

VOCALTEC COMMUNICATIONS LTD

Form 20-F

April 02, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE
SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended December 31, 2003

OR

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

For the transition period from _____ to _____

Commission file number: 2-0-27648

VocalTec Communications Ltd.
(Exact name of registrant as specified in its charter and
translation into English)

State of Israel
(Jurisdiction of incorporation or organization)

2 Maskit Street
Herzliya Pituach 46733
Israel
(Address of principal executive offices)

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

None.

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

| | |
|--|--|
| Ordinary Shares, par value of NIS 0.01 | Nasdaq |
| Title of each class | Name of each exchange on which registered |

Securities for which there are a reporting obligation pursuant to Section
15(d) of the Act:

None.

The number of outstanding shares of each of the issuer's classes of capital or
common stock as of December 31, 2003

12,445,299 Ordinary shares, par value NIS 0.01 per share

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

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registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety (90) days.

Yes
 No

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17
 Item 18

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes
 No

PRELIMINARY NOTE

This annual report contains historical information and forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995 with respect to VocalTec's business, financial condition and results of operations. The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "project" and "should" and similar expressions, as they relate to VocalTec or its management, are intended to identify forward-looking statements. Such statements reflect the current views and assumptions of VocalTec with respect to future events and are subject to risks and uncertainties. Many factors could cause the actual results, performance or achievements of VocalTec to be materially different from any future results, performance or achievements that may be expressed or implied by such forward-looking statements, including, among others, changes in the telecommunications and VoIP markets and in general economic and business conditions, loss of key customers and unpredictable sales cycles, competitive pressures, market acceptance of new products, inability to meet efficiency and cost reduction objectives, changes in business strategy and various other factors, both referenced and not referenced in this annual report. These risks are more fully described under "Item 3 - Key Information - Risk Factors" of this annual report. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated, expected, intended, planned or projected. VocalTec does not intend or assume any obligation to update these forward-looking statements.

In this annual report, all references to "VocalTec," "we," "us" or "our" are to VocalTec Communications Ltd., a company organized under the laws of the State of Israel, and its wholly-owned subsidiaries.

In this annual report, unless otherwise specified or unless the context otherwise requires, all 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, VocalTec are

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presented in U.S. dollars.

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SIGNATURES

PART ONE

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

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ITEM 3. KEY INFORMATION

3A. Selected Financial Data

Our historical Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles in the United States ("GAAP") and are presented in U.S. dollars. The selected historical consolidated financial information set forth below has been derived from the historical Consolidated Financial Statements of VocalTec Communications Ltd. for the years presented. Historical information as of and for the five years ended December 31, 2003 is derived from our Consolidated Financial Statements, which have been audited by Kost Forer Gabbay & Kasierer, a Member Firm of Ernst & Young Global, and Luboshitz Kasierer, an Affiliate Member of Ernst & Young International.

The information presented below is qualified by the more detailed historical Consolidated Financial Statements set forth elsewhere in this document, and should be read in conjunction with those Consolidated Financial Statements, the notes thereto and the discussion under "Operating and Financial Review and Prospects" included elsewhere in this report.

Statement of Operations Data - Year Ended December 31st
(in thousands of U.S. dollars, except per share data)

| | 1999 | 2000 | 2001 | 2002 |
|--|-----------|-----------|-----------|-----------|
| Sales | \$ 26,615 | \$ 37,499 | \$ 27,018 | \$ 15,600 |
| Cost of sales | 8,156 | 13,040 | 9,433 | 6,000 |
| Inventory write off | -- | -- | 1,441 | |
| Gross profit | 18,459 | 24,459 | 16,144 | 8,600 |
| Research and development expenses, net | 13,157 | 8,290 | 7,842 | 6,000 |
| Selling and marketing expenses, net | 27,171 | 23,018 | 23,692 | 16,000 |
| General and administrative expenses | 6,592 | 6,720 | 6,420 | 4,000 |
| Restructuring costs | 827 | -- | 1,753 | 2,000 |
| Total operating expenses | 47,747 | 38,028 | 39,707 | 29,000 |
| Operating loss | (29,288) | (13,569) | (23,563) | (21,000) |
| Other income (expenses), net | -- | 57,744 | 941 | 10,000 |
| Financial income, net | 902 | 3,184 | 1,872 | |
| Income (loss) from continuing operations before tax benefit (income taxes) | (28,386) | 47,359 | (20,750) | (11,000) |

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| | | | | |
|--|----------|---------|----------|-----|
| Tax benefit (income taxes) | -- | (9,013) | 292 | 5 |
| Income (loss) from continuing operations after tax benefit (income taxes) | (28,386) | 38,346 | (20,458) | (5) |
| Loss from operations of discontinued segment | -- | (9,510) | (8,966) | |
| Gain (loss) on disposal of segment | -- | -- | (2,359) | (1) |
| Net income (loss) | (28,386) | 28,836 | (31,783) | (8) |
| Basic net income (loss) per share from continuing operations | (2.47) | 3.17 | (1.69) | (1) |
| Diluted net income (loss) per share from continuing operations | (2.47) | 2.89 | (1.69) | (1) |
| Basic net income (loss) per share | (2.47) | 2.39 | (2.62) | (1) |
| Diluted net income (loss) per share | (2.47) | 2.18 | (2.62) | (1) |
| Weighted average number of shares used in computing net loss per share amount (in thousands) - basic | 11,498 | 12,082 | 12,127 | 12 |
| Weighted average number of shares used in computing net loss per share amount (in thousands) - diluted | 11,498 | 13,252 | 12,127 | 12 |

Balance Sheet Data - Year Ended December 31
(in thousands of U.S. dollars)

| | 1999 | 2000 | 2001 | 2002 |
|---|----------|----------|----------|----------|
| Working capital | \$35,975 | \$42,673 | \$17,117 | \$14,700 |
| Total assets | 89,271 | 92,967 | 51,561 | 28,500 |
| Long-term liabilities | 21,778 | 6,449 | 7,577 | 2,610 |
| Net assets | 58,990 | 62,370 | 31,229 | 15,990 |
| Total shareholders' equity / net assets | 58,990 | 62,370 | 31,229 | 15,990 |
| Number of shares outstanding | 11,771 | 12,127 | 12,127 | 12,127 |

3B. Capitalization and Indebtedness

Not applicable.

3C. Reasons for the Offer and Use of Proceeds

Not applicable.

3D. Risk Factors

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Many factors could have an effect on our financial condition, cash flows and results of operations. We are subject to various risks resulting from changing economic, political, industry, business and financial conditions. The principal factors are described below.

WE HAVE EXPERIENCED AND MAY CONTINUE TO EXPERIENCE SIGNIFICANT FLUCTUATIONS IN OUR QUARTERLY RESULTS, WHICH MIGHT MAKE IT DIFFICULT FOR INVESTORS TO MAKE RELIABLE PERIOD-TO-PERIOD COMPARISONS AND MAY CONTRIBUTE TO VOLATILITY IN THE MARKET PRICE FOR OUR ORDINARY SHARES.

Our operating results have fluctuated and may continue to fluctuate from period to period for a number of reasons. Over the past few years, telecommunications carriers, who are our primary customers, have reduced their capital expenditures as a result of excess capacity, heavy debt, and significant operating losses. In addition, the Voice over Internet Protocol (VoIP) market for telecommunications carriers is experiencing a shift from H.323 technology to softswitch technology, resulting in a transitional period for many VoIP vendors, including ourselves. Large carriers have only recently begun to show a serious interest in migrating their public switch telephone networks, or PSTN, to VoIP softswitch networks, and there is still uncertainty with respect to the extent and timing of shifting PSTN networks to VoIP softswitch networks. We have long sales cycles and short delivery cycles, and as a result we do not usually have a large order backlog. These factors make the forecasting of sales inherently uncertain. Significant annual and quarterly fluctuations in our results of operations may also be caused by, among other factors, the timing and composition of orders from our customers, reduced prices for our products, the economic viability and credit-worthiness of our customers, and the collectability of our receivables, some of which are recognized on a cash basis, the timing of new product announcements and releases by both us and our competitors, and still generally depressed economic conditions in the telecommunications markets and the VoIP industry in which we operate.

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

As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. The volatility in our operating results may also result in significant volatility in our share price. Furthermore, our share price is also subject to the price volatility experienced by many companies in the telecommunications sector, VoIP industry and related sectors. It is also possible that our quarterly results of operations may be below the expectations of public market analysts and investors. If this happens, the price of our ordinary shares is likely to decrease.

WE HAVE INCURRED SIGNIFICANT HISTORICAL OPERATING LOSSES AND MAY CONTINUE TO INCUR OPERATING LOSSES.

Since our incorporation in 1989, we have had limited sales and have incurred significant operating losses. We had operating losses in 2003, 2002 and 2001 of \$ 8.1 million, \$21.7 million, and \$23.6 million, respectively. To achieve profitability and increased sales levels, we must, among other things, establish and increase market demand and acceptance of our products and systems, respond effectively to competitive pressures, offer high quality customer service and support, and introduce advanced versions, enhancements, and new products that meet market needs on a timely basis.

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We may continue to incur operating losses in 2004 and thereafter if revenues are insufficient to cover sales and marketing, product development, administrative and other expenses. If revenue levels do not sufficiently increase, operating results will be adversely affected because any reduction in expenses may not sufficiently cover reduction in revenues. There can be no assurance that we will achieve or sustain significant sales or profitability in the future.

IF VOIP MARKETS FOR OUR PRODUCTS AND TECHNOLOGY FAIL TO GROW, OR OUR CURRENT OR NEW PRODUCTS FAIL TO ACHIEVE MARKET ACCEPTANCE, OUR BUSINESS WILL BE ADVERSELY AFFECTED.

The markets for our products are relatively new, are rapidly evolving technologically, and are characterized by competitors that have developed similar products and services. Conversion from PSTN to VoIP is not as widespread as expected, and carriers are only now beginning to show a serious interest in migrating their PSTN networks to VoIP softswitch networks. Sales of VoIP products have fluctuated and have been generally unpredictable, as fluctuation in demand for voice infrastructure products is dependent on the customers establishing and/or expansion of their networks. As is typical in the case of an evolving industry, demand and market acceptance for recently introduced technology products and services are subject to a high level of uncertainty. Further, there is continuing uncertainty as to whether and when the size of the VoIP market will further increase, if at all. Broad market demand and acceptance of our technology, products and solutions, including our new Essentra product line, and interoperability of our products with other VoIP products are very important to our success and to our ability to generate revenues. Market demand and acceptance of our technology, products and solutions will be highly dependent on functionality, interoperability, reliability, stability and performance as well as on matters beyond our control such as the introduction of competing products or technologies into the market before our new technologies and products. There can be no assurance that packet based voice networks will become widespread, that connections between Internet Protocol, or IP, networks and the publicly switched telephone networks, or PSTN, will become widespread or that our products and solutions, including our new Essentra softswitch, will generate sales or gain market acceptance. The adaptation process of connecting IP networks and PSTNs can be time consuming and costly to both us and to our customers and the acceptance of the product or system may depend, to a substantial extent, on the success of the adaptation. There can be no assurance that the market for our products and services will grow above current levels or that our products and solutions will achieve market acceptance. If the market does not grow above current levels, or if our products and solutions do not achieve market acceptance, our business, financial condition and results of operations will be materially adversely affected.

LOW LEVELS OF CAPITAL SPENDING BY TELECOMMUNICATIONS COMPANIES WILL ADVERSELY AFFECT OUR REVENUES AND OUR FUTURE GROWTH.

The turbulent economic events of the past several years precluded the establishment of potential new carrier customers. In addition, numerous competitive local exchange carriers ("CLECs") entered into bankruptcy, while other existing telecommunications providers, including many of our customers, sustained significant economic losses and were forced to reduce planned capital expenditures in order to reduce debt and operating expenses. This environment resulted in decreased market demand for our products and longer sales and procurement cycles, and adversely affected our revenues.

IF OUR RELATIONSHIPS WITH OUR KEY CUSTOMERS ARE TERMINATED, OUR REVENUES WILL DECLINE AND OUR BUSINESS WILL BE ADVERSELY AFFECTED.

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During 2003, our two main customers, Deutsche Telekom and its T-Systems subsidiary and DataAccess (India) Limited, accounted for 52% and 22% of our sales, respectively. If for any reason, our relationship with Deutsche Telekom or DataAccess is terminated, or if either of these key customers reduces purchases of our products, then our business, financial condition and results of operations would be materially adversely affected. In addition, if any of our key customers decided to replace our existing equipment in their networks with competitor's equipment, this would pose a serious competitive problem. The impact of the termination or reduction of our key customer relationships would be intensified if we are unable to increase sales to other customers in order to offset this termination or reduction.

IF OUR NEW SOLUTIONS DO NOT MEET MARKET AND CUSTOMER REQUIREMENTS OR IF OUR PRODUCTS DO NOT ACHIEVE INDUSTRY STANDARD CERTIFICATIONS IN EXISTING OR EMERGING MARKETS, WE WILL NOT ATTRACT AND RETAIN CUSTOMERS.

Maintaining and increasing our sales revenues are dependent upon the ability of our products to meet market and customer requirements. To this end, we are involved in a continuous process to evaluate changing market demands and customer requirements, and to develop and introduce new products, features and applications to meet such changing demands and requirements. A number of risks are inherent in this process. We may not successfully anticipate market requirements or complete the development or introduction of these products. In addition, the development of new technologies and products is increasingly complex and uncertain. This can result in delay in the introduction of new technologies and products, and requires close collaboration and continued technological advancement involving multiple hardware and software design teams and outside suppliers of key components. The failure of any one of these elements could cause new products to fail to meet specifications, market requirements or customer demands, or to miss delivery schedules. As the variety and complexity of our product lines increase, the process of planning production and inventory levels also becomes increasingly complex.

Our results could be adversely affected by factors such as lack of market acceptance of our new products, development or manufacturing delays, and delays in customer purchases of products in anticipation of the introduction of new products and the rapidly changing landscape of emerging standards. In addition, products in our inventory that are not timely sold may become obsolete, resulting in inventory write-downs.

Further, telecommunications carriers outside the U.S. increasingly require that VoIP products be designed to meet local homologation requirements to demonstrate interoperability with existing networks of incumbent telecommunications carriers, each of which may have different specifications. Failure to obtain such homologation certifications or other industry standard certifications for our products may result in decreased revenues, significant warranty, support and repair costs, may divert the attention of our engineering personnel, and cause significant customer relations problems.

WE MAY NEED TO RAISE ADDITIONAL FUNDS TO SUSTAIN OUR FUTURE OPERATIONS, RESEARCH AND DEVELOPMENT AND SALES INFRASTRUCTURES. ADDITIONAL CAPITAL MAY NOT BE AVAILABLE ON TERMS ACCEPTABLE TO US OR AT ALL, AND IF RAISED MAY DILUTE OUR SHAREHOLDERS.

Our total cash, cash equivalents, restricted cash, and short term deposits as of December 31, 2003 was approximately \$12.2 million. In March 2004, we completed a private placement of equity securities to institutional investors of 2.4 million of our ordinary shares. We received approximately \$9.3 million, net of expenses, which will be used for working capital and general corporate purposes. We also issued to the institutional investors warrants to purchase up to 1.2 million ordinary shares at an exercise price of \$4.75 per share. The warrants are exercisable for four and a half years, beginning six months after

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closing. If we do not increase our revenues, we may need to further reduce expenses and/or raise additional capital or funds in order to cover the cost of our operations, research and development, and sales infrastructures. Such additional funding, whether obtained through public or private debt or equity financing, or from strategic alliances may not be available when needed or may not be available on terms acceptable to us, if at all. If additional funds are raised through the issuance of equity securities, the value of our shares may decrease, the percentage ownership of our then current shareholders may be diluted and such equity securities may have rights, preferences or privileges senior or more advantageous to those of the holders of our ordinary shares. If additional funds are raised through debt instruments, we may become subject to various covenants, restrictions, pledges and other security interests that typically accompany such funding. Any downturn in capital markets and the potential difficulties in raising funds faced by high technology companies are likely to make it difficult to raise additional capital. See "Item 5B - Liquidity and Capital Resources" below.

THE MARKET PRICE OF OUR ORDINARY SHARES MAY BE VOLATILE AND INVESTORS MAY NOT BE ABLE TO RESELL THEIR SHARES AT OR ABOVE THE PRICE PAID, OR AT ALL.

In addition to our significant operating losses, generally depressed economic conditions have adversely affected our share price and trading volumes over the past few years. In December 2002, the Nasdaq approved our application to transfer the quotation of our ordinary shares to the Nasdaq SmallCap Market from the Nasdaq National Market. On July 29, 2003, our ordinary shares were listed back on the Nasdaq National Market, where they continue to be traded under the symbol "VOCL".

Additional factors that could cause the market price of our stock to further decrease significantly include the loss of any of our major customers or key personnel, new product developments or enhancements by our competitors, sales of our securities by our shareholders, quarterly fluctuations in actual or anticipated operating results, continued significant operating losses, market conditions in the industry, analysts reports, announcements by competitors, regulatory actions or other events or factors, including the risk factors described herein and general economic conditions. In the past, following decreases or volatility in the market price of a company's securities, securities class action litigation has often been instituted. Such litigation could result in substantial costs and a diversion of management's attention and resources, which would have a material adverse effect on our business, operating results and financial condition.

WE ARE SUBJECT TO STRONG COMPETITION. GREATER MARKET DEMAND AND ACCEPTANCE OF OUR COMPETITORS' PRODUCTS AND TECHNOLOGY COULD RESULT IN REDUCED REVENUES OR GROSS MARGINS.

The competition in the VoIP communications market is very strong. Our competitors include telecommunications companies, data communication companies and pure voice over IP companies. Almost all of our competitors are larger than we are, and can offer more comprehensive solutions either on their own or by partnering with others. In addition, many of our competitors have greater name recognition, larger installed customer bases, broader product offerings, and significantly greater financial, technical and marketing resources than we do. Such competition may result in a reduction in prices. Even if we reduce the prices of our products, there can be no assurance that we will be able to successfully launch our new products, or compete successfully and effectively for deals against other companies' product offerings. Furthermore, if we reduce our prices below current levels due to the competition, our operating losses may increase and we may be unable to maintain revenues and gross margins.

We expect that additional companies will compete in the packet based voice

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networks market. In the future, we may also develop and introduce other products with new or additional telecommunications capabilities or services. As a result of any such development or introductions, we may compete directly with traditional telecommunications infrastructure and service providers. Additional competitors may include companies that currently provide computer software products and services, such as telephone, media, and cable television. The ability of some of our competitors to bundle other enhanced services and other products with VoIP products could give these competitors an advantage over us.

OUR COSTS OF SALES HAVE INCREASED AND ARE EXPECTED TO CONTINUE INCREASING DUE TO INCREASED COMPETITION, AND THE PROVISIONING OF TURNKEY SOLUTIONS. THIS HAS AND WILL CONTINUE TO NEGATIVELY IMPACT OUR OPERATING MARGINS.

During the past few years, our costs of sales have increased due to the higher costs of the hardware components contained in our solutions. Further, most of our customers and potential customers are demanding end-to-end turnkey solutions consisting of all necessary hardware and software for their VoIP communications solutions. Accordingly, we purchase hardware components, such as servers and circuit boards to integrate into our solutions from a small number of manufacturers some of which may not always have sufficient quantities of inventory available to timely fill our orders. We also rely on partial outsourcing for the integration and assembly of our turnkey solutions.

IF WE ARE UNABLE TO MAINTAIN OUR RELATIONSHIPS WITH OUR SUPPLIERS, OR IF OUR SUPPLIERS' BUSINESSES ARE ADVERSELY AFFECTED BY DEVELOPMENTS UNRELATED TO US, OUR SALES COULD BE HARMED.

We are dependent on a number of suppliers for the manufacture, supply and support of hardware components that are integrated into our solutions. We do not have long-term contracts with some of our suppliers and integrators, and they are not obligated to provide us with products or services for any specified period of time. If any of our hardware manufacturers or integrators cease production, cease operations or fail to make timely delivery of orders, we may not be able to meet our delivery obligations to our customers, and may lose revenues and suffer damage to our customer relationships. The need to stock up on such components would increase our inventories and costs of sales, and would negatively impact our gross margins. In addition, increased inventory levels may result in obsolete inventory if such inventory was not sold. Any continuation or intensification of these trends would negatively affect our results of operations and could delay or prevent us from achieving profitability.

