

MAGICJACK VOCALTEC LTD
Form 10-Q
November 09, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2015

OR

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

For transition period from _____ to _____

Commission file number: 000-27648

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

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

12 BENNY GAON STREET, BUILDING 2B
POLEG INDUSTRIAL AREA, NETANYA, ISRAEL 42504
(Address of principal executive offices, including zip code)

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any,

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every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large Accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

Yes No

There were 15,751,254 ordinary shares with no par value outstanding at October 31, 2015.

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

ITEM

<u>1.</u>	<u>Financial Statements</u>	
	<u>Condensed Consolidated Balance Sheets (Unaudited)</u>	3
	<u>Condensed Consolidated Statements of Operations (Unaudited)</u>	4
	<u>Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited)</u>	5
	<u>Condensed Consolidated Statement of Capital Equity (Unaudited)</u>	6
	<u>Condensed Consolidated Statements of Cash Flows (Unaudited)</u>	7
	<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	9

ITEM

<u>2.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	24
-----------	--	----

ITEM

<u>3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	34
-----------	---	----

ITEM

<u>4.</u>	<u>Controls and Procedures</u>	34
-----------	--------------------------------	----

PART II OTHER INFORMATION

<u>ITEM</u>	<u>Legal Proceedings</u>	35
-------------	--------------------------	----

1.

ITEM

<u>1A.</u>	<u>Risk Factors</u>	35
------------	---------------------	----

ITEM

<u>2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	35
-----------	--	----

ITEM

<u>3.</u>	<u>Defaults Upon Senior Securities</u>	35
-----------	--	----

ITEM

<u>4.</u>	<u>Mine Safety Disclosures</u>	35
-----------	--------------------------------	----

ITEM

<u>5.</u>	<u>Other Information</u>	36
-----------	--------------------------	----

ITEM

<u>6.</u>	<u>Exhibits</u>	36
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DEFINITIONS

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

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

PART I – FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

	September 30, 2015	December 31, 2014
ASSETS		
(Unaudited)		
Current assets:		
Cash and cash equivalents	\$79,569	\$75,945
Investments, at fair value	367	367
Accounts receivable, net of allowance for doubtful accounts and billing adjustments of \$503 and \$1,171, respectively	2,568	3,903
Inventories	6,240	5,635
Deferred costs	1,838	2,765
Prepaid income taxes	-	12,513
Deferred tax assets, current	9,115	13,341
Deposits and other current assets	2,079	1,170
Total current assets	101,776	115,639
Property and equipment, net	3,520	3,564
Intangible assets, net	7,177	9,473
Goodwill	32,304	32,304
Deferred tax assets, non-current	30,798	32,510
Deposits and other non-current assets	749	743
Total assets	\$176,324	\$194,233
LIABILITIES AND CAPITAL EQUITY		
Current liabilities:		
Accounts payable	\$1,322	\$2,879
Income tax payable	2,369	9,197
Accrued expenses and other current liabilities	5,452	8,406
Deferred revenue, current portion	53,280	56,445
Total current liabilities	62,423	76,927
Deferred revenue, net of current portion	51,078	54,782
Other non-current liabilities	11,919	13,438
Total liabilities	125,420	145,147
Commitments and contingencies (Note 9)		
Capital equity		
Ordinary shares, No par value; 100,000 shares authorized; 25,032 shares issued at September 30, 2015 and December 31, 2014, respectively	111,771	111,771
Additional paid-in capital	13,869	10,414
Treasury stock (8,860 and 7,164 shares at September 30, 2015 and December 31, 2014, respectively)	(120,891)	(107,683)

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Retained earnings	46,155	34,584
Total capital equity	50,904	49,086
Total liabilities and capital equity	\$ 176,324	\$ 194,233

See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
Net revenues	\$25,409	\$25,813	\$76,331	\$90,606
Cost of revenues	8,225	9,477	26,361	33,891
Gross profit	17,184	16,336	49,970	56,715
Operating expenses:				
Marketing	2,357	6,244	6,940	15,230
General and administrative	6,286	9,402	21,297	26,721
Research and development	1,088	1,494	3,418	4,613
Total operating expenses	9,731	17,140	31,655	46,564
Operating income (loss)	7,453	(804)	18,315	10,151
Other income (expense):				
Gains on investments	-	-	-	37
Interest and dividend income	6	13	23	108
Interest expense	-	(34)	(57)	(154)
Other income (expense), net	4	1	(2)	4
Total other income (expense)	10	(20)	(36)	(5)
Income (loss) before income taxes	7,463	(824)	18,279	10,146
Income tax (benefit) expense	4,152	(823)	6,708	2,559
Net income (loss)	\$3,311	\$(1)	\$11,571	\$7,587
Net Income (loss) per ordinary share:				
Basic	\$0.20	\$(0.00)	\$0.66	\$0.43
Diluted	\$0.20	\$(0.00)	\$0.66	\$0.43
Weighted average ordinary shares outstanding:				
Basic	16,651	17,832	17,400	17,830
Diluted	16,658	17,832	17,426	17,832

See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
Net income (loss)	\$3,311	\$(1)	\$11,571	\$7,587
Other comprehensive income (loss):				
Reclassification of unrealized loss on marketable securities to gains on investments	-	-	-	642
Comprehensive income (loss)	\$3,311	\$(1)	\$11,571	\$8,229

See accompanying notes to condensed consolidated financial statements.

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

	Ordinary Shares Number	Amount	Additional Paid-in Capital	Treasury Stock Number	Amount	Retained Earnings	Total Capital Equity
Balance, January 1, 2015	25,032	\$ 111,771	\$ 10,414	(7,164)	\$(107,683)	\$ 34,584	\$ 49,086
Share-based compensation	-	-	3,906	-	-	-	3,906
Issuance of ordinary shares	-	-	(451)	36	451	-	-
Purchase of treasury stock	-	-	-	(1,732)	(13,659)	-	(13,659)
Net income	-	-	-	-	-	11,571	11,571
Balance, September 30, 2015 (unaudited)	25,032	\$ 111,771	\$ 13,869	(8,860)	\$(120,891)	\$ 46,155	\$ 50,904

See accompanying notes to condensed consolidated financial statements.

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

	For the Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net income	\$11,571	\$7,587
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision (recovery) for doubtful accounts and billing adjustments	70	(64)
Share-based compensation	3,906	5,714
Depreciation and amortization	2,877	3,811
Impairment of intangible asset	-	2,464
(Release) increase of uncertain tax positions	(1,124)	351
Deferred income tax provision (benefit)	6,105	(1,105)
Interest expense - non-cash	57	154
Gains on investments	-	(37)
Change in operating assets and liabilities		
Accounts receivable	1,265	548
Inventories	(605)	1,145
Deferred costs	927	2,299
Prepaid Income taxes	5,985	1,428
Deposits and other current assets	(909)	(1,865)
Other non-current assets	(6)	(51)
Accounts payable	(1,546)	1,064
Income taxes payable	(873)	1,745
Accrued expenses and other current liabilities	(1,511)	(694)
Deferred revenue	(6,869)	(988)
Other non-current liabilities	11	-
Net cash provided by operating activities	19,331	23,506
Cash flows from investing activities:		
Proceeds from sales of investments	-	9,094
Purchases of property and equipment	(548)	(1,911)
Acquisition of intangible assets	-	(15)
Net cash (used in) provided by investing activities	(548)	7,168
Cash flows from financing activities:		
Purchase of treasury stock	(13,565)	-
Repurchase of ordinary shares to settle withholding liability	(94)	-
Payment of other non-current liabilities	(1,500)	(1,500)
Proceeds from exercise of ordinary share options	-	27
Net cash used in financing activities	(15,159)	(1,473)
Net increase in cash and cash equivalents	3,624	29,201
Cash and cash equivalents, beginning of period	75,945	45,997

Cash and cash equivalents, end of period	\$79,569	\$75,198
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See accompanying notes to condensed consolidated financial statements.

