

MAGICJACK VOCALTEC LTD  
Form 10-Q  
November 09, 2018

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2018

OR

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

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

Commission file number: 000-27648

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

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

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

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

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

Yes      No

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

Yes      No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

There were 16,248,299 ordinary shares with no par value outstanding at October 31, 2018.

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## DEFINITIONS

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

references to “magicJack VocalTec,” the “Company,” “we,” “us” or “our” are to magicJack VocalTec Ltd., a company organized under the laws of the State of Israel (the “Registrant”), and its subsidiaries;

references to “common shares”, “ordinary shares”, “our shares” and similar expressions refer to the Registrant’s Ordinary Shares, no par value;

references to “\$” or “dollars” are to U.S. dollars. All references to “NIS” are to New Israeli Shekels and “PLN” are to Polish Zloty. Except as otherwise indicated, financial statements of, and information regarding, magicJack VocalTec are presented in U.S. dollars; and

references to the “magicJack devices” are to the original magicJack<sup>®</sup>, the magicJack PLUS<sup>™</sup>, the New magicJack PLUS<sup>™</sup>, the magicJackGO and the magicJackEXPRESS<sup>™</sup>.

## PART I – FINANCIAL INFORMATION

## ITEM 1. Financial Statements

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

|   | September<br>30,<br>2018<br>(Unaudited) | December<br>31,<br>2017 |
|---|---|-------------------------|
| <b>ASSETS</b>   |   |                         |
| Current assets:   |   |                         |
| Cash and cash equivalents   | \$ 62,108                               | \$52,638                |
| Investments, at fair value  | 369                                     | 369                     |
| Accounts receivable, net of allowance for doubtful accounts and<br>billing adjustments of \$235 and \$234, respectively | 2,240                                   | 2,428                   |
| Inventories   | 2,018                                   | 1,880                   |
| Deferred costs  | -                                       | 1,936                   |
| Contract costs, current portion   | 334                                     | -                       |
| Prepaid income taxes  | 646                                     | 2,016                   |
| Deposits and other current assets   | 1,399                                   | 1,874                   |
| Total current assets  | 69,114                                  | 63,141                  |
| Property and equipment, net   | 1,997                                   | 2,772                   |
| Intangible assets, net  | 8,284                                   | 10,190                  |
| Goodwill  | 32,304                                  | 32,304                  |
| Deferred tax assets   | 31,270                                  | 31,726                  |
| Contract costs, net of current portion  | 519                                     | -                       |
| Deposits and other non-current assets   | 788                                     | 909                     |
| Total assets  | \$ 144,276                              | \$ 141,042              |
| <b>LIABILITIES AND CAPITAL EQUITY</b>   |   |                         |
| Current liabilities:  |   |                         |
| Accounts payable  | \$ 2,866                                | \$3,199                 |
| Accrued expenses and other current liabilities  | 5,272                                   | 6,454                   |
| Deferred revenue, current portion   | -                                       | 42,243                  |
| Contract liabilities, current portion   | 37,649                                  | -                       |
| Total current liabilities   | 45,787                                  | 51,896                  |
| Deferred revenue, net of current portion  | -                                       | 38,797                  |
| Contract liabilities, net of current portion  | 35,095                                  | -                       |
| Other non-current liabilities   | 14,183                                  | 13,787                  |
| Total liabilities   | 95,065                                  | 104,480                 |
| Commitments and contingencies (Note 9)  |   |                         |
| Capital equity  |   |                         |
| Ordinary shares, No par value; 100,000 shares authorized;   |   |                         |
| 25,072 shares issued at September 30, 2018 and December 31, 2017  | 112,038                                 | 112,038                 |
| Additional paid-in capital  | 15,836                                  | 13,848                  |
| Treasury stock (8,823 and 8,882 shares at September 30, 2018  |   |                         |

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|                                      |            |            |
|--------------------------------------|------------|------------|
| and December 31, 2017, respectively) | (117,402 ) | (118,146)  |
| Retained earnings                    | 38,739     | 28,822     |
| Total capital equity                 | 49,211     | 36,562     |
| Total liabilities and capital equity | \$ 144,276 | \$ 141,042 |

See accompanying notes to condensed consolidated financial statements.

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

|   | For the Three<br>Months Ended<br>September 30,<br>2018 |          | For the Nine<br>Months Ended<br>September 30,<br>2017 |            |
|---|--|----------|---|------------|
| Net revenues                                    | \$19,472   | \$21,657 | \$59,509  | \$67,235   |
| Cost of revenues                                | 6,988  | 7,830    | 21,251  | 25,447     |
| Gross profit                                    | 12,484   | 13,827   | 38,258  | 41,788     |
| Operating expenses:                             |  |          |   |            |
| Marketing                                       | 714  | 1,933    | 2,799   | 6,460      |
| General and administrative                      | 6,203  | 7,330    | 19,504  | 29,699     |
| Impairment of intangible assets and goodwill    | -  | -        | 131   | 31,527     |
| Research and development                        | 1,210  | 1,477    | 4,071   | 4,438      |
| Consideration adjustment/Gain on mark-to-market | -  | (894 )   | -   | (894 )     |
| Total operating expenses                        | 8,127  | 9,846    | 26,505  | 71,230     |
| Operating income (loss)                         | 4,357  | 3,981    | 11,753  | (29,442)   |
| Other income (expense):                         |  |          |   |            |
| Interest and dividend income                    | 215  | 42       | 495   | 65         |
| Other income (expense), net                     | (4 )   | 2        | (1 )  | (28 )      |
| Total other income (expense)                    | 211  | 44       | 494   | 37         |
| Income (loss) before income taxes               | 4,568  | 4,025    | 12,247  | (29,405)   |
| Income tax expense (benefit)                    | 1,383  | 1,574    | 3,000   | (7,194 )   |
| Net income (loss)                               | \$3,185  | \$2,451  | \$9,247   | \$(22,211) |
| Income (loss) per share:                        |  |          |   |            |
| Basic   | \$0.20   | \$0.15   | \$0.57  | \$(1.38 )  |
| Diluted   | \$0.20   | \$0.15   | \$0.57  | \$(1.38 )  |
| Weighted average common shares outstanding:     |  |          |   |            |
| Basic   | 16,233   | 16,114   | 16,210  | 16,076     |
| Diluted   | 16,248   | 16,114   | 16,250  | 16,076     |

See accompanying notes to condensed consolidated financial statements.

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

|   | Common Stock |            | Additional<br>Paid-in<br>Capital | Treasury Stock |             | Retained<br>Earnings | Total<br>Capital<br>Equity |
|---|--------------|------------|----------------------------------|----------------|-------------|----------------------|----------------------------|
|   | Number       | Amount     |                                  | Number         | Amount      |                      |                            |
| Balance at December 31, 2017,<br>as previously reported | 25,072       | \$ 112,038 | \$ 13,848                        | (8,882)        | \$(118,146) | \$ 28,822            | \$ 36,562                  |
| Impact of change in accounting<br>policy*               | -            | -          | -                                | -              | -           | 670                  | 670                        |
| Adjusted balance at January 1, 2018                     | 25,072       | \$ 112,038 | \$ 13,848                        | (8,882)        | \$(118,146) | \$ 29,492            | \$ 37,232                  |
| Share-based compensation                                | -            | -          | 2,785                            | -              | -           | -                    | 2,785                      |
| Issuance of ordinary shares                             | -            | -          | (797 )                           | 65             | 797         | -                    | -                          |
| Purchase of treasury stock                              | -            | -          | -                                | (6 )           | (53 )       | -                    | (53 )                      |
| Net income  | -            | -          | -                                | -              | -           | 9,247                | 9,247                      |
| Balance at September 30, 2018<br>(unaudited)            | 25,072       | \$ 112,038 | \$ 15,836                        | (8,823)        | \$(117,402) | \$ 38,739            | \$ 49,211                  |

\* The net impact of changes in accounting policy is comprised of (i) \$1.300 million cumulative effect of initial application of Topic 606, "Revenue from Contracts with Customers," (ASC 606) to beginning balance of retained earnings, (ii) (\$0.407 million) tax impact of initial application of ASC 606, and (iii) (\$0.223 million) tax impact of adoption of ASU 2016-16, "Intra-Entity Transfers of Assets Other than Inventory" (ASU 2016-16).

See accompanying notes to condensed consolidated financial statements.



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

|   | For the Nine<br>Months Ended<br>September 30, |            |
|---|---|------------|
|   | 2018  | 2017       |
| Cash flows from operating activities:   |   |            |
| Net income (loss)   | \$9,247                                       | \$(22,211) |
| Adjustments to reconcile net income (loss) to net cash<br>provided by (used in) operating activities: |   |            |
| Provision for doubtful accounts and billing adjustments   | 31  | 8          |
| Share-based compensation  | 2,785   | 2,053      |
| Depreciation and amortization   | 2,596   | 3,397      |
| Impairment of goodwill and intangible assets  | 131   | 31,527     |
| Loss on sale of assets  | -   | 115        |
| Increase of uncertain tax positions   | 124   | 1,789      |
| Deferred income tax provision   | 327   | (7,910 )   |
| Change in operating assets and liabilities  |   |            |
| Accounts receivable   | 157   | 635        |
| Inventories   | (138 )  | 2,289      |
| Deferred costs/Contract costs   | (167 )  | 303        |
| Prepaid income taxes  | 1,147   | (2,507 )   |
| Deposits and other current assets   | 475   | 673        |
| Other non-current assets  | 121   | 249        |
| Receivable from earnout escrow  | -   | 2,000      |
| Accounts payable  | (333 )  | 648        |
| Income taxes payable  | -   | 38         |
| Accrued expenses and other current liabilities  | (1,182 )                                      | (2,377 )   |
| Deferred revenue/Contract liabilities   | (5,746 )                                      | (9,391 )   |
| Other non-current liabilities   | (6 )  | (993 )     |
| Net cash provided by (used in) operating activities   | 9,569   | 335        |
| Cash flows from investing activities:   |   |            |
| Purchases of property and equipment   | (30 )   | (510 )     |
| Proceeds from sale of investment in joint venture   | -   | 245        |
| Proceeds from sale of property and equipment  | -   | 15         |
| Acquisition of intangible assets  | (16 )   | (1,090 )   |
| Net cash used in investing activities   | (46 )   | (1,340 )   |
| Cash flows from financing activities:   |   |            |
| Repurchase of shares to settle withholding liability  | (53 )   | (135 )     |
| Net cash used in financing activities   | (53 )   | (135 )     |
| Net increase (decrease) in cash and cash equivalents  | 9,470   | (1,140 )   |
| Cash and cash equivalents, beginning of period  | 52,638  | 52,394     |
| Cash and cash equivalents, end of period  | \$62,108                                      | \$51,254   |

See accompanying notes to condensed consolidated financial statements.



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

For the Nine  
Months Ended  
September 30,  
2018 2017

Supplemental disclosures:

|                   |         |         |
|-------------------|---------|---------|
| Income taxes paid | \$1,833 | \$3,313 |
|-------------------|---------|---------|

See accompanying notes to condensed consolidated financial statements.

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NOTE 1 – DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

magicJack VocalTec Ltd. and its subsidiaries (the “Company”) is the cloud communications leader that invented the magicJack device as well as other telecommunication products and services. The Company is a vertically integrated group of companies, with capabilities including Voice-over-Internet-Protocol (“VoIP”) services and related equipment sales, and development of the magicJack device. The Company also provides VoIP services and related equipment to small to medium sized businesses, wholesales telephone service to VoIP providers and telecommunication carriers and provides hosted Unified Communication as a Service (“UCaaS”) and related hardware and network equipment primarily to medium-to-large, multi-location enterprise customers.

magicJack devices weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source, providing users with complete phone service for home, business and travel. magicJack devices come with the right to access the Company’s servers (“access right”), which provides customers the ability to obtain free telephone services. Access rights are renewable. The Company currently offers the magicJack GO version of the device, which has its own CPU and can connect a regular phone directly to the user’s broadband modem/router and function as a standalone phone without using a computer. The sale of devices is done through distribution channels that include retailers, wholesalers and direct to customer sales via the Company’s web-site.

The Company also offers magicJack mobile apps, which are applications that allow users to make and receive telephone calls through their smart phones or devices. The Company currently offers the magicApp, magicJack Connect and magicJack Spark. The magicApp and magicJack Connect are mobile apps available for both iOS and Android. In 2017, the Company launched magicJack Spark on iOS and Android devices. The mobile apps allow customers to place and receive telephone calls in the U.S. or Canada on their mobile devices through either an existing or new magicJack account. The mobile apps also give users the ability to add a second phone number to their smart phone for a monthly or annual fee. Customers may purchase international minutes to place telephone calls through the magicJack device or mobile apps to locations outside of the U.S. and Canada.

On November 9, 2017, the Company entered into a Merger Agreement with B. Riley Financial, Inc. (“B. Riley”), in which B. Riley has agreed to acquire all of the outstanding shares of the Company for \$8.71 per share (“The Transaction”). The purchase price represents a premium of approximately (i) 18.5% over the closing price of the Company’s ordinary shares on the NASDAQ Global Select Market on March 14, 2017, the last completed trading day prior to the date that the Company announced that it had received unsolicited indications of interest and would be considering its strategic alternatives, (ii) 23.6% over the 90-day average closing price of the Company’s ordinary shares for the period ended November 7, 2017, and (iii) 54.2% over the closing price of the Company’s ordinary shares on November 8, 2017, the last completed trading day prior to the Company’s announcement that it entered into the Merger Agreement. The Transaction is subject to various closing conditions, including Company shareholder approval and regulatory approvals. On March 19, 2018, the shareholders voted to approve the Transaction. As previously discussed, the Company had received all required consents and approvals from the various state public service commissions. On November 6, 2018, the Federal Communications Commission approved the merger agreement between the Company and B. Riley Financial Inc satisfying the last regulatory approval required. The parties have agreed to a scheduled closing date of November 14, 2018.

On May 8, 2018, the Company and B. Riley executed an amendment to the Merger Agreement documenting B. Riley’s intent to reorganize the Company’s structure as soon as practicable after the closing date of the Transaction to transfer ownership of YMax Corporation and subsidiaries to a US subsidiary of B. Riley.

The Company was incorporated in the State of Israel in 1989 and is domiciled in Netanya, Israel, with executive and administrative offices, and a customer care call center in West Palm Beach, Florida. In addition, the Company has offices for technology management in Franklin, Tennessee, research and development in Plano, Texas, Alpharetta,

Georgia and Warsaw, Poland and the UCaaS provider in West Palm Beach and Fort Lauderdale, Florida.

#### Basis of Presentation

The Company's unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the Company's unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included. The balance sheet at December 31, 2017 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

The Company's unaudited condensed consolidated financial statements are the basis for the discussion and analysis of the Company's results of operations, liquidity and capital resources. References to authoritative accounting literature in this report, where applicable, are based on the Accounting Standards Codification ("ASC"). The Company's functional and reporting currency is the United States Dollar ("U.S. Dollar"), which is the currency of the primary economic environment in which its consolidated operations are conducted. Transactions and balances originally denominated in U.S. Dollars are presented at their original amounts. Transactions and balances in currencies other than U.S. Dollars, including New Israeli Shekels ("NIS") and Polish Zlotny ("PLN"), are re-measured in dollars and any gains or losses are recognized in the Company's unaudited condensed consolidated statement of operations in the period they occur. Approximately 84% and 85% of the Company's consolidated revenues in the three and nine months ended September 30, 2018, respectively, were from sales to customers located in the United States. Approximately 85% and 86% of the Company's consolidated revenues in the three and nine months ended September 30, 2017, respectively, were from sales to customers located in the United States.

