9A, Management's Annual Report on Internal Control Over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying "Item 9A, Management's Annual Report on Internal Control over Financial Reporting", management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Broadsmart Global, Inc., which was acquired on March 16, 2016, and which is included in the consolidated balance sheets of magicJack Vocaltec, Ltd. and Subsidiaries as of December 31, 2016, and the related consolidated statements of operations comprehensive income, capital equity, and cash flows for the year then ended. Broadsmart Global, Inc. constituted 6.6% and 17.4% of total assets and net assets, respectively, as of December 31, 2016, and 9.3% and (44.0)% of revenues and net income, respectively, for the year then ended. Management did not assess the effectiveness of internal control over financial reporting of Broadsmart Global, Inc. because of the timing of the acquisition which was completed on March 16, 2016. Our audit of internal control over financial reporting of magicJack Vocaltec, Ltd and Subsidiaries also did not include an evaluation of the internal control over financial reporting of Broadsmart Global Inc.



In our opinion, magicJack VocalTec Ltd. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of magicJack VocalTec, Ltd. and Subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income, capital equity, and cash flows for each of the three years in the period ended December 31, 2016 and our report dated March 16, 2017 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP  
Certified Public Accountants  
West Palm Beach, Florida

March 16, 2017

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ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

We refer you to our Proxy Statement for the 2016 Annual General Meeting of Shareholders under the captions "Corporate Governance," "Report of the Audit Committee," "Biographies of our Board Nominees," "Meetings and Committees of the Board," and "Section 16(a) Beneficial Ownership Reporting Compliance," which sections are incorporated by reference herein. Biographical information on our executive officers is contained in Part I of this Annual Report on Form 10-K.

ITEM 11. EXECUTIVE COMPENSATION

We refer you to our Proxy Statement for the 2016 Annual General Meeting of Shareholders under the captions "Executive Compensation and Related Matters," including "Compensation Discussion and Analysis" and "Compensation Committee Report," which sections are incorporated by reference herein.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

We refer you to our Proxy Statement for the 2016 Annual General Meeting of Shareholders under the captions "Security Ownership of Certain Beneficial Owners and Management," and "Certain Relationships and Related Transactions," which sections are incorporated by reference herein.

We refer you to Item 5, "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" for information with respect to all of our equity compensation plans in effect as of December 31, 2016, which section is incorporated by reference herein.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

We refer you to our Proxy Statement for the 2016 Annual General Meeting of Shareholders under the captions "Corporate Governance" and "Certain Relationships and Related Transactions," which sections are incorporated by reference herein.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

We refer you to our Proxy Statement for the 2016 Annual General Meeting of Shareholders under the caption "Ratification of Appointment of Independent Registered Public Accounting Firm," which section is incorporated by reference herein.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