7

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

	For the Nine Months Ended September 30,	
	2015	2014
Supplemental disclosures:		
Interest paid	\$-	\$-
Income taxes paid	\$3,318	\$165
Non-cash investing and financing activities:		
Property and equipment (acquired but not paid)	\$-	\$103
Intangible assets (acquired through financing)	\$-	\$470
Accrued expenses and other current liabilities	\$-	\$(573)

See accompanying notes to condensed consolidated financial statements.

NOTE 1 –DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

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

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

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

Basis of Presentation

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

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

The Company prepares its unaudited condensed consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of the Company’s revenues in the three and nine months ended September 30, 2015 and 2014 were from sales to customers located in the United States. The majority of the Company’s revenues

recognized were generated from sales of the magicJack product line and from the software access right that accompanies these products, which were \$21.8 million and \$21.7 million for the three months ended September 30, 2015 and 2014, respectively, and \$65.6 million and \$77.7 million for the nine months ended September 30, 2015 and 2014, respectively. The Company also provides its customers with the ability to make prepaid calls using the magicJack devices and magicJack APP by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were \$2.0 million and \$2.5 million for the three months ended September 30, 2015 and 2014, respectively, and \$6.4 million and \$8.0 million for the nine months ended September 30, 2015 and 2014, respectively.

Basis of Consolidation

The Company's unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications, LLC ("VocalTec US", formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, "Dialmaxx"). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three and nine months ended September 30, 2015 may not be indicative of the results for the entire year ending December 31, 2015. The interim unaudited condensed consolidated financial statements should be read in conjunction with the Company's financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this report and in the Company's Annual Report on Form 10-K for the year ended December 31, 2014 filed on March 16, 2015.

NOTE 2 – SUMMARY OF ACCOUNTING POLICIES

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

Use of Estimates

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

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

Net Revenues

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

Revenue Recognition

magicJack Devices and Renewal Access Revenue

The Company recognizes revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of its software to access the Company's servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period. Revenue from the sales of magicAPP Premium 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 record or recognize revenue until the 30-day trial period has expired and a customer's credit card has been charged.

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. The Company estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the three and nine months ended September 30, 2015 and 2014, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

Prepaid Minutes and Access and Wholesale Charges

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

Deferred Revenues

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

Cost of Revenues

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

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were \$0.8 million and \$1.1 million for the three months ended September 30, 2015 and 2014, respectively, and \$2.6 million and \$3.5 million for the nine months ended September 30, 2015 and 2014, respectively.

Marketing Expenses

Marketing expenses of \$2.4 million and \$6.2 million for the three months ended September 30, 2015 and 2014, respectively, and \$6.9 million and \$15.2 million for the nine months ended September 30, 2015 and 2014, respectively, consist primarily of advertising media buys for television commercials, Internet advertising and print advertising, as well as marketing related personnel costs and other marketing projects including sponsorships. Marketing costs are expensed when incurred. A break-down of marketing expense by category is as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
Advertising media buys	\$ 2,002	\$ 4,297	\$ 5,165	\$ 9,795
Marketing personnel related	229	596	1,154	2,176
Other marketing projects	126	1,351	621	3,259

Total Marketing Expense	\$ 2,357	\$ 6,244	\$ 6,940	\$ 15,230
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11

Research and Development Expenses

The Company's research and development activities consist primarily of the design and development of its proprietary software used in the magicJack devices, magicJack APP and its servers, as well as the development of new products and applications for use in its broadband service offerings. The Company accounts for research and development costs in accordance with applicable accounting pronouncements. These pronouncements specify that costs incurred internally in researching and developing a product should be charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all costs should be capitalized until the product is available for general release to customers. The Company has determined that technological feasibility for its products is reached after all high-risk development issues have been resolved through internal and customer base testing. Generally, new products offered to customers and improvements to the Company's servers are placed in service on attainment of technological feasibility. The Company has not capitalized any of its research and development activities and related costs. Research and development expenses were \$1.1 million and \$1.5 million for the three months ended September 30, 2015 and 2014, respectively, and \$3.4 million and \$4.6 million for the nine months ended September 30, 2015 and 2014, respectively.

Earnings per Ordinary Share

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

Cash and Cash Equivalents

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

Allowance for Doubtful Accounts and Billing Adjustments

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

Marketable Securities and Other Investments

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

Certain Risks and Concentrations

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

The Company places its cash and cash equivalents in high quality financial institutions and management believes that the Company is not exposed to any significant risk on its cash accounts. The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the Federal Deposit Insurance Corporation or FDIC up to \$250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at each Israeli bank are not insured. The Company has never experienced any losses related to these balances. At September 30, 2015, the Company had cash and cash equivalents totaling \$79.6 million, which included (i) \$79.2 million in U.S. financial institutions, and (ii) \$0.4 million in an Israeli financial institution.

The Company's non-interest bearing cash balances in U.S. banks, which included \$1.3 million in one individual financial institution, were fully insured. The Company had money market accounts with a financial institution with balances totaling approximately \$77.9 million.

No telecommunication carrier accounted for more than 10% of gross accounts receivable at September 30, 2015. One telecommunication carrier accounted for approximately 15% of gross accounts receivable at December 31, 2014. For the three and nine months ended September 30, 2015 and 2014, no telecommunications carrier accounted for more than 10% of the Company's total net revenues.

Two U.S. retail customers accounted for approximately 16% and 15% of gross accounts receivable at September 30, 2015, respectively. One U.S. retail customer accounted for approximately 17% of gross accounts receivable at December 31, 2014. For the three and nine months ended September 30, 2015 and 2014, no retailer accounted for more than 10% of the Company's total net revenues.

Fair Value

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

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

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

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

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

When available, the Company uses quoted market prices to determine fair value, and it classifies such measurements within Level 1. Fair value measurements are classified according to the lowest level input or value-driver that is significant to the valuation. Fair value includes the consideration of nonperformance risk. Nonperformance risk refers to the risk that an obligation (either by a counterparty or the Company) will not be fulfilled. For the Company's financial assets traded in an active market (Level 1), the nonperformance risk is included in the market price. The Company's assets and liabilities measured on a recurring basis at fair value may include marketable securities and time deposits. As of September 30, 2015 and December 31, 2014, all of them are Level 1 instruments. The fair value of Level 2 securities is estimated based on observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts payable and accrued expenses are expected to approximate fair value because of their immediate availability,

near term maturities or potential interest payments at settlement.

In connection with the Company's purchase of certain intangible assets during June 2011, the Company made payments of \$1.5 million in May 2011, May 2012, May 2013 and May 2014, respectively. The Company made a final non-interest bearing annual payment of \$1.5 million in May 2015. The liability for such payments had been discounted at a rate of 10% to a total fair value of \$1.4 million included in accrued expenses and other current liabilities at December 31, 2014.