## Adoption of ASC 606 “Contracts with Customers”

On January 1, 2018, the Company adopted Topic 606, “Revenue from Contracts with Customers,” (“ASC 606”) for revenue recognition. The new standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. The Company adopted the requirements of ASC 606 using the modified retrospective transition method under which the standard was applied only to the most current period presented and the cumulative effect of applying the new standard was recognized at the date of initial application as a cumulative adjustment to retained earnings. The Company applied the guidance to contracts that were not completed at the date of initial application. Therefore, the comparative information has not been adjusted and continues to be reported under ASC Topic 605. The cumulative effect of initially applying ASC 606 on January 1, 2018 increased retained earnings by approximately \$1.3 million, with offsetting adjustments to deferred revenue and deferred costs, not including the tax impact of \$0.4 million as an adjustment to the opening balance of equity at January 1, 2018 as follows:

## Adjustments for the initial application of ASC 606

|                                       |           |
|---------------------------------------|-----------|
| Deferred costs/Contract costs         | \$(1,246) |
| Deferred revenue/Contract liabilities | 2,634     |
| Other                                 | (88 )     |
| Total adjustment                      | \$1,300   |

A summary of the significant changes to accounting policies are set out below:

| Products/<br>services          | Changes to accounting policies  |
|--------------------------------|---|
| magicJack<br>device<br>revenue | <p>Under ASC 605, the device and initial access right were accounted for as a combined unit of accounting and recognized ratably over the service term. Under ASC 606, the transaction price for magicJack device sales is now allocated between equipment and service based on stand-alone selling prices. Revenues allocated to equipment are recognized upon delivery (when control transfers to the customer), and service revenue is recognized ratably over the service term.</p> <p>Direct sales include shipping charges and a 30-day free trial, during which customers can return the device and cancel the service, before payment. Prior to 2018, the Company did not recognize revenue until the 30-day trial period had expired and a customer’s credit card had been charged, at which point revenues for hardware, service and shipping were recognized ratably over the remaining service term. As of January 1, 2018, the Company no longer delays revenue recognition for devices sold with a right of return and instead estimates the returns as part of the transaction price using a six month rolling average of historical returns. Revenues for hardware and shipping are recognized at the time of delivery and revenues for service are recognized ratably over the service term.</p> <p>For retail sales, there is a delay between shipment to the retailer and the ultimate sale to a customer (end-user). Prior to 2018, the Company deferred revenue recognition on retail sales for the delay period, after which revenue for both hardware and service were recognized ratably over the remaining access right period. As of January 1, 2018, the Company recognizes revenue for hardware based on delivery terms to the retailer and revenue for service is deferred for the delay period and recognized ratably over the remaining access right period.</p> |
| magicJack<br>device cost       | <p>Prior to 2018, direct costs of producing magicJack devices were deferred on shipment and charged to cost of sales ratably over the initial access right period. As of January 1, 2018, direct costs of producing magicJack devices are charged to cost of sales when control transfers, consistent with the</p>  |

hardware revenue recognition.

Access  
right  
renewal  
costs

Prior to 2018, sales commissions associated with our multi-year service renewal plans were expensed as incurred at the time of sale. Under ASC 606, these are considered incremental costs to obtain a customer contract, which are deferred and amortized to cost of sales over the periods of expected benefit. The Company utilizes the practical expedient permitting expensing of these costs when the expected amortization period is one year or less.

UCaaS  
costs

Under ASC 606, certain incentive commissions to partners are considered incremental costs to obtain a customer contract, which are deferred and amortized to cost of sales ratably over the contract term.

Refer to Note 2, “Summary of Accounting Policies”, Note 7, “Deferred Costs/Contract Costs and Deferred Revenue/Contract Liabilities” and Note 11, “Revenue” for further details.

#### Adoption of ASU 2016-16 “Intra-Entity Transfers of Assets Other than Inventory”

On January 1, 2018, the Company adopted ASU 2016-16, “Intra-Entity Transfers of Assets Other than Inventory” (“ASU 2016-16”) which requires an entity to recognize the income tax consequences of intra-entity transfers of assets other than inventory when the transfer occurs. The ASU was applied retrospectively as an adjustment to retained earnings, for a decrease of approximately \$0.2 million, with an offsetting adjustment to prepaid taxes.

#### Segments

In the three months ended March 31, 2017, the Company reported results of its operations in three separate reportable segments – “Core Consumer”, “Enterprise” and “SMB”. During the first quarter of 2017, management restructured the Company to absorb within the Core Consumer segment, all of operations and functions of the SMB Segment which was based on the activities of magicJack SMB, Inc. (“SMB”). Accordingly, this segment does not show activity for periods after March 31, 2017.

The majority of the Company’s Core Consumer segment revenues recognized were generated from sales of the magicJack product line and from the software access right that accompanies these products, which were \$15.2 million and \$16.8 million for the three months ended September 30, 2018 and 2017, respectively, and \$46.1 million and \$52.0 million for the nine months ended September 30, 2018 and 2017, respectively. The Company’s Core Consumer segment also provides its customers with the ability to make prepaid calls using the magicJack devices and mobile apps by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were \$0.8 million and \$1.1 million for the three months ended September 30, 2018 and 2017, respectively, and \$2.8 million and \$3.5 million for the nine months ended September 30, 2018 and 2017, respectively.

The Company’s Enterprise segment was launched with the acquisition of North American Telecommunications Corporation d/b/a Broadsmart (“Broadsmart”) on March 16, 2016. The majority of the Company’s Enterprise segment revenues recognized were generated from Broadsmart hosted UCaaS services and sales of hardware and equipment which were \$2.5 million and \$2.6 million for the three months ended September 30, 2018 and 2017, respectively, and \$8.0 million and \$8.3 million for the nine months ended September 30, 2018 and 2017, respectively.

The Company’s SMB segment did not generate significant revenue for the three months ended March 31, 2017. Refer to Note 16, “Segment Reporting” for further details.

#### Basis of Consolidation

The Company’s unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three and nine months ended September 30, 2018 may not be indicative of the results for the entire year ending December 31, 2018. The interim unaudited condensed consolidated financial statements should be read in conjunction with the Company’s financial statements and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in this report and in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 filed on March 16, 2018.

#### Noncontrolling Interest



During the year ended December 31, 2016, the Company formed a new subsidiary and entered into a joint venture with an unrelated third party which resulted in the Company having a 60% controlling interest in the joint venture which sold high-technology residential consumer products. On March 31, 2017, this interest was reduced to 36% and on June 30, 2017 the Company sold its remaining interest to the unrelated third party. Based on the difference between the sales price from the agreement and the carrying value of the asset, the Company recognized an impairment loss of \$0.4 million in general and administrative expense in the Core Consumer segment of the consolidated statement of operations for the year ended December 31, 2017. The operations of the joint venture for the three and nine months ended September 30, 2017 were not significant to the Company's financial statements.

## NOTE 2 – SUMMARY OF ACCOUNTING POLICIES

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

### Use of Estimates

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

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

### Fair Value

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

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

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

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

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

When available, the Company uses quoted market prices to determine fair value, and it classifies such measurements within Level 1. Fair value measurements are classified according to the lowest level input or value-driver that is significant to the valuation. Fair value includes the consideration of nonperformance risk. Nonperformance risk refers to the risk that an obligation (either by a counterparty or the Company) will not be fulfilled. For the Company's financial assets traded in an active market (Level 1), the nonperformance risk is included in the market price. The

Company's assets and liabilities measured on a recurring basis at fair value may include marketable securities and time deposits. As of September 30, 2018 and December 31, 2017, all of them were Level 1 instruments. The fair value of Level 2 securities is estimated based on observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts payable and accrued expenses are expected to approximate fair value because of their immediate availability, near term maturities or potential interest payments at settlement.

#### Cash and Cash Equivalents

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

## Certain Risks and Concentrations

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

The Company places its cash and cash equivalents in high quality financial institutions and management believes that the Company is not exposed to any significant risk on its cash accounts. The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the Federal Deposit Insurance Corporation or FDIC up to \$250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at Israeli or Polish banks are not insured. The Company has never experienced any losses related to these balances. At September 30, 2018, the Company had cash and cash equivalents totaling \$62.1 million, which included (i) \$61.8 million in U.S. financial institutions, and (ii) \$0.3 million in foreign financial institutions.

The Company's non-interest bearing cash balances in U.S. banks, which included \$1.3 million in one individual financial institution, were fully insured at September 30, 2018. The Company had money market accounts with financial institutions with balances totaling approximately \$60.5 million at September 30, 2018.

For the Core Consumer segment, no telecommunication carrier accounted for more than 10% of gross accounts receivable at September 30, 2018 and December 31, 2017. For the three and nine months ended September 30, 2018 and 2017, no telecommunications carrier accounted for more than 10% of the segment's total operating revenues.

For the Core Consumer segment, one U.S. retail customer accounted for approximately 11% of the segment's gross accounts receivable at September 30, 2018 and December 31, 2017. For the three and nine months ended September 30, 2018 and 2017, no retailer accounted for more than 10% of the segment's total operating revenues.

For the Enterprise segment, two U.S. retail customers accounted for approximately 41% of gross accounts receivable at September 30, 2018. Two customers accounted for approximately 55% of gross accounts receivable at December 31, 2017. For the three months ended September 30, 2018 and 2017, one customer accounted for approximately 19% and two customers accounted for approximately 27% of the segment's total operating revenues, respectively. For the nine months ended September 30, 2018 and 2017, one customer accounted for approximately 19% and two customers accounted for approximately 30% of the segment's total operating revenues, respectively.

## Investments

Investments consist of interest bearing time deposits with maturity dates of greater than 90 days totaling \$369 thousand at September 30, 2018 and December 31, 2017.

The fair value of time deposits at September 30, 2018 and December 31, 2017 was determined based on face value, which approximates fair value and is a Level 1 input. There was no realized gain or loss on investments for the nine months ended September 30, 2018 and 2017.

## Allowance for Doubtful Accounts and Billing Adjustments

The Company maintains an allowance for doubtful accounts and billing adjustments based on the expected collectability of its accounts receivables. That estimate is based on historical collection experience, current economic and market conditions and a review of the current status of each customer's trade accounts receivable. The allowance includes estimates of billing adjustments, which are negotiated with other telecommunications carriers and are common in the telecommunications industry. There was no impairment of receivables for the nine months ended

September 30, 2018 and 2017.

#### Inventories

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

#### Deferred Costs/Contract Costs

Prior to 2018, deferred costs for the Core Consumer segment primarily consisted of costs of producing magicJack devices which were amortized to cost of sales ratably over the initial access right period. With the adoption of ASC 606 on January 1, 2018, these costs are no longer amortized but are expensed upon sale.

ASC 606 requires that contract costs related to obtaining contracts be expensed over the life of the contract. A practical expedient is allowed for all contracts with lives that are less than one year. Upon adoption, as of January 1, 2018, contract costs for the Core Consumer segment consist primarily of sales commissions associated with our multi-year service renewal plans which are amortized to cost of sales over the respective periods of expected benefit. The Company is using the practical expedient to recognize the cost of sales commissions associated with one year or less service renewal plans immediately.

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For the Enterprise segment, deferred costs/contract costs consist of hardware or equipment purchased but not yet delivered and put into service and third party service charges not yet billed to customers. These costs are recognized in the period they are billed to the customer. As of January 1, 2018, certain incentive commissions are considered incremental costs to obtain a customer contract, which are deferred and amortized to cost of sales ratably over the contract term.

Deferred costs/contract costs to be recognized over the next twelve months are classified as current and included in deferred costs/contract costs, current portion in the Company's consolidated balance sheets. The remaining amounts are classified as non-current in the consolidated balance sheets and included in deferred costs/contract costs, net of current portion. There was no impairment of contract costs for the three and nine months ended September 30, 2018.

#### Property, Equipment and Depreciation Expense

Property and equipment are accounted for under ASC 360, "Property, Plant and Equipment" and consist primarily of servers, computer hardware, furniture, and leasehold improvements. Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives, which range from three to fifteen years. Leasehold improvements are depreciated over the shorter of the term of the lease or useful life of the assets. The cost of substantial improvements is capitalized while the cost of maintenance and repairs are charged to operating expenses as incurred. Refer to Note 4, "Property and Equipment" for further details.

The Company reviews property and equipment for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss is based on the fair value of the asset compared to its carrying value. Property and equipment to be disposed of are reported at the lower of carrying amount or fair value less costs to sell. Management believes there was no impairment of the Company's property or equipment at September 30, 2018.

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

#### Intangible Assets

Identifiable intangible assets are stated at cost and accounted based on whether the useful life of the asset is definite or indefinite. Identified intangible assets with definite useful lives are amortized using the accelerated and straight-line methods over their estimated useful lives, which range from one to seventeen years. Intangible assets with indefinite lives are not amortized to operations, but instead are reviewed for impairment at least annually, or more frequently if there is an indicator of impairment.

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

The Company recognized impairment charges of \$0.1 million on intangible assets during the nine months ended September 30, 2018 on an intangible asset that the Company has determined will no longer be used in the future. The Company recognized impairment charges of \$16.6 million on intangible assets during the nine months ended September 30, 2017. Refer to Note 5, "Intangible Assets" for further details.

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

## Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired in a business combination. Goodwill is not amortized to operations, but instead is reviewed for impairment at least annually, or more frequently if there is an indicator of impairment. Indicators include, but are not limited to: sustained operating losses or a trend of poor operating performance and a decrease in the Company's market capitalization below its book value.

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

The Company may utilize a qualitative assessment to determine if it is "more-likely-than-not" that the fair value of the reporting unit is less than its carrying value. If so, an impairment test must be performed. If not, no further testing is required and the Company documents the relevant qualitative factors that support its fair value. Qualitative factors may include, but are not limited to: macroeconomic conditions, industry and market considerations, cost factors that may have a negative effect on earnings, overall financial performance, and other relevant entity-specific events. In the first quarter of 2017, the Company adopted ASU 2017-04, "Intangibles – Goodwill and Other", which eliminated step two of the goodwill impairment test.

In 2017, goodwill was allocated between two reporting units, "Core Consumer" and "Enterprise" which were consistent with the reportable segments and evaluated separately. The Company recognized impairment charges of \$14.9 million on goodwill for the Enterprise reporting unit, the full value of its goodwill, during the nine months ended September 30, 2017. There was no change in goodwill during the nine months ended September 30, 2018. Refer to Note 6, "Goodwill" and Note 16, "Segment Reporting" for further details.

## Deferred Revenues/Contract Liabilities

Deferred revenues/contract liabilities for the Core Consumer segment consist primarily of billings and payments for magicJack devices access rights renewals and prepaid international minutes billed and collected in advance of revenue recognition. Prior to adoption of ASC 606, the revenue related to the sale of magicJack devices, including a period of service, was recognized as revenue over the period of service. After the adoption, the revenue from the sale of magicJack devices is allocated between the revenue from the sale of the device and the sale of service included based on stand-alone selling prices. The revenue allocated to the sale of the device is recognized immediately and the revenue from the sale of the service included with the device is recognized over the period of service.

For the Enterprise segment, deferred revenues/contract liabilities consist of hardware or equipment purchased but not yet delivered. There were no deferred revenues/contract liabilities for the Enterprise segment as of September 30, 2018. Deferred revenues/contract liabilities for the Enterprise segment were not significant as of September 30, 2017.

Deferred revenues/contract liabilities to be recognized as revenue over the next twelve months are classified as current and included in deferred revenue/contract liabilities, current portion in the Company's consolidated balance sheets. The remaining amounts are classified as non-current in the consolidated balance sheets and included in deferred revenue/contract liabilities, net of current portion.

## Revenues

Revenues consist of revenue from sales of magicJack devices to retailers, wholesalers or directly to customers, access right renewal fees, fees charged for shipping magicJack devices, usage of domestic and international prepaid minutes, access charges to other carriers, recurring sales of the Company's hosted UCaaS voice services, non-recurring sales of



equipment related to its UCaaS services and other miscellaneous charges. The Company typically enters into multi-year agreements, typically with durations of three to five years, to provide the hosted voice and other services. The Company earns revenue from the sale of the hardware and network equipment necessary to operate its UCaaS services directly to its customers. All revenue is recorded net of any taxes collected from customers. All revenue is from contracts with customers.