POLITICAL, ECONOMIC AND MILITARY CONDITIONS IN DOMESTIC OR FOREIGN LOCATIONS, INCLUDING ISRAEL, COULD NEGATIVELY IMPACT OUR BUSINESS.

Significant portions of our operations are conducted outside the United States, and our principal offices and research and development facilities are located in the State of Israel. Although virtually all of our sales currently are made to customers outside Israel, we are nonetheless directly influenced by the political, economic, military and other conditions in and around Israel and in other countries in which our business is located or in which our products are sold. In addition, any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, financial conditions or results of operations.

The general state of political and economic instability in the Middle East has adversely affected security and economic conditions in Israel. Throughout the years, Israel experienced hostilities with its Arab neighbors, and several Arab countries still restrict business with Israeli companies. Since October 2000, there has been a significant increase in hostility and violence between

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Israel and the Palestinians.

It is possible that the situation may deteriorate further and may impact our operations in Israel. There can be no assurance that ongoing or revived hostilities or other events related to Israel will not have a material adverse effect on us or on our business. In addition, we could be adversely affected by restrictive laws or policies directed towards Israel and Israeli businesses.

WE EXTEND CREDIT TO CUSTOMERS FOR PURCHASES OF OUR PRODUCTS AND MAY NOT BE ABLE TO COLLECT ACCOUNTS RECEIVABLE.

A portion of our receivables result from credit extended to customers for purchases of our products. There can be no assurance that any of our accounts receivable will be completely collected. Any failure in the collection of accounts receivables will adversely affect our cash flow position and will result in decreased revenues.

SOME OF OUR DIRECTORS, OFFICERS AND EMPLOYEES ARE OBLIGATED TO PERFORM MILITARY RESERVE DUTY.

Some of our Israeli directors, and many of our Israeli male officers and employees are currently obligated to perform up to 36 days of annual reserve duty. Additionally, all such persons are subject to being called to active duty at any time under emergency circumstances. We have operated effectively under these requirements since we began operations. No assessment can be made, however, as to the full impact of these requirements on our workforce or business if conditions should change, and we cannot predict the effect on us of any expansion or reduction of these obligations.

UNDETECTED ERRORS OR DEFECTS IN OUR PRODUCTS COULD INCREASE OUR COSTS AND HARM OUR BUSINESS.

Products offered by us may contain undetected errors or defects when first introduced or as new versions are released. The introduction of products with reliability, quality or compatibility problems could result in reduced revenues and orders, uncollectible accounts receivable, delays in collecting accounts receivable and additional costs. There can be no assurance that, despite testing by us or by our customers, errors will not be found in our products after commencement of commercial deployment. Errors of this sort could result in product redevelopment costs and loss of market demand, delay in market acceptance, loss of revenues, loss of market share, loss of potential new customers, and increased warranty and maintenance costs. In addition, there can be no assurance that we will not experience significant product returns in the future. Any such event could have a material adverse effect on our business, financial condition or results of operations.

WE ARE DEPENDENT UPON THE CONTINUED EMPLOYMENT OF KEY PERSONNEL.

Our future success depends to a significant extent upon the continued active participation of Dr. Elon Ganor, our Chairman of the Board of Directors and CEO. The loss of his services could have a material adverse effect on our business. In addition to Dr. Ganor, the success of our company depends upon the continued services of our senior executive officers. These officers, including Dr. Ganor, are not bound by employment agreements for any specific term. The loss of the services of any of our officers may adversely affect the development and sales of our products, and the management of our company. Our future is also dependent upon our continuing ability to attract and retain highly qualified personnel and key engineers, to perform research and development, commercialize products, and perform the sales and marketing functions required to bring these products to the market. There can be no assurance that we will continue to attract and retain such personnel.

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OUR INTERNATIONAL OPERATIONS EXPOSE US TO THE RISKS INHERENT IN CONDUCTING BUSINESS IN INTERNATIONAL MARKETS.

A substantial portion of our sales are in international markets. There are certain risks inherent in conducting business in international markets, including unexpected changes in regulatory requirements, export restrictions, homologation certifications, tariffs and other trade barriers, difficulties in staffing and managing foreign operations, longer payment cycles, credit-worthiness of potential customers, and political instability, all of which can adversely impact the success of our international operations. There can be no assurances that one or more of such factors will not have a material adverse effect on our international operations and, consequently, on our business, financial condition or results of operations.

WE MAY BE UNABLE TO ADEQUATELY PROTECT OUR PROPRIETARY RIGHTS, WHICH MAY LIMIT OUR ABILITY TO COMPETE EFFECTIVELY.

Our success is dependent, to a certain extent, upon our proprietary technology. We currently rely on a combination of trade secret, patent, copyright and trademark law, together with non-disclosure, contractual licensing restrictions, and invention assignment agreements, to establish and protect the proprietary rights and technology used in our products. There can be no assurance, however, that such measures will provide commercially significant protection for our proprietary technology, that competitors will not develop products with features based upon, or otherwise similar to, our products or that we will be able to prevent competitors from selling similar products.

In addition, the software market has traditionally experienced widespread unauthorized reproduction of products in violation of manufacturers' intellectual property rights. Such activity is difficult to detect and legal proceedings to enforce the manufacturers' intellectual property rights are often burdensome and involve a high degree of uncertainty and costs. Unauthorized use and reproduction of the registration codes contained in our various software products has occurred from time to time and may continue to occur in the future. There can be no assurance that our software products will not experience unauthorized use or reproduction on a massive scale, which will adversely affect our business, financial condition and results of operations.

LITIGATION AND OTHER DISPUTES REGARDING OUR INTELLECTUAL PROPERTY COULD PROVE COSTLY AND THEREBY ADVERSELY IMPACT OUR FINANCIAL POSITION AND COULD ALSO RESULT IN AN INJUNCTION OR JUDGMENT AGAINST US, WHICH COULD ADVERSELY AFFECT OUR BUSINESS.

Third parties have asserted patent infringement and other claims against us from time to time. A number of these claims were directed at certain basic and fundamental components of our products. There can be no assurance that third parties will not assert such claims against us in the future or that such present and future claims will not be successful. Patents relating to basic technologies in the communications and multimedia areas have been recently allowed and patents may be filed in the future which relate to basic technologies incorporated in our products. We would incur substantial costs and would experience diversion of management resources with respect to the defense of any claims relating to proprietary rights, and this could have a material adverse effect on our business, financial condition and results of operations. Furthermore, parties making such claims could secure a judgment awarding substantial damages, as well as injunctive or other equitable relief which could effectively block our ability to make, use, sell, distribute or otherwise license our products in the United States or abroad. Such a judgment could have a material adverse effect on our business, financial condition and results of operations. Litigation, which is generally costly and time

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consuming, may be necessary to determine the scope and validity of others' proprietary rights or to enforce any patents issued to us, in judicial or administrative proceedings. In the event a claim relating to proprietary technology or information is asserted against us, we may seek licenses for such intellectual property. There can be no assurance, however, that licenses could be obtained on commercially reasonable terms, if at all, or that the terms of any offered licenses will be acceptable to us. The failure to obtain the necessary licenses or other rights could preclude the sale, manufacture or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition or results of operations. The cost of responding to any such claim may be material, whether or not the assertion of such claim is valid.

IF WE ARE UNABLE TO MAINTAIN OUR RELATIONSHIPS WITH OUR DISTRIBUTORS, OR IF OUR DISTRIBUTORS' BUSINESSES ARE ADVERSELY AFFECTED BY DEVELOPMENTS UNRELATED TO US, OUR SALES COULD BE HARMED.

Our marketing strategy includes sales through distributors and resellers, as well as direct sales by our own sales force. There is no assurance that we will be successful in extending the terms of our various agreements or in establishing similar relationships with other entities if our current agreements are not extended, and changes in our relationships with our suppliers, distributors, value added resellers and agents, or other changes to their respective businesses could have a material adverse effect on our business, financial condition or results of operations.

ANY FUTURE MERGERS WITH OR ACQUISITIONS OF COMPANIES OR TECHNOLOGIES AND THE RESULTANT INTEGRATION PROCESS MAY DISTRACT OUR MANAGEMENT AND DISRUPT OUR BUSINESS.

One of our business strategies is to pursue strategic partnerships, alliances, mergers and/or acquisitions of complementary businesses, products and technologies. Pursuit of such strategies requires significant investments in management time and attention.

We have no current understandings, commitments or agreements with respect to any mergers or acquisitions. However, mergers with or acquisitions of companies involve a number of risks including the difficulty of assimilating the operations and personnel of the merged or acquired companies and of maintaining uniform standards, controls and policies. There can be no assurance that technology or rights acquired by us will be incorporated successfully into products we introduce or market, that such products will achieve market acceptance or that we will not encounter other problems in connection with such acquisitions. If we consummate one or more significant acquisitions in which the consideration consists of ordinary shares, shareholders would suffer significant dilution of their interests in us.

OUR PRINCIPAL SHAREHOLDERS, INCLUDING OUR EXECUTIVE OFFICERS AND DIRECTORS, ARE ABLE TO INFLUENCE MATTERS REQUIRING SHAREHOLDER APPROVAL.

As of March 30, 2004 our principal shareholders, including our directors and certain executive officers, beneficially owned more than 30.6% of the outstanding ordinary shares of our company. As a result, such shareholders together have the ability to significantly influence the election of our directors and most corporate actions.

Certain provisions of our articles of association and Israeli law could delay, hinder or prevent a change in our control.

Our articles of association contain provisions which could make it more difficult for a third party to acquire control of us, even if that change

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would be beneficial to our shareholders. Specifically, our articles of association provide that our board of directors is divided into three classes, each serving three-year terms. In addition, certain provisions of the Israeli Companies Law, which came into effect in February 2000, could also delay or otherwise make more difficult a change in our control. The provision of the Companies Law relating to mergers and acquisitions are discussed in greater detail in "Item 10: Additional Information."

OUR UNITED STATES INVESTORS COULD SUFFER ADVERSE TAX CONSEQUENCES IF WE ARE CHARACTERIZED AS A PASSIVE FOREIGN INVESTMENT COMPANY.

Depending on various factors described in Item 10E, we could be characterized, for United States income tax purposes, as a passive foreign investment company ("PFIC"). Such characterization could result in adverse United States tax consequences to U.S. Holders (as defined in Item 10E). Our status as a PFIC could cause, among other things, any gain recognized on the sale or disposition of our ordinary shares to be treated as ordinary income for U.S. Holders. Although we do not believe that we should have been characterized as a PFIC for any tax year through and including 2003, there can be no assurance that the United States Internal Revenue Service will agree with this conclusion. Furthermore, there can be no assurance that we will not be a PFIC in the future. For further discussion of the consequences of our possible PFIC status, please refer to Item 10E.

THE TAX AND OTHER BENEFITS AVAILABLE TO US FROM ISRAELI GOVERNMENT PROGRAMS MAY BE DISCONTINUED OR REDUCED AT ANY TIME, WHICH WOULD LIKELY INCREASE OUR TAXES IN THE LONG TERM AND OUR NET RESEARCH AND DEVELOPMENT EXPENSES.

We benefit from certain tax and other benefits, particularly as a result of the "Approved Enterprise" status of certain existing facilities and approved programs from the Government of Israel. In addition, we benefit from participation by the Office of the Chief Scientist of the State of Israel (the "Chief Scientist") in research and development projects. To be eligible for these participations and tax benefits, we must continue to meet certain conditions, including, with respect to the tax benefits, making certain specified investments in fixed assets. There can be no assurance that such participations and tax benefits will be continued at their current levels or otherwise. The termination or reduction of certain tax benefits (particularly benefits available to us as a result of the "Approved Enterprise" status of certain of our existing facilities and approved programs) could have a material adverse effect on our business, financial condition or results of operations. The termination or reduction of the participation of the Chief Scientist in research and development projects could increase our net research and development expenses or limit or terminate certain research and development projects.

WE MAY BE ADVERSELY AFFECTED IF THE RATE OF INFLATION IN ISRAEL EXCEEDS THE RATE OF DEVALUATION OF THE NEW ISRAELI SHEKEL (NIS) AGAINST THE DOLLAR.

A significant portion of our sales are made outside of Israel in dollars and we incur a significant portion of our expenses in NIS. The cost of our operations in Israel, as expressed in dollars, is influenced by the extent to which any increase in the rate of inflation is not offset by the devaluation of the NIS in relation to the dollar. During the calendar years 2001, 2002 and 2003 the annual rate of inflation (deflation) was 1.4%, 6.5% and -1.9% respectively. In 2001 and 2002, the NIS was devalued against the dollar by approximately 9.3% and 7.3% and appreciated against the dollar by 7.6% in 2003. As of March 25, 2004, the rate of inflation for 2004 was 0%, and the NIS depreciated by approximately 3.3%. Although to date we have not purchased forward currency options to decrease our exchange rate risk, we may do so in the future, to the extent we deem it advisable.

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SERVICE AND ENFORCEMENT OF LEGAL PROCESS ON US AND OUR DIRECTORS AND OFFICERS MAY BE DIFFICULT TO OBTAIN.

Service of process upon our non-U.S. directors and officers may be difficult to obtain within the United States. Furthermore, any judgment obtained in the United States against us or these individuals may not be collectible within the United States. There is doubt as to the enforceability of civil liabilities under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of the Securities Act and the Exchange Act.

COMMUNICATION AUTHORITIES MAY IMPOSE CHARGES, CONTRIBUTIONS AND OTHER COMMON CARRIER REGULATIONS ON IP TELEPHONY PROVIDERS.

To date, neither the Federal Communications Commission ("FCC"), state communications authorities, nor the communications authorities of other countries have subjected IP telephony providers nor VoIP solutions providers to the regulations that apply to long distance telecommunications carriers. At this time it is uncertain whether or to what extent the FCC, state communications authorities, or the communications authorities of other countries will impose access charges, universal service contributions, and other common carrier regulations on IP telephony providers or to VoIP solutions providers. There can be no assurance that future action by the FCC or other communications authorities will not have an impact on us, directly or indirectly.

ITEM 4. INFORMATION ON THE COMPANY

4A. History and development of VocalTec Communications Ltd.

Our corporate name is VocalTec Communications Ltd. for both legal and commercial purposes. We were incorporated as a company under the laws of the State of Israel in 1989 and are subject to the Israeli Companies Law - 1999 ("Companies Law"). Our principal executive offices are located at 2 Maskit Street, Herzliya Pituach, 46733, Israel, and the telephone number at that location is +972-9-970-7800. Our website is located at <http://www.vocaltec.com>. Our wholly owned U.S. subsidiary, VocalTec Communications Inc., is located at Two Executive Drive, Suite 592, Fort Lee, NJ, USA 07024.

In May 2002, we finalized the carve-out of our Surf&Call operations into a separate corporate entity in which we held a minority interest, and therefore we did not incur any capital expenditures for Surf & Call in 2002. In December 2003, we sold our entire interests in Surf & Call to Cosmocom, Inc, in consideration for full payment of all outstanding debts of Surf & Call in the amount of \$0.1 million, future royalty payments in the event of certain types of licensing of the Surf & Call technology during the subsequent 24 months, and a portion of the proceeds in the event of a sale of the Surf & Call technology by Cosmocom to a third party during the subsequent 24 months.

During 2002, we implemented a number of organizational changes due to substantial reduction in market demand, based on an ongoing review of our operations. This initiative included reductions in worldwide headcount of 108 employees, or approximately 42% of our workforce including the Surf & Call spin-off, reduction in the office facilities used for our activities, the closing of our sales offices in France, Italy, Spain, Sweden, and Australia, and the carve-out of our Surf&Call operations. In 2003, we closed our offices in China and Japan.

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Commencing in 2000, we gradually reduced our shareholdings in ITXC Corp, or ITXC. In 2000, we sold 779,743 shares of ITXC Corp. in the net amount of approximately \$61.2 million and recorded a net gain of approximately \$60.7 million. In 2001, we sold 180,000 shares of ITXC, and realized net proceeds of approximately \$1 million. In 2002, we sold the remainder of our shares of ITXC, and realized net proceeds of approximately \$13.1 million.

In December 2002, the Nasdaq approved our application to transfer the quotation of our ordinary shares to the Nasdaq SmallCap Market from the Nasdaq National Market. On July 29, 2003, our ordinary shares were listed back on the Nasdaq National Market, where they continued to be traded under the symbol "VOCL".

In March 2004, we completed a private placement of equity securities to institutional investors of 2.4 million of our ordinary shares at an aggregate purchase price of \$9.8 million or \$4.10 per ordinary share. We received approximately \$9.3 million, net of expenses, which will be used for working capital and general corporate purposes. We also issued to the institutional investors warrants to purchase up to 1.2 million ordinary shares at an exercise price of \$4.75 per share. The warrants are exercisable for four and a half years, beginning six months after closing.

Our capital expenditures for fiscal years 2003, 2002, and 2001 amounted to \$0.7 million, \$0.8 million, and \$1.8 million, respectively. These expenditures were primarily for hardware and software in our Israel and worldwide offices.

Capital expenditures for our Surf&Call business unit were approximately \$0.1 million or 7% of total capital expenditures in 2001.

As of March 25, capital expenditures currently in progress consist of approximately \$0.1 million to be used in 2004 for research and development activities.

4B. Business Overview

We are a leading supplier of packet-based voice solutions for next generation telecommunication networks suitable for the telecommunications and enterprise markets. Our solutions incorporate carrier-class switching equipment and software that enables voice to be delivered over packet-based networks, including the Internet. Our solutions enable telecommunications carriers and service providers to reduce both capital and operating expenses by utilizing a more efficient network infrastructure to establish and operate voice networks. In addition, our solutions provide a platform for telecommunications carriers and service providers to increase their revenues through the delivery of IP-based voice and data services (such as voice virtual private networks) helping them to retain and expand their customer base.

Our solutions can be rapidly deployed and easily expanded to accommodate growth in traffic volume. Our products interoperate with many existing networks, both traditional and VoIP, enabling best-of-breed solutions and allowing customers to preserve their investment in their current networks. We believe that our solutions offer a level of reliability and voice quality equivalent to that of the PSTN.

Our customers include traditional local, international and wholesale long distance telecommunication companies, competitive local exchange carriers ("CLECs"), alternative carriers, telephony wholesalers, Internet telephony service providers ("ITSPs") and clearinghouses. We sell our products through a direct sales force, as well as through resellers and distributors.

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Industry Background

Historically, voice and data have been transmitted over separate networks using different technologies. Traditional voice carriers have typically built telephone networks based on circuit switching. Circuit switching establishes and maintains a dedicated path until a call is terminated. While a circuit-switched system reliably transmits voice communications, circuit switching does not efficiently use transmission capacity. Once a circuit is dedicated, it is unavailable to transmit any other information, even when the particular users of that circuit are not speaking or otherwise transmitting information.

Packet switching, the technology used in data networks, is increasingly replacing circuit switching. Packet-switching technologies, such as IP, divide signals into packets that are simultaneously routed over different channels to a final destination where they are reassembled in the original order in which they were transmitted. Packet switching provides for more efficient use of the capacity in the network because the network does not establish dedicated circuits, which waste unused capacity. As a result, substantially greater traffic can be transmitted over a packet-switched network than over a circuit-switched network. Driven by the Internet, the volume of data traffic has already exceeded voice traffic, and is growing at a much faster rate. By combining their voice and data networks, carriers can realize significant savings in equipment purchases and network operating costs. In addition, this convergence allows carriers to bundle voice services together with web-based and other data services to create attractive high margin revenue-generating service offerings.

In 2003 we responded to the industry shift from H.323 VoIP technology to softswitch technology by launching our Essentra softswitch (See below " - Platform Components - Essentra Softswitch Architecture").

Global forces driving the growth of IP Communications

Deregulation of the communications industry eliminated to a large extent the barriers that restricted service providers to specific geographies, services and rates. Deregulation encouraged new entrants to the telecommunications market and existing carriers to expand into new markets, usually internationally. Intense competition between carriers continues to drive down service prices and erode profit margins as voice becomes a commodity. As a result, carriers are continually looking for ways to reduce their operating expenses and for differentiated service offerings to establish new revenue sources and retain and expand their customer base.