Inventories

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

Property, Equipment and Depreciation Expense

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

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

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management believes there is no impairment at September 30, 2015.

Intangible Assets

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

Goodwill

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

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

If the two-step goodwill impairment test is required to be performed, under the first step, the fair value of the reporting unit is compared with its carrying value (including goodwill). If the fair value of the reporting unit is less than its carrying value, the Company proceeds to step two of the goodwill impairment test. Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of

that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its implied fair value.

In connection with the Company's annual goodwill impairment analysis, as of October 1, 2014, the annual measurement date, the Company's analysis did not indicate any impairment of goodwill has occurred. Management believes there is no impairment at September 30, 2015.

Share-based Compensation

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

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes to enacted tax rates or tax laws are included in the provision for income taxes in the period of enactment. The Company's net deferred tax assets consist primarily of foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its' net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. The Company decreased the valuation allowance by \$0.7 million and \$0.1 million during the three and nine months ended September 30, 2015, respectively. The Company decreased the valuation allowance by \$0.3 million during the three and nine months ended September 30, 2014.

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

The Company records its income tax expense for interim financial statements by using an estimated annual effective income tax rate based on its expected annual results after consideration of permanent nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2015 and changes in other deferred tax assets and liabilities are recognized during interim periods based on an annual forecast as of the interim reporting date. At September 30, 2015, the estimated annual effective income tax rate is expected to approximate 31.1%, excluding discrete tax items, which includes federal, foreign, state and local taxes. This rate may fluctuate due to changes in jurisdictional income and to the timing of other discrete period transactions during the remainder of the year.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." The standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. The standard will become effective for the Company with the annual and interim reporting periods beginning after December 15, 2017. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows, and financial statement disclosures.

In June 2014, the FASB issued ASU 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." The standard requires entities to treat a performance target that affects vesting and that could be achieved after the requisite service period as a performance condition. The standard is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. ASU 2014-12 may be adopted either prospectively for share-based payment awards granted or modified on or after the effective date, or retrospectively, using a modified

retrospective approach. The modified retrospective approach would apply to share-based payment awards outstanding as of the beginning of the earliest annual period presented in the financial statements on adoption, and to all new or modified awards thereafter. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows.

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.

NOTE 3 – INVESTMENTS

Investments consists of time deposits with maturity dates of greater than 90 days totaling \$367 thousand at September 30, 2015, and December 31, 2014.

The fair value of time deposits at September 30, 2015 and December 31, 2014 was determined based on its face value, which approximates its fair value and is a Level 1 input.

There were no realized gain or loss on investments for the three and nine months ended September 30, 2015. Gains on investments for the three months ended September 30, 2014 was \$0, and did not include any reclassification of unrealized gain (loss) on marketable securities from other comprehensive gains (losses) on investments. Gains on investments for the nine months ended September 30, 2014 was \$37 thousand and included reclassification of unrealized loss on marketable securities from other comprehensive loss to gains on investments of \$0.6 million. During the nine months ended September 30, 2014, the Company sold investments in marketable equity securities for approximately \$9.1 million realizing a gain on the sale of approximately \$37 thousand over the cost basis of the investment which was determined based on specific identification.

NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

	September 30, 2015	December 31, 2014
Raw materials	\$ 2,704	\$ 2,793
Finished goods	3,536	2,842
Total	\$ 6,240	\$ 5,635

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished goods are comprised primarily of magicJack devices on hand or in transit to the Company's distribution center in the United States. The Company did not write-off any inventory during the three months ended September 30, 2015. The Company wrote-off approximately \$102 thousand of obsolete inventory during the nine months ended September 30, 2015. The Company wrote-off approximately \$42 thousand of obsolete inventory during the three and nine months ended September 30, 2014.

NOTE 5 – PROPERTY AND EQUIPMENT

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

	Estimated Useful Lives (in years)	September 30, 2015	December 31, 2014
Switches	3 - 15	\$ 8,943	\$ 8,436
Computers	3	2,707	2,707
Furniture	5	257	257
Leasehold-improvements	*	702	681

Accumulated depreciation and amortization	(9,089)	(8,517)
Total	\$ 3,520	\$ 3,564

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

Depreciation and amortization expense for the three months ended September 30, 2015 and 2014 was \$0.2 million and \$0.2 million, respectively. Depreciation and amortization expense for the nine months ended September 30, 2015 and 2014 was \$0.6 million and \$0.4 million, respectively.

NOTE 6 – INTANGIBLES ASSETS

As of September 30, 2015 and December 31, 2014, the Company had intangible assets with carrying values of \$7.2 million and \$9.5 million, respectively. Identified intangible assets not subject to amortization consisted of tradename and domain names with combined carrying value of \$1.2 million as of September 30, 2015 and December 31, 2014. Identified intangible assets with finite lives subject to amortization consist of the following (in thousands):

	Estimated Useful Lives (in years)	September 30, 2015				December 31, 2014			
		Gross Carrying Amount	Accumulated Amortization	Net	Weighted-Average Life	Gross Carrying Amount	Accumulated Amortization	Net	Weighted-Average Life
Technology	3 - 17	\$4,930	\$ (4,439)	\$491	4.93	\$5,221	\$ (4,554)	\$667	5.37
Intellectual property rights	3 - 17	14,161	(9,330)	4,831	5.51	14,161	(7,713)	6,448	6.70
Covenants not-to-compete and not-to-sue	2 - 5	2,085	(1,807)	278	0.67	2,085	(1,494)	591	1.42
Tradename	3 - 6	321	(315)	6	0.25	321	(297)	24	1.00
Customer relationships	5 - 7	500	(500)	-	-	750	(660)	90	2.58
Backlog	1	800	(800)	-	-	800	(800)	-	-
Other		470	(110)	360	3.25	470	(28)	442	4.00
Total		\$23,267	\$ (17,301)	\$5,966		\$23,808	\$ (15,546)	\$8,262	

Amortization expense for the three months ended September 30, 2015 and 2014 was \$0.7 million and \$0.8 million, respectively. Amortization expense for the nine months ended September 30, 2015 and 2014 was \$2.3 million and \$3.4 million, respectively. Due to the passing of the Company's founder and former CEO in July 2014, the Company recorded an impairment charge of \$2.5 million included in general and administrative expense related to the write-off of \$2.5 million net carrying value associated with the non-compete agreement with the Company's founder and former CEO included in intangible assets. Based on the carrying value of identified intangible assets recorded at September 30, 2015, and assuming no subsequent impairment of the underlying assets, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

Fiscal Year	Amortization Expense
Three months ending December 31, 2015	\$ 489
2016	1,644
2017	1,420
2018	964
2019	558
Thereafter	891
	\$ 5,966

NOTE 7 – DEFERRED COSTS AND REVENUES

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

Deferred revenues are comprised of the following at September 30, 2015 and December 31, 2014 (in thousands):

	September 30, 2015	December 31, 2014
magicJack devices	\$ 9,485	\$ 10,619
Access right renewals	41,345	43,231
Prepaid minutes	2,450	2,595
Deferred revenue, current	53,280	56,445
Deferred revenue, non-current*	51,078	54,782
Total deferred revenues	\$ 104,358	\$ 111,227

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

Costs necessary to fulfill the Company's obligations to provide broadband telephone service to new and existing customers who have purchased magicJack devices or access rights to access the Company's servers are expensed as incurred. Such costs were approximately \$3.7 million and \$4.7 million for the three months ended September 30, 2015 and 2014, respectively, and approximately \$11.9 million and \$15.3 million for the nine months ended September 30, 2015 and 2014, respectively.