#### Revenue Recognition

Prior to 2018, the Company recognized revenue in accordance with ASC 605, "Revenue Recognition", which provided authoritative guidance on revenue recognition. For arrangements that included more than one product or service (deliverables), the Company applied Section 25 of ASC 605, "Multiple-Element Arrangements". ASC 605-25 established criteria for separating deliverables into different units of accounting and allocating consideration to those units of accounting.

On January 1, 2018, the Company adopted ASC 606, "Revenue from Contracts with Customers," for revenue recognition. Set forth below is a description of revenue recognition policies for our various segments.

## Revenue Recognition - Core Consumer Segment

### magicJack Devices

Prior to 2018, magicJack devices, which include an initial access right service period, were multiple deliverables per ASC 605-25. Since the device and initial access right were not previously sold separately, they were accounted for as a combined unit of accounting. Under ASC 605, the device and initial access right were accounted for as a combined unit of accounting and recognized ratably over the service term.

Under ASC 606, the sale of the device and the initial access right service are considered as two distinct performance obligations. The transaction price for magicJack device sales is now allocated between equipment and service based on the relative stand-alone selling prices of separate sales which occur at consistent prices. Revenues allocated to the device are recognized when control transfers to the customer, and service revenue is recognized ratably over the service term.

Direct sales of devices include shipping charges and a 30-day free trial period, during which customers can return the device and cancel the service, before payment. Prior to 2018, the Company did not recognize revenue until the 30-day trial period had expired and a customer's credit card had been charged, at which point revenues for hardware, service and shipping were recognized ratably over the remaining service term. Under ASC 606, control is considered to transfer to the customer for direct sales when the item has been delivered to the customer. As a result, the Company no longer delays revenue recognition for devices sold with a right of return and instead estimates the returns as part of the return allowance. Revenues for hardware and shipping are recognized at the time of delivery and revenues for service are recognized ratably over the service term.

For retail sales of devices, there is a delay between shipment to the retailer and the ultimate sale to a customer (end-user). Based on sales and inventory data provided by retail partners, the Company's estimate of the delay for the three and nine months ended September 30, 2018 and 2017 was 30 days. Prior to 2018, the Company deferred revenue recognition on retail sales for the delay period, after which revenue for both hardware and service were recognized ratably over the remaining initial access right period. As of January 1, 2018, the Company recognizes revenue for hardware based on delivery terms to the retailer and revenue for service is deferred for the delay period and recognized ratably over the remaining initial access right period.

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company estimates all potential returns of devices using a six month rolling average of historical returns and reviews the actual returns against the allowance on a quarterly basis. For the three and nine months ended September 30, 2018 and 2017, the Company's estimates of returns and actual returns have not been materially different.

### Access Right Renewals and Mobile Apps

Customers may renew access rights for periods ranging from one month to five years. All payments are due upon purchase of a renewal term and are not considered to include a financing component since the payment terms are primarily not for financing purposes. Under both ASC 605 and ASC 606, the revenue associated with access right renewals is deferred and recognized ratably as time elapses over the extended access right period purchased. Revenues from the sales of magicApp, magicJack Connect and magicJack Spark mobile app access rights are recognized ratably over the access right period.

### Other magicJack-Related Products and services

The Company offers customers other optional products and services related to their magicJack devices and services, such as custom or vanity phone numbers, Canadian phone numbers, and the ability to either change their existing phone numbers or port them to a magicJack device. These revenues are recognized when the performance obligation

has been satisfied. In 2017, the Company also offered battery powerbanks for mobile devices for which revenue was recognized when shipped.

#### Prepaid Minutes and Access and Wholesale Charges

The Company generates revenues from the sales of prepaid international minutes to customers, fees for origination of calls to 800-numbers, and access fees charged to other telecommunication carriers on a per-minute basis for Interexchange Carriers (“IXC”) calls terminated on the Company’s servers. Revenues from access fee charges to other telecommunication carriers are recorded based on rates set forth in the respective state and federal tariffs or negotiated contract rates, less a provision for billing adjustments. The Company is using the as-invoiced method for access and wholesale fees. Revenues from prepaid minutes and access and wholesale charges are recognized as minutes are used.

### Revenue Recognition - Enterprise Segment

UCaaS services and equipment sales related to the Broadsmart subsidiary can be sold separately and used with other products and services. As such, they qualified as multiple deliverables accounted for as separate units of accounting under ASC 605-25 and qualify as two distinct performance obligations under ASC 606. The Company recognizes revenues from sales of its hosted services in the period the services are provided over the term of the respective customer agreements. Customers are billed monthly in advance for these recurring services and in arrears for one time service and equipment charges and usage charges. Revenues from sales of hardware and network equipment are recognized in the period that the equipment is delivered. Revenue from the sale of equipment purchased but not yet delivered is deferred and recognized in the period that the hardware or equipment is delivered and put into service. Revenues from one time service and usage are recognized in the period incurred.

### Revenue Recognition - SMB Segment

SMB provided phone equipment and services that are interdependent and not sold separately. As such they were accounted for as a combined unit of accounting under ASC 605-25. Some agreements included a refund period or a promotion for free introductory service. Revenue recognition was deferred for either period, after which the Company recognized the revenue for the combined unit ratably over the remaining service period. Revenue from this segment was not significant for the three months ended March 31, 2017. During the first quarter of 2017, management restructured the Company to absorb all operations and functions of the SMB segment within the Core Consumer segment. Accordingly, this segment does not show activity for periods after March 31, 2017.

### Cost of Revenues

#### Core Consumer Segment

Cost of revenues for the Core Consumer segment include direct costs of operation of the Company's servers, which are expensed as incurred. These costs include i) the Company's internal operating costs, ii) depreciation and amortization expense, iii) access and interconnection charges to terminate domestic and international telephone calls on the public switched telephone network and related taxes, iv) regulatory costs, v) server maintenance, and vi) costs to co-locate the Company's equipment in other telephone companies' facilities.

Prior to 2018, direct costs of producing magicJack devices were deferred on shipment and charged to cost of sales ratably over the initial access right period. As of January 1, 2018, direct costs of producing magicJack devices are charged to cost of sales at the time of sale, to match recognition of hardware revenue.

Costs for the Core Consumer segment include sales commissions associated with our multi-year service renewal plans. Prior to 2018, these costs were expensed as incurred. Under ASC 606, these are considered incremental costs to obtain a customer contract, which are deferred and amortized to cost of sales over the respective periods of expected benefit. The Company utilizes the practical expedient permitting expensing of these costs when the expected amortization period is one year or less.

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were \$0.5 million and \$0.7 million for the three months ended September 30, 2018 and 2017, respectively and \$1.7 million and \$2.4 million for the nine months ended September 30, 2018 and 2017, respectively.

#### Enterprise Segment

Cost of revenues related to the Company's UCaaS services include direct costs of providing the services, which are expensed as incurred. These costs include charges for access to the public switched telephone network, internet service for its customers, maintenance costs for its software, commissions, credit card charges, contract labor for installation and depreciation and amortization. The Company also incurs costs for hardware and equipment sold to customers and third party service costs, which are deferred and recognized in the period they are billed to the customer. Under ASC 606, certain incentive commissions to partners are considered incremental costs to obtain a customer contract, which are deferred and amortized to cost of sales ratably over the contract term.

#### SMB Segment

Cost of revenues for the SMB segment included direct costs of providing the services, which were expensed as incurred, and costs for phone equipment, which were recognized ratably over the service period. Cost of revenues from this segment were not significant for the three months ended March 31, 2017.

## Marketing Expenses

Marketing expenses consisted primarily of advertising media buys for television commercials, internet and print advertising, marketing related personnel costs and other marketing projects including sponsorships. Marketing costs are expensed when incurred.

A break-down of marketing expense by category is as follows (in thousands):

|                             | For the Three |         | For the Nine  |         |
|-----------------------------|---------------|---------|---------------|---------|
|                             | Months Ended  |         | Months Ended  |         |
|                             | September 30, |         | September 30, |         |
|                             | 2018          | 2017    | 2018          | 2017    |
| Advertising media buys      | \$249         | \$550   | \$610         | \$2,469 |
| Marketing personnel related | 413           | 586     | 1,435         | 1,806   |
| Other marketing projects    | 52            | 797     | 754           | 2,185   |
| Total marketing expenses    | \$714         | \$1,933 | \$2,799       | \$6,460 |

## Research and Development Expenses

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

Research and development expenses were \$1.2 million and \$1.5 million for the three months ended September 30, 2018 and 2017, respectively, and \$4.1 million and \$4.4 million for the nine months ended September 30, 2018 and 2017, respectively.

## Share-based Compensation

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

## Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in

enacted tax rates or tax laws are included in the provision for income taxes in the period of enactment. The Company's net deferred tax assets consist primarily of foreign net operating loss carry-forwards, timing differences between recognition of income for book and tax purposes, and the tax benefit related to the impairment of intangible assets, including goodwill, in the Enterprise segment. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. The Company increased the valuation allowance by \$11 thousand and \$33 thousand during the three and nine months ended September 30, 2018, respectively. The Company increased the valuation allowance by \$15 thousand and \$44 thousand during the three and nine months ended September 30, 2017, respectively.

The Company assesses its income tax positions and records tax benefits for all years subject to examination based upon its evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where it is more likely than not that a tax benefit will be sustained, the Company has recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that the Company estimates where it is not more likely than not that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. The Company revised its liability for uncertain tax positions by an increase of \$180 thousand and \$124 thousand in the three and nine months ended September 30, 2018, respectively, due primarily to the net impact of accrued interest on previously recorded uncertain positions and the revaluation impact of previously recorded Israeli uncertain tax positions. The Company revised its liability for uncertain tax positions by a decrease of \$20 thousand and an increase of \$1.6 million in the three and nine months ended September 30, 2017, respectively, due primarily to an increase in uncertain tax positions related to various state issues and the revaluation impact of certain Israeli uncertain tax positions.

The Company records its income tax expense for interim financial statements by using an estimated annual effective income tax rate based on its expected annual results after consideration of permanent nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2018 and changes in other deferred tax assets and liabilities are recognized during interim periods based on an annual forecast as of the interim reporting date. At September 30, 2018, the estimated annual effective income tax rate is expected to approximate 21.9%, excluding discrete tax items, which includes federal, foreign, state and local taxes. This rate may fluctuate due to changes in jurisdictional income and to the timing of other discrete period transactions during the remainder of the year.

#### Earnings (Loss) per Share

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

#### Recent Accounting Pronouncements

##### Pronouncements adopted in the current period

In August 2016, the FASB issued ASU 2016-15, “Classification of Certain Cash Receipts and Cash Payments”. ASU 2016-15 reduces the diversity of how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, Statement of Cash Flows, and other Topics. The standard is effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The ASU should be applied retrospectively to all periods presented. There was no impact on the Company’s financial condition, results of operations and cash flows resulting from the adoption of ASU 2016-15.

In October 2016, the FASB issued ASU 2016-16, “Intra-Entity Transfers of Assets Other than Inventory”. ASU 2016-16 requires an entity to recognize the income tax consequences of intra-entity transfers of assets other than inventory when the transfer occurs. The standard is effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The ASU should be applied retrospectively as an adjustment to retained earnings. The impact of adopting ASU 2016-16 on January 1, 2018 was a decrease to retained earnings of approximately \$0.2 million, with offsetting adjustments to prepaid taxes.

In May 2017, the FASB issued ASU 2017-09, “Compensation - Stock Compensation: Scope of Modification Accounting”. ASU 2017-09 provides guidance on determining which changes to share-based awards require modification accounting under ASC 718. The standard is effective for annual and interim periods beginning after December 15, 2017, and early adoption is permitted. There was no impact on the Company’s financial condition, results of operations and cash flows for the nine months ended September 30, 2018 resulting from the adoption of ASU 2017-09.

In March 2018, the FASB issued ASU 2018-05, “Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118”. ASU 2018-05 provides guidance on certain income tax effects of the Tax Cuts and Jobs Act. The standard is effective immediately. The Company’s financial condition, results of operations and cash flows was impacted by the new tax rates resulting in lower income tax expense.

##### Pronouncements to be adopted in future periods



In February 2016, the FASB issued ASU 2016-02, "Leases". ASU 2016-02 requires that long-term lease arrangements be recognized on the balance sheet. The standard is effective for interim and annual periods beginning after December 15, 2018, and early adoption is permitted. The Company is currently evaluating the guidance to determine the potential impact on the Company's financial condition, results of operations and cash flows, but the standard will result in the Company recording both assets and liabilities for leases currently classified as operating leases.

In June 2018, the FASB issued ASU 2018-07, "Compensation - Stock Compensation: Improvements to Nonemployee Share Based Payment Accounting". ASU 2018-07 provides guidance on accounting for share-based awards issued to nonemployees. The standard is effective for annual and interim periods beginning after December 15, 2018, and early adoption is permitted. The Company is currently evaluating the guidance to determine the potential impact on its financial condition, results of operations and cash flows.

## NOTE 3 – INVENTORIES

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished goods are comprised primarily of magicJack devices on hand or in transit to the Company's distribution center in the United States and customer equipment, as well as hardware and equipment pending delivery or sale to Enterprise segment customers. Inventories were comprised of the following (in thousands):

|                | September<br>30, 2018 | December<br>31, 2017 |
|----------------|-----------------------|----------------------|
| Raw materials  | \$ 424                | \$ 746               |
| Finished goods | 1,594                 | 1,134                |
| Total          | \$ 2,018              | \$ 1,880             |

The Company wrote-off approximately \$81 thousand of obsolete inventory during the three and nine months ended September 30, 2018. The Company (recovered) wrote-off approximately (\$33) thousand and \$370 thousand of obsolete inventory during the three and nine months ended September 30, 2017, respectively. Inventory write-offs are reflected in cost of revenues in the unaudited condensed consolidated statements of operations.

## NOTE 4 – PROPERTY AND EQUIPMENT

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

|                          | Estimated<br>Useful<br>Lives<br>(in years) | September<br>30,<br>2018 | December<br>31,<br>2017 |
|--------------------------|--|--------------------------|-------------------------|
| Switches                 | 3 - 15                                     | \$ 6,853                 | \$ 6,851                |
| Computers                | 3  | 1,995                    | 2,457                   |
| Furniture                | 5 - 7                                      | 76                       | 100                     |
| Leasehold-improvements   | *  | 387                      | 615                     |
| Accumulated depreciation |  | (7,314 )                 | (7,251 )                |
| Total                    |  | \$ 1,997                 | \$ 2,772                |

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

Depreciation expense was \$0.3 million for both of the three months ended September 30, 2018 and 2017, and \$0.8 million and \$1.0 million for the nine months ended September 30, 2018 and 2017, respectively. Refer to Note 16, "Segment Reporting" for further details.

## NOTE 5 – INTANGIBLE ASSETS

Identified intangible assets consisted of the following (in thousands):

| Estimated<br>Useful<br>Lives<br>(in<br>years) | September 30, 2018          |                             |     | Weighted-Average<br>Life | December 31, 2017           |                             |     |
|---|-----------------------------|-----------------------------|-----|--------------------------|-----------------------------|-----------------------------|-----|
|   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net |                          | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net |

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|   |                    |          |              |         |      |          |              |          |      |
|---|--------------------|----------|--------------|---------|------|----------|--------------|----------|------|
| Technology                                    | 3 -<br>17          | \$2,630  | \$ (2,620 )  | \$10    | 0.25 | \$3,110  | \$ (2,973 )  | \$137    | 5.29 |
| Intellectual property rights                  | 3 -<br>17          | 7,333    | (5,829 )     | 1,504   | 5.19 | 14,162   | (11,996 )    | 2,166    | 4.87 |
| Covenants not-to-compete and not-to-sue       | 2 - 5<br>5 -<br>10 | 100      | (78 )        | 22      | 0.67 | 2,185    | (2,137 )     | 48       | 1.42 |
| Customer relationships                        | 2 -<br>10          | 4,400    | (817 )       | 3,583   | 7.46 | 4,900    | (900 )       | 4,000    | 8.21 |
| Software license                              | 10                 | 2,087    | (951 )       | 1,136   | 5.60 | 2,297    | (554 )       | 1,743    | 1.46 |
| Process know how                              | 5                  | 400      | (116 )       | 284     | 4.25 | 400      | (49 )        | 351      | 5.00 |
| Intangible assets subject to amortization     |                    | \$16,950 | \$ (10,411 ) | \$6,539 |      | \$27,054 | \$ (18,609 ) | \$8,445  |      |
| Tradename                                     |                    | \$1,700  | \$ -         | \$1,700 | N/A  | \$1,700  | \$ -         | \$1,700  | N/A  |
| Domain names                                  |                    | 45       | -            | 45      | N/A  | 45       | -            | 45       | N/A  |
| Intangible assets not subject to amortization |                    | \$1,745  | \$ -         | \$1,745 |      | \$1,745  | \$ -         | \$1,745  |      |
| Total intangible assets                       |                    | \$18,695 | \$ (10,411 ) | \$8,284 |      | \$28,799 | \$ (18,609 ) | \$10,190 |      |

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Amortization expense was \$0.6 million and \$0.7 million for the three months ended September 30, 2018 and 2017, respectively, and \$1.8 million and \$2.4 million for the nine months ended September 30, 2018 and 2017, respectively. Refer to Note 16, “Segment Reporting” for further details.