- Asset Purchase Agreement, dated as of March 15, 2016, by and among Todd A. Correll, Thomas J. Tharrington, North American Telecommunications Corporation, and magicJack Business Subsidiary, Inc., a subsidiary of the
- 2.1 Company and the Company (solely as guarantor of the obligations of magicJack Business Subsidiary, Inc.), filed with the SEC on May 12, 2016 as Exhibit 2.1 to the Company's Amendment No. 1 to the Quarterly Report on Form 10-Q/A and incorporated herein by reference.[1]
- Amended and Restated Articles of Association, filed with the SEC on April 2, 2013 as Exhibit 3.1 to the
- 3.1 Company's Annual Report on Form 10-K and incorporated herein by reference.
- Form of Share Certificate of the Company, filed with the SEC on January 12, 2011 as Exhibit 4.2 to the
- 4.1 Company's Amendment No. 1 to Registration Statement on Form F-3 (File No. 333-169659) and incorporated herein by reference.
- 2003 Amended Master Stock Option Plan,\* filed with the SEC on January 19, 2011 as Exhibit 99.1 to the
- 10.1 Company's registration statement on Form S-8 (File Number 333-171771) and incorporated herein by reference.
- Amended and Restated Appendix to Stock Option Plan – U.S.A. Employees,\* filed with the SEC on January 19,
- 10.2 2011 as Exhibit 99.2 to the Company's registration statement on Form S-8 (File Number 333-171771) and incorporated herein by reference.
- Amended and Restated Appendix to Stock Option Plan – Non-U.S. and Non-Israeli Employees and Consultants,\*
- 10.3 filed with the SEC on January 19, 2011 as Exhibit 99.3 to the Company's registration statement on Form S-8 (File Number 333-171771) and incorporated herein by reference.
- Form of indemnification and release undertaking between the Company and its officers and directors,\* filed
- 10.4 with the SEC on November 18, 2010 as Appendix B to proxy statement submitted on Form 6-K and incorporated herein by reference.
- Restricted Share Grant Letter Agreement, dated April 28, 2011, with Yoseph Dauber,\* filed with the SEC on
- 10.5 March 15, 2012 as Exhibit 10.11 to the Company's Annual Report on Form 10-K and incorporated herein by reference.
- Restricted Share Grant Letter Agreement, dated April 28, 2011, with Tal Yaron-Eldar,\* filed with the SEC on
- 10.6 March 15, 2012 as Exhibit 10.11 to the Company's Annual Report on Form 10-K and incorporated herein by reference.
- Executive Employment Agreement, effective January 1, 2013, by and between MagicJack VocalTec Ltd and
- 10.7 Gerald Vento,\* filed with the SEC on April 8, 2013 as Exhibit 10.1 to the Company's Current Report on Form 8-K and incorporated herein by reference.
- Form of Restricted Stock Agreement,\* filed with the SEC on April 8, 2013 as Exhibit 10.4 to the Company's
- 10.8 Current Report on Form 8-K and incorporated herein by reference.
- Consulting Agreement, dated May 11, 2013, by and between magicJack VocalTec Ltd. and Peter J. Russo,\*
- 10.9 filed with the SEC on May 13, 2013 as Exhibit 10.2 to the Company's Current Report on Form 8-K and incorporated herein by reference.

- 10.10 Executive Employment Agreement, dated May 8, 2013 by and between magicJack VocalTec Ltd. and Jose Gordo,\* filed with the SEC on May 13, 2013 as Exhibit 10.3 to the Company's Current Report on Form 8-K and incorporated herein by reference.
- 10.11 Form of Stock Option Agreement,\* filed with the SEC on May 13, 2013 as Exhibit 10.5 to the Company's Current Report on Form 8-K and incorporated herein by reference.
- 10.12 magicJack VocalTec Ltd. Compensation Policy,\* filed with the SEC on June 3, 2013 as Appendix B to the Company's proxy statement and incorporated herein by reference.
- 10.13 magicJack VocalTec Ltd. 2013 Stock Incentive Plan,\* filed with the SEC on June 3, 2013 as Appendix C to the Company's proxy statement and incorporated herein by reference.
- 10.14 magicJack VocalTec Ltd. 2013 Israeli Stock Incentive Plan,\* filed with the SEC on June 3, 2013 as Appendix D to the Company's proxy statement and incorporated herein by reference.

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10.15 Amendment to magicJack VocalTec Ltd. 2013 Stock incentive Plan,\* filed with the SEC on March 21, 2014 on the Company's Definitive Additional Materials on Schedule 14A and incorporated herein by reference.

10.16 Amendment to magicJack VocalTec Ltd. 2013 Israeli Stock incentive Plan,\* filed with the SEC on March 21, 2014 on the Company's Definitive Additional Materials on Schedule 14A and incorporated herein by reference.

10.17 Executive Employment Agreement, dated December 13, 2013, by and between magicJack VocalTec Ltd. and Timothy R. McDonald, filed with the SEC on December 17, 2013 as Exhibit 10.1 to the Company's Current Report on Form 8-K and incorporated herein by reference.

10.18 Amendment to Executive Employment Agreement, dated as of July 15, 2015, by and between the Company and Gerald T. Vento, filed with the SEC on August 10, 2015 as Exhibit 10.1 to the Company's Annual Report on Form 10-K and incorporated herein by reference.

10.19 Separation Agreement, dated as of June 5, 2015, by and between the Company and Timothy McDonald, filed with the SEC on August 10, 2015 as Exhibit 10.2 to the Company's Annual Report on Form 10-K and incorporated herein by reference.