NOTE 8 – OTHER LIABILITIES

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

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Legal Proceedings

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

In April 2015, the Company engaged in mediation to settle a dispute for legal fees incurred in relation to the hiring of an employee whose employment by the Company was alleged to have violated confidentiality obligations of the employee. The Company paid approximately \$0.7 million to settle the dispute in June 2015.

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

NOTE 10 –TREASURY STOCK

During the first quarter of 2015, the Company's Board of Directors authorized a stock repurchase program to enable the Company to purchase its ordinary shares at such times as management deems appropriate up to a maximum cumulative repurchase authority of \$20 million. The primary objective of the Company's stock repurchase program is to improve stockholders' returns. The Company expended \$13.6 million under its repurchase program through September 30, 2015 and there was \$6.4 million remaining authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased and not yet retired, are recorded as treasury stock. The Company repurchased 1,720,390 ordinary shares under this program through September 30, 2015.

The Company issued 36,595 of its ordinary shares held as treasury stock with a cost of \$451 thousand, or \$12.32 per share, to officers, directors and consultants as a result of restricted stock units that were granted in fiscal 2013 and 2014, which vested during the nine months ended September 30, 2015. Refer to Note 11, "Share-Based Compensation" for further details. As part of the stock issuance to a former executive in June 2015, the Company repurchased 12,161 ordinary shares from a former executive to satisfy the former executive's tax withholding obligation upon the vesting of the restricted stock.

The changes in treasury stock during the nine months ended September 30, 2015 are as follows (in thousands, except for number of shares):

	Nine Months Ended September 30, 2015	
	Number	Amount
Balance, beginning of period	7,164,260	\$ 107,683
Ordinary shares purchased through the stock repurchase program	1,720,390	13,565
Ordinary shares purchased to settle withholding liability	12,161	94
Ordinary shares issued due to vesting of restricted stock units	(36,595)	(451)
Balance, end of period	8,860,216	\$ 120,891

NOTE 11 – SHARE-BASED COMPENSATION

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

number of share based awards available for grant. As of September 30, 2015, the aggregate number of shares subject to awards under the 2013 Plans, as amended, is 3,600,000. The Company had previously granted shares under the VocalTec amended Master Stock Plan (the “2003 Plan”) which expired in April 2013. Share-based awards are generally exercisable or issuable upon vesting. The Company’s policy is to recognize compensation expense for awards with only service conditions and a graded vesting on a straight-line basis over the requisite vesting period for the entire award.

The Company’s share-based compensation expense for ordinary share options, issued restricted stock units and ordinary shares for the three and nine months ended September 30, 2015 and 2014 was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Ordinary share options	\$ 945	\$ 1,176	\$ 3,085	\$ 4,882
Restricted stock units	261	286	821	832
Ordinary shares	-	-	-	-
	\$ 1,206	\$ 1,462	\$ 3,906	\$ 5,714

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Cost of revenues	\$ 30	\$ 53	\$ 46	\$ 405
Marketing	101	277	442	1,312
General and administrative	995	864	3,051	3,301
Research and development	80	268	367	696
	\$ 1,206	\$ 1,462	\$ 3,906	\$ 5,714

The decrease in share based compensation for the three and nine months ended September 30, 2015, is due in part to the favorable impact of forfeitures on the calculation of stock based compensation expense which resulted in the reversal of \$0.5 million in previously recognized expense associated with non-vested ordinary share options and restricted stock units that were forfeited during the nine months ended September 30, 2015.

Ordinary Share Options

Ordinary share options granted under the 2013 Plans have a five-year life and vest over a period of 24 to 36 months beginning at the date of grant. The 2013 Plans, as amended, currently allow for a maximum term of five years for awards granted. The following table provides additional information regarding ordinary share options issued, outstanding and exercisable for the year ended December 31, 2014, and nine months ended September 30, 2015 (aggregate intrinsic value in thousands):

Date of Grant	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value *
January 1, 2014	1,285,207	\$ 14.95	4.41	\$ -
Granted	762,500	\$ 14.71		
Exercised	(3,820)	\$ 7.33		
Expired or cancelled	(30)	\$ 147.55		
December 31, 2014	2,043,857	\$ 14.87	3.80	\$ -
Granted	-	\$ -		
Exercised	-	\$ -		
Forfeited	(247,257)	\$ 14.42		
Expired or cancelled	-	\$ -		
Outstanding at September 30, 2015 (unaudited)	1,796,600	\$ 14.93	2.52	\$ -
Vested at September 30, 2015 (unaudited)	1,153,668	\$ 14.73	2.21	\$ -

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

Share-based compensation expense recognized for ordinary share options was approximately \$0.9 million and \$1.2 million for the three months ended September 30, 2015 and 2014, respectively, and approximately \$3.1 million and \$4.9 million for the nine months ended September 30, 2015 and 2014, respectively. The total intrinsic value of ordinary share options exercised during the nine months ended September 30, 2015 and 2014 was \$0 and \$42 thousand, respectively. As of September 30, 2015, there was approximately \$1.9 million of unrecognized share-based compensation expense related to unvested ordinary share options, which is expected to be recognized over a weighted average remaining period of 0.99 years.

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's expected stock price volatility over the term of the awards, assumed employee exercise behaviors, risk-free interest rate and expected dividends. For purposes of valuing ordinary share options, the Company used historical volatility at the date of grant. The approximate risk-free interest rate was based on the U.S. Treasury yield for comparable periods. As the Company does not have historical data available regarding employee exercise patterns, it did not anticipate any forfeiture of the ordinary share options granted and the expected term of the ordinary share options was calculated using the simplified method in accordance with SAB No. 107, "Share Based Payment." The Company does not expect to pay dividends on its ordinary shares in the foreseeable future. Accordingly, the Company used a dividend yield of zero in its option pricing model. There were no ordinary share options granted during the nine months ended September 30, 2015. The weighted average fair value of ordinary share options granted during the nine months ended September 30, 2014 was \$6.22, and was measured at the date of grant using the following assumptions:

	Nine Months Ended	
	2015	2014
Expected term (in years)	-	3.2 - 3.5
Dividend yield	-	0.00%
Expected volatility	-	57.2% to 58.8%
Risk free interest rate	-	1.07% to 1.64%
Forfeiture rate	-	0.00%

Restricted Stock Units

The Company may also award non-vested restricted stock units to its executives, employees, directors and outside consultants under the 2013 Plans, which may vest based on service or a combination of service and other conditions, such as market share price. The compensation expense for the award will be recognized assuming that the requisite service is rendered regardless of whether the market conditions are achieved. Each non-vested stock unit, upon vesting, represents the right to receive one ordinary share of the Company. During the nine months ended September 30, 2015, the Company did not grant any restricted stock units under the 2013 Plans, as amended. During the nine months ended September 30, 2014, the Company granted 30,500 restricted stock units under the 2013 Plans.