During the nine months ended September 30, 2018, impairment losses of \$0.1 million were recognized in Operating Expenses under the Consumer segment in the statement of operations. The impairment was comprised of a software license of \$131 thousand (net of accumulated amortization) related to magicJack Connect app, which will no longer be offered.

As part of the Company’s quarterly impairment review for intangible assets with indefinite lives, including goodwill, performed as of March 31, 2017, management determined that there were impairment indicators at the Enterprise segment. Based on the knowable impairment indicators as of March 31, 2017 discussed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, the Company engaged an independent third party to perform a valuation of the Enterprise segment’s long-lived assets and indefinite-lived intangible assets, including goodwill, as of March 31, 2017. Based on the results of the valuation, impairment losses of \$16.6 million were recognized on the following intangible assets in operating expenses under the Enterprise segment in the unaudited condensed consolidated statements of operations for the nine months ended September 30, 2017 as follows:

|                        | March 31, 2017  |                  |            |
|------------------------|-----------------|------------------|------------|
|                        | Carrying Amount | Valuation Amount | Impairment |
| Customer Relationships | \$ 19,572       | \$ 4,400         | \$ 15,172  |
| Process Know How       | 974             | 400              | 574        |
| Tradename              | 1,700           | 800              | 900        |
|                        | \$ 22,246       | \$ 5,600         | \$ 16,646  |

Based on the carrying value of finite lived identified intangible assets recorded at September 30, 2018, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

| Fiscal Year                           | Amortization Expense |
|---------------------------------------|----------------------|
| Three months ending December 31, 2018 | \$ 464               |
| 2019                                  | 1,527                |
| 2020                                  | 1,070                |
| 2021                                  | 762                  |
| 2022                                  | 696                  |
| Thereafter                            | 2,020                |
|                                       | \$ 6,539             |

NOTE 6 – GOODWILL

There were no changes in the carrying amount of goodwill for the three and nine months ended September 30, 2018.

As part of the Company’s quarterly impairment review for intangible assets with indefinite lives, including goodwill, performed as of March 31, 2017, management determined that there were impairment indicators at the Enterprise segment. Based on the knowable impairment indicators as of March 31, 2017 discussed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, the Company engaged an independent third party to perform a valuation of the Enterprise reporting unit’s long-lived assets and indefinite-lived intangible assets, including goodwill, as of March 31, 2017.

Based on a discounted future cash-flows approach, the third party valuation estimated the fair value of the Enterprise reporting unit to be \$17.9 million. Recognition of the goodwill impairment resulted in a tax benefit which was recorded as a deferred tax asset. Since the deferred tax asset increases the carrying value of the reporting unit, it would result in an additional impairment. The accounting guidance requires an entity to calculate the impairment charge and the deferred tax effect using a simultaneous equations method, which effectively grosses up the goodwill impairment charge to account for the related deferred tax benefit so that the resulting carrying value does not exceed the calculated fair value. The resulting impairment is limited to the carrying value of goodwill. In the valuation performed for the Company the impairment calculated using the simultaneous equation method resulted in an impairment charge that exceeded the carrying value of the goodwill. Accordingly, an impairment loss of \$14.9 million on goodwill was recognized in operating expenses under the Enterprise segment in the unaudited condensed consolidated statements of operations for the three months ended March 31, 2017.

The changes in the carrying amount of goodwill for the nine months ended September 30, 2017 were as follows (in thousands):

|                              | Nine Months Ended September 30, 2017 |            |      |       |              |
|------------------------------|--------------------------------------|------------|------|-------|--------------|
|                              | Core Consumer                        | Enterprise | SMB  | Other | Consolidated |
| Balance, beginning of period | \$32,304                             | \$ 14,881  | \$ - | \$ -  | \$ 47,185    |
| 2017 impairment              | -                                    | (14,881 )  |      |       | (14,881 )    |
| Balance, end of period       | \$32,304                             | \$-        | \$ - | \$ -  | \$ 32,304    |

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

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

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

#### NOTE 7 – DEFERRED COSTS AND REVENUES/CONTRACT COSTS AND LIABILITIES

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

Deferred costs/contract costs were comprised of the following in the periods shown (in thousands):

|   | Core Consumer                         |                            |         | Enterprise                            |                            |       | Consolidated                          |                            |         |
|---|---------------------------------------|----------------------------|---------|---------------------------------------|----------------------------|-------|---------------------------------------|----------------------------|---------|
|   | Incremental costs to obtain contracts | Costs to fulfill contracts | Total   | Incremental costs to obtain contracts | Costs to fulfill contracts | Total | Incremental costs to obtain contracts | Costs to fulfill contracts | Total   |
| Balance at December 31, 2017            | \$-                                   | \$ 1,893                   | \$1,893 | \$-                                   | \$ 43                      | \$43  | \$-                                   | \$ 1,936                   | \$1,936 |
| Adoption of ASC 606                     | 647                                   | (1,893 )                   | (1,246) | -                                     | -                          | -     | 647                                   | (1,893 )                   | (1,246) |
| Balance at January 1, 2018, as adjusted | 647                                   | -                          | 647     | -                                     | 43                         | 43    | 647                                   | 43                         | 690     |

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|  |       |     |       |      |       |      |   |       |   |       |      |   |       |   |       |   |
|--|-------|-----|-------|------|-------|------|---|-------|---|-------|------|---|-------|---|-------|---|
| Costs recognized from previous contracts       | (146) | -   | (146) | )    | -     | (43) | ) | (43)  | ) | (146) | (43) | ) | (189) | ) |       |   |
| Additions for contracts acquired in the period | 132   | -   | 132   |      | 236   | 105  |   | 341   |   | 368   | 105  |   | 473   |   |       |   |
| Costs recognized from new contracts            | (18)  | )   | -     | (18) | )     | (31) | ) | (72)  | ) | (103) | (49) | ) | (72)  | ) | (121) | ) |
| Balance at September 30, 2018                  | \$615 | \$- | \$615 |      | \$205 | \$33 |   | \$238 |   | \$820 | \$33 |   | \$853 |   |       |   |
| Current  | 240   | -   | 240   |      | 81    | 13   |   | 94    |   | 321   | 13   |   | 334   |   |       |   |
| Non-current                                    | 375   | -   | 375   |      | 124   | 20   |   | 144   |   | 499   | 20   |   | 519   |   |       |   |

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Deferred revenues/contract liabilities were related to the Core Consumer segment and were comprised of the following (in thousands):

|  | magicJack<br>devices<br>direct<br>sales (1) | magicJack<br>devices<br>retail<br>sales (1) | Access<br>right<br>renewals<br>current | Prepaid<br>minutes | Other  | Total<br>Current | Access<br>right<br>renewals<br>non-current | Other | Total     |
|--|---|---|--|--------------------|--------|------------------|--|-------|-----------|
| Balance at December 31, 2017                         | \$ 3,056                                    | \$ 2,221                                    | \$ 34,607                              | \$ 2,254           | \$ 105 | \$ 42,243        | \$ 38,797                                  | \$ -  | \$ 81,040 |
| Adoption of ASC 606                                  | (1,656 )                                    | (978 )                                      | -                                      | -                  | -      | (2,634 )         | -  | -     | (2,634 )  |
| Balance at January 1, 2018,<br>as adjusted           | 1,400                                       | 1,243                                       | 34,607                                 | 2,254              | 105    | 39,609           | 38,797                                     | -     | 78,406    |
| Revenue recognized from<br>previous contracts        | (1,304 )                                    | (1,121 )                                    | (31,091 )                              | (1,989 )           | (105)  | (35,610)         | -  | -     | (35,610)  |
| Additions for<br>contracts<br>acquired in the period | 2,569                                       | 2,461                                       | 23,682                                 | 2,379              | 649    | 31,740           | 8,427                                      | 27    | 40,194    |
| Revenue recognized from<br>new contracts             | (1,614 )                                    | (1,422 )                                    | (5,894 )                               | (774 )             | (542)  | (10,246)         | -  | -     | (10,246)  |
| Transfer of current<br>portion                       | -   | -   | 12,153                                 | -                  | 3      | 12,156           | (12,153 )                                  | (3 )  | -         |
| Balance at September 30, 2018                        | \$ 1,051                                    | \$ 1,161                                    | \$ 33,457                              | \$ 1,870           | \$ 110 | \$ 37,649        | \$ 35,071                                  | \$ 24 | \$ 72,744 |

(1) Deferred revenues/contract liabilities from device sales include only the service portion.

Contract liabilities as of September 30, 2018 were related to the Core Consumer segment and are expected to be recognized as revenue in future years as follows (in thousands):

| Recognition Period | Estimated<br>Recognition<br>of<br>Contract<br>Liabilities |
|--------------------|---|
| Next 12 months     | \$ 37,649   |
| 13-24 Months       | 16,530  |
| 25-36 Months       | 10,040  |
| 37-48 months       | 4,303   |
| 49-60 Months       | 1,763   |
| 61+ Months         | 2,459   |
|                    | \$ 72,744   |

Certain costs necessary to fulfill the Company's obligations to provide broadband telephone service to new and existing customers who have purchased magicJack devices or access rights to access the Company's servers are expensed as incurred. For the Core Consumer segment, such costs were approximately \$2.1 million and \$2.4 million for the three months ended September 30, 2018 and 2017, respectively and \$6.4 million and \$7.5 million for the nine



months ended September 30, 2018 and 2017, respectively. For the Enterprise segment, such costs were approximately \$0.7 million and \$0.6 million for the three months ended September 30, 2018 and 2017, respectively and \$2.0 million and \$1.9 million for the nine months ended September 30, 2018 and 2017, respectively. Costs related to providing broadband telephone service to SMB segment customers were not significant for the three months ended March 31, 2017.

#### NOTE 8 – OTHER LIABILITIES

As of September 30, 2018 and December 31, 2017, other non-current liabilities primarily consisted of provisions for uncertain tax positions of \$13.4 million and \$13.1 million, respectively.

#### NOTE 9 – COMMITMENTS AND CONTINGENCIES

##### Legal Proceedings

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

On August 11, 2017, a putative class action lawsuit titled *Freedman v. magicJack VocalTec Ltd. et al.*, Case 9-17-cv-80940, was filed against the Company and its Board of Directors in the United States District Court for the Southern District of Florida. The complaint alleged claims against the Company and the current members of its Board of Directors as well as two former members for violations of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934, arising from proxy statements issued in connection with the April 19, 2017 shareholders meeting and the July 31, 2017 shareholders meeting that allegedly misrepresented material facts concerning the “true value” of Broadsmart Global, Inc. and its future prospects in order that the individual defendants (the Board members) could entrench themselves on the Board and extract unwarranted compensation from the Company in connection with their attempt to sell the Company. In January 2018, the plaintiff filed an Amended Complaint. On February 16, 2018, the Company and all of the individual defendants filed a motion to dismiss the Amended Complaint. The plaintiff filed his opposition to the motion to dismiss on April 2, 2018, and defendants’ reply was filed on April 19, 2018. The court issued an order dismissing the amended complaint without prejudice on August 9, 2018. The plaintiff filed an amended complaint, and on August 20, 2018, the Company filed a motion to dismiss the second amended complaint. No decision has yet been reached on the motion. The Company cannot estimate the amount of potential liability, if any, that could arise from this matter.

On March 1, 2018, Flexijet Technologies, Inc. (“Flexijet”) served a complaint for patent infringement against magicJack VocalTec Ltd. The complaint asserts that certain of the Company’s products infringe United States Patent Nos. 8,296,757; 8,533,352; 8,595,717; 9,043,482; and 9,116,723. The Company disputes all of the claims by Flexijet and intends to vigorously defend the action. The Company answered the complaint on May 31, 2018, and served its invalidity contentions on August 27, 2018.. The Company cannot estimate the amount of potential liability, if any, that could arise from this matter.

In June 2018, Galilee Acquisition LLC f/k/a Sutton View Acquisition LLC (“GAL”) filed a complaint, served the following month, (case No.:50-2018-CA-007976-XXXX-MB) in the Circuit Court of the Fifteenth Judicial Circuit in and for Palm Beach County, Florida against magicJack Vocaltec Ltd. alleging a claim for negligent misrepresentation. The complaint alleges that the Company provided false, material information to the plaintiff concerning its business, including information related to the operations, revenue projections, profit projections and growth forecast of Broadsmart. It alleges that the plaintiff relied on the information provided in determining whether to pursue acquiring the Company and to incur the cost of conducting due diligence. The suit seeks an unspecified amount of damages. The Company disputes GAL’s claims and intends to vigorously defend the action. The Company filed a motion to dismiss on September 4, 2018, which remains pending. The Company cannot estimate the amount of potential liability, if any, that could arise from this matter.

On July 12, 2018, plaintiffs Ramon G. Martinez and Moses Lopez filed a putative class action complaint against magicJack LP and YMAX Holdings Corporation in the U.S. District Court for the Southern District of Florida as case number 9:18-cv-80917-RLR, alleging violations of the Telephone Consumer Protection Act in connection with calls placed by an autodialer using a pre-recorded voice without the requisite consent. The Plaintiffs entered into a stipulation with the Company under which the Complaint has been dismissed with prejudice, and on October 24, 2018, the Court issued an order closing the case.

#### Tax Contingencies

The Company believes that it files all required tax returns and pays all required federal, state and municipal taxes (such as sales, excise, utility, and ad valorem taxes), fees and surcharges. The Company is the subject of inquiries and examinations by various states and municipalities in the normal course of business. In accordance with generally accepted accounting principles, the Company makes a provision for a liability for taxes when it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impact of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. The Company believes any possible claims are without merit and vigorously defends its rights. However, if a government entity were to prevail in any matter, it could have a

material adverse effect on the Company's financial condition, results of operation and cash flows. In addition, it is at least reasonably possible that a potential loss may exist for tax contingencies in addition to the provisions taken by the Company. For those potential additional tax contingencies which can be reasonably estimated, that additional potential liability ranges from \$0 to \$2.5 million dollars.

The Company is currently under examination for potential state tax liabilities in some states and local jurisdictions. On June 8, 2017, the Company offered to settle a state examination for payment of \$0.6 million and the agreement to remit certain taxes on a prospective basis. The taxing authority subsequently rejected the Company's offer, and as of September 30, 2018, the Company has not reached an agreement with the state.

In a letter dated April 23, 2018, the Company received notice that the Internal Revenue Service (the "IRS") has selected our 2015 United States income tax return for examination. The Company had an initial meeting with the IRS in June 2018 and has supplied responses for all of the IRS's document requests to date. The Company believes that the positions taken in its 2015 return are reasonable and appropriate, however, the Company cannot be sure of the ultimate outcome of the examination and cannot estimate the likelihood of liability or the amount of potential assessments, if any, that could arise from the examination.