VoIP packet-based networks are more flexible and efficient than traditional circuit switched networks, with reduced operating and equipment costs. The architecture of packet-based networks can also be leveraged to support voice services, enabling carriers to avoid the costs involved in maintaining their traditional circuit switched networks in parallel to their packet networks.

In 2003, large established carriers in developed countries began to show a serious interest in technology that will enable them to reduce their operating costs, and offer enhanced services to their customer base to increase revenues. As VoIP technology evolves from its early generations of products to the current softswitch architecture generation, these carriers are able to leverage VoIP and migrate their networks from traditional TDM networks to full blown softswitch VoIP networks where the core of the network is IP based.

Softswitch solutions enable telecommunications carriers and service providers to reduce both capital and operating expenses by utilizing a more efficient network infrastructure to establish and operate voice networks. Softswitch technology enables telecommunications carriers to connect national

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long-distance networks ("NLD") and international long-distance ("ILD") networks and to thereby offer both NLD and ILD services on the same interconnected network, rather than on separate networks, thereby reducing both capital and operating expenses. In addition, softswitch deployments allow for additional enhanced services, allowing carriers to generate new revenue streams from these enhanced services. Further, softswitch deployments result in full convergence of new IP services to different networks and devices using a new IP core network working together with existing networks

Requirements for the new voice infrastructure solutions

For voice traffic to run over packet networks, voice infrastructure solutions must satisfy a number of requirements that differ among carriers, including:

- o Carrier class equipment that complies with telecommunications carriers' quality standards.
- o Scalable solutions that support incremental growth from entry level deployments to massive global networks.
- o Solutions compatible with the existing infrastructure, supporting the full range of traditional telephone signaling variants (SS7 -the standard signaling protocol for inter-carrier traffic).
- o Simple and rapid installation, deployment and support.

The VocalTec Solution

We develop, market and/or sell a variety of carrier-grade solutions based on our softswitch architecture and VoIP products.

We believe that our particular advantages are:

- o Modular solutions for all sizes of networks.
- o Extensive next generation network experience.
- o Significant installed base with commercially deployed solutions in over 130 countries.
- o Interoperability with many revenue-generating VoIP ports worldwide.
- o Multiple relationships with various solutions providers for the telecommunications markets.

Our solutions provide two types of offerings - network services, for basic international and national long distance telephony services and global hosted services (or global managed services), for enhanced services.

Network Services

International Long Distance Services - This solution enables long distance carriers to exchange traffic using an IP network containing VoIP technology. The solution combines Class 4 tandem switch features with enhanced VoIP-enabled services. It combines connectivity to PSTN networks and VoIP networks with a wide variety of sophisticated routing algorithms required to manage complex international routes and networks operated by different carriers and required to support global hosted services, such as voice virtual private network, or VPN. It provides interoperability to ensure global service reach and comprehensive security features necessary to protect carriers' managed networks.

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National Long Distance Services - This solution enables carriers to replace or expand their existing national long distance PSTN networks with VoIP-enabled networks. Optimized for the national long distance market, this solution provides carrier-class reliability, end-to-end security, scalability and high performance used to control large-scale, high-density trunking gateways. It allows for PSTN quality voice services with full SS7 tunneling capabilities. Leveraging the inherent benefits of IP networks, this solution reduces feature upgrade and service creation costs, lowers carriers' maintenance and transport costs for long distance services, and enables a more efficient network topology.

Exchange Carrier Services - This solution enables carriers to offer wholesale VoIP services, such as purchasing and reselling of minutes, or connecting affiliates to a united global carrier. It provides a cost-effective, scalable platform for VoIP carriers seeking to offer minute-based exchange services to affiliate service providers worldwide. This solution increases the minutes passing through the network by offering global call coverage to affiliate service providers.

Trunk Replacement - This is a cost-effective VoIP solution for point-to-point voice trunking. Our trunk replacement solution utilizes IP-based networks, rather than the PSTN, to pass voice traffic between two Class 4 tandem switches. This solution allows carriers to operate and manage one convergent network for data and voice, while ensuring maximum bandwidth utilization through standards-based voice compression.

Rural Telephony - A complete, field proven rural telephony solution based on the integration of VoIP technology with Wireless Local Loop, or WLL, and satellite remote gateways at the transport layer. This solution enables the rapid deployment of basic telephony services, as well as the introduction of enhanced services over time. Prepaid and postpaid billing, centralized management and bandwidth optimization techniques address the key challenges of rural telephony, particularly in emerging economies. Standards-based VoIP interoperability with other vendors/services ensures maximum flexibility in building solutions.

Global Hosted Services

Voice VPN - This solution enables carriers to provide their enterprise customers with private voice services that utilize shared IP networks and integrate seamlessly with the customer's existing corporate dialing plans. Comprehensive security features control access to corporate network resources. For independent voice service providers, our Voice VPN solution results in substantial cost savings over PSTN-based voice VPNs. Data service providers can leverage this solution to add voice VPN services to their current IP-based VPN data services.

Calling Card - A cost-effective, pre-paid/post-paid, centrally managed Calling Card solution for VoIP calling over public or private networks. Service providers can bypass circuit-switched networks, gain customers from countries where they have no presence, enjoy low-cost termination rates and expand their service destinations via VocalTec-certified partners. Advanced features include real-time billing and a flexible interactive voice response supporting multiple languages, currencies and call flows.

IP Centrex/Hosted PBX - Working with IP centrex application vendors, we offer solutions that enable carriers to offer enterprise customers a hosted service bypassing the need for an in-house PBX (private branch exchange). Service providers can utilize this solution of offer managed IP Centrex/Hosted PBX services to their enterprise customers. Leveraging the benefits of IP networks, this integrated networks solution supports converged voice and data services - both within the enterprise and on the network access connection.

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The IP Centrex solution combines Class 5 telephony switches (the switches linking subscribers to the telephone network) with location insensitivity, enabling quick rollout of uniform services among all enterprise sites, centralized management control, simplified move/add/changes, and elimination of intra-site toll charges.

Global Call Center - This network based call center solution enables service providers to offer multi-channel customer interactions (regular telephone, IP telephony, fax, email, voicemail, SMS) in a single high-capacity, multi-tenant platform. Routing of calls to agents and Interactive Voice Response, or IVR, can be performed at the network level, allowing the provider to disperse agents at different locations to ensure maximum efficiency and global coverage. It readily delivers the capacity, reliability and security required by carriers and large enterprises.

Platform Components

Essentra(TM) SIP-Based Softswitch Architecture

Essentra is a scalable, carrier-grade SIP-based softswitch architecture for carriers looking to deploy a reliable next generation network (NGN) solution. Leveraging our extensive global experience in implementing large packet tandem networks, Essentra offers high quality voice services, carrier grade reliability and maximum service flexibility. Essentra enables smooth migration to NGN, while maintaining seamless connectivity to PSTN/SS7 services.

Essentra enables carriers to enjoy the benefits of an open, distributed architecture, including flexible creation of innovative SIP-based services. Compared to traditional switching systems, Essentra helps service providers to achieve significant reductions in operational costs, while facilitating the rapid deployment of new services and routing schemes.

The Essentra network components are :

Essentra SIP Server - This service integration layer enables carriers to build scalable, reliable packet voice networks. Utilizing the open, standards-based Session Initiation Protocol (SIP), the Essentra SIP Server provides a full array of call routing capabilities to maximize network performance in both small and large packet voice networks. By incorporating a SIP-based service integration layer, all service/routing logic and network complexity is "hidden" from the networking layer, accelerating time to market and simplifying network management.

Essentra MGC - Performing call control and signaling routing for PSTN and SS7 voice traffic, the Essentra MGC frees the media gateway to serve as a pure voice transport device. By working opposite multiple high-density media gateways simultaneously, the Essentra MGC maximizes network performance, cost-effectiveness and scalability. This module supports MEGACO/H.248 standards, enabling integration with most third party media gateway for best-of-breed networks.

VSG430 Signaling Gateway - The standards-based, carrier-grade VSG430 signaling gateway enables SIP/VoIP services to terminate on SS7 networks, ensuring seamless mediation of services between next generation networks and the PSTN. Full SS7 tunneling over IP via SIGTRAN and protocol interworking between SS7 variants of 60 countries facilitate worldwide deployment in a variety of applications.

Essentra OSS Server - This centralized server performs remote element management and configuration, accelerating service provisioning and reducing costs. Using a web-based, intuitive GUI architecture, the OSS provides role-based security, alarm handling, historical information, reversible mass

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configurations and network provisioning. The OSS allows network administrators to manage and monitor the Essentra modules, as well as adjacent network elements (e.g., media gateways, application servers). Secured management protocols using SNMPv3 and HTTPS provide additional administrative security.

VocalTec Softswitch Architecture 1000

VGK1000 Gatekeeper - Serving as the intelligent hub of the IP telephony network, VGK1000 provides a carrier-grade platform for centralized call control, routing, addressing, security and accounting functions. VGK1000 enables service providers to set up a robust and secure Internet telephony service, suitable for large-scale public and corporate networks.

VNM100 Network Manager - This operations, administration, management and provisioning tool offers centralized remote management of VoIP services and network elements. VNM100 is fully interoperable with third party H.323 Gateways, supporting up to 300 real-time monitored H.323 devices and over 1000 network elements.

VocalTec Gateways

Telephony gateways are the network elements that directly convert traditional PSTN telephone traffic to VoIP data at the originating end of a VoIP phone call or fax, and re-convert VoIP data into traditional PSTN telephone traffic at the terminating end of the VoIP phone call or fax. VocalTec offers a diverse range of low, medium and high-density H.323 gateways, enabling carriers to select equipment that is best suited for a particular installation. Our gateways include a flexible, customizable front-end IVR to support advanced subscriber services, such as calling card. In addition, support for multiple telephony interface types and signaling protocols (e.g., SS7, PRI, E&M, analog) facilitates global deployments. VocalTec's Signaling Gateway provides SS7 service switching point (SSP) functionality and supports approximately 60 national SS7 variants.

Contracts with Suppliers

We are dependent on the following suppliers for the manufacture, supply and support of hardware components that are integrated into our solutions: Audiocodes Ltd. for the supply of VoIP DSP processor boards, gateways and media gateways, ECI Telecom Ltd. (and its affiliates) for the supply of VoIP DSP processor boards, Intel for the supply of signaling boards and components, and Telica, Inc. for the supply of large-capacity media gateways. If our relationship with any of these suppliers is terminated, then we will need to invest time and resources to integrate our products with the hardware components of alternative suppliers.

Marketing, Sales and Distribution

We market and distribute our products both directly and via multiple distribution channels. We have designed our distribution strategy to address the diverse markets we target, including telecommunications service providers, ITSPs, CLECs and clearinghouses. Our marketing strategy includes direct sales to telecommunication service providers, strategic cooperations, value added resellers and integration arrangements with vendors of complementary hardware and software products and services. We currently have a direct global sales organization with sales and support based in Israel, the United States, India, Germany, Hong Kong, and Singapore. See Item 5 - Operating Review and Financial Prospects - for a breakdown of revenues by geographic market.

We typically license and sell our solutions to end users and distributors pursuant to purchase orders, distribution agreements and/or end user agreements, as applicable. The sales cycles for our solutions are long due to

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the nature of the products and solutions as well as due to the strong competition for sales of VoIP solutions. Once purchased by our end user customers, our solutions require installation in our customer's networks. After installation, we offer warranty and maintenance services to support our customers.

In 2002, we developed and implemented a new marketing strategy in response to the weak demand for telecommunications products in the developed countries, and re-focused our marketing efforts on deregulating emerging markets, with large installations of our products for companies such as DataAccess in India, and the Communications Authority of Thailand.

In addition, we responded in 2003 to the industry shift from H.323 VoIP technology to softswitch technology, by launching our Essentra softswitch. Our softswitch marketing strategy consists of targeting greenfield carriers, as well as large telecommunications carriers in developed countries to gradually migrate their existing ILD networks into softswitch networks using our Essentra softswitch platform.

Industry Standards

We recognize that standards are important for interoperability and for providing the means for market growth. Since 1996, we have taken an active role in international standards bodies. Our strong involvement and contribution led our employees to hold official positions over the years in a number of international standard bodies, including: ITU (International Telecommunications Union), ETSI (the European Telecommunications Standards Institute), IMTC (the International Multimedia Teleconferencing Consortium), and IETF (the Internet Engineering Task Force).

We actively support important communications standards in our products, including IETF SIP, ITU-T H.323, , SS7 and many others, and work closely with our tier-1 carrier customers and equipment manufacturers in ensuring standards are correctly and uniformly implemented. Our products have been ranked by industry analysts as having the largest number of different SS7 installations world-wide.

Customer and Technical Support

We believe that responsive, prompt and efficient customer and technical support is essential to the success of obtaining and retaining customers. We currently maintain a customer and technical support infrastructure in the US, Europe and Asia. We offer support to our customers and back office support to our resellers and distributors. Our technical support agreements are based on a percentage charge of the cost of the system purchased. We intend to continue to charge for such technical support in the future. We also train certain distributors, resellers and subcontractors to provide customers with first level technical support.

On a routine basis, our technical support staff provides feedback to our marketing and research and development groups. This assists us in designing products featuring ease of use and installation, to maintain compatibility with third party products in order to minimize the requirements for service and support, and to improve product quality.

Research and Development

See Item 5 - Operating Review and Financial Prospects - for a discussion on research and development.

Competition

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Our market is intensely competitive and rapidly evolving, and is characterized by evolving standards and new alliances. Our principal competitors include Cisco Systems, Inc., Alcatel, Lucent Technologies Inc., Siemens, Nortel Networks Corporation, Nuera Communications, Comworks Technologies, Sonus Networks Inc., Verso Technology Inc. and Veraz Networks, Inc. Many of our competitors are difficult to compete with, as they are larger than we are, have broader name recognition, have greater long-term resources and can sustain larger price reductions for their products than we can.

We believe that in such a rapidly changing market, key competitive factors include a broad base of users, strategic alliances, key reference customers, interoperability, integration of products with complementary hardware and software products and services, technological leadership, product performance and ease of use, price, customer support, name recognition, distribution channels and the ability to respond quickly to emerging opportunities.

4C. Organizational Structure

We are organized under the laws of the State of Israel. Our directly and indirectly held principal operating wholly-owned subsidiaries and their countries of incorporation are:

- o VocalTec Communications Inc. (United States)
- o VocalTec Communications Deutschland GmbH (Germany)
- o VocalTec Communications Hong Kong Limited (Hong Kong)
- o VocalTec Communications International B.V. (Netherlands)
- o VocalTec Communications Singapore Pte Ltd. (Singapore)
- o VocalTec Communications India Private Limited (India)

4D. Property, Plants and Equipment

Our headquarters are located in Herzliya Pituach, Israel and occupy approximately 40,700 square feet pursuant to a lease expiring in January 2005. We currently pay total yearly rental and management fees of approximately \$1.01 million, which are linked to the Israeli Consumer Price Index. These facilities are used for management, marketing, sales, research and development and production. Of this amount, approximately 33,200 square feet are currently being used by our company. We are subleasing approximately 7,500 square feet to Pioneer Administrative Services Ltd. as of March 1, 2003.

We maintain car leases, and our total liability for early termination of the leases is up to an aggregate of approximately \$166,000.

The following facilities accommodate our sales and customer support worldwide and are being fully utilized. We believe they are all flexible enough to accommodate expansion of operations.

In March of 2003, we renegotiated the lease for our subsidiary in the United States, for smaller offices of approximately 3,870 square feet in Fort Lee, New Jersey under a lease expiring on February 28, 2006. The annual rent for these facilities is approximately \$110,000.

Our subsidiary in Germany leases approximately 1,500 square feet in Bonn under a lease expiring in June 2004. The annual rent for the facility is approximately \$32,000. We are planning to either renew this lease or to seek alternative similar facilities for our German subsidiary.

Our subsidiary in Hong Kong leases approximately 970 square feet under a lease expiring in June 2004. The annual rent for the facility is approximately \$37,000. We are planning to either renew this lease or to seek alternative similar facilities for our Hong Kong subsidiary.

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Our subsidiary in India leases approximately 1200 square feet under a lease expiring in December 2005. The annual rent for the facility is approximately \$26,000.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this annual report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ significantly from those projected in the forward-looking statements. Factors that might cause future results to differ significantly from those projected in the forward-looking statements include, but are not limited to, those discussed below and elsewhere in this annual report particularly those described above under "Item 3 - Key Information - Risk Factors."

Our consolidated financial statements are stated in U.S. dollars and prepared in accordance with U.S. GAAP. Our functional and reporting currency is the U.S. dollar, which is the currency of the primary economic environment in which our consolidated operations are conducted. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in currencies other than dollars (including NIS) are remeasured in dollars in accordance with the principles set forth in FASB Statement No. 52 - "Foreign Currency Translation".

Overview

As a result of the turbulent economic conditions worldwide over the past several years, spending in the telecommunications industry decreased substantially in 2001 and 2002 over prior years. Although the VoIP sectors have grown in terms of minutes according to independent market research, sales of VoIP products to telecommunications service providers continue being generally unpredictable. However, starting in 2002 we observed an increase in sales of VoIP products in certain emerging and deregulating markets worldwide. In addition, we have recently begun to observe an interest in telecommunications carriers to migrate their systems from traditional PSTN systems to VoIP networks to reduce their operating expenses. Industry analysts predict that such network migrations will occur during the course of the next decade.

Our major product changes during the past three years included the introduction of our softswitch technology and our gateway 2000, gateway 480 and Essentra product line. Our current competition and product lines are described in Item 4B - "Business Overview".

Our Consolidated Financial Statements are prepared in accordance with U.S. GAAP, and are the basis of our discussion and analysis of our financial condition and results of operations. Our reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities are based on certain estimates and judgments made in the preparation of our financial statements, which estimates and judgments are revised periodically as required. Our estimates and assumptions are based on factors such as analysis of prior years' experience, trends within our company, and within the telecommunications industry, and general economic conditions. However, 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 bigger operating losses.

Critical Accounting Policies

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

Revenue Recognition: We recognize revenue when (1) we and a customer enter into a legally binding commitment to pay for products or services free of contingencies or significant uncertainties, (2) we deliver the products or fulfill our obligations to provide the services, (3) payment is fixed and determinable, and (4) collection is probable. We assess each sale to ensure that the above conditions are met. In contracts for which an acceptance provision is required by the customer, the Company defers revenue (and the related costs) until receiving the acceptance confirmation. Service and maintenance revenues are recognized over the period during which such services are rendered. Revenue earned on software arrangements involving multiple elements is allocated to each element based on the relative fair value of the elements. Fair value is determined based on vendor specific objective evidence (VSOE) of the fair value of the elements. The VSOE of fair value of the elements is based on the price charged for the undelivered element when sold separately. Revenue is recognized under the residual method when VSOE of fair value exists for all undelivered elements and VSOE does not exist for all of the delivered elements. Under the residual method, any discount in the arrangement is allocated to the delivered elements. This policy ensures that we report revenues in accordance with U.S. GAAP. Factors that could materially adversely affect our revenue recognition include longer payment terms, longer procurement cycles, financial viability of our customer base, the mix of products and services provided, failure to timely provide products and services to customers, and fewer large customers.

Allowance of Doubtful Accounts: We treat our estimated losses for customer failure or inability to make payments as allowances for doubtful accounts. These allowances are calculated based on ongoing assessments of our customers' financial conditions. Should our customer's financial conditions deteriorate, we may be required to increase allowance for doubtful accounts.

Restructuring Charges and Discontinued Operations: We separate the exit costs related to the disposal of discontinued operations as "non-operating costs". We present these costs as "discontinued operations" in our statements of operations. We include both past actual expenses and accruals for expected expenses, along with the write-off of fixed assets belonging to these discontinued segments. Exit costs relating to continuing operations are presented as "restructuring costs" within the operating expenses. In cases where actual costs differ from projected costs, we adjust the costs accordingly. These exit costs include, among other items, severance and notice payments to employees and other contractual obligations. In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 also requires liabilities incurred in respect of such costs to be measured at fair value. SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. The company will implement the rules set forth in SFAS No. 146 if such exit costs or disposal activities will take place.