The following table summarizes the Company's restricted stock unit activity for the nine months ended September 30, 2015:

	Number of Shares	Average Fair Value at Grant Date
December 31, 2014	147,264	\$ 15.05
Granted	-	\$ -
Vested	(36,595)	\$ 11.25
Forfeited	-	\$ -

Non-vested at September 30, 2015 110,669 \$ 15.29

Share-based compensation expense recognized for restricted stock units was approximately \$0.3 million and \$0.3 million for the three months ended September 30, 2015 and 2014, respectively, and approximately \$0.8 million and \$0.8 million for the nine months ended September 30, 2015 and 2014, respectively. As of September 30, 2015, there was \$0.5 million in unrecognized share-based compensation costs related to restricted stock units. The unrecognized share-based compensation expense is expected to be recognized over a weighted average remaining period of 0.44 years.

NOTE 12 – INCOME TAXES

Total income tax expense / (benefit) was \$4.2 million and \$(0.8) million for the three months ended September 30, 2015 and 2014, respectively, and \$6.7 million and \$2.6 million for the nine months ended September 30, 2015 and 2014, respectively. The principal components of our income taxes for the three and nine months ended September 30, 2015 and 2014 are the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Income before income taxes	\$ 7,463	\$ (824)	\$ 18,279	\$ 10,146
Income tax (benefit) expense	4,152	(823)	6,708	2,559
Effective income tax rate	55.63 %	99.88 %	36.70 %	25.22 %

The Company primarily operates in the U.S. and Israel, and the Company's Israeli operations are subject to a statutory income tax rate of 26.5% that is lower than the Company's U.S. federal income tax rate which is 35% as of September 30, 2015.

For the nine months ended September 30, 2015, the Company recorded income tax expense of \$6.7 million, which is higher than the expected tax provision of \$6.4 million, using the statutory rate of 35%, due, in part, to the net impact of increases resulting from the changes in the exchange rate on the Company's net deferred tax assets associated with the Israeli operations with a tax effect of \$0.6 million, and the tax effect of various other discrete tax items totaling \$0.4 million, partially offset by the lower jurisdictional tax rate charged on the operating income of the Company's Israeli operations. Excluding the impact of the discrete tax items noted, the Company's effective tax rate would have been 31.6% and 31.1% for the three and nine months ended September 30, 2015, respectively.

The Company revised its liability for uncertain tax positions by a net decrease of \$7.9 million in the nine months ended September 30, 2015, due primarily to the effective settlement of various positions taken in connection with the U.S. federal income tax years 2010 through 2013 which were examined by the IRS totaling \$7.2 million and to a reduction in the accrual for intercompany interest and currency revaluation income of approximately \$0.8 million. These reductions were partially offset by increases from other discrete tax items totaling \$0.1 million.

During the nine months ended September 30, 2015, the Company received notification from the IRS that its examination of the 2010 through 2013 tax years had been finalized. The examination resulted in an amount due of \$2.6 million which the Company paid in May 2015. In addition to the cash payment, the Company utilized tax benefits of \$4.2 million in conjunction with the settlement. As part of finalizing the examination, the Company utilized \$5.8 million of its prepaid tax assets to satisfy \$5.8 million of income tax payable related to the examination. The Company does not intend to appeal or litigate any aspect of the tax positions included in the completed examination. Additionally, the Company believes that it is remote that the IRS would reexamine any aspect of the Company's tax position included in the completed examination.

NOTE 13 – INCOME PER SHARE

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

contracts on the Company's own stock (if applicable).

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
(in thousands)				
Numerator:				
Net income (loss)	\$3,311	\$(1)	\$11,571	\$7,587
Denominator:				
Denominator for basic net income per share - weighted average ordinary shares outstanding	16,651	17,832	17,400	17,830
Effect of dilutive options to purchase ordinary shares	7	-	7	2
Effect of dilutive options or restricted stock units vesting, exercised or expired during the period	-	-	19	-
Denominator for diluted net income per share - weighted average ordinary shares outstanding	16,658	17,832	17,426	17,832
Net income per ordinary share attributable to shareholders				
Basic	\$0.20	\$(0.00)	\$0.66	\$0.43
Diluted	\$0.20	\$(0.00)	\$0.66	\$0.43

For the three months ended September 30, 2015 and 2014, 1,900,519 and 2,227,088 outstanding ordinary share options and restricted stock units, respectively, were excluded from the earnings per share calculation because they would be anti-dilutive. For the nine months ended September 30, 2015 and 2014, 1,900,519 and 2,020,338 outstanding ordinary share options and restricted stock units, respectively, were excluded from the earnings per share calculation because they would be anti-dilutive.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited condensed consolidated financial statements as of September 30, 2015 and for the three and nine month periods ended September 30, 2015 and 2014, as well as our Annual Report on Form 10-K for the year ended December 31, 2014. This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, the accuracy of which involves risk and uncertainties. We use words such as "anticipates," "believes," "plans," "expects," "future," "intends," "estimates," "projects," and similar expressions to identify forward-looking statements. Readers should not place undue reliance on these forward-looking statements, which apply only as of the date of this report. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons. Factors that might cause or contribute to such differences include, but are not limited to, those discussed under the section titled "Risk Factors" of our Form 10-K for the year ended December 31, 2014 filed on March 16, 2015.

Overview

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

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

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

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

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

Basis of Presentation

Our unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, our unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in our Annual Report on Form 10-K for the year ended December 31, 2014. The balance sheet at December 31, 2014 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included.

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

We prepare our consolidated financial statements on the basis of being a single reporting entity. Approximately 90% of our revenues in the three and nine months ended September 30, 2015 and 2014 were derived from sales to customers located in the United States.

Basis of Consolidation

Our consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications LLC (“VocalTec US”, formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, “Dialmaxx”). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three and nine months ended September 30, 2015 may not be indicative of the results for the entire year ending December 31, 2015. The interim unaudited condensed consolidated financial statements should be read in conjunction with our financial statements and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in this report and in our Annual Report on Form 10-K for the year ended December 31, 2014 filed on March 16, 2015.

Use of Estimates

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

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

CRITICAL ACCOUNTING POLICIES

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

REVENUE RECOGNITION

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

magicJack Devices and Renewal Access Revenue

We recognize revenues from sales and shipping of direct sales of the magicJack devices over the period associated with the initial access right period. Customers may purchase access rights for continued use of our software to access our servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period. Revenue from the sales of magicAPP Premium access rights is 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 record or recognize revenue until the 30-day trial period has expired and a customer's credit card has been charged.

Returns from retailers are accepted on an authorized basis for devices deemed defective. We may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. We estimate potential returns under these arrangements at point of sale and re-estimate potential returns on a quarterly basis. For the three and nine months ended September 30, 2015 and 2014, our estimates of returns and actual returns from initial stocking orders have not been materially different.

Prepaid Minutes and Access and Wholesale Charges

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

INCOME TAXES

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. Our net deferred tax assets consist of primarily foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. We record a valuation allowance to reduce the net deferred tax assets to the amount that we estimate is more-likely-than-not to be realized. We evaluated the valuation allowance as of December 31, 2014, which resulted in adjustments of \$1.2 million to bring the allowance to \$16.2 million, an amount which reduces the net deferred tax assets to the amount that will more-likely-than-not be realized. We periodically review the composition of our net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required. We decreased the valuation allowance by \$0.1 million during the nine months ended September 30, 2015.

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

We record our income tax expense for interim financial statements by using an estimated annual effective income tax rate based on our expected annual results after elimination of nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2015 and certain other deferred tax assets were recognized for financial reporting purposes at December 31, 2014. At September 30, 2015, the estimated annual effective income tax rate is expected to approximate 31.1%, excluding discrete tax items, which includes federal, foreign, and state and local taxes. This rate may fluctuate due to changes in our jurisdictional income and due to the timing of other discrete period transactions during the remainder of the year.