Historically, the Company has considered the requirements to collect sales taxes under the auspices of a 1991 Supreme Court case, *Quill Corp. v. North Dakota*, which established the precedent that a physical presence in the respective state is required for an entity to be subject to a state's sales and use tax requirements. Accordingly, the Company had concluded that the Company did not have nexus for sales tax in those states in which it had no physical presence (i.e., it had no employees regularly and systematically there and it had no property there). On June 21, 2018, via *South Dakota v. Wayfair, Inc.* (No. 17-494) the U.S. Supreme Court reversed its prior ruling and eliminated the "physical presence" requirement. The South Dakota law included no prospective liability for sellers, a safe harbor minimum for the number of transactions and dollar value of sales and relaxed registration procedures. However, it is still uncertain how other states will react to the ruling and what kind of overall impact that will have on internet sellers in the United States. In consideration of the recent ruling, the Company has made the decision to start collecting sales tax on direct sales of its magicJack device in states that have adopted similar "Economic Nexus" laws. To date, the Company has identified approximately 29 states that have similar laws. The Company began registering for, collecting and remitting sales tax to the identified jurisdictions during the third quarter of 2018. The Company will continue to monitor the situation and add additional states if deemed necessary. Though the South Dakota law is to be applied prospectively, it is not certain if other states may try to enact laws on a retrospective basis based on the Wayfair ruling, and the Company cannot estimate the likelihood of liability or the potential amount of assessments that could arise from prior periods if other states tried to apply the ruling on a retrospective basis.

Historically, the Company has from time to time received Letters of Inquiry ("LOI") from the Enforcement Bureau of the Federal Communications Commission ("FCC") regarding the nature of the Company's Core Consumer product offering. The Company has promptly responded to the inquiries of the Enforcement Bureau. As it has previously disclosed, the Company believes that under current regulations it is not an interconnected VoIP provider subject to FCC regulations. To date, the Company has not received any formal notice from the FCC of any enforcement action. The Company intends to vigorously defend itself if an enforcement action is initiated. The Company, however, cannot be sure of the ultimate outcome of any possible FCC action and cannot estimate the likelihood of liability or the amount of potential assessments, if any, that could arise.

#### NOTE 10 – TREASURY STOCK

In March 2018, the Company issued 21,897 of its ordinary shares held as treasury shares with a cost of \$270 thousand, or \$12.32 per share, to employees as a result of restricted stock vesting. In March 2018, the Company purchased 6,365 of its ordinary shares at \$8.40 per share, for an aggregate purchase price of approximately \$53 thousand, in settlement of the withholding tax liability on the vesting of the restricted stock. In August 2018, the Company issued 42,873 of its ordinary shares held as treasury shares with a cost of \$528 thousand, or \$12.32 per share, to board members as a result of restricted stock vesting.

In January 2017, the Company reclassified 16,666 shares previously issued out of treasury stock as they had been issued as new ordinary shares. In April 2017, the Company issued 6,996 of its ordinary shares held as treasury shares with a cost of \$86 thousand, or \$12.32 per share, to Board members as a result of restricted stock vesting. In May 2017, the Company issued 76,211 of its ordinary shares held as treasury shares with a cost of \$939 thousand, or \$12.32 per share, to an executive officer as a result of restricted stock vesting. In May 2017, the Company purchased 20,844 of its ordinary shares at \$6.50 per share, for an aggregate purchase price of approximately \$135 thousand, in settlement of the withholding tax liability on the vesting of that restricted stock.

## NOTE 11 – REVENUE

The Company's revenues for the three and nine months ended September 30, 2018, disaggregated by segment and timing of revenue recognition were as follows (in thousands):

|   |                         | For the Three Months Ended September 30, 2018 |            |              |              |
|---|-------------------------|---|------------|--------------|--------------|
|   |                         | Core  |            |              |              |
|   | Trigger for recognition | Consumer                                      | Enterprise | Intercompany | Consolidated |
| Revenues recognized at a point in time      |                         |   |            |              |              |
| Sale of magicJack devices, hardware portion | Transfer of control     | \$ 522  | \$ -       | \$ -         | \$ 522       |
| Shipping and handling                       | Transfer of control     | 223   | -          | -            | 223          |
| magicJack-related products and services     | Transfer of control     | 1,029   | -          | -            | 1,029        |
| UCaaS equipment                             | Transfer of control     | -   | 142        | -            | 142          |
| Other                                       | Various                 | 212   | -          | -            | 212          |
| Revenues recognized over time               |                         |   |            |              |              |
| Sale of magicJack devices, service portion  | Service period          | 1,158   | -          | -            | 1,158        |
| Access right renewals                       | Service period          | 12,286  | -          | -            | 12,286       |
| Prepaid minutes                             | Usage                   | 798   | -          | -            | 798          |
| Access and wholesale charges                | Usage                   | 698   | -          | -            | 698          |
| UCaaS service                               | Service period          | -   | 2,375      | (49 )        | 2,326        |
| UCaaS usage                                 | Usage                   | -   | 78         | -            | 78           |
|   |                         | \$ 16,926                                     | \$ 2,595   | \$ (49 )     | \$ 19,472    |
|   |                         | For the Nine Months Ended September 30, 2018  |            |              |              |
|   |                         | Core  |            |              |              |
|   | Trigger for recognition | Consumer                                      | Enterprise | Intercompany | Consolidated |
| Revenues recognized at a point in time      |                         |   |            |              |              |
| Sale of magicJack devices, hardware portion | Transfer of control     | \$ 1,925                                      | \$ -       | \$ -         | \$ 1,925     |
| Shipping and handling                       | Transfer of control     | 570   | -          | -            | 570          |
| magicJack-related products and services     | Transfer of control     | 3,117   | -          | -            | 3,117        |
| UCaaS equipment                             | Transfer of control     | -   | 532        | -            | 532          |
| Other                                       | Various                 | 517   | -          | -            | 517          |
| Revenues recognized over time               |                         |   |            |              |              |
| Sale of magicJack devices, service portion  | Service period          | 3,465   | -          | -            | 3,465        |
| Access right renewals                       | Service period          | 36,990  | -          | -            | 36,990       |
| Prepaid minutes                             | Usage                   | 2,754   | -          | -            | 2,754        |
| Access and wholesale charges                | Usage                   | 2,209   | -          | -            | 2,209        |
| UCaaS service                               | Service period          | -   | 7,281      | (72 )        | 7,209        |
| UCaaS usage                                 | Usage                   | -   | 221        | -            | 221          |

\$51,547 \$ 8,034 \$ (72 ) \$ 59,509

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The following tables summarize the impacts of adopting Topic 606 on the Company's consolidated financial statements as of and for the three and nine months ended September 30, 2018:

|  | As reported | Adjustments | Balances without adoption of ASC 606 |
|--|-------------|-------------|--------------------------------------|
| <b>ASSETS</b>                          |             |             |                                      |
| Current assets:                        |             |             |                                      |
| Deferred costs, current portion        | \$-         | \$ 2,140    | \$2,140                              |
| Contract costs, current portion        | 334         | (334 )      | -                                    |
| Prepaid income taxes                   | 646         | (201 )      | 445                                  |
| Other current assets                   | 68,134      | -           | 68,134                               |
| Total current assets                   | 69,114      | 1,605       | 70,719                               |
| Deferred tax assets                    | 31,270      | -           | 31,270                               |
| Deferred costs, net of current portion | -           | 144         | 144                                  |
| Contract costs, net of current portion | 519         | (519 )      | -                                    |
| Other non-current assets               | 43,373      | -           | 43,373                               |
| Total assets                           | \$144,276   | \$ 1,230    | \$145,506                            |

**LIABILITIES AND CAPITAL EQUITY**

|  |           |           |           |
|--|-----------|-----------|-----------|
| Current liabilities:                         |           |           |           |
| Deferred revenue, current portion            | -         | 39,544    | 39,544    |
| Contract liabilities, current portion        | 37,649    | (37,649 ) | -         |
| Other current liabilities                    | 8,138     | -         | 8,138     |
| Total current liabilities                    | 45,787    | 1,895     | 47,682    |
| Deferred revenue, net of current portion     | -         | 35,095    | 35,095    |
| Contract liabilities, net of current portion | 35,095    | (35,095 ) | -         |
| Other non-current liabilities                | 14,183    | -         | 14,183    |
| Total liabilities                            | 95,065    | 1,895     | 96,960    |
| Capital equity                               |           |           |           |
| Retained earnings                            | 38,739    | (665 )    | 38,074    |
| Other capital equity                         | 10,472    | -         | 10,472    |
| Total capital equity                         | 49,211    | (665 )    | 48,546    |
| Total liabilities and capital equity         | \$144,276 | \$ 1,230  | \$145,506 |

|                  | For the Three Months Ended<br>September 30, 2018 |             |                                      | For the Nine Months Ended<br>September 30, 2018 |             |                                      |
|------------------|--|-------------|--------------------------------------|---|-------------|--------------------------------------|
|                  | As reported                                      | Adjustments | Balances without adoption of ASC 606 | As reported                                     | Adjustments | Balances without adoption of ASC 606 |
| Net revenues     | \$19,472   | \$ 97       | \$19,569                             | \$59,509  | \$ 804      | \$60,313                             |
| Cost of revenues | 6,988  | (24 )       | 6,964                                | 21,251  | (32 )       | 21,219                               |
| Gross profit     | 12,484   | 121         | 12,605                               | 38,258  | 836         | 39,094                               |

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|                            |         |       |          |         |        |          |
|----------------------------|---------|-------|----------|---------|--------|----------|
| Operating expenses         | 8,127   | -     | 8,127    | 26,505  | -      | 26,505   |
| Operating income           | 4,357   | 121   | 4,478    | 11,753  | 836    | 12,589   |
| Total other income         | 211     | -     | 211      | 494     | -      | 494      |
| Income before income taxes | 4,568   | 121   | 4,689    | 12,247  | 836    | 13,083   |
| Income tax expense         | 1,383   | 40    | 1,423    | 3,000   | 201    | 3,201    |
| Net income                 | \$3,185 | \$ 81 | \$ 3,266 | \$9,247 | \$ 635 | \$ 9,882 |

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For the Nine Months Ended  
September 30, 2018

|  | As<br>reported | Adjustments | Balances<br>without<br>adoption<br>of ASC<br>606 |
|--|----------------|-------------|--|
| Cash flows from operating activities:  |                |             |  |
| Net income   | \$9,247        | \$ 635      | \$9,882  |
| Adjustments to reconcile net income to net cash<br>provided by operating activities: |                |             |  |
| Non-cash adjustments   | 5,994          | -           | 5,994  |
| Change in operating assets and liabilities   |                |             |  |
| Deferred costs/Contract costs  | (167 )         | (154 )      | (321 )   |
| Prepaid Income taxes   | 1,147          | 201         | 1,348  |
| Deferred revenue/Contract liabilities  | (5,746 )       | (739 )      | (6,485 )   |
| Other changes  | (906 )         | 57          | (849 )   |
| Net cash provided by operating activities  | 9,569          | -           | 9,569  |
| Net cash used in investing activities  | (46 )          | -           | (46 )  |
| Net cash used in financing activities  | (53 )          | -           | (53 )  |
| Net increase in cash and cash equivalents  | 9,470          | -           | 9,470  |
| Cash and cash equivalents, beginning of period                                       | 52,638         | -           | 52,638   |
| Cash and cash equivalents, end of period   | \$62,108       | \$ -        | \$ 62,108  |

The Company uses the practical expedient that allows it to recognize revenue for access and wholesale charges and certain usage charges billed in arrears at the amount to which it has the right to invoice in the future. Therefore, we do not disclose the estimated revenues that were unsatisfied (or partially unsatisfied) at the end of the reporting period. Estimated revenues expected to be recognized in the future for other revenue streams related to performance obligations that were unsatisfied (or partially unsatisfied) at the end of the reporting period are discussed in Note 7, “Deferred Costs and Revenues/Contract Assets and Liabilities”.

#### NOTE 12 – SHARE-BASED COMPENSATION

The Company has granted ordinary share options and restricted stock as an alternative or supplement to the compensation of its executives, employees, directors and outside consultants. The Company’s share-based compensation program is a long-term retention program intended to attract and reward talented executives, employees and outside consultants, and align their interests with shareholders. The Company is currently granting share-based awards under the Amended and Restated magicJack VocalTec Ltd. 2013 Stock Incentive Plan and the Amended and Restated magicJack VocalTec Ltd. 2013 Israeli Stock Incentive Plan (together, the “2013 Plans”) which were approved by shareholders in July 2013 at the annual general meeting of shareholders to allow grants of ordinary share options, restricted stock and ordinary shares. In April 2014 and July 2017, the shareholders approved amendments to the 2013 Plans increasing the number of share based awards available for grant. As of September 30, 2018, the aggregate number of shares subject to awards under the 2013 Plans was 5,600,000. The Company’s policy is to recognize compensation expense for awards with only service conditions and a graded vesting on a straight-line basis over the requisite vesting period for the entire award.

The Company’s share-based compensation expense for ordinary share options and issued restricted stock for the three and nine months ended September 30, 2018 and 2017 was as follows (in thousands):

| Three<br>Months<br>Ended<br>September<br>30, |      | Nine Months<br>Ended<br>September 30, |      |
|--|------|---------------------------------------|------|
| 2018   | 2017 | 2018                                  | 2017 |

|                        |       |       |         |         |
|------------------------|-------|-------|---------|---------|
| Ordinary share options | \$517 | \$407 | \$1,757 | \$1,020 |
| Restricted stock       | 283   | 343   | 1,028   | 1,033   |
|                        | \$800 | \$750 | \$2,785 | \$2,053 |

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The detail of total share-based compensation recognized by classification on the unaudited condensed consolidated statements of operations for the three and nine months ended September 30, 2018 and 2017 was as follows (in thousands):

|                            | Three Months Ended September 30, |       | Nine Months Ended September 30, |         |
|----------------------------|----------------------------------|-------|---------------------------------|---------|
|                            | 2018                             | 2017  | 2018                            | 2017    |
| Cost of revenues           | \$16                             | \$57  | \$66                            | \$159   |
| Marketing                  | 62                               | 50    | 206                             | 64      |
| General and administrative | 722                              | 643   | 2,513                           | 1,840   |
| Research and development   | -                                | -     | -                               | (10 )   |
|                            | \$800                            | \$750 | \$2,785                         | \$2,053 |

Ordinary Share Options

Ordinary share options granted under the 2013 Plans have a five-year life and typically vest over a period of 36 months beginning at the date of grant. The 2013 Plans, as amended, currently allow for a maximum term of five years for awards granted. The following table provides additional information regarding ordinary share options issued, outstanding and exercisable for the year ended December 31, 2017, and nine months ended September 30, 2018 (aggregate intrinsic value in thousands):

| Date of Grant                                 | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value <sup>(1)</sup> |
|---|-------------------|---------------------------------|--|--|
| January 1, 2017                               | 3,488,059         | \$ 11.13                        | 3.11   | \$ -                                     |
| Granted                                       | 2,896,304         | \$ 9.42                         |  |  |
| Exercised                                     | (181,666 )        | \$ 7.15                         |  |  |
| Forfeited <sup>(2)</sup>                      | (2,501,614)       | \$ 11.12                        |  |  |
| Expired or cancelled                          | (276,436 )        | \$ 11.01                        |  |  |
| December 31, 2017                             | 3,424,647         | \$ 9.92                         | 3.77   | \$ -                                     |
| Granted                                       | -                 | N/A                             |  |  |
| Exercised                                     | -                 | N/A                             |  |  |
| Forfeited                                     | -                 | N/A                             |  |  |
| Expired or cancelled                          | -                 | N/A                             |  |  |
| Outstanding at September 30, 2018 (unaudited) | 3,424,647         | \$ 9.92                         | 3.08   | \$ -                                     |
| Vested at September 30, 2018 (unaudited)      | 1,350,446         | \$ 10.86                        | 2.74   | \$ -                                     |

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

(2) In 2017, two former executive officers surrendered a total of 1,244,777 ordinary share options with a weighted average exercise price of \$14.57. Additionally, 1,256,837 options with a weighted average strike price of \$7.70 were forfeited by terminated executives in the SMB and Enterprise segments. The surrender of options resulted in a \$2.4 million increase in tax expense during the second quarter.