Tax Allowance Practices: Our subsidiaries operate world-wide under various tax regimes, and as such, we are subject to the tax laws and regulations of many countries. At the end of every accounting period, we estimate our existing and future tax results, and create tax assets or liabilities, as applicable. As part of this process, we generally consult with reputable tax advisors in

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various overseas locations, and follow established tax precedents in our tax allowance practices. The tax expense and benefits of the company of this process are reflected in our financial statements.

Use of estimates. The preparation of the financial information requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, mainly related to trade receivables, inventories, long-lived assets, restructuring charges, revenues and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe we are conservative in the application of accounting rules relating to future events in our consolidated financial statements. Predicted future losses or expenses are generally reported immediately in our Consolidated Financial Statements, while predicted incomes are reported upon actual occurrence.

5A. Operating Results

Sales

Sales consist of sales of VoIP turnkey solutions, products and related support and maintenance services.

We recorded sales in 2003 of \$18.7 million, or 19.9% higher than sales in 2002 of \$15.6 million. Sales for 2003 were 30.8% lower than sales in 2001 of \$27 million. The increase in sales compared with 2002 was primarily attributable to increased repeat sales to two of our existing customers, Deutsche Telekom's T-Systems subsidiary and Data Access, and to increased revenues from maintenance services.

Product revenues in 2003 were approximately \$15.7 million, an increase of 16% compared to year 2002 product revenues of \$13.5 million, and a decrease of 38.5% compared to year 2001 product revenues of \$25.5 million. The increase in 2003 was due to repeat sales to our two major customers, Deutsche Telekom and Data Access.

Service revenues from maintenance and other support services in 2003 were \$3.0 million, an increase of 45.3% compared to year 2002 services revenues of \$2.1 million, and an increase of 97.1% compared to year 2001 service revenues of \$1.5 million. Services revenues increased in 2003 compared with 2002 due to the award of larger support contracts from our customers. Revenues from maintenance and other support services exceeded ten percent of our total revenues for each of 2002 and 2003.

Sales of our solutions, consisting of a combination of software, hardware and services, continue to comprise the most significant portion of sales in 2003. Other revenues were generated by projects and support. We expect this trend to continue.

As in recent years, revenues from consulting for customization services in 2003 were negligible, because our sales mostly consist of turnkey projects that do not have customization requirements.

We distribute substantially all of our products through a combination of direct sales to telecommunications service providers, and indirectly via strategic partners, alliances, distributors, dealers and agents.

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Sales to Deutsche Telekom and its T-Systems subsidiary in 2003 and to DataAccess (India) Limited each accounted for a significant portion of our sales in 2003. If for any reason, our relationship with Deutsche Telekom / T-Systems or DataAccess is terminated, or if either of these key customers reduces purchases of our products, our business, financial condition and results of operations will be materially adversely affected.

Geographic revenues as a percentage of overall revenues changed as follows:

- o Sales in the Americas decreased to 4% of total revenues in 2003, compared to 10% of total revenues in 2002, and 35% in 2001.
- o Sales in Europe increased to 64% of total revenues in 2003, compared with 48% of total revenues in 2002, and 35% of total revenues in 2001.
- o Sales in Asia Pacific decreased to 31% of total revenues in 2003, compared with 39% of total revenues in 2002, and 25% of total revenues in 2001.
- o Sales in the rest of the world decreased to 1% of total revenues in 2003, compared with 3% of total revenues in 2002, and 6% of total revenues in 2001.

Sales in Israel were 0%, 1%, and 4% for 2003, 2002 and 2001 respectively. Sales in Germany were 52%, 24%, and 8% for 2003, 2002 and 2001 respectively. Sales in India were 22%, 23%, and 0% for 2003, 2002 and 2001 respectively. Total sales in all countries outside Israel were 100%, 99%, and 96% for 2003, 2002 and 2001 respectively.

The difference in 2003 percentages in geographic revenue distribution from previous years is mainly a result of the increase in sales to Deutsche Telekom's T-Systems subsidiary in Europe in 2003. Sales in the Americas continued to decrease significantly as a result of lower sales to ITXC during 2002, and no sales to ITXC during 2003.

To date, most of our global sales have been in U.S. dollars and have not been adversely affected by foreign currency fluctuations. If global business conditions require us to sell our solutions in other local currencies, our sales may be adversely affected by devaluation of local currencies against the U.S. dollar.

Our business is not seasonal.

Cost of Sales

Cost of sales was \$8.7 million or 47% of sales in 2003 compared with \$7.5 million or 48% of sales in 2002, including an inventory write-off in the amount of \$0.9 million. Cost of sales in 2001 was \$10.9 million or 40% of sales, including an inventory write-off in the amount of \$1.4 million. Cost of sales of products in 2003 was \$7.4 million in 2003 compared with \$6.0 million in 2002, and \$8.9 million in 2001. Cost of sales of service was \$1.3 million in 2003 compared with \$0.7 million in 2002, and \$0.5 million in 2001.

Cost of sales of products primarily includes the cost of hardware in our turnkey solutions, third party billing software, reserves for products and components in inventory, royalties to third parties, and other expenses associated with the provisioning of products. Cost of services primarily consist of salaries and travel expenses for rendering maintenance services to customers.

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As in 2002, cost of sales in 2003 increased as a percentage of sales due to increased competition in the VoIP market resulting in lower prices for VoIP products. The cost of sales as a percentage of sales may increase in the future due to increasingly competitive prices, and increased inventory-related costs. In years 2001 and 2002, we wrote off obsolete inventory product components in the amount of \$1.4 million and \$0.9 million, respectively.

In 2003, gross margins were 53%. In 2002, gross margins were 52% including inventory write-offs and 57% excluding inventory write-offs. In 2001, gross margins, including an inventory write-off for obsolete stock, was 60%, and excluding the inventory write-off was 65%. Due to price pressure generated by intense competition in the VoIP industry, gross margins have declined over the past three years. We believe that the gross margin may further decrease in future periods due to increased competition which may cause us to reduce prices of certain of our products and services, increased amounts paid for licensed technology to be incorporated in future products, a larger percentage of hardware components in our solutions, price increases in the cost of such hardware components, as well as higher standard requirements from our customers. In addition, we expect that our gross margins will be affected in future periods by the mix of hardware, software and services sold.

Operating Expenses

Research and development costs, net. Research and development costs, net were \$4.1 million in 2003 or 22% of sales, compared with \$6.1 million or 39% of sales in 2002, and \$7.8 million, or 29% of sales in 2001. Research and development costs, net consist principally of salaries and benefits for software engineers, related facilities costs and activities and expenses associated with computer equipment used in software development. None of our software development costs have been capitalized during any of the reported periods as the amount of software development costs eligible for capitalization at this stage has historically been insignificant.

We believe that continued investment in research and development is essential to remain competitive in the marketplace and is directly related to the timely developments of new and enhanced products.

Our research and development efforts have been financed from internal resources and through programs sponsored by the Government of Israel through the Chief Scientist, as well as the European Commission through the Fifth Framework Programme. We participate in a royalty-bearing program sponsored by the Chief Scientist in Israel. Pursuant to the terms of the royalty-bearing program of the Chief Scientist, we are required to pay a royalty of between 3% and 3.5% of sales of products and related services developed in any project partially funded by the Chief Scientist, up to an amount of 100% of the grant obtained. For grants received under programs approved subsequent to January 1, 1999, royalties are payable up to 100% of the grant obtained plus interest at LIBOR. We expect to participate only in royalty bearing programs but we cannot make any assurances that we will be awarded any future grants.

Our research and development expenses in 2003 were net of participation from the Chief Scientist. In 2003, participation from the Chief Scientist was \$1.6 million, of which \$1.3 million was attributed to the 2003 approved plan and additional \$0.3 million was attributed to the 2002 plan. All of these participations are related to royalty bearing programs. Total cash receipts from the Chief Scientist in 2003 were \$1.8 million of which \$0.5 million were from the 2002 plan. In 2003, we paid royalties to the Chief Scientist in an aggregate amount of approximately \$0.5 million.

Our research and development expenses in 2002 were net of participation from the Chief Scientist. In 2002, participation from the Chief Scientist was \$1.7 million, of which \$1.6 million attributed to the 2002 approved plan and

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additional \$0.1 million from the 2001 plan. All of these participations are related to royalty bearing programs. Total cash receipts from the Chief Scientist in 2002 were \$1.8 million, of which \$0.4 million were from the 2001 plan.

In 2002, we paid royalties to the Chief Scientist in an aggregate amount of approximately \$0.6 million.

In 2001, Chief Scientist participation was in the amount of \$2.5 million. \$1.7 million of that amount was related to the 2001 plan while the other \$0.8 million was related to the 2000 plan all of which related to royalty bearing programs. Total cash grants received from the Chief Scientist in 2001 were \$2.5 million, of which \$1.4 million related to the 2001 plan and \$1.1 million to the 2000 plan.

In 2001, we paid royalties to the Chief Scientist in an aggregate amount of approximately \$0.9 million.

In January 2000, we joined the Fifth Framework Programme of the European Commission for a non-royalty bearing program. During 2003, we received 175,000 Euros from the program. In 2002, total research and development grants from the Fifth Framework Programme were 50,000 Euros, compared with 100,000 Euros in 2001.

Research and Development Consortia

We are a member in the International Packet Communication Consortium, formerly known as the International Softswitch Consortium, a nonprofit organization aimed at improving existing and new products related to the communications industry by promoting interoperable Internet protocol-based, real-time interactive communications and related applications. The Consortium endorses and supports foundation protocol and interface specifications, facilitates the creation of an open architecture testing environment, sponsors interoperability events, and provides information to its members relating to the foregoing.

Selling and Marketing expenses

In 2003, selling and marketing expenses were \$10.3 million, or 55% of sales, compared with \$16.4 million or 105% of sales in 2002, and \$23.7 million, or 88% of sales in 2001. Selling and marketing expenses include salaries and benefits, sales commissions, travel expenses and related facilities costs for our sales, marketing, and distribution personnel, as well as reserves for potential damages to, loss of, or obsolescence of trial systems. Selling and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows and other market development programs.

The decrease in selling and marketing expenses in both absolute terms and as a percentage of sales in 2003 over prior years was the result of cost reductions in our sales and marketing operations, closure of some of our overseas sales offices, and more efficient use of our sales and marketing resources.

General and administrative expenses

General and administrative expenses consist principally of salaries and benefits, outside legal, accounting and consultant fees, travel expenses, and related facility costs for management, finance, logistics, human resources, legal, information services, and administrative personnel. General and administrative expenses also include expenses associated with computing equipment and software used in the administration operations. General and administrative expenses were \$3.6 million or 19% of sales in 2003, compared

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with \$4.5 million or 29% of sales in 2002, and \$6.4 million or 24% of sales in 2001. General and administrative expenses in 2003 decreased in absolute numbers and as a percentage of sales compared to 2002 due to the continued operational efficiencies we effectuated in 2003.

Restructuring costs.

We had no restructuring charges in 2003. During 2002, we implemented a number of organizational changes due to substantial reduction in market demand, including a reduction in worldwide headcount of 108 employees (including the spun-off Surf & Call employees), or approximately 42% of our workforce, reductions in the office facilities used for our activities, renegotiation of some of our office leases, moving to smaller office premises, and the closing of our sales offices in France, Italy, Spain, Sweden, and Australia. We recorded \$1.3 million for severance and termination payments and other benefits. The total costs associated with these charges was \$2.7 million, paid mostly in cash. We closed our offices in China and Japan in 2003.

During 2001, organizational changes included a reduction in worldwide headcount of 140 employees, or approximately 40% of our workforce and reduction in the office facilities used for our activities. The total costs associated with these charges was \$1.8 million, paid mostly in cash, (\$0.3 million of restructuring costs related to Surf & Call segment were reclassified to discontinued operations).

Other Income (Expense), net

Other income of \$0.1 million in 2003 was mainly from the sale of obsolete inventory to third parties. During 2002, we sold 4,608,165 shares of ITXC, representing the remainder of our holdings in ITXC, and realized net proceeds of approximately \$13.1 million. In 2001, we sold 180,000 shares of ITXC Corp, and realized net proceeds of approximately \$1.0 million.

Financial Income, net

Financial income, net in 2003 was negligible, compared with financial income, net of \$0.4 million, or 3% of sales in 2002, and \$1.9 million, or 7% of sales in 2001. The decrease in financial income in 2003 was primarily a result of fluctuations of the NIS against the U.S. dollar, lower cash balances and lower interest rates on deposits.

Taxes on Income, Tax Refunds and Tax Benefits

Taxes on income in 2003 in the amount of \$0.1 million were mainly attributed to subsidiaries outside the United States. Net tax benefits in 2002 were \$5.3 million, including a tax refund in the U.S. of \$3.8 million, and we paid taxes in the amount of \$1.0 million for our various subsidiaries. The 2002 tax refund resulted from carry-back losses in 2001 against federal tax payments made in 2000. In addition, since the company sold its remaining shares in ITXC in 2002, it re-assessed its tax liability due to the change in circumstances and, as a result, decreased its tax liability by approximately \$2.5 million.

Net tax benefits in 2001 amounted to \$0.3 million, comprised of \$0.6 million in net tax benefit, less \$0.3 million tax paid for our various subsidiaries.

We currently have two Approved Enterprise programs under the Law for the Encouragement of Capital Investments, 1959. Such programs are eligible for certain tax benefits for the first several years in which they generate taxable income. Income derived from an Approved Enterprise is subject to a zero tax rate for two years and up to an additional eight years of reduced corporate tax rate of 25% until the earlier of (i) seven to ten consecutive years, commencing the year in which the specific Approved Enterprise first

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generates taxable income, (ii) twelve years from commencement of production or (iii) fourteen years from the date of approval of the Approved Enterprise status. Some of our production and development facilities have been granted Approved Enterprise status. To date, neither of our Approved Enterprise programs has generated any taxable income.

As of December 31, 2003, we had net operating loss carryforwards in Israel of approximately \$88 million for tax purposes, and net operating loss carry forwards in the U.S. of approximately \$4.5 million. These net operating losses may be carried forward and offset against future taxable income under applicable tax laws. Tax benefits which apply to us under Israeli law do not apply to any income generated by any of our other subsidiaries.

Discontinued Operations

In June 2001 we made a strategic decision to cease operations of our wholly owned subsidiary, TrulyGlobal Inc., after being unsuccessful in obtaining external financing, and we decided to merge TrulyGlobal's operations with VocalTec Communications, Inc. Expenses incurred by TrulyGlobal until June 30, 2001 were \$4.4 million. The loss on the disposal of segment of \$2.4 million included the disposal of fixed assets, the fulfillment of contractual obligations, severance payments and notice payments for those TrulyGlobal employees that were not retained by VocalTec. The merger was formally completed in November 2001, and our profit and loss figures for 2000 reflect this transaction according to U.S. GAAP.

In May 2002, we finalized the carve-out of our Surf&Call operations into a separate corporate entity, Surf&Call Solutions Ltd., in which we held a minority interest with the remaining equity being held by a group of previous employees of the Surf&Call unit. Operating loss posted by the Surf & Call segment until March 31, 2001 was \$0.6 million, while expenses on disposal of the segment were \$1.8 million, including a \$0.55 million convertible loan write-off and the write-off in the amount of \$0.76 million for transferred equipment. The results of operations of Surf&Call were reclassified to be reported as discontinued operations in 2001 and 2000, and affected various items in our Income Statement for 2001 and 2000, although the net loss for 2001 and 2000 was unchanged. In December 2003, we sold our entire interests in Surf & Call to Cosmocom, Inc., in consideration for full payment of all outstanding debts of Surf & Call, future royalty payments in the event of licensing of the Surf & Call technology, and a portion of the proceeds in the event of a sale of the Surf & Call technology by Cosmocom to a third party. This transaction resulted in a reduction of the accrual for discontinued operations in the amount of \$0.1 million.

Net Income (Loss)

Loss from continuing operations in 2003 was \$8.1 million, representing 43% of sales, or \$0.66 per share, compared with a loss from continuing operations of \$5.8 million, representing 37% of sales or \$0.48 per share in 2002. Net loss was \$8.0 million in 2003, representing 43% of sales, or \$0.65 per share. In 2002, the net loss was \$8.2 million representing 52% of sales, or \$0.68 per share, including a charge for restructuring costs of \$2.7 million, or \$0.22 per share, a charge for discontinued operations of \$2.4 million representing \$0.20 per share, a gain from our sale of ITXC shares of \$10.3 million or \$0.85 per share, a tax benefit of \$5.3 million or \$0.44 per share, and a charge due to an inventory write-off of \$0.9 million or \$0.07 per share.

Loss from continuing operations in 2001 was \$20.5 million, representing 76% of sales or \$1.69 per share. Net loss was \$31.8 million representing 118% of sales, or \$2.62 per share, including a charge for restructuring costs of \$1.8 million, or \$0.14 per share, a charge for discontinued operations of \$11.3 million or \$0.93 per share, a gain from our sale of ITXC shares of \$0.94

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million or \$0.08 per share, a tax benefit of \$0.3 million or \$0.02 per share, and a charge due to an inventory write-off of \$1.4 million or \$0.12 per share.

Our financial statements are reported in dollars and the vast majority of our sales are made in U.S. dollars. Most of our expenses are in New Israeli Shekels (NIS) and dollars. The cost of our operations in Israel, as expressed in dollars, is influenced by the extent to which any increase/decrease in the rate of inflation in Israel is not offset by the appreciation/depreciation of the NIS in relation to the dollar. In 2003, the rate of deflation in Israel was -1.9%. The rate of appreciation of the NIS in relation to the dollar was 7.6%.

5B. Liquidity and Capital Resources

During the past three years, we covered our cash flow requirements using operating revenues, proceeds from gradual sales of our holdings of ITXC shares, grants from the Chief Scientist and other cash reserves. In March 2004, we raised \$9.3 million, net of expenses, through the issuance of 2.4 million of our ordinary shares to institutional investors.

As of December 31, 2003, we had approximately \$12.2 million in cash, cash equivalents and short-term investments, comprised of \$2.4 million in cash and cash equivalents, \$1.4 million in restricted cash, and \$8.4 million in short-term investments. As of December 31, 2002, we had approximately \$17.7 million in cash, cash equivalents and short-term investments, comprised of \$10 million in cash and cash equivalents and \$7.7 million in short-term investments. Some of our short-term investments consist of commercial papers currently rated either A1/P1 or A2/P2. We generally hold commercial papers until maturity. In addition, some of our cash is invested in time deposits, under which penalties are imposed if withdrawn before maturity.

As of December 31, 2003, we had working capital of approximately \$8.0 million compared with \$14.7 million as of December 31, 2002. The net decrease in working capital during 2003 resulted primarily from our operating loss. The decrease in cash and cash investments was a direct result of our usage of cash to cover our operating loss for the year, as sales were insufficient to cover operating expenses.

Net cash used in operating activities was \$5.4 million, \$12.5 million, and \$30.3 million, for the years ended December 31, 2003, 2002, and 2001, respectively. The principal use of cash in each of these years was to fund our operations. Amounts paid as income tax payments were \$0.1 million in 2003, \$0.4 million in 2002, and \$0.1 million in 2001.

Net cash used in investing activities was \$2.7 million for the year ending December 31, 2003. Net cash generated by investing activities was \$12.6 million, and \$22.7 million for the years ending December 31, 2002, and 2001, respectively. Investments in restricted cash were \$1.4 million in 2003 and zero in 2002 and 2001. In 2003, net cash used for short-term investments amounted to \$0.6 million while in 2002 and 2001 net cash received from maturing of short term investments net of the purchase of new short time investment amounted to \$0.8 million and \$24.2 million respectively. Proceeds from the sale of ITXC shares were \$13.1 million in 2002, and \$1.0 million in 2001. In 2001, our investments in the shares of other companies amounted to \$0.7 million. Cash used for purchase of equipment was \$0.7 million, \$0.8 million, and \$1.8 million for 2003, 2002, and 2001, respectively. Proceeds from the sale of equipment were \$0.1 million in 2002, and were negligible in 2003 and 2001. In 2002, we extended a convertible loan to Surf&Call in the amount of \$0.6 million as part of the carve-out of Surf&Call (see Item 5A - Operating Results).