SHARE-BASED COMPENSATION

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

RESULTS OF OPERATIONS

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

	Three Months Ended September 30,		2015 Compared to 2014		Nine Months Ended September 30,		2015 Compared to 2014	
	2015	2014			2015	2014		
Net Revenues								
Sale of magicJack devices	\$4,466	\$3,107	\$1,359	43.7 %	\$12,087	\$21,586	\$(9,499)	(44.0) %
Access right renewals	16,199	16,834	(635)	(3.8)	49,814	48,378	1,436	3.0
Shipping and handling	208	356	(148)	(41.6)	628	1,868	(1,240)	(66.4)
magicJack-related products	905	1,442	(537)	(37.2)	3,032	5,870	(2,838)	(48.3)
Prepaid minutes	2,042	2,502	(460)	(18.4)	6,416	7,978	(1,562)	(19.6)
Access and wholesale charges	1,589	1,572	17	1.1	4,347	4,919	(572)	(11.6)
Other	-	-	-	-	7	7	-	-
Total Net Revenue	25,409	25,813	(404)	(1.6)	76,331	90,606	(14,275)	(15.8)
Cost of Revenues								
Cost of magicJack devices	1,957	1,725	232	13.4	6,117	9,373	(3,256)	(34.7)
Shipping and handling	310	603	(293)	(48.6)	911	1,551	(640)	(41.3)
Credit card processing fees	490	530	(40)	(7.5)	1,711	1,980	(269)	(13.6)
Network and carrier charges	3,697	4,734	(1,037)	(21.9)	11,863	15,306	(3,443)	(22.5)
Other	1,771	1,885	(114)	(6.0)	5,759	5,681	78	1.4
Total Cost of Revenues	8,225	9,477	(1,252)	(13.2)	26,361	33,891	(7,530)	(22.2)
Gross Profit	17,184	16,336	848	5.2	49,970	56,715	(6,745)	(11.9)
Operating expenses:								
Marketing	2,357	6,244	(3,887)	(62.3)	6,940	15,230	(8,290)	(54.4)
General and administrative	6,286	9,402	(3,116)	(33.1)	21,297	26,721	(5,424)	(20.3)
Research and development	1,088	1,494	(406)	(27.2)	3,418	4,613	(1,195)	(25.9)
Total operating expenses	9,731	17,140	(7,409)	(43.2)	31,655	46,564	(14,909)	(32.0)
Operating income (loss)	7,453	(804)	8,257	1,027.0	18,315	10,151	8,164	80.4

Other income (expense):												
Gains on investments	-	-	-	*	-	37	(37))	*			
Interest and dividend income	6	13	(7))	*	23	108	(85))	*		
Interest expense	-	(34))	34	*	(57))	(154))	97	*	
Other income (expense), net	4	1	3	*	(2))	4	(6))	*		
Total other income (expense)	10	(20))	30	*	(36))	(5))	(31))	*
Income (loss) before income taxes	7,463	(824)	)	8,287	*	18,279	10,146	8,133	80.2		
Income tax expense (benefit)	4,152	(823)	)	4,975	*	6,708	2,559	4,149	162.1		
Net income (loss)	\$3,311	\$(1)	)	\$3,312	*	\$11,571	\$7,587	\$3,984	52.5		

* - Not meaningful.

Components of Net Revenues

Our net revenues are comprised of the following sources:

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

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

Components of Cost of Revenues

Our cost of revenues is comprised of the following components:

- Cost of magicJack devices sold – represents the costs of components and manufacturing of the magicJack devices, as well as broker commissions, production, packaging and other inventory-related costs. The cost of components and manufacturing of the magicJack devices is recognized from sales of the magicJack devices to retailers, wholesalers, or direct to customers over the period associated with the initial three, six or twelve months access right period;
- Shipping and handling – represents freight, postage and other transportation costs related to: (i) transportation of the magicJack devices from the manufacturer to our warehouse and distribution center, and (ii) freight, shipping and handling fees incurred to ship the magicJack devices to retailers and directly to customers. These costs are expensed as incurred;
- Credit card processing fees – represents transaction and other fees incurred as a result of accepting credit card payments for sales of magicJack devices, access right renewals, shipping and handling charges, magicJack related products and prepaid minutes sold directly to customers through our website. These fees are expensed as incurred;
- Network and carrier charges – represents facilities charges to establish and maintain our network as well as network usage fee charges from other telecommunications carriers. These rates or charges are based upon commercial agreements or applicable state and/or federal tariffs. These charges are expensed as incurred; and
- Other cost of revenues – represents allocation of personnel-related costs, amortization and depreciation expense related to assets employed in generating our revenues, as well as costs from discontinued revenue sources.

THREE MONTHS ENDED SEPTEMBER 30, 2015 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2014

Net Revenues

Total net revenue was \$25.4 million and \$25.8 million for the three months ended September 30, 2015 and 2014, respectively, representing a decrease of \$0.4 million, or 1.6%. The decrease in the components of net revenues was primarily attributable to the following:

- \$0.6 million decrease in access right renewal revenues;
- \$0.5 million decrease in magicJack related product revenue reflecting lower volumes;
- \$0.5 million decrease in revenues from prepaid minutes resulting from lower usage levels; and
- \$0.1 million decrease in shipping and handling revenue reflecting lower sales volumes and promotions.

These decreases in components of net revenue were partially offset by a \$1.4 million increase in revenues from the sale of magicJack devices primarily reflecting the impact of magicJackExpress sales for which income is recognized over three months rather than the twelve months associated with the magicJackGO and the six months associated with the 2014 magicJack Plus.

For the three months ended September 30, 2015 and 2014, sales of the magicJack devices through retail outlets represented approximately 68% and 64%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 32% and 36%, respectively, of magicJack devices sold. For the three months ended September 30, 2015 and 2014, no retailer accounted for more than 10% of the Company's total net revenue.

Cost of Revenues

Total cost of revenues was \$8.2 million and \$9.5 million for the three months ended September 30, 2015 and 2014, respectively, representing a decrease of approximately \$1.3 million, or 13.2%. This decrease in cost of revenues was primarily attributable to: (i) a \$1.0 million decrease in network and carrier charges primarily as a result of lower traffic and better negotiated rates with other carriers, (ii) a \$0.3 million combined decrease in shipping and handling costs and credit card processing fees as a result of lower direct sales volumes, and (iii) a \$0.2 million decrease in other cost of revenues primarily attributable to a decrease in overhead allocation reflecting lower personnel related costs. These decreases in components of cost of revenues was partially offset by a \$0.2 million increase in the cost of magicJack devices primarily reflecting increased commission costs associated with various customer retention and promotions activity.

Operating Expenses

Total operating expenses were \$9.7 million and \$17.1 million for three months ended September 30, 2015 and 2014, respectively, representing a decrease of \$7.4 million, or 43.2%. This decrease in operating expenses is attributable to: (i) a \$3.9 million decrease in marketing expense reflecting reduced media buys and marketing related spends as well as lower personnel related costs; (ii) a \$3.1 million decrease in General and Administrative ("G&A") expense due to several factors including lower legal fees, customer care fees, and a \$2.5 million charge related to a non-compete with the Company's founder that was impaired in July 2014 offset in part by higher personnel related costs primarily as a result of severance pay for terminated employees; and (iii) a \$0.4 million decrease in R&D expenses primarily due to lower personnel related and other R&D costs.