Share-based compensation expense recognized for ordinary share options was approximately \$0.5 million and \$0.4 million for the three months ended September 30, 2018 and 2017, respectively, and \$1.8 million and \$1.0 million for the nine months ended September 30, 2018 and 2017, respectively. No ordinary share options were exercised during the nine months ended September 30, 2018 and 2017. As of September 30, 2018, there was approximately \$2.8 million of unrecognized share-based compensation expense related to unvested ordinary share options, which is expected to be recognized over a weighted average remaining period of 1.43 years.

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's expected stock price volatility over the term of the awards, assumed employee exercise behaviors, risk-free interest rate and expected dividends. For purposes of valuing ordinary share options, the Company used historical volatility at the date of grant. The approximate risk-free interest rate was based on the U.S. Treasury yield for comparable periods. The Company has experienced forfeitures in the past and estimates a forfeiture rate for awards issued when deemed applicable. The expected term of the ordinary share options was calculated using the simplified method in accordance with section 10-S99 of ASC 718, "Compensation - Stock Compensation" ("ASC 718"). The Company does not expect to pay dividends on its ordinary shares in the foreseeable future. Accordingly, the Company used a dividend yield of zero in its option pricing model. The Company did not grant any ordinary share options during the nine months ended September 30, 2018. The Company granted 2,896,304 ordinary share options during the nine months ended September 30, 2017 with a weighted average fair value of \$2.14. The grants were measured using the following assumptions:

|                          |   |
|--------------------------|---|
|                          | Nine Months<br>Ended<br>September 30,<br>2017 |
| Expected term (in years) | 3.22 to 3.50                                  |
| Dividend yield           | 0.00%   |
| Expected volatility      | 48.88%  |
| Risk free interest rate  | 1.53% to 1.63%                                |
| Forfeiture rate          | 0.00%   |

#### Restricted Stock

The Company may also award restricted stock to its executives, employees, directors and outside consultants under the 2013 Plans, which may vest based on service or a combination of service and other conditions, such as market share price. The compensation expense for the award will be recognized assuming that the requisite service is rendered regardless of whether the market conditions are achieved. During the nine months ended September 30, 2018, the Company did not grant any restricted stock under the 2013 Plans, as amended. During the nine months ended September 30, 2017 the Company granted 276,890 restricted stock awards under the 2013 Plans, as amended.

The following table summarizes the Company's restricted stock activity for the nine months ended September 30, 2018:

|                                  | Number<br>of<br>Shares | Average<br>Fair<br>Value<br>at Grant<br>Date |
|----------------------------------|------------------------|--|
| December 31, 2017                | 349,555                | \$ 7.65                                      |
| Granted                          | -                      | N/A  |
| Vested                           | (64,770 )              | \$ 7.27                                      |
| Forfeited                        | -                      | N/A  |
| Non-vested at September 30, 2018 | 284,785                | \$ 7.22                                      |

Share-based compensation expense recognized for restricted stock was approximately \$0.3 million for both of the three months ended September 30, 2018 and 2017, and \$1.0 million for both of the nine months ended September 30, 2018 and 2017. As of September 30, 2018, there was approximately \$0.9 million in unrecognized share-based

compensation costs related to restricted stock. The unrecognized share-based compensation expense is expected to be recognized over a weighted average remaining period of 0.44 years.

#### NOTE 13 – INCOME TAXES

Total income tax expense (benefit) was \$1.4 million and \$1.6 million for the three months ended September 30, 2018 and 2017, respectively, and \$3.0 million and (\$7.2) million for the nine months ended September 30, 2018 and 2017, respectively. The calculation of the Company's effective income tax rate for the three and nine months ended September 30, 2018 and 2017 was (in thousands):

|                              | Three Months  |         | Nine Months Ended |            |
|------------------------------|---------------|---------|-------------------|------------|
|                              | Ended         |         | September 30,     |            |
|                              | September 30, |         | September 30,     |            |
|                              | 2018          | 2017    | 2018              | 2017       |
| Income before income taxes   | \$4,568       | \$4,025 | \$12,247          | \$(29,405) |
| Income tax expense (benefit) | 1,383         | 1,574   | 3,000             | (7,194)    |
| Effective income tax rate    | 30.28%        | 39.11%  | 24.50%            | 24.47%     |

The Company primarily operates in the U.S. and Israel, and the Company's Israeli operations are subject to a statutory income tax rate of 24% in 2017 and 23% in 2018 which is higher than the Company's U.S. federal income tax rate of 21% as of September 30, 2018.

For the three months ended September 30, 2018, the Company recorded income tax expense of \$1.4 million, which is higher than the expected tax expense of \$1.0 million, using the statutory rate of 21%, due, in part, to increases in the Company's uncertain tax positions of \$0.2 million and a return to provision adjustment related to its 2017 U.S. tax return of \$0.2 million. Additionally, the effective tax rate was impacted by the higher jurisdictional tax rate charged on the operating income of the Company's Israeli operations.

For the nine months ended September 30, 2018, the Company recorded income tax expense of \$3.0 million, which is higher than the expected tax expense of \$2.6 million, using the statutory rate of 21% due primarily to increases in the Company's uncertain tax positions of \$0.1 million and a return to provision true-up related to its 2017 U.S. tax return of \$0.2 million.

## NOTE 14 – NET INCOME (LOSS) PER SHARE

Net income (loss) per share – basic, is calculated by dividing net income (loss) (the “Numerator”), by the weighted average number of common shares outstanding during the period, (the “Denominator”). Net income (loss) per share – diluted, is computed by increasing the basic denominator to include the number of ordinary shares that would have been issued if the Company’s dilutive potential common shares had been exercised or vested. The Company’s potential common shares are the share-based awards (ordinary share options and restricted stock) discussed in Note 12, “Share-Based Compensation”.

The Company calculates the diluted denominator using the treasury stock method, which assumes that all exercise proceeds are used to repurchase common shares, reducing the net number of shares to be added. Share-based awards only have a dilutive effect when the average stock price for the period exceeds their exercise price (“in the money”) and the entity has net income.

The following table presents the computation of basic and diluted net income (loss) per common share (in thousands, except for per share information):

|  | Three Months<br>Ended September<br>30,<br>2018 |         | Nine Months<br>Ended September<br>30,<br>2017 |            |
|--|--|---------|---|------------|
| Numerator:   |  |         |   |            |
| Net income (loss) attributable to common shareholders  | \$3,185  | \$2,451 | \$9,247                                       | \$(22,211) |
| Denominator:   |  |         |   |            |
| Denominator for basic net income per share -<br>weighted average ordinary shares outstanding   | 16,233   | 16,114  | 16,210  | 16,076     |
| Effect of dilutive share-based awards outstanding  | -  | -       | -   | -          |
| Effect of dilutive share-based awards vested,<br>exercised or expired during the period        | 15   | -       | 40  | -          |
| Denominator for diluted net income per share -<br>weighted average ordinary shares outstanding | 16,248   | 16,114  | 16,250  | 16,076     |
| Net income (loss) per share:   |  |         |   |            |
| Basic  | \$0.20   | \$0.15  | \$0.57  | \$(1.38 )  |
| Diluted  | \$0.20   | \$0.15  | \$0.57  | \$(1.38 )  |
| Anti-dilutive share-based awards not included above  | 3,340  | 4,031   | 3,340   | 4,031      |

## NOTE 15 – BROADSMART ACQUISITION

In March 2016, the Company acquired the assets of Broadsmart for approximately:

(i) \$38.0 million in cash,

(ii) 233,402 shares of the Company's ordinary shares issued from treasury stock with a fair value of \$1.7 million based on closing market price per share as of the date of the acquisition, and

(iii) additional contingent cash payments of

(a)

up to \$0.2 million, if two certain individuals (\$0.1 million for each) previously employed by Broadsmart did not accept the Company's employment offer, and

(b) \$2.0 million, if the acquired assets generated 2016 revenues of at least \$15.6 million.

At the time of closing, \$3.0 million of the cash consideration was paid into escrow to cover indemnification claims by the Company against the sellers. No asset or liability is included in the accompanying unaudited condensed consolidated balance sheets for this item. The \$0.2 million contingent payment discussed in (iii)(a) above was made during the three months ended March 31, 2018. This payment had not been made as of December 31, 2017 and was included in accrued expenses and other current liabilities in the accompanying unaudited condensed consolidated balance sheet. The \$2.0 million contingent payment discussed in (iii)(b) above was paid into escrow at the time of closing, but was not earned, as revenues for the year ended December 31, 2016 did not reach the target. The Company recorded a \$2.0 million receivable from earnout escrow in the unaudited condensed consolidated balance sheet as of December 31, 2016 and a \$1.7 million consideration adjustment/gain on mark-to-market reducing operating expenses for the year ended December 31, 2016.

During the quarter ended March 31, 2017, the Company recognized impairment charges of \$31.5 million on Broadsmart intangible assets, including goodwill. The carrying value of the Broadsmart business after the impairment was \$18.5 million at March 31, 2017. Refer to Note 5, "Intangible Assets" and Note 6, "Goodwill" for further details.

On June 23, 2017, the founders of Broadsmart left the Company. On August 4, 2017, the Company reached a mutual agreement with the founders that included release to the Company of \$1.0 million of the \$3.0 million held in escrow to cover indemnification claims and the \$2.0 million earnout amount. The remaining \$2.0 million escrow to cover indemnification claims will remain in escrow until March 2019, pursuant to the provisions of the purchase agreement, to cover potential claims by the Company for telecommunications taxes. During the year ended December 31, 2017, the Company collected both escrow amounts. The \$1.0 million was recorded as a consideration adjustment/gain on mark-to-market, less amounts due from the founders and the \$2.0 million receivable from earnout escrow was removed.



NOTE 16 – SEGMENT REPORTING

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

In the three months ended March 31, 2017, the Company reported the results of its operations in three separate reportable segments – “Core Consumer”, “Enterprise” and “SMB”. These segments were organized by the products and services that were sold, the customers that were served and the executive teams that managed their operations. During the first quarter of 2017, management restructured the Company to absorb within the Core Consumer segment, all of operations and functions of the SMB segment which was based on the activities of magicJack SMB, Inc. (“SMB”) and included the magicJack for Business product line. Accordingly, this segment was no longer an operating segment and does not show separate activity for periods after March 31, 2017.

The Company measures and evaluates its reportable segments based on revenues and gross profit margins. The Company’s segments and their principal activities consist of the following:

Core Consumer

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

magicJack is the cloud communications leader that invented the magicJack device and other magicJack products and services. magicJack devices and mobile apps provide customers the ability to make and receive telephone calls in the U.S. or Canada with no additional cost. Customers may also purchase international minutes to place telephone calls outside of the U.S. and Canada.

Enterprise

This segment includes Broadsmart, which is a provider of UCaaS hardware and connectivity for enterprise customers.

SMB

Through this segment, the Company provided VoIP services to small to medium sized businesses. During the first quarter of 2017, management restructured the Company to absorb all operations and functions of the SMB segment within the Core Consumer segment. The expenses of this restructuring included severance for the majority of the employees in the segment and future rent payments for the Alpharetta, Georgia office.

Selected information is presented by reportable segment below (in thousands):

|                                 | For the Three Months Ended September 30, 2018 |            |              |              |
|---------------------------------|---|------------|--------------|--------------|
|                                 | Core  |            |              |              |
|                                 | Consumer                                      | Enterprise | Intercompany | Consolidated |
| <b>Statement of Operations:</b> |   |            |              |              |
| Net revenues                    | \$ 16,926                                     | 2,595      | (49          | ) \$ 19,472  |
| Cost of revenues                | 5,102   | 1,886      | -            | 6,988        |
| Gross profit (loss)             | 11,824  | 709        | (49          | ) 12,484     |
| Marketing                       | 517   | 197        | -            | 714          |
| General and administrative      | 5,732   | 520        | (49          | ) 6,203      |
| Impairment of intangible assets | -   | -          | -            | -            |
| Research and development        | 1,210   | -          | -            | 1,210        |
| Operating expenses              | 7,459   | 717        | (49          | ) 8,127      |
| Operating income (loss)         | 4,365   | (8         | ) -          | 4,357        |
| <b>Other Data:</b>              |   |            |              |              |
| Depreciation expense            | \$ 219  | 48         | -            | \$ 267       |
| Amortization expense            | \$ 354  | 198        | -            | \$ 552       |

|                                 | For the Nine Months Ended September 30, 2018 |            |              |              |
|---------------------------------|--|------------|--------------|--------------|
|                                 | Core   |            |              |              |
|                                 | Consumer                                     | Enterprise | Intercompany | Consolidated |
| <b>Statement of Operations:</b> |  |            |              |              |
| Net revenues                    | \$ 51,547                                    | 8,034      | (72          | ) \$ 59,509  |
| Cost of revenues                | 15,750                                       | 5,501      | -            | 21,251       |
| Gross profit (loss)             | 35,797                                       | 2,533      | (72          | ) 38,258     |
| Marketing                       | 1,963  | 836        | -            | 2,799        |
| General and administrative      | 17,605                                       | 1,971      | (72          | ) 19,504     |
| Impairment of intangible assets | 131  | -          | -            | 131          |
| Research and development        | 4,071  | -          | -            | 4,071        |
| Operating expenses              | 23,770                                       | 2,807      | (72          | ) 26,505     |
| Operating income (loss)         | 12,027                                       | (274       | ) -          | 11,753       |
| <b>Other Data:</b>              |  |            |              |              |
| Depreciation expense            | \$ 661                                       | 144        | -            | \$ 805       |
| Amortization expense            | \$ 1,200                                     | 591        | -            | \$ 1,791     |

|                            | As of September 30, 2018 |            |              |              |
|----------------------------|--------------------------|------------|--------------|--------------|
|                            | Core                     |            |              |              |
|                            | Consumer                 | Enterprise | Intercompany | Consolidated |
| <b>Balance Sheet Data:</b> |                          |            |              |              |
| Goodwill                   | \$ 32,304                | -          | -            | \$ 32,304    |
| Total assets               | \$ 129,265               | 15,003     | 8            | \$ 144,276   |



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For the Three Months Ended September 30, 2017

|   | Previous<br>Core<br>Consumer | SMB | Revised<br>Core<br>Consumer | Enterprise | Intercompany | Consolidated |
|---|------------------------------|-----|-----------------------------|------------|--------------|--------------|
| <b>Statement of Operations:</b>                 |                              |     |                             |            |              |              |
| Net revenues                                    | \$ 19,010                    | -   | \$ 19,010                   | 2,691      | (44 )        | \$ 21,657    |
| Cost of revenues                                | 6,099                        | -   | 6,099                       | 1,731      | -            | 7,830        |
| Gross profit (loss)                             | 12,911                       | -   | 12,911                      | 960        | (44 )        | 13,827       |
| Marketing                                       | 1,563                        | -   | 1,563                       | 370        | -            | 1,933        |
| General and administrative                      | 6,656                        | -   | 6,656                       | 718        | (44 )        | 7,330        |
| Impairment of goodwill and<br>intangible assets | -                            | -   | -                           | -          | -            | -            |
| Research and development                        | 1,472                        | -   | 1,472                       | 5          | -            | 1,477        |
| Gain on mark-to-market                          | (894 )                       | -   | (894 )                      | -          | -            | (894 )       |
| Operating expenses                              | 8,797                        | -   | 8,797                       | 1,093      | (44 )        | 9,846        |
| Operating income (loss)                         | 4,114                        | -   | 4,114                       | (133 )     | -            | 3,981        |
| <b>Other Data:</b>                              |                              |     |                             |            |              |              |
| Depreciation expense                            | \$ 254                       | -   | \$ 254                      | 67         | -            | \$ 321       |
| Amortization expense                            | \$ 472                       | -   | \$ 472                      | 184        | -            | \$ 656       |