Net cash generated by financing activities was \$0.5 million for the year ended

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December 31, 2003, and resulted exclusively from proceeds from the exercise of employee stock options throughout the year.

We anticipate that operating expenses may exceed revenues, net of cost of sales in 2004 and possibly beyond if we do not sufficiently increase sales. Throughout 2002 and 2001, we undertook a series of cost reduction measures and may need to consider additional cost reduction measures in the future to further reduce our operating expenses. We believe that current cash and cash equivalents balances, cash flows from operations, grants from the Chief Scientist, and funds raised through the private placement of our ordinary shares in March 2004 will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. However, if our revenues were to decrease, whether due to evolving industry standards and rapid technological changes that could result in our products being no longer in demand, the reduction in our product prices, or our failure to retain our customers, we may need to reduce our operating expenses or use more of our cash reserves to fund operating expenses. Similarly, in the event that the amounts we receive from research and development grants decline, we may need to reduce operating expenses and utilize more of our cash reserves for our operations. If such measures are insufficient, we may attempt to establish lines of credit or sell additional equity securities or debt securities. If we are unable to raise additional capital on terms favorable to us or at all, our ability to sustain our current or future operations, research and development and sales infrastructures, and to compete in the VoIP market will be adversely affected.

In 2003 and to date, we have not incurred any debt.

Capital expenditures in 2003 were approximately \$0.7 million, compared with \$0.8 million in 2002 and \$1.8 million in 2001. See Item 4A for further details.

The cost of sales of our solutions did not significantly increase in 2003 compared to 2002.

In the beginning of 2002 we received an IRS income tax refund in the amount of \$4.4 million, for 2000 and 2001. These refunds relate to taxes paid on capital gains for year 2000, offset by losses incurred in years 2000 and 2001 which were carried-back. See Item 5A "Taxes on Income, Tax Refunds and Tax Benefits".

We maintain annual car leases in the amount of approximately \$1.3 million, and our total liability for early termination of the leases is in the amount of up to \$166,000.

Inventory and Receivables

Inventories at the end of 2003 were \$1.5 million, compared to \$4.1 million at the end of 2002 and \$3.6 million at the end of 2001. The decrease in 2003 compared with 2002 was due to recognition of sales of inventory sent to customers in 2002, increased inventory turns, and shorter lead times of inventory orders. The increase in inventory in 2002 was due to large quantities of inventory delivered to customers for deals that were recognized as revenues during 2003.

Trade receivables are from purchases of our products primarily by telecommunications companies and service providers. Trade receivables are presented at gross value, less reserves for unrecognized sales, and less reserves for doubtful accounts. Trade receivables, net at the end of 2003 were approximately \$1.5 million, compared with \$0.7 million at the end of 2002, and \$5.4 million at the end of 2001. The increase in 2003 was mainly due to the reduction in the allowance for doubtful accounts. The reduction in 2002 was

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due to the decline in our sales and increased collection of customer payments prior to shipping products. There can be no assurance that our reserves for bad debts are adequate due to the short history and lack of collection experience we have with these types of providers.

Prepaid expenses and other receivables were \$0.9 million at the end of 2003, compared with \$2 million at the end of 2002 and \$2.5 million at the end of 2001. The decreases in 2003 and 2002 were due to accelerated actual grant payments received from the Chief Scientist, lower leasing deposits, and lower prepaid expenses.

Off-Balance Sheet Arrangements

There are no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Aggregate Contractual Obligations

| Contractual Obligations | Payment Due by Period | | | | |
|--|-----------------------|---------------------|--------------|--------------|----------------------|
| | Total | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Long-Term Debt Obligations | - | - | - | - | - |
| Capital Lease Obligations | - | - | - | - | - |
| Operating Lease Obligations | 1,606 | 1,193 | 413 | - | - |
| Purchase Obligations | 161 | 161 | - | - | - |
| Other Long Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP | 3,104 | - | - | - | 3,104 |
| Total | 4,871 | 1,354 | 413 | - | 3,104 |

5C. Research and development, patents and licenses

Intellectual Property

We believe that the improvement of existing products, our technologies and the development of new products are important in establishing and maintaining a competitive advantage. We believe that the value of our products is dependent, to a certain extent, upon the maintenance of patent, trade secret or copyright protection of our proprietary software and technologies. We rely on a combination of trade secrets, copyright, trademark and patent law, together with non-disclosure and invention assignment agreements, to establish and protect the technology used in our products.

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We have filed numerous patent applications in the United States and other countries with respect to certain technologies employed in our products. Some of those applications have already registered and we own those registered patents. In addition, we have filed trademark applications in the United States and other countries with respect to trademarks associated with us, and our products. Some of those applications have already been registered and we own those registered trademarks.

Generally, we enter into non-disclosure and invention assignment agreements with our employees, and into non-disclosure agreements with our consultants, subcontractors and distributors. However, there can be no assurance that such measures will protect our proprietary technology, that competitors will not develop products with features based upon, or otherwise similar to, our products or that we will be able to enjoin competitors from selling similar products.

Although we do not believe that our products infringe on any valid claim of a patent owned by any third party, third parties have asserted infringement and other claims against us from time to time. These claims have been directed at certain basic and fundamental components of our products, those of which were not abandoned were resolved by successfully implementing a licensing agreement. There can be no assurance that third parties will not assert such claims against us in the future or that such claims will not be successful.

On February 15, 2000, Multi-Tech Systems, Inc., filed a complaint in the United States District Court for the District of Minnesota, in which it alleged that we and our wholly owned subsidiary, VocalTec Communications Inc., as well as other named defendants, are infringing four of Multi-Tech's Patents. In October 2001, we settled the suit on terms and conditions not materially adverse to VocalTec. The settlement, terms and conditions are subject to confidentiality obligations between VocalTec and Multi-Tech.

We could incur substantial costs and diversion of management resources with respect to the defense of any claims relating to proprietary rights that could have a material adverse effect on our business, financial condition or results of operations. If any such claims or actions are asserted or prosecuted against us, we may seek to obtain a license under a third party's intellectual property rights. There can be no assurance, however, that under such circumstances a license would be available on reasonable terms or at all. In the event a party that is successful in asserting a claim against us does not grant a license, such party could secure a judgment resulting in the award of damages, as well as injunctive or other equitable relief which could effectively block us from manufacturing, using, selling, or otherwise distributing its products.

VocalTec, Essentra, VocalTec Telephony Gateway, Internet Phone, Internet Phone Lite, Internet Voice Mail, VocalTec Conference Server, VocalTec Network Manager, VocalTec Gatekeeper, I2N, PassaPort, PassaFax, Internet Phone Call Waiting, , VocalTec Unipop, Gateswitch, are all trademarks or registered trademarks of VocalTec. All other trademarks or registered trademarks used in this Annual Report on Form 20-F are the property of their respective owners.

Research and Development

We believe that our ability to enhance our current products, develop and introduce new products on a timely basis, maintain technological competitiveness and meet customer requirements is essential to our future success. Accordingly, we devote and intend to continue to devote a significant portion of our personnel and financial resources to research and development. We also intend to continue seeking and maintaining close relationships with our customers in order to remain responsive to their needs. We have a multi-disciplinary research and development team that specializes in audio and

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voice processing, computer and networking software, embedded software, hardware integration, and communications protocols and drivers. We seek to employ highly qualified technical personnel in order to maintain our technological expertise.

In 2003, we invested \$3.6 million in our research and development efforts for salaried personnel, compared with \$4.9 million in 2002 and \$8.8 million (\$6.4 million without Surf&Call) in 2001. Our research and development personnel regularly examine and test new software and communication and networking technologies in order to evaluate their applicability to our products. Our research and development personnel are also involved in creating and improving standards within the international standard, setting bodies, so as to lead the industry into compliance with interoperable and robust solutions that will enable mainstream acceptance of new technologies and products.

We intend to continue to develop solutions to provide carrier-grade VoIP telephony equipment and solutions. However, we can provide no assurance that we will successfully develop new or enhanced products.

See Item 5A "Operating Results - Research and development costs, net".

5D. Trend Information

The VoIP market has moved from infancy to growth stage and is poised to become the mainstream technology of choice for service providers worldwide. This is evidenced by the double digit growth in voice traffic, based on minutes of use. In comparison to the general decline in many sectors of the telecommunications industry over the past few years, long distance Voice over Packet minutes grew approximately 78% to 161 billion minutes of use in 2003 according to research firms Telegeography and Probe Research industry sources. Packet telephony networks generated in 2003 approximately 18% of the world's international traffic and 5% of the world's domestic long distance traffic, according to such sources. Going forward, these industry analysts expect that by the year 2008, 63% of world's international traffic and 38% of national long distance traffic will be on packet networks - translating to more than 1.4 trillion minutes of use. This continuing growth comes from increased migration to packet switch networks by incumbent national carriers worldwide. The migration to VoIP is seen as a worldwide phenomenon. Additionally analysts such as the Yankee Group expect an uptake in deployment of hosted VoIP applications like IP Centrex, VoIP VPN, Conferencing, etc. According to the Yankee Group, the equipment market for hosted IP Telephony application servers will increase from \$206 million in 2003 to \$1.5 billion in 2007.

During the past few months, we have begun to observe an interest in telecommunications carriers to migrate their systems from traditional PSTN systems to VoIP softswitch networks in order to (a) reduce their operating expenses, (b) enable them to provide new applications and services, and (c) because incumbent equipment vendors are discontinuing PSTN switches and other equipment, making traditional PSTN networks unsustainable. However, there can be no assurance that these migrations will occur in the near future, or that we will be selected for such migration projects.

During 2002, we undertook cost reduction measures that resulted in restructuring charges of approximately \$2.7 million. Among the restructuring measures in 2002, there was a reduction of approximately 42% of the total workforce (including the carve out of Surf & Call employees, presented as discontinued operations), and we closed our sales offices in Australia, Italy, France, Spain and Sweden, among other measures.

During 2001, we undertook cost reduction measures that resulted in a restructuring charge in the second quarter of approximately \$1.6 million, and in the fourth quarter of approximately \$0.2 million. Among the restructuring

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measures in 2001, there was a reduction of approximately 40% of the total workforce at that time, and a salary reduction of an average of above 12%, among other measures.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

6A. Directors and Senior Management

The following sets forth certain information regarding our directors and executive officers:

| Name ---- | Position ----- |
|-------------------|---|
| Dr. Elon A. Ganor | Chairman of the Board of Directors and Chief Executive Officer |
| Ami Tal | Director and Executive Vice President of Global Sales |
| Yoav Chelouche | Director |
| Lior Haramaty | Director |
| Douglas Dunn | Director |
| Hugo Goldman | Chief Financial Officer |

Set forth below, is a biographical summary of the business experience of each of the directors and executive officers named above:

Dr. Elon A. Ganor has served as the Chairman of our Board of Directors since 1993. From 1993 to October 1998, and since November 1999, Dr. Ganor also served as our Chief Executive Officer. From 1990 to 1992, Dr. Ganor was responsible for the sales and marketing of our products through his association with a subsidiary of LaCresta, where he served as a vice president. Before becoming a shareholder of our company, LaCresta acted as a distributor of our products. Dr. Ganor is the brother-in-law of Ami Tal.

Ami Tal has served as Executive Vice President of Global Sales since November 1999, and as director since 1992. He served as Vice President of Operations from April 1998 to November 1999, Chief Operating Officer from 1995 to May 2000 and Chief Financial Officer from 1992 to 1995. From 1990 to 1992, Mr. Tal served as Vice President and head of the International Trading Division of LaCresta. Mr. Tal is the brother-in-law of Dr. Ganor.

Lior Haramaty is a co-founder of our company and was a major contributor in creating and propelling the Internet Telephony industry. Mr. Haramaty served as director since the company's inception in 1989 and held multiple executive positions until mid 2000. Currently he serves as a consultant to various companies, including StructuredWeb at which he also serves as a board member, and is the co-founder and CEO of Designfenzider, a New York based design firm.

Douglas Dunn has served as director since January 2000. Mr. Dunn, former Vice President of Visual Communications and Multimedia Strategy at AT&T, has spent 26 years at the telecommunications and multimedia company where his business acumen spanned both the commercial sector and research arenas at Bell Laboratories. Mr. Dunn recently retired from his position as Dean of Carnegie Mellon University's Graduate School of Industrial Administration.

Yoav Chelouche has served as director since July 2000. Mr. Chelouche is the

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Chairman of the Fantine Group. From November 1995 to mid-2001, Mr. Chelouche was President and Chief Executive Officer of Scitex Corporation Ltd., and was a director of Scitex from May 1996 to 2001. Since 1979, Mr. Chelouche has held several positions within Scitex, including executive vice president of marketing and business development. Mr. Chelouche qualifies as an External Director according to the Israel Companies Law - 1999.

Hugo Goldman has served as Chief Financial Officer since March 2001. Prior to joining VocalTec and since December 1999, Mr. Goldman held various key executive positions at Algorithmic Research, an Internet security company. Previously, Mr. Goldman worked at Motorola Semiconductor Products Sector for over sixteen years (1983-1999) in Israel and in the U.S., including in the position of Chief Financial Officer of Motorola Semiconductor Israel. Prior to his long tenure at Motorola, Mr. Goldman held audit management positions at Kesselman & Kesselman (PriceWaterhouseCoopers) until 1983.

6B. Compensation of Directors and Executive Officers(3)

The aggregate compensation paid to all our directors and officers as a group during the fiscal year 2003 was approximately \$0.8 million in salaries, directors' fees, and bonuses, and 150,000 options, approved for grant on May 9, 2004 at an exercise price of \$1.18 per option. Options expire ten years after the date of the grant. The aggregate total amounts set aside or accrued by the Company or its subsidiaries to provide for severance payments is approximately \$0.1 million.

6C. Board practices

The period during which our directors and senior management have each served in their respective offices is set forth in "Item 6A - Directors and Senior Management". There is no date of expiration of the current term of office of any of the senior management members. The expiration date of the terms of office of our directors are as follows: (a) for Yoav Chelouche in May 2006; (b) Ami Tal's term as director expires at the 2005 annual shareholder's meeting and may be renewed; (c) Elon Ganor's term as director expires at the annual shareholders meeting in 2006 and may be renewed; and (d) Lior Haramaty and Douglas Dunn, their respective terms as directors expire at the annual shareholders meeting in 2004 and may be renewed.

There are no service contracts between us or any of our subsidiaries and our directors in their capacity as directors providing for benefits upon termination of employment, except for the termination provisions included in the employment agreement of officers that also act as directors and that concern solely their termination from their positions as employees. In October 2000, we entered into Indemnification Agreements with our directors and senior management in order to assure continued service in an effective manner. The indemnification agreements provide protection against personal liability due to an act performed or failure to act in the capacity as a director or officer.

Our audit committee is comprised of Douglas Dunn, Yoav Chelouche and Lior Haramaty. We believe that Mr. Dunn and Mr. Chelouche qualify as audit committee financial experts as such term is defined under the Exchange Act, and that all three directors qualify as independent directors as such term is defined under the Nasdaq Rules. The purpose of the Audit Committee is to provide assistance to the Board of Directors in fulfilling its legal and fiduciary obligations with respect to matters involving the accounting, auditing, financial reporting and internal control functions of VocalTec and its subsidiaries as well as complying with the legal requirements under Israeli law and the Sarbanes-Oxley Act of 2002. The following are examples of functions within the authority of the Audit Committee:

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- o To detect irregularities in the management of our business and our internal controls procedures through, among other things, consultation with our internal and external auditors and to suggest to the Board of Directors methods to correct those irregularities.
- o To decide whether to approve acts or transactions involving directors, executive officers, controlling shareholders and third parties in which directors, executive officers or controlling shareholders have an interest.
- o To assist our Board of Directors in performing its duties to oversee our accounting and financial policies, internal controls, and financial reporting practices and to communicate on a regular basis with the company's outside auditors and review their operation and remuneration.
- o To maintain and facilitate communication between our Board of Directors and our financial management and our auditors.

Our audit committee convenes at least once per quarter to review the company's quarterly financial results, and as necessary to resolve issues that are in the scope of responsibility of the committee.

Our compensation committee is comprised of Elon Ganor, Yoav Chelouche and Douglas Dunn, and meets as necessary several times per year regarding options allocations and general compensation issues relating to our employees.

6D. Employees

At December 31, 2003, we employed 140 full time employees and 7 part-time employees, of which 51 were employed in research and development (compared with 48 in 2002 and 99 in 2001), 69 were employed in sales and marketing (compared with 65 in 2002 and 110 in 2001), 22 were employed in general and administrative (compared with 24 in 2002 and 47 in 2001), and 5 were employed in operations. Of these employees, 111 were based in our facilities in Israel, 16 in the United States, 14 in Asia Pacific and 6 in Europe. As of March 25, 2004 we employed a total of 146 employees, consisting of 140 full time employees and 6 part time employees.

We believe that our relations with our employees are good. Neither our employees nor we are parties to any collective bargaining agreements, except for provisions of such agreements that are applicable to the industry by virtue of extension orders issued under applicable Israeli laws. During 2002, we eliminated 108 positions as part of our restructuring plans.

6E. Share ownership

As of March 25, 2004 each of the individuals listed in Item 6A beneficially owned less than one (1%) percent of our ordinary shares, and each such person's individual share ownership has not been previously disclosed to shareholders or otherwise made public, with the exception of Lior Haramaty who owns 425,000 shares and 115,000 options, and of Elon Ganor and Ami Tal who beneficially own the 940,050 shares held by LaCresta International Trading Inc., as well as 7,500 shares and 490,000 options held by Elon Ganor and 198,000 options held by Ami Tal.

We have established a number of employee option plans containing terms and conditions for the vesting and exercising of options granted to employees for the purchase of our ordinary shares.

The various employee stock option plans are as follows: (a) 1996 Stock Option and Incentive Plan; (b) 1997 Stock Option and Incentive Plan; (c) 1998 Stock

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Option and Incentive Plan; (d) 1999 Stock Option and Incentive Plan; (e) 2000 Master Stock Option Plan; and (f) 2003 Master Stock Option Plan.

Options generally have a term of ten (10) years. Earlier termination may occur if the employee's employment with us is terminated or if certain corporate changes or transactions occur. Our Board of Directors determines the grant and the exercise price at the time the options are granted upon recommendation of the Compensation Committee.

The exercise price per share is usually granted at the approximate fair market value of the shares on the date of grant, as determined by the closing price for our ordinary shares as reported by the Nasdaq Market on the date of grant for incentive stock options.

Each stock option agreement specifies the date and period over which the option becomes exercisable. Options granted by us generally vest over a period of four years, either in equal quarterly installments of 6.25% of the option shares, starting three months after the date of grant, or 25% of the option shares are vested one year following option grant, and the remaining 75% vest in equal quarterly installments of 6.25% over the remaining three years. Vesting is conditional upon employee remaining continuously employed by VocalTec or its subsidiaries.

Since we believe that there is great significance in maintaining the equity incentive of our employees, we implemented a stock option exchange program in August 2001 under which employees had an opportunity to cancel their outstanding stock options that were issued under the Company's stock option plans in exchange for new options granted in February 2002. Employees who elected to participate in the exchange were issued 0.8 new options in exchange for each cancelled old option at a new exercise price determined as of the date of grant of the new options. The new options vest and are exercisable during a period of two and one half (2 1/2) years from the date of grant, in accordance with the following schedule: (a) 34% of the new options vest six months after the date of grant of the new options; and (b) 8.25% of each such new options grant vest every three months thereafter.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

7A. Major Shareholders

The following table sets forth, as of March 25, 2004, the number of our ordinary shares, which constitute our only voting securities, beneficially owned by (i) all shareholders known to us to own more than five percent (5%) of our outstanding ordinary shares, and (ii) all of our directors and executive officers as a group. The percentages in the table reflect new ownership percentages subsequent to the private placement of our ordinary shares in March 2004.

| Name and Address ----- | Ordinary Shares Beneficially Owned | |
|--|------------------------------------|------------------|
| | Number ----- | Percent ----- |
| Deutsche Telekom A.G. Friedrich-Ebert-Allee 140 D-53113 Bonn, Germany | 2,300,000 | 15.5% |
| LaCresta International Trading Inc. (1) c/o L.C.I.T. S.A Dufourstrasse 131 P.O.B. 219 Zurich 8034, Switzerland | 1,411,690 | 9.5% |

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Officers and directors as a group (2) 2,259,050 15.2%
(6 persons)

- (1) Dr. Elon Ganor, who is VocalTec's Chairman of the Board and Chief Executive Officer, and Ami Tal, who is VocalTec's Executive Vice President of Global Sales and a Director, each own 50% of the outstanding voting shares of LaCresta. Dr. Ganor and Mr. Tal are brothers-in-law.