Income Taxes

Total income tax expense (benefit) was \$4.2 million and (\$0.8) million for the three months ended September 30, 2015 and 2014, respectively. The principal components of our income taxes for the three months ended September 30, 2015 and 2014 are the following (in thousands):

	Three Months Ended September 30,	
	2015	2014
Income (loss) before income taxes	\$ 7,463	\$ (824)
Income tax expense (benefit)	4,152	(823)
Effective income tax rate	55.63 %	99.88 %

We primarily operate in the U.S. and Israel, and our Israeli operations are subject to a statutory income tax rate of 26.5% that is lower than our U.S. federal income tax rate which is 35% as of September 30, 2015.

For the three months ended September 30, 2015, we recorded an income tax expense of \$4.2 million, which is higher than the expected tax provision of \$2.6 million, using the statutory income tax rate of 35%, due primarily, to the net impact of increases resulting from changes in the exchange rate on our net deferred tax assets associated with the

Israeli operations with a tax effect of \$2.0 million, and the tax effect of decreases in various other items totaling \$0.4 million. The increase was partially offset by the lower jurisdictional tax rate charged on the operating income of our Israeli operations.

The 2015 estimated annual effective tax rate is expected to approximate 31.1%, excluding discrete tax items, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

Net income

As a result of the foregoing items, net income increased to \$3.3 million in the three months ended September 30, 2015, as compared to a net loss of \$1 thousand in the three months ended September 30, 2014. Net income (loss) per diluted share increased to \$0.20 per ordinary share for the three months ended September 30, 2015, as compared to (\$0.00) per ordinary share in the prior year comparable period primarily as a result of increased profitability reflecting reductions in cost of revenues and operating expenses, as well as a reduction in the number of diluted shares outstanding resulting from the impact of our share-buy-back program.

NINE MONTHS ENDED SEPTEMBER 30, 2015 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2014

Net Revenues

Total net revenue was \$76.3 million and \$90.6 million for the nine months ended September 30, 2015 and 2014, respectively, representing a decrease of \$14.3 million, or 15.8%. The decrease in the components of net revenues was primarily attributable to the following:

- \$9.5 million decrease in revenues from the sale of magicJack devices primarily reflecting lower price points and lower unit sales volumes;
 - \$2.8 million decrease in magicJack related product revenue reflecting lower volumes;
 - \$1.6 million decrease in revenues from prepaid minutes resulting from lower usage levels;
- \$1.2 million decrease in shipping and handling revenue reflecting the lower sales volumes on devices discussed above; and
 - \$0.6 million decrease in access and wholesale charges.

These decreases in components of net revenue were partially offset by a \$1.4 million increase in access right renewal revenues reflecting higher average renewal rates, a higher number of devices on renewal and the impact of marketing to expiring customers.

For the nine months ended September 30, 2015 and 2014, sales of the magicJack devices through retail outlets represented approximately 68% and 71%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 32% and 29%, respectively, of magicJack devices sold. For the nine months ended September 30, 2015 and 2014, no retailer accounted for more than 10% of the Company's total net revenue.

Cost of Revenues

Total cost of revenues was \$26.4 million and \$33.9 million for the nine months ended September 30, 2015 and 2014, respectively, representing a decrease of approximately \$7.5 million, or 22.2%. This decrease in cost of revenues was primarily attributable to: (i) a \$3.3 million decrease in the cost of magicJack devices resulting primarily from lower device sales volumes; (ii) a \$3.4 million decrease in network and carrier charges primarily as a result of lower charges reflecting less traffic and better negotiated rates with other carriers, and (iii) a \$0.9 million combined decrease in shipping and handling costs and credit card processing fees as a result of lower sales volumes.

Operating Expenses

Total operating expenses were \$31.7 million and \$46.6 million for the nine months ended September 30, 2015 and 2014, respectively, representing a decrease of \$14.9 million, or 32.0%. This decrease in operating expenses is attributable to: (i) an \$8.3 million decrease in marketing expense reflecting reduced media buys and marketing related spends as well as lower personnel related costs; (ii) a \$5.4 million decrease in G&A expense due to several factors including lower legal fees, customer care fees, travel expenses and lower amortization expense as the non-compete with the Company's founder was impaired in July 2014 offset in part by higher personnel related costs primarily as a result of payments due upon the termination of employees; and (iii) a \$1.2 million decrease in R&D expenses related to lower expenditures on R&D related activities and lower personnel related costs.

Income Taxes

Total income tax expense was \$6.7 million and \$2.6 million for the nine months ended September 30, 2015 and 2014, respectively. The principal components of our income taxes for the nine months ended September 30, 2015 and 2014 are the following (in thousands):

	Nine Months Ended September 30,	
	2015	2014
Income before income taxes	\$ 18,279	\$ 10,146
Income tax expense	6,708	2,559
Effective income tax rate	36.70 %	25.22 %

We primarily operate in the U.S. and Israel, and our Israeli operations are subject to a statutory income tax rate of 26.5% that is lower than our U.S. federal income tax rate which is 35% as of September 30, 2015.

For the nine months ended September 30, 2015, we recorded income tax expense of \$6.7 million, which is higher than the expected tax provision of \$6.4 million, using the statutory rate of 35%, due, in part, to the net impact of increases resulting from changes in the exchange rate on our net deferred tax assets associated with the Israeli operations with a tax effect of \$0.6 million, and, in part, to the tax effect of various other discrete tax items totaling \$0.4 million, partially offset by the lower jurisdictional tax rate charged on the operating income of our Israeli operations. Excluding the impact of the discrete tax items noted, our effective tax rate would have been 31.1% for the nine months ended September 30, 2015.

The 2015 estimated annual effective tax rate is expected to approximate 31.1%, excluding discrete items, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

Net income

As a result of the foregoing items, net income increased to \$11.6 million in the nine months ended September 30, 2015, as compared to \$7.6 million in the nine months ended September 30, 2014. Net income per diluted share increased to \$0.66 per ordinary share for the nine months ended September 30, 2015, as compared to \$0.43 per ordinary share in the prior year comparable period primarily as a result of reductions in cost of revenues and operating expenses, as well as a reduction in the number of diluted shares outstanding resulting from the impact of our share-buy-back program.

BUSINESS TRENDS

Despite softening during the third quarter, renewal revenues remained strong during the nine months ended September 30, 2015, increasing more than 3% over the same period in the prior year. We remain encouraged by the loyalty of our existing customer base and will continue to undertake efforts to improve our customer renewal rates. Device sales and other device related revenues declined during the nine months ended September 30, 2015 reflecting a continuing gradual decline in device sales in both our direct and retail channels. In our ongoing efforts to strengthen device sales to new customers, we launched the magicJack EXPRESS in May 2015 which offers customers the same dependable magicJack service at a lower entry price and includes 3 months of service with the initial purchase rather than the year that is included with the magicJackGO. We are maintaining our efforts to expand device sales to new markets, and with the launch of the magicAPP Premium to both iOS and Android customers, we are increasing our efforts to reposition the device with its companion service, the magicAPP Premium. We believe that there will continue to be solid consumer demand for our low priced, unlimited phone service, whether through our magicJack device, our magicAPP, or a combination of both, in the United States and international markets.