For the Nine Months Ended September 30, 2017

|   | Previous<br>Core<br>Consumer | SMB     | Revised<br>Core<br>Consumer | Enterprise | Intercompany | Consolidated |
|---|------------------------------|---------|-----------------------------|------------|--------------|--------------|
| <b>Statement of Operations:</b>                 |                              |         |                             |            |              |              |
| Net revenues                                    | \$ 58,774                    | 116     | \$ 58,890                   | 8,462      | (117 )       | \$ 67,235    |
| Cost of revenues                                | 19,441                       | 131     | 19,572                      | 5,875      | -            | 25,447       |
| Gross profit (loss)                             | 39,333                       | (15 )   | 39,318                      | 2,587      | (117 )       | 41,788       |
| Marketing                                       | 4,525                        | 1,089   | 5,614                       | 846        | -            | 6,460        |
| General and administrative                      | 25,930                       | 1,056   | 26,986                      | 2,830      | (117 )       | 29,699       |
| Impairment of goodwill and<br>intangible assets | -                            | -       | -                           | 31,527     | -            | 31,527       |
| Research and development                        | 3,836                        | 596     | 4,432                       | 6          | -            | 4,438        |
| Gain on mark-to-market                          | (894 )                       | -       | (894 )                      | -          | -            | (894 )       |
| Operating expenses                              | 33,397                       | 2,741   | 36,138                      | 35,209     | (117 )       | 71,230       |
| Operating income (loss)                         | 5,936                        | (2,756) | 3,180                       | (32,622 )  | -            | (29,442 )    |
| <b>Other Data:</b>                              |                              |         |                             |            |              |              |
| Depreciation expense                            | \$ 790                       | 21      | \$ 811                      | 175        | -            | \$ 986       |
| Amortization expense                            | \$ 1,196                     | -       | \$ 1,196                    | 1,215      | -            | \$ 2,411     |

As of December 31, 2017

Core  
Consumer Enterprise Intercompany Consolidated

Balance Sheet Data:

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|              |           |        |     |              |
|--------------|-----------|--------|-----|--------------|
| Goodwill     | \$32,304  | -      | -   | \$ 32,304    |
| Total assets | \$125,537 | 15,601 | (96 | ) \$ 141,042 |

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited condensed consolidated financial statements as of September 30, 2018 and for the three and nine month periods ended September 30, 2018 and 2017, as well as our Annual Report on Form 10-K for the year ended December 31, 2017. This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, the accuracy of which involves risk and uncertainties. We use words such as "anticipates," "believes," "plans," "expects," "future," "intends," "estimates," "projects," and similar expressions to identify forward-looking statements. Readers should not place undue reliance on these forward-looking statements, which apply only as of the date of this report. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons. Factors that might cause or contribute to such differences include, but are not limited to, those discussed under the section titled "Risk Factors" of our Form 10-K for the year ended December 31, 2017 filed on March 16, 2018.

Overview

magicJack VocalTec Ltd. and its subsidiaries (the "Company") is the cloud communications leader that invented the magicJack device as well as other telecommunication products and services. The Company is a vertically integrated group of companies, with capabilities including Voice-over-Internet-Protocol ("VoIP") services and related equipment sales, and development of the magicJack device. In addition to residential consumers, the Company provides VoIP services and related equipment to small to medium sized businesses, wholesales telephone service to VoIP providers and telecommunication carriers and provides hosted Unified Communication as a Service ("UCaaS") and related hardware and network equipment primarily to medium-to-large, multi-location enterprise customers.

The Company was incorporated in the State of Israel in 1989 and is domiciled in Netanya, Israel, with executive and administrative offices, and a customer care call center in West Palm Beach, Florida. In addition the Company has offices for technology management in Franklin, Tennessee, research and development in Plano, Texas, Alpharetta, Georgia and Warsaw, Poland and the UCaaS provider in West Palm Beach and Fort Lauderdale, Florida.

Basis of Presentation

Our unaudited condensed consolidated financial statements are prepared in conformity with United States generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, our unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements that are included in our Annual Report on Form 10-K for the year ended December 31, 2017. The balance sheet at December 31, 2017 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included.

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

In the three months ended March 31, 2017, the Company reported results of its operations in three separate reportable segments – “Core Consumer”, “Enterprise” and “SMB”. During the first quarter of 2017, management restructured the Company to absorb within the Core Consumer segment, all of operations and functions of the SMB Segment which was based on the activities of magicJack SMB, Inc. (“SMB”). Accordingly, this segment does not show activity for periods after March 31, 2017. Refer to Note 16, “Segment Reporting,” in the Notes to our unaudited condensed consolidated financial statements included in Item 1 herein for further details.

Approximately 84% and 85% of our consolidated revenues in the three and nine months ended September 30, 2018, respectively, were derived from sales to customers located in the United States. Approximately 85% and 86% of our consolidated revenues in the three and nine months ended September 30, 2017, respectively, were derived from sales to customers located in the United States.

#### Basis of Consolidation

Our consolidated financial statements include the accounts of magicJack VocalTec and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation.

The results for the three and nine months ended September 30, 2018 may not be indicative of the results for the entire year ending December 31, 2018. The interim unaudited condensed consolidated financial statements should be read in conjunction with our financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this report and in our Annual Report on Form 10-K for the year ended December 31, 2017 filed on March 16, 2018.

#### Use of Estimates

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

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

#### CRITICAL ACCOUNTING POLICIES

We have identified below our critical accounting policies that have changed since our Annual Report on Form 10-K for the year ended December 31, 2017 filed on March 16, 2018. Please refer to the Form 10-K for a full discussion of critical accounting policies. These policies are both the most important to the portrayal of our financial condition and results of operations and require our management's most difficult, subjective and complex judgments and estimates. Actual results may differ from these estimates under different assumptions or conditions.

#### REVENUE RECOGNITION

Prior to 2018, we recognized revenue in accordance with ASC 605, "Revenue Recognition", which provides authoritative guidance on revenue recognition. For arrangements that included more than one product or service ("deliverables"), we applied Section 25 of ASC 605, "Multiple-Element Arrangements". ASC 605-25 establishes criteria for separating deliverables into different units of accounting and allocating consideration to those units of accounting.

On January 1, 2018, we adopted ASC 606, "Revenue from Contracts with Customers," for revenue recognition. The new standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. We adopted the requirements of ASC 606 using the modified retrospective transition method under which the standard was applied only to the most current period presented and the cumulative effect of applying the new standard was recognized at the date of initial application as a cumulative adjustment to retained earnings. We applied the guidance to contracts that were not completed at the date of initial application. The cumulative effect of initially applying ASC 606 on January 1, 2018 increased retained earnings by approximately \$1.3 million, with offsetting adjustments to deferred revenue and deferred costs, not including the tax impact of \$0.4 million as an adjustment to the opening balance of equity at January 1, 2018. Refer to Note 1, "Description of Business and Basis of Presentation", Note 2, "Summary of Accounting Policies", Note 7, "Deferred Costs and Revenues/Contract



Costs and Liabilities” and Note 11, “Revenue” in the Notes to our unaudited condensed consolidated financial statements included in Item 1 herein for further details.

#### INCOME TAXES

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the year of enactment. Our net deferred tax assets consist primarily of foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. We record a valuation allowance to reduce the net deferred tax assets to the amount that we estimate is more-likely-than-not to be realized. We periodically review the composition of our net deferred tax assets and related valuation allowances and make adjustments if available evidence indicates that it is more-likely-than-not a change in the carrying amounts is required. We increased the valuation allowance by \$11 thousand and \$33 thousand during the three and nine months ended September 30, 2018, respectively, and we increased the valuation allowance by \$15 thousand and \$44 thousand during the three and nine months ended September 30, 2017, respectively.

We assess our income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where it is more likely than not that a tax benefit will be sustained, we have recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that are not more likely than not, no tax benefit has been recognized in the financial statements. We revised our liability for uncertain tax positions by an increase of \$0.2 million and \$0.1 million during the three and nine months ended September 30, 2018, due primarily to the net impact of accrued interest on previously booked uncertain tax positions and the revaluation impact of previously recorded Israeli uncertain tax positions.

We record our income tax expense for interim financial statements by using an estimated annual effective income tax rate based on our expected annual results after elimination of nontaxable items. The tax benefits of net operating loss carry-forwards expected to be realized through 2018 and changes in other deferred tax assets and liabilities are recognized during interim periods based on annual forecasts as of the interim reporting date. At September 30, 2018, the estimated annual effective income tax rate is expected to approximate 21.9%, excluding discrete tax items, which includes federal, foreign, and state and local taxes. This rate may fluctuate due to changes in our jurisdictional income and due to the timing of other discrete period transactions during the remainder of the year.

#### SIGNIFICANT CHANGES IN FINANCIAL POSITION

The following table presents significant changes in our unaudited condensed consolidated balance sheets for the nine months ended September 30, 2018 (in thousands).

|  | September<br>30,<br>2018<br>(Unaudited) | December<br>31,<br>2017 | Change    |
|--|---|-------------------------|-----------|
| Cash and cash equivalents                      | \$ 62,108                               | \$ 52,638               | \$9,470   |
| Intangible assets, net                         | \$ 8,284                                | \$ 10,190               | \$(1,906) |
| Total deferred costs/contract costs            | \$ 853                                  | \$ 1,936                | \$(1,083) |
| Prepaid income tax                             | \$ 646                                  | \$ 2,016                | \$(1,370) |
| Accrued expenses and other current liabilities | \$ 5,272                                | \$ 6,454                | \$(1,182) |
| Total deferred revenue/contract liabilities    | \$ 72,744                               | \$ 81,040               | \$(8,296) |

During the nine months ended September 30, 2018:

cash and cash equivalents increased \$9.5 million, primarily reflecting cash generated from ongoing operations, composed of \$9.2 million in net income. A detailed discussion of this change is provided in “Liquidity and Capital Resources”.

net intangible assets decreased \$1.9 million primarily due to \$1.8 million of amortization.

total deferred costs/contract costs decreased \$1.1 million due primarily to the impact of the initial adoption of ASC 606.

Prepaid income tax decreased \$1.4 million due to the net impact of recorded tax expense, estimated tax payments and the adoption of ASU 2016-16 as discussed in Note 1.

accrued expenses and other current liabilities decreased \$1.2 million due primarily to payment of 2017 bonuses and lower year-over-year bonus accrual amounts.

total deferred revenue/contract liabilities decreased \$8.3 million due primarily to the recognition of 2017 contract liabilities exceeding the deferral associated with 2018 sales and the impact of the initial adoption of ASC 606.

## RESULTS OF OPERATIONS

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

|   | Three Months  |               |                |                | Nine Months   |                 |                 |                |
|---|---------------|---------------|----------------|----------------|---------------|-----------------|-----------------|----------------|
|   | Ended         |               | 2018           |                | Ended         |                 | 2018            |                |
|   | September 30, |               | Compared to    |                | September 30, |                 | Compared to     |                |
|   | 2018          | 2017          | 2017           |                | 2018          | 2017            | 2017            |                |
| <b>Revenues</b>                                   |               |               |                |                |               |                 |                 |                |
| Sale of magicJack devices                         | \$1,680       | \$2,608       | \$(928)        | (35.6)%        | \$5,390       | \$7,954         | \$(2,564)       | (32.2)%        |
| Access right renewals                             | 12,286        | 12,778        | (492)          | (3.9 )         | 36,990        | 39,328          | (2,338)         | (5.9 )         |
| Shipping and handling                             | 223           | 297           | (74 )          | (24.9)         | 570           | 1,012           | (442 )          | (43.7)         |
| magicJack-related products and services           | 1,029         | 1,126         | (97 )          | (8.6 )         | 3,117         | 3,723           | (606 )          | (16.3)         |
| Prepaid minutes                                   | 798           | 1,111         | (313 )         | (28.2)         | 2,754         | 3,490           | (736 )          | (21.1)         |
| Access and wholesale charges                      | 698           | 897           | (199 )         | (22.2)         | 2,209         | 2,944           | (735 )          | (25.0)         |
| UCaaS   | 2,546         | 2,646         | (100 )         | (3.8 )         | 7,962         | 8,344           | (382 )          | (4.6 )         |
| Other   | 212           | 194           | 18             | 9.3            | 517           | 440             | 77              | 17.5           |
| <b>Total Revenues</b>                             | <b>19,472</b> | <b>21,657</b> | <b>(2,185)</b> | <b>(10.1)</b>  | <b>59,509</b> | <b>67,235</b>   | <b>(7,726)</b>  | <b>(11.5)</b>  |
| <b>Cost of Revenues</b>                           |               |               |                |                |               |                 |                 |                |
| Cost of devices and related products              | 1,214         | 1,701         | (487 )         | (28.6)         | 3,855         | 6,285           | (2,430)         | (38.7)         |
| Shipping and handling                             | 170           | 273           | (103 )         | (37.7)         | 488           | 1,094           | (606 )          | (55.4)         |
| Credit card processing fees                       | 366           | 396           | (30 )          | (7.6 )         | 1,194         | 1,273           | (79 )           | (6.2 )         |
| Network and carrier charges                       | 2,109         | 2,436         | (327 )         | (13.4)         | 6,389         | 7,510           | (1,121)         | (14.9)         |
| UCaaS   | 1,886         | 1,731         | 155            | 9.0            | 5,501         | 5,875           | (374 )          | (6.4 )         |
| Other   | 1,243         | 1,293         | (50 )          | (3.9 )         | 3,824         | 3,410           | 414             | 12.1           |
| <b>Total Cost of Revenues</b>                     | <b>6,988</b>  | <b>7,830</b>  | <b>(842 )</b>  | <b>(10.8)</b>  | <b>21,251</b> | <b>25,447</b>   | <b>(4,196)</b>  | <b>(16.5)</b>  |
| <b>Gross Profit</b>                               | <b>12,484</b> | <b>13,827</b> | <b>(1,343)</b> | <b>(9.7 )</b>  | <b>38,258</b> | <b>41,788</b>   | <b>(3,530)</b>  | <b>(8.4 )</b>  |
| <b>Operating expenses:</b>                        |               |               |                |                |               |                 |                 |                |
| Marketing   | 714           | 1,933         | (1,219)        | (63.1 )        | 2,799         | 6,460           | (3,661 )        | (56.7 )        |
| General and administrative                        | 6,203         | 7,330         | (1,127)        | (15.4 )        | 19,504        | 29,699          | (10,195)        | (34.3 )        |
| Impairment of goodwill and intangible assets      | -             | -             | -              | -              | 131           | 31,527          | (31,396)        | (99.6 )        |
| Research and development                          | 1,210         | 1,477         | (267 )         | (18.1 )        | 4,071         | 4,438           | (367 )          | (8.3 )         |
| Consideration adjustment / gain on mark-to-market | -             | (894 )        | 894            | 100.0          | -             | (894 )          | 894             | 100.0          |
| <b>Total operating expenses</b>                   | <b>8,127</b>  | <b>9,846</b>  | <b>(1,719)</b> | <b>(17.5 )</b> | <b>26,505</b> | <b>71,230</b>   | <b>(44,725)</b> | <b>(62.8 )</b> |
| <b>Operating income (loss)</b>                    | <b>4,357</b>  | <b>3,981</b>  | <b>376</b>     | <b>9.4</b>     | <b>11,753</b> | <b>(29,442)</b> | <b>41,195</b>   | <b>139.9</b>   |
| <b>Other income (expense):</b>                    |               |               |                |                |               |                 |                 |                |
| Interest and dividend income                      | 215           | 42            | 173            | *              | 495           | 65              | 430             | *              |
| Other income (expense), net                       | (4 )          | 2             | (6 )           | *              | (1 )          | (28 )           | 27              | *              |
| <b>Total other income (expense)</b>               | <b>211</b>    | <b>44</b>     | <b>167</b>     | <b>*</b>       | <b>494</b>    | <b>37</b>       | <b>457</b>      | <b>*</b>       |
| <b>Income (loss) before income taxes</b>          | <b>4,568</b>  | <b>4,025</b>  | <b>543</b>     | <b>13.5</b>    | <b>12,247</b> | <b>(29,405)</b> | <b>41,652</b>   | <b>141.6</b>   |

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|                              |         |         |        |         |         |            |          |       |
|------------------------------|---------|---------|--------|---------|---------|------------|----------|-------|
| Income tax expense (benefit) | 1,383   | 1,574   | (191 ) | (12.1 ) | 3,000   | (7,194 )   | 10,194   | 141.7 |
| Net income (loss)            | \$3,185 | \$2,451 | \$734  | 29.9    | \$9,247 | \$(22,211) | \$31,458 | 141.6 |

\* - Not meaningful.