Includes, in addition to the ordinary shares held by LaCresta of record, (i) 330,100 options for ordinary shares held by Dr. Ganor that are exercisable within 60 days of the date stated above and (ii) 134,040 options for ordinary shares held by Mr. Tal that are exercisable within 60 days of the date stated above, and (ii) 7,500 shares held by Dr. Ganor.

- (2) Includes (i) 886,500 ordinary shares for which options granted to officers and directors of our Company are exercisable within 60 days of the date stated above, and (ii) 940,050 ordinary shares held by LaCresta, which may be deemed to be beneficially owned by Dr. Ganor and Mr. Tal, and (iii) 7,500 shares held by Dr. Ganor; and (iv) 425,000 ordinary shares held by Mr. Lior Haramaty. Does not include 430,700 ordinary shares for which options granted to officers and directors of our company are outstanding but are not currently or within 60 days exercisable.

In March 2004, we completed a private placement of equity securities to institutional investors of 2.4 million of our ordinary shares. We received approximately \$9.3 million, net of expenses, which will be used for working capital and general corporate purposes. As a result, our major shareholders were diluted. Our major shareholders do not have different voting rights from each other or other shareholders.

To our knowledge, (A) we are not directly or indirectly owned or controlled (i) by another corporation or (ii) by any foreign government or (iii) by any other natural or legal persons and (B) there are no arrangements, the operation of which may at a subsequent date result in a change in control of VocalTec.

For information as to the portion of each class of securities held in the United States and the number of record holders see "Item 9 - The Offer and Listing".

7B. Related Party Transactions

A credit line in an amount of up to \$25 million exists between VocalTec Communications Inc., as lender, and VocalTec Communications Ltd., as borrower, at the three months Libor interest rate. The largest amount outstanding during 2003 under this credit line was in the amount of \$17.4 million. To date, approximately \$15.8 million of the credit line has been used.

The company has engaged in various commercial transactions with its subsidiaries and associates, as follows:

- o In November 2001, we entered into a Reseller Agreement with Deutsche Telekom A.G., in which Deutsche Telekom was appointed as a strategic reseller of our products. The Reseller Agreement was assigned to Deutsche Telekom's T-Systems International subsidiary, following changes in the organizational structure of Deutsche Telekom.
- o In May 2002, we finalized the carve-out of our Surf&Call operations

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into a separate corporate entity, Surf&Call Solutions Ltd., in which we held a minority interest with the remaining equity being held by a group of previous employees of the Surf&Call unit. In December 2003, we sold our entire interests in Surf & Call to Cosmocom, Inc, in consideration for full payment of all outstanding debts of Surf & Call, future royalty payments for certain types of licensing of the Surf & Call technology during a period of 24 months after closing, and a portion of the proceeds in the event of a sale of the Surf & Call technology by Cosmocom to a third party during a period of 24 months after closing.

- o We have been generating sales of our products to Deutsche Telekom's T-Systems subsidiary. During calendar year 2003, such sales significantly exceeded 10% of our sales. Deutsche Telekom is a major shareholder of the company.

7C. Interests of Experts and Counsel

Not applicable.

ITEM 8. FINANCIAL INFORMATION

8A. Consolidated Statements and Other Financial Information

Our consolidated financial statements are set forth elsewhere in this document.

Export sales

Export sales in 2003 were \$18.6 million or almost 100% of sales, compared with \$15.5 million or 99% of sales in 2002, and \$25.9 million, or 96% of sales in 2001.

Legal Proceedings

From time to time, we are involved in various routine legal proceedings incidental to the ordinary course of our business. We do not believe that the outcome of these pending legal proceeding will have a material adverse effect on our business or consolidated financial condition.

Dividends

We have never declared or paid cash dividends on the ordinary shares. We intend to retain our earnings for future growth and therefore do not anticipate paying any cash dividends in the foreseeable future.

8B. Significant Changes

Except as disclosed elsewhere in this annual report, there have been no other significant changes since December 31, 2003.

ITEM 9. THE OFFER AND LISTING

9A. Offer and Listing Details

Through March 25, 2004 for the periods indicated, the high and low reported trading prices of our ordinary shares as reported by Nasdaq were as follows:

| High | Low |
|------|-----|
| ---- | --- |

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| | | |
|-------------------------------|-------|------|
| 1999 | 19.75 | 8.03 |
| 2000 | 53.25 | 3.50 |
| 2001 | 8.12 | 0.60 |
| 2002 | 3.02 | 0.26 |
| 2003 | 7.60 | 0.47 |
| 2002 | | |
| First quarter | 3.02 | 1.50 |
| Second quarter | 1.82 | 0.83 |
| Third quarter | 1.10 | 0.38 |
| Fourth quarter | 1.34 | 0.26 |
| 2003 | | |
| First quarter | 0.77 | 0.47 |
| Second quarter | 4.45 | 0.59 |
| Third quarter | 7.60 | 2.81 |
| Fourth quarter | 6.40 | 2.53 |
| Last six months | | |
| October 2003 | 4.48 | 2.50 |
| November 2003 | 6.40 | 2.60 |
| December 2003 | 5.98 | 4.21 |
| January 2004 | 6.90 | 4.50 |
| February 2004 | 5.75 | 4.05 |
| March 2004 (through March 31) | 4.49 | 3.19 |

As of March 31, 2004, 14,887,899 of our ordinary shares were issued and outstanding. This figure includes 2.4 million ordinary shares issued in connection with the private placement in March 2004. At such date, the last reported sale price of the ordinary shares was \$3.98 per share, and the ordinary shares were held by 155 record holders. Of those 155 record holders, 130 are shown on our records as having United States addresses. The number of record holders in the United States is not representative of the number of beneficial holders nor is it representative of where such beneficial holders are resident since many of these ordinary shares were held of record by brokers or other nominees. As of March 25, 2004 we believe approximately 78% of our outstanding ordinary shares were held in the United States.

9B. Plan of distribution

Not applicable.

9C. Markets

Our ordinary shares have been quoted on the Nasdaq National Stock Market, Inc. since February 7, 1996 under the symbol "VOCLF," which was changed to "VOCL" on April 20, 1999. Our ordinary shares have also been quoted on the Easdaq Stock Market since October 17, 2000, under the symbol "VOCL". In December 2002, NASDAQ approved our application to transfer to the NASDAQ SmallCap Market. On July 29, 2003, our ordinary shares were listed back on the Nasdaq National Market, where they continue to be listed under the trading symbol "VOCL".

9D. Selling shareholders

Not applicable.

9E. Dilution

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Not applicable.

9F. Expenses of the Issue

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

10A. Share capital

Not applicable

10B. Memorandum and Articles of Association

VocalTec is a public company organized in the State of Israel under the Companies Law. We are registered with the Registrar of Companies of the State of Israel and have been assigned company number 52-004262-3.

Objects and purposes

The objects and purposes of our company appear in Section 2 of our Memorandum of Association and include marketing, importing and acquiring computers, software for computers and related items; manufacturing, marketing and selling software for computers and related items; and the design, development and manufacture of software for computers.

Rights, preferences and restrictions upon shares

Our articles of association authorize one class of shares, which are our ordinary shares. We may declare a dividend to be paid to the holders of our ordinary shares according to their rights and interests in our profits. Our board may declare interim dividends and a final dividend for any fiscal year only out of retained earnings, or earnings derived over the two most recent fiscal years, whichever is higher. Our articles provide that our board may declare and pay dividends without any future action by our shareholders. All unclaimed dividends may be invested or otherwise used by the board for our benefit until those dividends are claimed. In the event an unclaimed dividend is claimed, only the principal amount of the dividend will be paid to the person entitled to the dividend. Subject to the creation of any special rights regarding the distribution of dividends, any dividends we declare will be distributed to shareholders in proportion to their holdings.

If we liquidate, after satisfying liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to their holdings.

Holders of ordinary shares have one vote for each paid-up ordinary share held on all matters submitted to a vote of our shareholders. These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

Our articles provide that directors are elected by an ordinary resolution of a general meeting of our shareholders. Our ordinary shares do not have cumulative voting rights in the election of directors. Accordingly, the holders of ordinary shares representing more than 50% of the voting power in our company have the power to elect all directors. However, our board of directors is divided into three classes: (a) one class to hold office until our annual meeting of shareholders to be held in 2004, (b) another class to hold office until our annual meeting of shareholders to be held in 2005 and (c) a third class to hold office until our annual meeting of shareholders to be held in 2006.

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We may, subject to the applicable provisions of the Companies Law, issue redeemable shares and subsequently redeem them. In addition, our board may make calls upon shareholders in respect of any sum which has not been paid up in respect of any shares held by those shareholders.

Under the Companies Law, the disclosure requirements that apply to an office holder and are described below under "Approval of Specified Related Party Transactions Under Israeli Law" also apply to a controlling shareholder of a public company. A shareholder that holds more than 50% of the voting rights in a public company is deemed to be a controlling shareholder. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval requires that: (a) the majority of shares voted at the meeting, including at least one third of the shares of disinterested shareholders voted at the meeting, vote in favor of the transaction; or (b) the total number of shares of disinterested shareholders voted against the transaction does not exceed one percent of the aggregate voting rights in the company.

The Companies Law also requires a shareholder to act in good faith towards a company in which he holds shares and towards other shareholders and to refrain from abusing his power in the company, including in connection with voting at a shareholders' meeting on:

- o Any amendment to the articles of association;
- o An increase in the company's authorized capital;
- o A merger; or
- o Approval of some of the acts and transactions that require shareholder approval.

A shareholder has the general duty to refrain from depriving other shareholders of their rights. Any controlling shareholder, any shareholder that knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, under the provisions of the articles of associations, has the power to appoint an office holder in the company, is under a duty to act in fairness towards the company. The Companies Law does not describe the substance of this duty.

Modifications of share rights

Under our articles of association, the rights attached to any class may be varied by adoption of the necessary amendment of the articles, provided that the holders of shares of the affected class approve the change by a class meeting in which the holders of at least 75% of the voting power represented at the meeting and voting on the issue approve the change. Our articles differ from the Companies Law in this respect as under the law, changes in the rights of shareholders require the consent of at least 50% of the voting power of the affected class represented at the meeting and voting on the change.

Shareholders meetings and resolutions

We are required to hold an annual general meeting of our shareholders once every calendar year, but no later than 15 months after the date of the previous annual general meeting. All meetings other than the annual general meeting of shareholders are referred to as extraordinary general meetings. Extraordinary general meetings may be called by our board whenever it sees

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fit, at such time and place, within or without the State of Israel, as it may be determined. In addition, the Companies Law provides that the board of a public company is required to convene an extraordinary meeting upon the request of (a) any two directors of the company or one quarter of the company's board of directors or (b) one or more shareholders holding, in the aggregate, (i) five percent of the outstanding shares of the company and one percent of the voting power in the company or (ii) five percent of the voting power in the company.

The quorum required for a meeting of shareholders consists of at least two shareholders present in person or by proxy who hold or represent between them at least 33.3% of our issued share capital. A meeting adjourned for lack of quorum is adjourned to the same day in the following week at the same time and place or any time and place as the chairman of the meeting decides. At such reconvened meeting, the required quorum consists of any two shareholders present in person or by proxy.

Notwithstanding the foregoing, our articles provide that a resolution in writing signed by all our shareholders then entitled to attend and vote at general meetings or to which all such shareholders have given their written consent (by letter, telegram, facsimile or otherwise) shall be deemed to have been unanimously adopted by a duly convened general meeting.

Our articles enable our board to fix a record date to allow us to determine the shareholders entitled to notice of, or to vote at, any general meeting of our shareholders. The record date may not be more than 40 days and not less than four days before the date of the meeting. Each shareholder of record as of the record date determined by the board may vote the shares then held by that shareholder unless all calls and other sums then payable by the shareholder in respect of its shares have not been paid.

Limitation on ownership of securities

The ownership and voting of our ordinary shares by non-residents of Israel are not restricted in any way by our articles or by the laws of the State of Israel, except for shareholders who are subjects of countries that are enemies of the State of Israel.

Mergers and Acquisitions; Anti-takeover provision

The Companies Law includes provisions allowing corporate mergers. These provisions require that the board of directors of each company that is party to the merger approve the transaction. In addition, the shareholders of each company must approve the merger by a vote of the majority of the company's shares, present and voting on the proposed merger at a shareholders' meeting. In determining whether the requisite majority has approved the merger, shares held by the other party to the merger or any person holding at least 25% of such other party are excluded from the vote.

The Companies Law does not require court approval of a merger other than in specified situations. However, upon the request of a creditor of either party to the proposed merger, a court may delay or prevent the merger if it concludes that there exists a reasonable concern that as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties of the merger to their creditors.

A merger may not be completed unless at least 70 days have passed from the time that a request for the approval of the merger has been filed with the Israeli registrar of companies. This request may be filed once a shareholder meeting has been called to approve the merger.

The Companies Law also provides that the acquisition of shares in a public

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company on the open market must be made by means of a tender offer if, as a result of the acquisition, the purchaser would become a 25% shareholder of the company. The rule does not apply if there already is another 25% shareholder of the company. Similarly, the law provides that an acquisition of shares in a public company must be made by means of a tender offer if, as a result of the acquisition, the purchaser would become a 45% shareholder of the company, unless there already is a 50% shareholder of the company. These rules do not apply if the acquisition is made by way of a merger as opposed to a tender offer.

If, following any acquisition of shares, the purchaser would hold 90% of more of the shares of the company, that acquisition must be made by means of a tender offer for all of the target company's shares. An acquirer who wishes to eliminate all minority shareholders must do so by means of a tender offer and acquire 95% of all shares not held by or for the benefit of the acquirer prior to the acquisition. However, in the event that the tender offer to acquire that 95% is not successful, the acquirer may not acquire tendered shares if by doing so the acquirer would own more than 90% of the shares of the target company.

Our articles contain provisions that could delay, defer or prevent a change in our control. These provisions include advance notice requirements and staggered board provision. Under the advance notice requirements, shareholders seeking to propose items for inclusion on the agenda for a general meeting of shareholders, must submit those items in writing to our corporate secretary not less than 60 days (or not less than 90 days for the nomination of candidates for election of directors) and not more than 120 days prior to the particular meeting. The staggered board provisions of our articles are described above under the caption "Rights, preferences and restrictions upon shares."

Board Practices

Under our articles of association, our board can, at its discretion, cause us to borrow money or secure the payment of any sum upon terms and conditions it deems fit. The board can utilize this power through various methods, including the issuance of bonds or debentures, or mortgages, charges or other securities on the whole company or any part of it.

Our directors are not subject to any age limit requirement, nor are they disqualified from serving on the board because of a failure to own VocalTec shares.

Directors are classified into three classes. Each class has a nearly equal number of directors, as determined by the Board of Directors. The terms for these classes of directors will expire at the annual shareholder meetings of 2004, 2005 and 2006. At each shareholder meeting, the successors of each class of directors whose terms expire are elected to hold office for a term expiring at the annual shareholders meeting held in the third year following the year of their election. The classified board structure may not be amended without the approval of the greater of (i) holders of not less than 75% of the voting power represented at a meeting in person or by proxy and voting thereon, or (ii) holders of a majority of the outstanding voting power of all shares of the Company.

External Directors

We are subject to the provisions of the Companies Law. Under the Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public in or outside of Israel are required to appoint two external directors. The Companies Law provides that a person may not be appointed as an external director if the person or the person's

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relative, partner, employer or any entity under the person's control, has, as of the date of the person's appointment to serve as external director, or had, during the two years preceding that date, any affiliation with the company, any entity controlling the company or any entity controlled by the company or by the controlling entity of the company. The term affiliation includes:

- o an employment relationship;
- o a business or professional relationship maintained on a regular basis;
- o control; and
- o service as an office holder.

In addition, no person can serve as an external director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an external director or may otherwise interfere with the person's ability to serve as an external director. Until the lapse of two years from termination of office, a company may not engage an external director to serve as an office holder and cannot employ or receive services from that person, either directly or indirectly, including through a corporation controlled by that person.

External directors are to be elected by a majority vote at a shareholders' meeting, provided that either: (a) the majority of shares voted at the meeting, including at least one third of the shares of non-controlling shareholders voted at the meeting, vote in favor of the election; or (b) the total number of shares of non-controlling shareholders voted against the election of the external director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an external director is three years and may be extended for an additional three years. External directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. Each committee of a company's board of directors is required to include at least one external director.

Independent Directors

We are subject to the rules of the Nasdaq applicable to listed companies. Under the Nasdaq rules, we are required to appoint a minimum of three independent directors. The independence standard under the Nasdaq rules excludes current employees, former employees of a company or of any of its affiliates for a period of three years after cessation of employment, as well as any immediate family member of an executive officer of a company or of any of its affiliates. Three of our current directors meet the independence standard of the Nasdaq rules.

Audit Committee

Under the Companies Law, the board of directors of any publicly traded company must also appoint an audit committee, comprised of at least three directors including all of the external directors, but excluding:

- o the chairman of the board of directors;
- o any controlling shareholder or a relative of a controlling shareholder; and

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- o any director employed by the company or who provides services to the company on a regular basis.

The role of the audit committee under the Companies Law is to detect irregularities in the management of the company's business through, among other things, consultation with the Company's internal or external auditor and to suggest to the board methods to correct those irregularities. In addition, the approval of the audit committee is required to effect specified actions and transactions with office holders, controlling shareholders and third parties in which they have an interest.

An audit committee may not approve an action or a transaction with an office holder or a controlling shareholder or an entity in which they have a personal interest unless at the time of approval the two external directors are serving as members of the audit committee. In addition, at least one of the external directors must be present at the meeting in which an approval was granted. We appointed the external directors elected under the Companies Law to our audit committee. Our current audit committee consists of Yoav Chelouche, Douglas Dunn, and Lior Haramaty.

Internal Auditor

The Companies Law also requires us to appoint an internal auditor nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether the company's actions comply with the law and orderly business procedure. Under the Companies Law, the internal auditor may not be an interested party, an office holder, or an affiliate, or a relative of an interested party, an office holder or affiliate, nor may the internal auditor be the company's independent accountant or its representative. In October 2000, the company appointed the firm of Brukner Ingber as the company's internal auditor in accordance with the requirements of the Companies Law.

Approval of Specified Related Party Transactions Under Israeli Law

The Companies Law imposes a duty of care and a duty of loyalty on all of a company's office holders as defined below, including directors and executive officers. The duty of care requires an office holder to act with the level of care that a reasonable office holder in the same position would have acted under the same circumstances. The duty of loyalty generally requires an office holder to act in good faith and for the good of the company. An "office holder" as defined in the Companies Law is a director, a general manager, a chief executive officer, a deputy general manager, a vice general manager, other managers directly subordinate to the general manager and any person who fills one of the above positions without regard to title.

The Companies Law requires that an office holder of a company promptly disclose any personal interest that he may have and all related material information known to him, in connection with any existing or proposed transaction by the company. Once an office holder complies with these disclosure requirements, the board of directors may approve a transaction between the company and the office holder, or a third party in which an office holder has a personal interest, unless the articles of association provide otherwise.

A transaction that is adverse to the company's interest cannot be approved. If the transaction is an extraordinary transaction under the Companies Law, then, in addition to any approval stipulated by the articles of association, it also requires audit committee approval before board approval and, in specified circumstances, subsequent shareholder approval.

Under the Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A

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controlling shareholder includes a shareholder that holds 25% or more of the voting rights in a public company if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval requires that: (a) the majority of shares voted at the meeting, including at least one third of the shares of disinterested shareholders voted at the meeting, vote in favor of the transaction; or (b) the total number of shares of disinterested shareholders voted against the transaction does not exceed one percent of the aggregate voting rights in the company.