With the release of the upgraded magicAPP Premium product to iOS customers in April 2015, we began offering monthly and annual subscription services for the magicAPP and providing our customers the ability to purchase international prepaid minutes directly from the app. We are focused on driving sales growth through monetizing the magicAPP and integrating the full range of our product offerings including the sale of international prepaid minutes. We expanded the service to Android users in late July 2015. However, there are factors that could materially, adversely affect our growth strategy to integrate the device with the APP and monetize the magicAPP, including that we have not previously generated any material revenues from the magicAPP as it has been a free service prior to April 2015, and we continue to offer a free version of the app. Additionally, the redeveloped magicAPP 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. We cannot assure that the features we are offering for monetization of the

magicAPP will be attractive to consumers at the price points we are offering, or at all.

Furthermore, we are continuing to work with Telefonica to expand distribution of our products into Latin American markets. Progress on the launch of our relationship with Telefonica has been slower than anticipated. In the meantime, the Company is continuing efforts to distribute the magicJackGO into Mexico. There can be no assurance that the launch in Mexico or any Central or South American country will be successful and the Company cannot predict what impact, if any, the arrangement with Telefonica will ultimately have on its business, results of operations, financial condition or cash flows.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash generated from operations and cash on hand and investments. As of September 30, 2015, we had cash and cash equivalents of \$79.6 million, marketable securities of \$0.4 million and accounts receivables of \$2.6 million. Our accounts payable at September 30, 2015 was \$1.3 million.

During the nine months ended September 30, 2015, we generated positive operating cash flows of \$19.3 million, as compared to \$23.5 million for the nine months ended September 30, 2014. The \$4.2 million decrease was primarily due to lower sales of magicJack devices and magicJack related products during the nine months ended September 30, 2015, partially offset by lower cost of revenues and operating costs and by increased revenues from access right renewals. Net income was \$11.6 million for the nine months ended September 30, 2015 as compared to \$7.6 million for the nine months ended September 30, 2014. We currently believe that available funds and cash flows generated by operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months. If we decide to make future acquisitions, we may require new sources of funding, including additional debt, equity financing or some combination thereof. There can be no assurances that we will be able to secure additional sources of funding or that such additional sources of funding will be available to us on acceptable terms.

Cash Flow – Operating Activities

Net cash provided by operating activities was \$19.3 million and \$23.5 million for the nine months ended September 30, 2015 and 2014, respectively.

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

During the nine months ended September 30, 2014, net cash provided by operating activities was primarily attributable to: (i) \$7.6 million of net income, (ii) \$11.3 million in non-cash items consisting of \$5.7 million of stock-based compensation expense, \$3.8 million of depreciation and amortization expense, \$2.5 million for impairment of intangible assets, and \$0.4 million in an increase in the uncertain tax position partially offset by a \$1.1 million decrease in the deferred income tax provision, (iii) a \$2.3 million decrease in deferred costs, (iv) a \$1.1 million decrease in inventory levels, (v) a \$0.5 million decrease in accounts receivable, (vi) a \$1.4 million decrease in prepaid income taxes, (vii) a \$1.7 million increase in income taxes payable and (viii) a \$1.1 million increase in accounts payable. These items were partially offset by: (i) a \$0.7 million decrease in accrued expenses, (ii) a \$1.0 million decrease in deferred revenue, and (iii) \$1.9 million increase in deposits and other current assets.

Cash Flow – Investing Activities

Net cash (used in) provided by investing activities was \$(0.5) million and \$7.2 million for the nine months ended September 30, 2015, and 2014, respectively.

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

Net cash provided by investing activities during the nine months ended September 30, 2014 was primarily attributable to \$9.1 million proceeds from sale of investments, offset in part by \$1.9 million used to purchase equipment and leasehold improvements primarily due to upgrades to our data storage facility and new warehouse and distribution center.

Cash Flow –Financing Activities

Net cash used in financing activities was \$15.2 million and \$1.5 million for the nine months ended September 30, 2015 and 2014, respectively.

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

Net cash used in financing activities during the nine months ended September 30, 2014 consisted primarily of a \$1.5 million annual payment in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets.

Stock Repurchase Program

During 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 deems appropriate up to a maximum cumulative repurchase authority of \$20 million. The primary objective of our stock repurchase program is to improve stockholders' returns. We expended \$13.6 million under our repurchase program through September 30, 2015 and as a result there remained as of September 30, 2015 \$6.4 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased and not yet retired, are recorded as treasury stock. We repurchased 1,720,390 ordinary shares under this program through September 30, 2015.

Other Liabilities

As of September 30, 2015, we no longer have an outstanding indebtedness in connection with an agreement entered into during June 2011 for the purchase of certain intangible assets, and secured only by such intangible assets. The Company made a final non-interest bearing annual payment of \$1.5 million in May 2015. Refer to Note 8, "Other Liabilities," in the Notes to our unaudited condensed consolidated financial statements included in Item 1 for further details.

Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements as of September 30, 2015.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

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

Exposure to Interest Rates

The primary objective of our investment activities is to preserve our capital until it is required to fund operations while at the same time maximizing the income we receive from our investments without incurring investment market volatility risk. Our investment income is sensitive to the general level of United States interest rates. In this regard, changes in the United States interest rates affect the interest earned on our cash and cash equivalents. Due to the short-term nature of our cash and cash equivalent holdings, a 10% movement in market interest rates would not materially impact the total fair value of our portfolio as of September 30, 2015.

Exposure to Exchange Rates

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

Exposure to Equity and Derivative Prices

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

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2015, there were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

Legal Proceedings

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

ITEM 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014.

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

During the first quarter of 2015, our Board of Directors authorized a stock repurchase program to enable us to purchase our ordinary shares from time to time on the open market or in privately negotiated transactions as management deems appropriate up to a maximum cumulative repurchase authority of \$20.0 million. The primary objective of our stock repurchase program is to improve stockholders’ returns. We expended \$13.6 million under our repurchase program through September 30, 2015 and as a result there remained as of September 30, 2015 \$6.4 million authorized to purchase ordinary shares pursuant to the stock repurchase program. All shares purchased and not yet retired, are recorded as treasury stock. We repurchased 1,720,390 ordinary shares under this program through September 30, 2015. During the three months ended September 30, 2015, we made the following purchases:

Period	(a) Total Number of Shares Purchased *	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs*	(d) Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Program (in thousands)
July 1, 2015 - July 31, 2015	545,611	\$7.12	545,611	\$ 10,962

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August 1, 2015 - August 31, 2015	176,613	\$7.41	176,613	\$ 9,654
September 1, 2015 - September 30, 2015	352,247	\$9.14	352,247	\$ 6,435
Total	1,074,471		1,074,471	

* Shares acquired under the new share repurchase program during the quarter ended September 30, 2015 were acquired through open market purchases. Refer to Note 10, "Treasury Stock," in the Notes to our unaudited condensed consolidated financial statements included in item 1 herein for further details.

The Company's prior \$100 million repurchase program, pursuant to which \$91.3 million of its outstanding ordinary shares was repurchased and \$8.7 million remained authorized for repurchases has been terminated.

ITEM 3. Defaults Upon Senior Securities

Not applicable.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

Not applicable.

ITEM 6. Exhibits

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

SIGNATURES

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

magicJack VocalTec Ltd.
(Registrant)

Dated: November 9, 2015

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

Dated: November 9, 2015

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

37