10.20 Consulting Agreement, dated as of June 6, 2015, by and between the Company and Timothy McDonald, filed with the SEC on August 10, 2015 as Exhibit 10.3 to the Company's Annual Report on Form 10-K and incorporated herein by reference.

10.21 Executive Employment Agreement, dated as of December 1, 2015, between the Company and Jose Gordo, filed with the SEC on December 7, 2015 as Exhibit 10.1 to the Company's Current Report on Form 8-K and incorporated herein by reference.

10.22 Executive Employment Agreement, dated as of December 1, 2015, between the Company and Keith Reed, filed with the SEC on December 7, 2015 as Exhibit 10.2 to the Company's Current Report on Form 8-K and incorporated herein by reference.

10.23 Executive Employment Agreement, dated as of March 17, 2016, between magicJack Business Subsidiary, Inc., a subsidiary of the Company, the Company (as guarantor of the obligations and agreements of magicJack Business Subsidiary, Inc.) and Todd A. Correll,\* filed with the SEC on May 12, 2016 as Exhibit 10.22 to the Company's Amendment No. 1 to the Quarterly Report on Form 10-Q/A and incorporated herein by reference.

10.24 Executive Employment Agreement, dated as of March 17, 2016, between magicJack Business Subsidiary, Inc., a subsidiary of the Company, the Company (as guarantor of the obligations and agreements of magicJack Business Subsidiary, Inc.) and Thomas J. Tharrington,\* filed with the SEC on May 12, 2016 as Exhibit 10.23 to the Company's Amendment No. 1 to the Quarterly Report on Form 10-Q/A and incorporated herein by reference.

10.25 Second Amendment to Executive Employment Agreement, effective as of December 31, 2016, by and between magicJack VocalTec Ltd. and Gerald Vento,\* filed with the SEC on January 5, 2017 as Exhibit 10.1 to the Company's Current Report on Form 8-K and incorporated herein by reference.

10.26 Settlement Agreement, dated January 31, 2017, entered into between the Company, David L. Kanen and Kanen Wealth Management LLC, filed with the SEC on February 2, 2017 as Exhibit 10.1 to the Company's Current Report on Form 8-K and incorporated herein by reference.

21.1 List of Subsidiaries

23.1 Consent of BDO USA, LLP.

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

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

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

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

Financial statement schedules have been omitted as they are not required under the related instructions or are inapplicable.

\* Management contract or compensatory plan or arrangement.

[1] – The exhibits and schedules to the Asset Purchase Agreement have been omitted pursuant to Item 601 (b)(2) of Regulation S-K. We agree to furnish supplementally to the SEC, upon request, a copy of the omitted exhibits and schedules.

**ITEM 16. FORM 10-K SUMMARY**

None.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MAGICJACK VOCALTEC LTD.  
(Registrant)

By: /s/ Don C Bell

/s/ Jose Gordo

\_\_\_\_\_  
Don C. Bell

\_\_\_\_\_  
Jose Gordo

President and Chief Executive Officer

Chief Financial Officer

Date: March 16, 2017

Date: March 16, 2017

Pursuant to the requirements of the Securities and Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature                                       | Title  | Date           |
|---|--|----------------|
| /s/ Don C Bell<br>_____<br>Don C Bell           | President & Chief Executive Officer and Director Nominee<br>( <del>principal executive officer</del> ) | March 16, 2017 |
| /s/ Jose Gordo<br>_____<br>Jose Gordo           | Chief Financial Officer (principal financial officer and principal accounting officer)                 | March 16, 2017 |
| /s/ Donald A. Burns<br>_____<br>Donald A. Burns | <del>Director, Chairman of the Board</del>   | March 16, 2017 |
| /s/ Gerald Vento<br>_____<br>Gerald Vento       | <del>Director</del>  | March 16, 2017 |
| /s/ Yuen Wah Sing<br>_____<br>Dr. Yuen Wah Sing | <del>Director</del>  | March 16, 2017 |
| /s/ Tal Yaron-Eldar<br>_____<br>Tal Yaron-Eldar | Director   | March 16, 2017 |
| /s/ Izhak Gross<br>_____<br>Izhak Gross         | Director   | March 16, 2017 |
| /s/ Richard Harris<br>_____<br>Richard Harris   | <del>Director</del>  | March 16, 2017 |