For information concerning the direct and indirect personal interests of certain of our office holders and principal shareholders in specified transactions with us, see "Item 7A - Major Shareholders".

Exculpation, Insurance and Indemnification of Directors and Officers

Under the Companies Law, an Israeli company may not exempt an office holder from liability with respect to a breach of his duty of loyalty, but may exempt in advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care. Under the Companies Law, a company may not indemnify an office holder, nor enter into an insurance contract that would provide coverage for any monetary liability incurred as a result of any of the following:

- o a breach by the office holder of his duty of loyalty unless the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- o a breach by the office holder of his duty of care if such breach was done intentionally or in disregard of the circumstances of the breach or its consequences;
- o any act or omission done with the intent to derive an illegal personal benefit; or
- o any fine levied against the office holder as a result of a criminal offense.

Office Holder Insurance

Our Articles of Association provide that, subject to the provisions of the Companies Law, we may enter into a contract for the insurance of the liability of any of our office holders with respect to:

- o a breach of his duty of care to us or to another person;
- o a breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or
- o a financial liability imposed upon him in favor of another person concerning an act performed by him in his capacity as an office holder.

Indemnification of Office Holders

Our Articles of Association provide that we may indemnify an office holder against:

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- o a financial liability imposed on him in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court concerning an act performed in his capacity as an office holder; and
- o reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him by a court, in proceedings we institute against him or instituted on our behalf or by another person, or in a criminal charge from which he was acquitted.

Under the Companies Law, our Articles of Association may also include:

- o a provision authorizing us to grant in advance an undertaking to indemnify an office holder, provided that the undertaking is limited to types of events which the board of directors deems to be anticipated and limited to an amount determined by the board of directors to be reasonable under the circumstances; and
- o a provision authorizing us to retroactively indemnify an office holder.

Required Approvals

In addition, under the Companies Law, indemnification of, and procurement of insurance coverage for our office holders must be approved by our audit committee and our board of directors and, in specified circumstances, by our shareholders.

10C. Material Contracts Not in the Ordinary Course of Business

In March 2004, we entered into a securities purchase agreement with institutional investors pursuant to which we issued to such investors an aggregate of 2.4 million of our ordinary shares. As consideration for such shares, we received \$9.3 million, net of expenses. We also issued to the investors warrants to purchase up to 1.2 million of our ordinary shares, at an exercise price of \$4.75 per ordinary share, which warrants are exercisable for 4.5 years, beginning on September 12, 2004. Pursuant to the terms of the securities purchase agreement, we agreed to file with the Securities and Exchange Commission, within 30 days following the consummation of the transactions contemplated by the securities purchase agreement, a registration statement covering the resale of the ordinary shares issued and the ordinary shares underlying the warrants. The securities purchase agreement includes customary representations and warranties made by us (among other things, with respect to our and our subsidiaries' business and the issuance of the shares and the warrants) and by the investors (among other things, with respect to their status as "accredited investors") and other provisions, including with respect to confidentiality, restrictions on the transfer of the shares and warrants and indemnification. Forms of the securities purchase agreement and the warrants are attached to this annual report as Exhibits 4.1(h) and 4.1(j), respectively.

10D. Exchange controls

There are currently no Israeli currency control restrictions on payments of dividends or other distributions with respect to our ordinary shares or the proceeds from the sale of shares, except for the obligation of Israeli residents to file reports with the Bank of Israel regarding certain transactions. However, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at any time.

Non-residents of Israel who purchase our securities with non-Israeli currency will be able to repatriate dividends (if any), liquidation distributions and

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the proceeds of any sale of such securities, into non-Israeli currencies at the rate of exchange prevailing at the time of repatriation, provided that any applicable Israeli taxes have been paid (or withheld) on such amounts.

Neither our Articles of Association nor the laws of the State of Israel restrict in any way the ownership or voting of ordinary shares by non-residents of Israel, except with respect to citizens of countries that are in a state of war with Israel.

10E. Taxation and Government Programs

The following is a summary of the current tax structure, which is applicable to companies in Israel, with special reference to its effect on our company, and certain Israeli Government programs benefiting our company. The following also contains a discussion of certain Israeli and U.S. tax consequences to persons purchasing the ordinary shares. To the extent that the discussion is based on new tax legislation, which has yet to be subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will accord with any such interpretation in the future. The discussion is not intended and should not be construed as legal or professional tax advice and is not exhaustive of all possible tax considerations.

The following summary is included herein as general information only and is not intended as a substitute for careful tax planning. Accordingly, each investor should consult his or her own tax advisor as to the particular tax consequences to such investor of the purchase, ownership or sale of an ordinary share, including the effect of applicable state, local, foreign or other tax laws and possible changes in the tax laws.

Israel Corporate Tax Considerations

General Corporate Tax Structure

The regular rate of corporate tax, which Israeli companies are subject to, is currently 36%. However, the effective rate of tax payable by a company (such as ours) which derives income from an "Approved Enterprise" (as further discussed below) may be considerably lower.

Law for the Encouragement of Capital Investments, 1959

General. Certain of our production and development facilities have been granted approved enterprise status pursuant to the Law for the Encouragement of Capital Investments, 1959. Each approval for approved enterprise status relates to a specific investment program, delineated both by the financial scope of the investment, including sources of funds, and by the physical characteristics of the facility or other assets. The tax benefits available under any approval relate only to taxable income attributable to the specific investment program and are contingent upon meeting the criteria set out in the instrument of approval.

Subject to certain provisions concerning income and subject to the Alternative Benefits (see below), any distributed dividends are deemed attributable to the entire enterprise, and the effective tax rate and the effective withholding tax rates represent the weighted combination of the various applicable tax rates.

Tax Benefits. Income derived from an approved enterprise is subject to corporate tax at the reduced rate of 25% subject to exceptions discussed below, until the earlier of (a) seven consecutive years commencing in the year in which the specific approved enterprise first generates taxable income (which income is not offset by deductions attributable to the other sources),

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(b) 12 years from the year of commencement of production or (c) 14 years from the year of approval of the approved enterprise status.

A company owning an approved enterprise which was approved after April 1, 1986 may elect to forego the entitlement to grants or state guarantees and apply for an alternative package of tax benefits. These benefits provide that undistributed income from the approved enterprise is fully tax exempt from corporate tax for a defined period. The tax holiday ranges between two and ten years from the first year of taxable income subject to the limitations as described above, depending principally upon the geographic location within Israel and the type of the approved enterprise. Upon expiration of the tax holiday, the approved enterprise is eligible for a beneficial tax rate (25% or lower in the case of a FIC, as described below), for the remainder of the otherwise applicable period of benefits, as described above.

The undistributed income derived from each of our approved enterprise programs is tax-exempt for a two year period beginning with the first year in which it generates otherwise taxable income and is subject to a reduced tax rate for the remainder of the benefit period.

Dividends paid out of income derived by an approved enterprise and dividends received from a company out of dividends it received from an approved enterprise are generally subject to withholding tax at the rate of 15% (deductible at the source). In the case of companies which do not qualify as a FIC, and which are at least 25% owned by non-Israeli residents, the reduced rate of 15% is limited to dividends and distributions out of income derived during the benefits period and actually paid at any time up to 12 years thereafter. In addition, a company which elects the alternative benefits package and which, at any time, pays a dividend out of income derived from its approved enterprise during the tax holiday period, will be subject to corporate tax at the otherwise applicable rate of 25% (or lower in the case of a FIC) on the grossed up income out of which such dividend has been paid, and an additional 15% withholding tax in respect of the amount distributed. We have elected the alternative benefits with respect to our current approved enterprise, including the exemption pursuant to which we will enjoy a tax holiday for a period of two years and reduced tax rates for an additional period of up to eight years (depending on the percentage of foreign stock ownership in our company).

The tax benefits available to an Approved Enterprise relate only to taxable income attributable to that specific enterprise and are contingent upon the fulfillment of the conditions stipulated by the Investment Law, the regulations published thereunder and the instruments of approval for the specific investments in the Approved Enterprises. In the event of our failure to comply with these conditions, the tax and other benefits could be canceled, in whole or in part, and we might be required to refund the amount of the canceled benefits, together with the addition of CPI linkage difference and interest. We believe that our Approved Enterprise substantially complies with all such conditions at present, but there can be no assurance that it will continue to do so.

A company which qualifies as a foreign investment company (FIC) is a company, like us, whereby more than 25% of the share capital (in terms of shares, rights to profit, voting and appointment of directors), and of the combined share and loan capital, is owned, directly or indirectly, by non-residents of Israel, is entitled to further tax benefits relating to its approved enterprises. Such a company will be eligible for an extension of the period of tax benefits for its approved enterprises (up to ten years) and further tax benefits, should the level of its foreign investment rise above 49%.

Notwithstanding the foregoing, proceeds received from the sale of our products may be deemed to be royalties under the domestic law of the country of

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residence of the purchaser/licensee or under an applicable tax treaty and as such subject to withholding tax in such country. For instance, proceeds received by our company from the sale of our software in the United States might be treated as royalties and as such subjected to U.S. withholding tax of either 10% or 15%, pursuant to the U.S.-Israel Tax Treaty.

Where withholding tax is paid by our company to the country of residence of the purchaser/licensee, such tax would generally be creditable by our company for Israeli income tax purposes, pursuant to any relevant income tax treaty and under Israeli law against income derived from the same source. However, where we do not have taxable income for Israeli tax purposes because of the application of a tax holiday available to an Approved Enterprise for example or because of losses for tax purposes, we would have no Israeli tax liability against which to credit the foreign withholding tax. Furthermore, under Israeli law, we cannot carry forward such unused credit for benefit in future tax years.

From time to time, the Government of Israel has discussed reducing the benefits available to companies under the Investment Law and currently such proposal is pending. The termination or substantial reduction of any of the benefits available under the Investment Law could have a material adverse effect on future investments by our company in Israel.

Grants under the Law for the Encouragement of Industrial Research and Development, 1984

Israeli tax laws have allowed, under certain conditions, a tax deduction in the year incurred for expenditures (including capital expenditures) in scientific research and development projects, if the expenditures are approved or funded by the relevant Israeli Government Ministry (determined by the field of research) and the research and development is for the promotion of the enterprise and is carried out by or on behalf of the company seeking such deduction. Expenditures not approved as above or funded are deductible in equal portions over a three-year period.

Under the law for the Encouragement of Industrial Research and Development, 1984 (the "Research Law"), research and development programs that meet specified criteria and are approved by a committee of the Chief Scientist, are eligible for grants of up to 50% of the program's expenses, as defined by the committee. Under the provisions of Israeli law in effect until 1996, royalties of 2%-3% of the revenues derived in connection with products developed according to, or as a result of, a research and development program funded by the Chief Scientist must be paid to the State of Israel. Pursuant to an amendment effected in 1996 effective with respect to Chief Scientist programs funded in or after 1994, royalties generally at the rate of 3% during the first three years, 4% over the following three years and 5% in or after the seventh year of the revenues derived in connection with products developed according to such programs are payable to the State of Israel. The maximum aggregate royalties will not exceed 100% (for funding prior to 1994, 100%-150%) of the dollar-linked value of the total grants received. Pursuant to an amendment effected in 2000, effective with respect to Chief Scientist programs funded in or after 2000, the royalty rates described above were updated to 3% during the first three years and 3.5% in or after the fourth year, of the revenues derived in connection with products developed under such programs. Pursuant to an amendment effected on January 1, 1999, effective with respect to Chief Scientist programs approved in or after 1999, funds received from the Chief Scientist shall bear annual interest at a rate equal to LIBOR for twelve months.

Generally, the Research Law requires that the manufacture of any product developed as a result of research and development funded by the Israeli Government shall take place in Israel. It also provides that know-how from the

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research and development that is used to produce the product, may not be transferred to third parties without the approval of a research committee. Such approval is not required for the export of any products resulting from such research or development.

However, under the Regulations, in the event that any of the manufacturing volume is not performed in Israel, if approved by the Chief Scientist, we would be required to pay an increased royalty and the payback sum of which would be 120%, 150% or 300% of the grant if the manufacturing volume that is performed outside of Israel is less than 50%, between 50% and 90% and more than 90%, respectively.

In 2002, the Research Law was amended to, among other things, enable companies applying for grants from the Office of the Chief Scientist to seek prior approval for conducting manufacturing activities outside of Israel without being subject to increased royalties. However, this amendment will not apply to any of our existing grants. In addition, the amendment provides that one of the factors to be taken into consideration by the Office of the Chief Scientist in deciding whether to approve a grant application is the percentage of the manufacturing of the relevant product that will be conducted outside of Israel. Accordingly, should we seek additional grants from the Office of the Chief Scientist in connection with which we also seek prior approval for manufacturing products outside of Israel, we may not receive such grant or may receive a grant in an amount that is less than the amount we sought.

Law for the Encouragement of Industry (Taxes), 1969

Pursuant to the Law for the Encouragement of Industry (Taxes), 1969, a company qualifies as an "Industrial Company" if it is a resident of Israel and at least 90% of its gross income in any tax year (exclusive of income from certain loans, capital gains, interest and dividends) is derived from an "industrial enterprise" it owns. An "industrial enterprise" is defined as an enterprise whose major activity, in a given tax year, is manufacturing.

We believe that we qualify as an Industrial Company. Accordingly, we are entitled to certain tax benefits, including a deduction of 12.5% per annum on the purchase of patents or certain other intangible property rights (other than goodwill) used for the development or promotion of the industrial enterprise over a period of eight years beginning with the year in which such rights were first used.

The tax laws and regulations dealing with the adjustment of taxable income for local inflation provide that an industrial enterprise, like us, is eligible for special rates of depreciation deductions. These rates vary in the case of plant and machinery according to the number of shifts in which the equipment is being operated and range from 20% to 40% on a straight-line basis, or 30% to 50% on a declining balance basis (instead of the regular rates which are applied on a straight-line basis).

Moreover, industrial enterprises which are approved enterprises (see below) can choose between (a) the special rates referred to above and (b) accelerated regular rates of depreciation applied on a straight-line basis with respect to property and equipment, generally ranging from 200% (with respect to equipment) to 400% (with respect to buildings) of the ordinary depreciation rates during the first five years of service of these assets, provided that the depreciation on a building may not exceed 20% per annum. In no event may the total depreciation exceed 100% of the cost of the asset.

Eligibility for benefits under the Encouragement of Industry Law is not contingent upon the approval of any governmental authority. No assurance can be given that we will continue to qualify as an Industrial Company, or will avail ourselves of any benefits under this law in the future or that

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Industrial Companies will continue to enjoy such tax benefits in the future.

Taxation Under Inflationary Conditions

The Income Tax Law (Inflationary Adjustments), 1985 ("Inflationary Adjustments Law") is intended to neutralize the erosion of capital investments in business and to prevent tax benefits resulting from deduction of inflationary interest expenses. This law applies a supplementary set of inflationary adjustments to the normal taxable income computed under regular historical cost principles.

The Inflationary Adjustments Law introduced a special tax adjustment for the preservation of equity, based on changes in the CPI, whereby certain corporate assets are classified broadly into fixed (inflation-resistant) assets and non-fixed assets. Where shareholders' equity, (as defined in the Inflationary Adjustment Law), exceeds the depreciated cost of fixed assets (as defined in the Inflationary Adjustment Law), a tax deduction which takes into account the effect of the annual rate of inflation on such excess is allowed (up to a ceiling of 70% of taxable income for companies in any single year, with the unused portion carried forward on a CPI-linked basis, without limit). If the depreciated cost of such fixed assets exceeds shareholders' equity, then such excess, multiplied by the annual inflation rate, is added to taxable income.

Under the Inflationary Adjustments Law, results for tax purposes are measured in real terms, in accordance with the changes in the CPI. We are taxed under this law. The discrepancy between the change in (i) the CPI and (ii) the exchange rate of the Israeli currency to the dollar, each year and cumulatively, may result in a significant difference between taxable income and other items as denominated in dollars as reflected in our financial statements (which are reported in dollars). In addition, subject to certain limitations, depreciation of fixed assets and losses carried forward are adjusted for inflation on the basis of changes in the Israeli CPI.

Taxation of our shareholders

Capital Gains and Income Taxes; Estate and Gift Tax

Until January 1, 2003, the basic capital gains tax rate applicable to corporations was 36% and the capital gains tax rate for individuals was based on the individual's tax bracket up to 50%. Since January 1, 2003 the real capital gains tax rate for both individuals and corporations is 25%. Capital gains on assets acquired prior to January 1, 2003 and disposed of after January 1, 2003 will be taxed on proportional basis such that the applicable tax rate before and after January 1, 2003 will be applied to the portion of the holding period before and after January 1, 2003 calculated on a linear basis. Specific tax rates apply to sales of publicly traded securities as described below. These tax rates are subject to the provisions of any applicable bilateral double taxation treaty. The treaty concerning double taxation between the United States and Israel (the "Treaty") is discussed below.

Israeli law generally imposes a capital gains tax on the sale of publicly traded securities. Pursuant to changes made to the Israeli Income Tax Ordinance in January 2003, capital gains on the sale of our ordinary shares will generally be subject to Israeli capital gains tax, generally at a rate of 15%. However, as of January 1, 2003 nonresidents of Israel will be exempt from capital gains tax in relation to the sale of our ordinary shares for so long as (a) our ordinary shares are listed for trading on a stock exchange outside of Israel, (b) the capital gains are not accrued or derived by the nonresident shareholder's permanent enterprise in Israel, (c) the ordinary shares in relation to which the capital gains are accrued or derived were acquired by the nonresident shareholder after the initial listing of the ordinary shares on a stock exchange outside of Israel and (d) neither the shareholder nor the

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particular capital gain is otherwise subject to certain sections of the Israeli Income Tax Ordinance. In addition, under the Treaty, a holder of ordinary shares who is a United States resident will be exempt from Israeli capital gains tax on the sale, exchange or other disposition of such ordinary shares unless the holder owns, directly or indirectly, 10% or more of our voting power during the 12 months preceding such sale, exchange or other disposition.

Individuals who are non-residents of Israel are subject to a graduated income tax on income accrued or derived from sources in Israel. On the distribution of dividends other than stock dividends, income tax at the rate of 25% (15% in the case of dividends distributed from the taxable income attributable to an Approved Enterprise) is withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. In the U.S., if the dividend recipient holds 10% of our voting stock for a certain period prior to the declaration and payment of the dividend, we are only required to withhold at a 12.5% rate. A non-resident of Israel who has interest, dividend or royalty income derived from or accrued in Israel, from which tax was withheld at source, is generally exempt from the duty to file tax returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer.

Israel presently has no estate or gift tax.

United States Federal Tax Income Considerations

The following discussion of United States federal income tax considerations is based on the United States Internal Revenue Code of 1986, as amended (the "Code"), Treasury regulations, judicial decisions and published positions of the United States Internal Revenue Service (the "IRS"), all as in effect on the date hereof. This discussion does not address all aspects of United States federal income taxation (including potential application of the alternative minimum tax) that may be relevant to a particular shareholder based on such shareholder's particular circumstances. In particular, the following discussion does not address the United States federal income tax consequences of purchasing, holding or disposing of our ordinary shares to shareholders who own (directly, indirectly or through attribution) 10% or more of our outstanding voting stock or who are broker-dealers, insurance companies, tax-exempt organizations, financial institutions, non-resident aliens of the United States or U.S. Holders (as defined below) whose functional currency is not the U.S. dollar. The following discussion also does not address any aspect of state, local or non-United States tax laws. Further, this summary generally considers only a U.S. Holder that will own our ordinary shares as capital assets (generally, assets held for investment). Each prospective investor should consult its tax advisor with respect to the specific United States federal, state and local tax consequences of purchasing, holding or disposing of our ordinary shares.

Taxation of U.S. Holders

For purposes of this discussion, a "U.S. Holder" means any beneficial owner of our ordinary shares who, for United States federal income tax purposes, is: (i) a citizen or resident of the United States; (ii) a corporation or partnership (or other entity or arrangement treated as a corporation or partnership) organized in or under the laws of the United States or any state thereof or the District of Columbia; (iii) an estate the income of which is subject to United States federal income taxation regardless of source; or (iv) a trust, if a United States court is able to exercise primary supervision over its administration and one or more United States persons have the authority to control all of its substantial decisions or a trust that was in existence on August 10, 1996 and validly elected to continue to be treated as a domestic trust. A "Non-U.S. Holder" is any beneficial owner other than a U.S. Holder.

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If a partnership or any other entity or arrangement treated as a partnership holds our ordinary shares, the United States federal income tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. If you are a partner in a partnership holding our ordinary shares, you should consult your tax advisor.

Distributions. We do not anticipate that we will make distributions to shareholders in the foreseeable future. If we do make any such distributions, the gross amount of such distributions (before reduction for any Israeli withholding tax) will be included in the gross income of U.S. Holders to the extent of our earnings and profits, as calculated under United States federal income tax principles. Such dividends will not qualify for the dividends received deduction available in certain circumstances to corporate holders. Subject to the PFIC discussion below, to the extent that any such distribution exceeds our earnings and profits, such distribution will be treated as a non-taxable return of capital to the extent of the U.S. Holder's adjusted basis in our ordinary shares and thereafter as taxable capital gain. For United States federal income tax purposes, the amount of any dividend that we pay in NIS to a U.S. Holder will equal the U.S. dollar value of such NIS at the exchange rate in effect on the date the dividend is considered to be received by the U.S. Holder, regardless of whether the NIS are actually converted into U.S. dollars at that time. A U.S. Holder who receives a foreign currency distribution and converts the foreign currency into U.S. dollars subsequent to receipt will have foreign exchange gain or loss, based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be United States source ordinary income or loss.

Credit for Israeli Taxes Withheld. Any dividends that we pay to a U.S. Holder with respect to our ordinary shares generally will be treated for United States federal income tax purposes as foreign-source income. Subject to certain conditions and limitations, any Israeli taxes withheld or paid with respect to dividends on our ordinary shares generally will be eligible for credit against the U.S. Holder's United States federal income tax liability. Such limitations include extensive separate computation rules under which foreign tax credits allowable with respect to specific classes of foreign-source income cannot exceed the United States federal income taxes otherwise payable with respect to such classes of income. Subject to the particular circumstances of a U.S. Holder, any dividends with respect to our ordinary shares generally will be classified as "passive income" for foreign tax credit purposes.

Alternatively, a U.S. Holder may elect to claim a United States tax deduction for any such Israeli tax, but only for a tax year in which the U.S. Holder elects to do so with respect to all foreign income tax as paid. In addition, a non-corporate U.S. Holder cannot elect to deduct Israeli taxes if such U.S. Holder does not itemize deductions.

Dispositions. In general, any gain or loss recognized by a U.S. Holder on the sale or other disposition of our ordinary shares will be United States-source income or loss for purposes of the United States federal foreign tax credit limitation. However, a U.S. Holder who is also a resident of the United States under the tax treaty between the United States and Israel and who sells our ordinary shares in Israel may elect to treat gain from the sale or other disposition of our ordinary shares as foreign-source income for purposes of the United States federal foreign tax credit limitation. Under current law, it is uncertain whether a similar election may be made to treat losses from the sale or other dispositions of our ordinary shares as a foreign source for purposes of such tax credit limitation. U.S. Holders should consult their tax advisors regarding the application of the United States federal foreign tax credit limitation to gain or loss recognized on the disposition of our ordinary shares and the treatment of any foreign currency gain or loss on any

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NIS received in respect of the sale or other disposition of our ordinary shares.

Passive Foreign Investment Company Status

Generally a non-United States corporation is treated as a passive foreign investment company ("PFIC") for United States federal income tax purposes if either (i) 75% or more of its gross income (including the pro rata gross income of any company (United States or non-United States) in which such corporation is considered to own 25% or more of the stock by value) for the taxable year is passive income, generally referred to as the "income test," or (ii) 50% or more of the average value of its assets (including the pro rata value of the assets of any company in which such corporation is considered to own 25% or more of the stock by value) during the taxable year produce or are held for the production of passive income in the taxable year, generally referred to as the "asset test".

We do not believe that we should be treated as a PFIC for any tax year through and including the tax year ended December 31, 2003. Our conclusion in this regard for years 2001 and 2002 is partly based upon advice received from our accountants in 2001 and 2002 that, given the general decline in the value of the stock market, it would be unreasonable to determine the value of our assets with reference to our market capitalization plus our liabilities, and that it would instead be appropriate to measure the value of our assets using the value of our identifiable assets. Applying this methodology, we would not have been a PFIC for 2001 or 2002.

Notwithstanding our conclusion, however, the statutory provisions, legislative history and administrative pronouncements with respect to the principles under which the asset test is to be implemented leave unanswered a number of questions pertaining to the valuation of a publicly traded foreign corporation's assets. In the absence of regulations, case law or other guidance from the Internal Revenue Service ("IRS") that address these questions, there is uncertainty with respect to the appropriate method for implementing the asset test. Accordingly, the IRS may disagree with this conclusion, asserting that the value of our assets should be determined by reference to the trading value of our ordinary shares and that, therefore, we were characterized as a PFIC during 2001 and 2002 based upon the trading value of our shares coupled with the fact that a significant portion of our assets consisted of cash. Thus, there can be no assurance that we were not a PFIC during 2001 or 2002.

In view of this uncertainty and the complexity of the issues surrounding our possible treatment as a PFIC for 2001, 2002 and possibly for subsequent years, U.S. Holders should consult their tax advisors for guidance.

If we were deemed to be a PFIC for any taxable year during which a U.S. Holder held ordinary shares and such holder failed to make either a "QEF election" or a "mark-to-market election" (each as described below):

- o gain recognized by the U.S. Holder upon the disposition of, as well as income recognized upon receiving certain dividends on, our ordinary shares would be taxable as ordinary income;
- o the U.S. Holder would be required to allocate such dividend income and/or disposition gain ratably over such holder's entire holding period for such ordinary shares;
- o the amount allocated to each year other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as applicable, and an interest charge would be imposed with respect to the resulting tax liability;

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- o the U.S. Holder would be required to file an annual return on IRS Form 8621 regarding distributions received on, and gain recognized on dispositions of, our ordinary shares; and
- o any U.S. Holder who acquired our ordinary shares upon the death of a U.S. Holder would not receive a step-up of the income tax basis to fair market value of such shares. Instead, such U.S. Holder beneficiary would have a tax basis equal to the decedent's basis, if lower.

Although a determination as to a corporation's PFIC status is made annually, an initial determination that a corporation is a PFIC for any taxable year generally will cause the above described consequences to apply for all future years to U.S. Holders who held shares in the corporation at any time during a year when the corporation was a PFIC and who did not timely make a QEF election or mark-to-market election (each as described below) with respect to such shares with their United States federal income tax return for the first tax year in which such U.S. Holder owned the shares and the corporation was a PFIC. This will be true even if the corporation ceases to be a PFIC in later years. However, with respect to a PFIC that does not make any distributions or deemed distributions, the above tax treatment would apply only to U.S. Holders who realize gain on their disposition of shares in the PFIC.

In the event that we were deemed to be a PFIC for 2001 and 2002, if a U.S. Holder made a timely and valid QEF election with respect to our ordinary shares:

- o the U.S. Holder would be required for each taxable year for which we are a PFIC to include in income such holder's pro rata share of our (i) ordinary earnings as ordinary income and (ii) net capital gain as long-term capital gain, in each case computed under United States federal income tax principles, even if such earnings or gains have not been distributed, unless the shareholder makes an election to defer this tax liability and pays an interest charge;
- o the U.S. Holder would not be required to include any amount in income for any taxable year during which we do not have ordinary earnings or net capital gain; and
- o the U.S. Holder would not be required to include any amount in income for any taxable year for which we are not a PFIC.

The QEF election is made on a shareholder-by-shareholder basis. Thus, any U.S. Holder of our ordinary shares can make its own decision whether to make a QEF election. A QEF election applies to all shares of the PFIC held or subsequently acquired by an electing U.S. Holder and can be revoked only with the consent of the IRS. It should be noted that U.S. Holders may not make a QEF election with respect to an option to acquire ordinary shares, and that certain classes of investors (for example, consolidated groups and grantor trusts) are subject to special rules regarding the QEF election. For those U.S. Holders whose tax advisors believe that we were a PFIC for 2002 or for any subsequent years and notify us in writing of their request for the information required to effectuate the QEF election, we may make such information available to them.

In the event that we were deemed to be a PFIC for 2001 and/or 2002 and a U.S. Holder failed to make a QEF election for the first taxable year that we were a PFIC and such U.S. Holder owned our ordinary shares, the U.S. Holder could obtain treatment similar to that afforded a shareholder who has made a timely QEF election by making a QEF election and a deemed sale election or "purging election" for the same taxable year. If a purging election is made, the U.S.

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Holder will be treated if it had sold our ordinary shares for their fair market value on the last day of the taxable year and will recognize gain, but not loss, on such deemed sale in accordance with the general PFIC rules, including the interest charge provisions described above. Thereafter, the U.S. Holder's interest will be treated as an interest in a qualified electing fund.

Alternatively, a U.S. Holder of shares in a PFIC can elect to mark the shares to market annually, recognizing as ordinary income or loss each year the shares are held, as well as on the disposition of the shares, in an amount equal to the difference between the U.S. Holder's adjusted tax basis in the PFIC stock and its fair market value. Losses are allowed only to the extent of net mark-to-market gains previously included in income by the U.S. Holder under the election in prior taxable years. As with the QEF election, a U.S. Holder who makes a mark-to-market election will not be subject to the ratable allocations of gain, the interest charge, and the denial of basis step-up at death described above. A mark-to-market election is irrevocable (except to the extent that our ordinary shares are no longer marketable or the IRS consents to a revocation of the election) and continues to apply even if the PFIC loses its status as such.

U.S. Holders of our ordinary shares should consult their tax advisors about the PFIC rules, including the possibility, and advisability of, and the procedure and timing for making a QEF or mark-to-market election in connection with their holding of ordinary shares, including options to acquire our ordinary shares.

Taxation of Non-U.S. Holders

Subject to the discussion below with respect to the United States backup withholding tax, a Non-U.S. Holder (i.e., any person other than a U.S. Holder) generally will not be subject to United States federal income tax on dividends from us, if any, or gain from the sale or other disposition of ordinary shares, unless (i) such income is effectively connected with the conduct by the Non-U.S. Holder of a United States trade or business, and in the case of a resident of a country which has an income tax treaty with the United States, such income is attributable to a permanent establishment (or in the case of an individual, a fixed place of business) in the United States; or (ii) with respect to any gain on the sale or other disposition of ordinary shares realized by an individual Non-U.S. Holder, such individual Non-U.S. Holder is present in the United States for 183 days or more in the taxable year of the sale or other disposition and meets certain other conditions.

Backup Withholding and Information Reporting

Under the Code, under certain circumstances, United States tax information reporting and "backup withholding" of United States federal income tax on dividends on, and the proceeds of dispositions of, our ordinary shares may apply to both U.S. Holders and Non-U.S. Holders. Backup withholding will not apply, however, to a holder who furnishes a correct taxpayer identification number or certificate of foreign status and makes any other required certification or who is otherwise exempt from backup withholding. Generally, a U.S. Holder will provide such certification on IRS Form W-9, and a non-U.S. Holder will provide such certification on IRS Form W-8. Any amounts withheld under the United States backup withholding rules will be allowed as a refund or credit against the U.S. Holder's or the non-U.S. Holder's United States federal income tax liability, provided the required information is furnished to the IRS.

10F. Dividends and Paying Agents

Not applicable.

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10G. Statement by Experts

Not applicable.

10H. Documents on Display

We are subject to certain of the information reporting requirements of the Exchange Act, as amended. We, as a "foreign private issuer" are exempt from the rules and regulations under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act, with respect to their purchase and sale of our shares. In addition, we are not required to file reports and financial statements with the Securities and Exchange Commission as frequently or as promptly as U.S. companies whose securities are registered under the Securities Exchange Act. However, we will file with the Securities and Exchange Commission an annual report on Form 20-F containing financial statements audited by an independent accounting firm.

You may read and copy any document we file with the SEC at its public reference facilities at, 450 Fifth Street, N.W., Washington, D.C. 20549 and at the SEC's regional offices at 500 West Madison Street, Suite 1400, Chicago, IL 60661-2511. You may also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 450 Fifth Street, N.W., Washington, D.C. 20549. The SEC also maintains a web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the SEC. The address of this web site is <http://www.sec.gov>. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference facilities.

10I. Subsidiary Information

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not use derivative financial instruments in our investment portfolio to hedge foreign currency or other types of market risks. We place our investments in instruments that meet high credit quality standards. We generally invest cash in time deposit and commercial papers, at a minimum rating of single "A2/P2." We do not expect any material loss with respect to our investment portfolio.

The table below provides information about our investment portfolio. For investment securities, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. Our investment policy requires that all investments mature in two years or less.

Principal (National) Amounts by Expected Maturity in U.S. Dollars:

Fair Market Value on December 31, 2003
(in thousands, except interest rates)

| | Dec 31, 2003 | FY 2004 |
|-----------------------|--------------|---------|
| Total Portfolio | 12,149 | 12,149 |
| Average Interest Rate | 1% | 1% |

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| | | |
|---|--------|-----|
| Average Duration (Month) | 1.3 | 1.3 |
| ----- | | |
| Cash Equivalents (up to three months maturity) | 12,074 | |
| ----- | | |
| Average Interest Rate | 1% | |
| ----- | | |
| Short Term Investments (three-twelve months maturity) | 75 | |
| ----- | | |
| Average Interest Rate | 1% | |
| ----- | | |

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART TWO

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

The company is not in default of any payment of principal, interest, sinking or purchase fund installment, or indebtedness of the company or any of its subsidiaries exceeding 5% of total assets on a consolidated basis. There has been no payment of dividends that is in arrears, and there has been no material delinquency relating to any class of preferred stock in the company or its subsidiaries.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

There have been no material changes or limitations on the rights of the holders of any class of registered shares caused by the changes in the terms of the securities or the issuance or modification of a different class of securities. There has been no material withdrawal or substitution of assets.

ITEM 15. CONTROLS AND PROCEDURES

15(a) Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this annual report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in reports that it files or submits under the Exchange Act.

15(b) Changes in Internal Controls over Financial Reporting

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There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this annual report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT.

The Company's audit committee is comprised of Douglas Dunn, Yoav Chelouche and Lior Haramaty. We believe that Mr. Dunn and Mr. Chelouche qualify as audit committee financial experts as such term is defined under Exchange Act rules.

ITEM 16B. CODE OF ETHICS.

We have adopted a written code of ethics that applies to our principal executive officer, principal financial officer, executive vice president global sales, principal controller, treasurer and to persons performing similar functions. A copy of our code of ethics is filed with this annual report as Exhibit 9.

We have also adopted written standards of business conduct that apply to all directors, officers and employees. A copy of our written standards of business conduct is filed with this annual report as Exhibit 14(a).

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Our audit committee pre-approval policies and procedures for audit and non-audit services are attached as Exhibit 4.1(k) to this annual report.

Our auditors received the following fees for audit and audit-related services in 2002 and 2003 (in thousands of U.S. dollars):

| | Year Ended December 31, | | | |
|-------------------|-------------------------|-------------|------|-------------|
| | 2002 | | 2003 | |
| | Fees | Percentages | Fees | Percentages |
| Services rendered | | | | |
| Audit (1) | 75 | 42% | 66 | 35% |
| Audit-related (2) | 25 | 14% | 20 | 11% |
| Tax (3) | 69 | 38% | 88 | 47% |
| Other (4) | 11 | 6% | 14 | 7% |
| Total | 180 | 100% | 188 | 100% |

(1) Audit fees consist of services that would normally be provided in connection with statutory and regulatory filings or engagements, including services that generally only the independent accountant can reasonably provide.

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(2) Audit-related fees relate to assurance and associated services that traditionally are performed by the independent auditor, including: accounting consultation and consultation concerning financial accounting and reporting standards.

(3) Tax fees relate to tax compliance, planning and advice.

(4) Other fees include services related to consulting services.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASER

None.

PART THREE

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

CONSOLIDATED FINANCIAL STATEMENTS AS OF DECEMBER 31, 2003

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ITEM 19. EXHIBITS

1. Articles of Association previously filed with the SEC on June 30, 2001 as Exhibit 1 to the Company's Annual Report on Form 20-F for the year ended December 31, 2000, which is incorporated herein by reference.

2.1 Form of Share Certificate of VocalTec Communications Ltd. previously filed with the SEC on January 5, 1996 as Exhibit 4.1 to the Company's Registration Statement on Form F-1, File Number 333-00120, which is incorporated herein by reference.

- 4.1
- (a) VocalTec Communications Ltd. 1996 Stock Option Plan and Incentive Plan previously filed with the SEC on August 2, 1996 as an exhibit to the Company's Registration Statement on Form S-8, File No. 2-0-27648, which is incorporated herein by reference.
 - (b) VocalTec Communications Ltd. 1997 Stock Option and Incentive Plan filed with the SEC on October 31, 1997 as an exhibit to the Company's Registration Statement on Form S-8, File No. 333-100120, which is incorporated herein by reference.
 - (c) VocalTec Communications Ltd. 1998 and 1999 Stock Option Plan and Incentive Plan previously filed with the SEC on August 2, 1999 as an exhibit to the Company's Registration Statement on Form S-8, File No. 333-10648, which is incorporated herein by reference.
 - (d) VocalTec Communications Ltd. 2000 Master Option Plan previously filed with the SEC on June 30, 2001 as Exhibit 4.1(d) to the Company's Annual Report on Form 20-F for the year ended December 31, 2000, which is incorporated herein by reference.
 - (e) VocalTec Communications Ltd. 2003 Master Option Plan previously filed with the SEC on June 24, 2003 as an exhibit to the Company's Registration Statement on Form S-8, File No. 333-106400, which is incorporated herein by reference.
 - (f) Summary of Lease Agreement for Herzliya Business Park, Building D, by and between VocalTec Communications Ltd. and Gemel Tsu'a Lehashka'ot Ltd. Herzeliya lease, dated July 20, 1998, previously filed with the SEC on June 30, 2001 as Exhibit 4.1(e) to the Company's Annual Report on Form 20-F for the year ended December 31, 2000, which is incorporated herein by reference.
 - (g) Summary of amendment to the Lease Agreement for Herzliya Business Park, Building D, by and between VocalTec Communications Ltd. and Gemel Tsu'a Lehashka'ot Ltd. Herzeliya lease, entered into on June 19, 2002, previously filed with SEC on May 13, 2003 as Exhibit 4.1(f) to the Company's Annual Report on Form 20-F for the year ended December 31, 2002, which is incorporated herein by reference.
 - (h) Lease Agreement Fort Lee Executive Park, by and between

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VocalTec Communications Inc. and Executive Park LLC., dated March 7, 2003, previously filed with SEC on May 13, 2003 as Exhibit 4.1(g) to the Company's Annual Report on Form 20-F for the year ended December 31, 2002, which is incorporated herein by reference.

- (i) Form of securities purchase agreement dated March 10, 2004 between the Company and certain institutional investors.
- (j) Form of warrant issued to the investor parties to the securities purchase agreement attached as Exhibit 4.1(I).
- (k) Audit Committee pre-approval policies and procedures for audit and non-audit services.

8. List of Subsidiaries.

11. Code of Ethics.

12 Certifications of CEO and CFO of VocalTec Communications Ltd. required by Rule 13a-14(a) (17 CFR 240.13a - 14(a)) or Rule 15d-14(a) (17 CFR 240.15d - 14(a)).

13 Certifications of CEO and CFO of VocalTec Communications Ltd. required by Rule 13a-14(b) (17 CFR 240.13a - 14(b)) or Rule 15d-14(b) (17 CFR 240.15d - 14(b)).

14(a) Standards of Business Conduct.

(b) Consent of Independent Public Accountants of VocalTec Communications Ltd.

SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and it has duly caused and authorized the undersigned to sign this annual report on its behalf.

By: /s/ Elon Ganor
Name: ELON GANOR
Title: CHAIRMAN OF THE BOARD OF DIRECTORS
AND CHIEF EXECUTIVE OFFICER

By: /s/ Hugo Goldman
Name: HUGO GOLDMAN
Title: CHIEF FINANCIAL OFFICER

VOCALTEC COMMUNICATIONS LTD.

Date: March 31, 2004