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## Core Consumer Segment

|   | Three Months  |          |             |         | Nine Months   |          |             |         |
|---|---------------|----------|-------------|---------|---------------|----------|-------------|---------|
|   | Ended         |          | 2018        |         | Ended         |          | 2018        |         |
|   | September 30, |          | Compared to |         | September 30, |          | Compared to |         |
|   | 2018          | 2017     | 2017        |         | 2018          | 2017     | 2017        |         |
| Net revenues                                      | \$16,926      | \$19,010 | \$(2,084)   | (11.0)% | \$51,547      | \$58,890 | \$(7,343)   | (12.5)% |
| Cost of revenues                                  | 5,102         | 6,099    | (997)       | (16.3)  | 15,750        | 19,572   | (3,822)     | (19.5)  |
| Gross Profit                                      | 11,824        | 12,911   | (1,087)     | (8.4)   | 35,797        | 39,318   | (3,521)     | (9.0)   |
| Operating expenses:                               |               |          |             |         |               |          |             |         |
| Marketing   | 517           | 1,563    | (1,046)     | (66.9)  | 1,963         | 5,614    | (3,651)     | (65.0)  |
| General and administrative                        | 5,732         | 6,656    | (924)       | (13.9)  | 17,605        | 26,986   | (9,381)     | (34.8)  |
| Impairment of intangible assets                   | -             | -        | -           | -       | 131           | -        | 131         | 100.0   |
| Research and development                          | 1,210         | 1,472    | (262)       | (17.8)  | 4,071         | 4,432    | (361)       | (8.1)   |
| Consideration adjustment / gain on mark-to-market | -             | (894)    | 894         | 100.0   | -             | (894)    | 894         | 100.0   |
| Total operating expenses                          | 7,459         | 8,797    | (1,338)     | (15.2)  | 23,770        | 36,138   | (12,368)    | (34.2)  |
| Operating income                                  | 4,365         | 4,114    | 251         | 6.1     | 12,027        | 3,180    | 8,847       | 278.2   |

## Enterprise Segment

|  | Three Months  |         |             |         | Nine Months   |          |             |         |
|--|---------------|---------|-------------|---------|---------------|----------|-------------|---------|
|  | Ended         |         | 2018        |         | Ended         |          | 2018        |         |
|  | September 30, |         | Compared to |         | September 30, |          | Compared to |         |
|  | 2018          | 2017    | 2017        |         | 2018          | 2017     | 2017        |         |
| Net revenues                                 | \$2,595       | \$2,691 | \$(96)      | (3.6)%  | \$8,034       | \$8,462  | \$(428)     | (5.1)%  |
| Cost of revenues                             | 1,886         | 1,731   | 155         | 9.0     | 5,501         | 5,875    | (374)       | (6.4)   |
| Gross Profit                                 | 709           | 960     | (251)       | (26.1)  | 2,533         | 2,587    | (54)        | (2.1)   |
| Operating expenses:                          |               |         |             |         |               |          |             |         |
| Marketing                                    | 197           | 370     | (173)       | (46.8)  | 836           | 846      | (10)        | (1.2)   |
| General and administrative                   | 520           | 718     | (198)       | (27.6)  | 1,971         | 2,830    | (859)       | (30.4)  |
| Impairment of goodwill and intangible assets | -             | -       | -           | -       | -             | 31,527   | (31,527)    | (100.0) |
| Research and development                     | -             | 5       | (5)         | (100.0) | -             | 6        | (6)         | (100.0) |
| Total operating expenses                     | 717           | 1,093   | (376)       | (34.4)  | 2,807         | 35,209   | (32,402)    | (92.0)  |
| Operating loss                               | (8)           | (133)   | 125         | 94.0    | (274)         | (32,622) | 32,348      | 99.2    |

## THREE MONTHS ENDED SEPTEMBER 30, 2018 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2017

## Revenues

Total revenues were \$19.5 million and \$21.7 million for the three months ended September 30, 2018 and 2017, respectively, representing a decrease of \$2.2 million, or 10.1%. The decrease in the components of revenues was primarily attributable to the following:

- a \$0.9 million decrease in revenues from the sale of magicJack devices primarily reflecting lower sales volume and the adoption of ASC 606. Refer to Note 11, "Revenue" in the Notes to our unaudited condensed consolidated financial

statements included in Item 1 herein for further details;

- a \$0.5 million decrease in access right renewal revenues reflecting customer churn;
- a \$0.1 million decrease in shipping and handling revenues primarily due to lower sales volume;
- a \$0.1 million decrease in revenues from magicJack-related products and services primarily due to lower sales volume;
- a \$0.3 million decrease in revenues from prepaid minutes resulting from lower usage levels;
- a \$0.2 million decrease in revenues from access and wholesale charges due to lower network traffic; and
- a \$0.1 million decrease in revenues from UCaaS reflecting customer churn.

For the three months ended September 30, 2018 and 2017, sales of the magicJack devices through retail outlets represented approximately 59% and 60%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 41% and 40%, respectively, of magicJack devices sold. For the three months ended September 30, 2018 and 2017, no retailer accounted for more than 10% of the Company's total revenue.

### Cost of Revenues

Total cost of revenues was \$7.0 million and \$7.8 million for the three months ended September 30, 2018 and 2017, respectively, representing a decrease of approximately \$0.8 million, or 10.8%. This decrease in cost of revenues was primarily attributable to:

- a \$0.5 million decrease in the cost of devices and related products primarily reflecting lower sales volumes,
- a \$0.1 million decrease in shipping and handling costs due to lower direct sales volume and reduction in costs following the outsourcing of the fulfillment function in the fourth quarter of 2017, and
- a \$0.3 million decrease in network and carrier charges primarily as a result of lower usage.

These decreases were partially offset by an increase of \$0.2 million in UCaaS costs primarily reflecting the reclassification of software support costs from general and administrative costs to cost of revenues.

### Operating Expenses

Total operating expenses were \$8.1 million and \$9.8 million for three months ended September 30, 2018 and 2017, respectively, representing a decrease of \$1.7 million, or 17.9%. This change in operating expenses is primarily attributable to:

- a \$1.2 million decrease in marketing expense, primarily related to reduced media buys for the Core Consumer segment,
- a \$1.1 million decrease in General and Administrative (“G&A”) expense, primarily related to the Core Consumer segment and primarily composed of:
  - i. \$0.3 million decrease in legal expense related to 2017 costs associated with responding to activist shareholders and costs associated with the strategic process,
  - ii. \$0.3 million decrease in professional fees related to the expiration of certain consulting agreements with members of the prior senior management team, and
  - iii. approximately \$0.2 million related to costs associated with terminated initiatives.

These decreases were partially offset by an increase of \$0.9 million reflecting a consideration adjustment / gain on mark-to-market that occurred in 2017 that did not recur in 2018.

### Income Taxes

Total income tax expense was \$1.4 million and \$1.6 million for the three months ended September 30, 2018 and 2017, respectively. The calculation of our effective income tax rate for the three months ended September 30, 2018 and 2017 was (in thousands):

| Three Months<br>Ended<br>September 30, |      |
|--|------|
| 2018                                   | 2017 |



|                                       |         |         |
|---------------------------------------|---------|---------|
| Net income (loss) before income taxes | \$4,568 | \$4,025 |
| Income tax (benefit) expense          | 1,383   | 1,574   |
| Effective income tax rate             | 30.28%  | 39.11%  |

We primarily operate in the U.S. and Israel, and our Israeli operations were subject to a statutory income tax rate of 24% in 2017, which declined to 23% in 2018 and is higher than our U.S. federal income tax rate anticipated to be 21% as of September 30, 2018.

For the three months ended September 30, 2018, we recorded income tax expense of \$1.4 million, which is higher than the expected tax expense of \$1.0 million, using the statutory income tax rate of 21% due in part, to increases to uncertain tax positions of \$0.2 million and \$0.2 million related to the adjustment of the 2017 tax provision to reflect the actual return filed. The effective tax rate was also impacted by state taxes in the United States and the higher jurisdictional tax rate charged on the operating income of the Company's Israeli operations.

The 2018 estimated annual effective tax rate is expected to approximate 21.9%, excluding discrete tax items, but may fluctuate during the year due to changes in our jurisdictional income and due to the timing of other discrete period transactions.

#### Net Income (Loss)

As a result of the foregoing items, net income increased to \$3.2 million in the three months ended September 30, 2018, as compared to \$2.5 million in the three months ended September 30, 2017. Net income per diluted ordinary share was \$0.20 for the three months ended September 30, 2018, as compared to \$0.15 for the three months ended September 30, 2017. Although revenues were lower in the current year, the decrease was offset by operating expense savings as compared to the high operating expenses in 2017 related to response to activist shareholders, costs associated with the strategic process and management changes as well as lower marketing spend in 2018 as compared to 2017.

NINE MONTHS ENDED SEPTEMBER 30, 2018 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2017

## Revenues

Total revenues were \$59.5 million and \$67.2 million for the nine months ended September 30, 2018 and 2017, respectively, representing a decrease of \$7.7 million, or 11.5%. The decrease in the components of revenues was primarily attributable to the following:

- a \$2.6 million decrease in revenues from the sale of magicJack devices primarily reflecting lower sales volume and the adoption of ASC 606. Refer to Note 11, "Revenue" in the Notes to our unaudited condensed consolidated financial statements included in Item 1 herein for further details;
- a \$2.3 million decrease in access right renewal revenues reflecting customer churn;
- a \$0.4 million decrease in shipping and handling revenues primarily due to lower sales volume;
- a \$0.6 million decrease in revenues from magicJack-related products and services primarily due to lower sales volume;
- a \$0.7 million decrease in revenues from prepaid minutes resulting from lower usage levels;
- a \$0.7 million decrease in revenues from access and wholesale charges due to lower network traffic; and
- a \$0.4 million decrease in revenues from UCaaS due to customer churn.

For the nine months ended September 30, 2018 and 2017, sales of the magicJack devices through retail outlets represented approximately 63% and 52%, respectively, of sales of all magicJack devices sold. For the same periods, direct sales represented approximately 37% and 48%, respectively, of magicJack devices sold. For the nine months ended September 30, 2018 and 2017, no retailer accounted for more than 10% of the Company's total revenue.

## Cost of Revenues

Total cost of revenues was \$21.3 million and \$25.4 million for the nine months ended September 30, 2018 and 2017, respectively, representing a decrease of approximately \$4.2 million, or 16.5%. This decrease in cost of revenues was primarily attributable to:

- a \$2.4 million decrease in the cost of devices and related products primarily reflecting lower sales volumes,
- a \$0.6 million decrease in shipping and handling costs due to lower direct sales volume and reduction in costs following the outsourcing of the fulfillment function in the fourth quarter of 2017,
- a \$1.1 million decrease in network and carrier charges primarily as a result of lower usage, and
- a \$0.4 million decrease in UCaaS costs primarily attributable to the successful transition of the customer base to the Company's Core network for customer call termination and lower amortization expense related to impaired assets, partially offset by software support costs reclassified from general and administrative costs.

These decreases were partially offset by an increase of \$0.4 million in other cost of revenues primarily due to year-over-year changes to personnel related cost allocations.

## Operating Expenses

Total operating expenses were \$26.4 million and \$71.2 million for nine months ended September 30, 2018 and 2017, respectively, representing a decrease of \$44.8 million, or 62.9%. This change in operating expenses is primarily attributable to:

- a \$3.7 million decrease in marketing expense, primarily related to reduced media buys for the Core Consumer segment,
- a \$10.2 million decrease in General and Administrative (“G&A”) expense due to several factors including:
  - i. a \$9.4 million decrease in costs related to the Core Consumer segment, primarily composed of:
    - § \$2.8 million decrease in legal and regulatory related expense associated with responding to activist shareholders and costs associated with the strategic process,
    - § \$2.1 million decrease in personnel related expenses primarily reflecting 2017 severance and new executive officer compensation accruals including accruals for anticipated sign-on bonuses,
    - § \$1.6 million decrease in professional fees related to cost incurred related to the expiration of certain consulting agreements with members of the prior senior management team,
    - § \$0.6 million decrease in chat services primarily attributable to the restructuring of our customer service function,
    - § approximately \$1.1 million related to costs associated with terminated initiatives
    - § \$0.6 million decrease in facility, travel and other administrative costs related to management’s cost savings initiatives and
    - § \$0.5 million asset impairment primarily related to our 2017 exit from our joint venture in the home consumer product market; and
  - ii. a \$0.9 million decrease in costs related to the Enterprise segment, reflecting approximately \$0.4 million in lower compensation costs, including stock-based compensation expense, related to the departure of the Broadsmart founders, approximately \$0.2 million in lower expense related to consultants and professional fees and approximately \$0.3 million in software support and maintenance expense reclassified to cost of revenues, and lower facility related costs.
- a \$31.5 million impairment of intangible assets, including goodwill, related to the Enterprise segment in 2017 compared to a \$0.1 million impairment of intangible assets in 2018. Refer to Note 5, “Intangible Assets” and Note 6, “Goodwill” in the Notes to our unaudited condensed consolidated financial statements included in Item 1 herein for further details.

## Income Taxes

Total income tax expense (benefit) was \$3.0 million and (\$7.2) million for the nine months ended September 30, 2018 and 2017, respectively. The calculation of our effective income tax rate for the nine months ended September 30, 2018 and 2017 was (in thousands):

|                                       | Nine Months Ended<br>September 30, |            |
|---------------------------------------|------------------------------------|------------|
|                                       | 2018                               | 2017       |
| Net income (loss) before income taxes | \$ 12,247                          | \$(29,405) |
| Income tax (benefit) expense          | 3,000                              | (7,194 )   |
| Effective income tax rate             | 24.50 %                            | 24.47 %    |

We primarily operate in the U.S. and Israel, and our Israeli operations were subject to a statutory income tax rate of 24% in 2017, which declined to 23% in 2018 and is higher than our U.S. federal income tax rate anticipated to be 21% as of September 30, 2018.

For the nine months ended September 30, 2018, we recorded income tax expense of \$3.0 million, which is higher than the expected tax expense of \$2.6 million using the statutory income tax rate of 21% due primarily to increases in our uncertain tax positions of \$0.1 million and a return to provision adjustment related to our 2017 U.S. tax return of \$0.2 million.

The 2018 estimated annual effective tax rate is expected to approximate 21.4%, excluding discrete tax items, but may fluctuate during the year due to changes in our jurisdictional income or other factors.

## Net Income (Loss)

As a result of the foregoing items, net income increased to \$9.2 million in the nine months ended September 30, 2018, as compared to a net loss of (\$22.2) million in the nine months ended September 30, 2017. Net income per diluted ordinary share was \$0.57 for the nine months ended September 30, 2018, as compared to (\$1.38) for the nine months ended September 30, 2017. The change was primarily due to the 2017 impairment of the Enterprise segment intangible assets and high operating expenses related to response to activist shareholders, the strategic process, management changes and investments made in the SMB segment incurred in 2017.

## BUSINESS TRENDS

Revenues in our Core Consumer segment continued to decline during the three and nine months ended September 30, 2018. However, we were able to control costs and generate positive operating cash flows and net income. We remain encouraged by the loyalty of our existing customer base and we continue to undertake efforts to improve retention, invest in new product development and innovation, capitalize on our strong retail distribution, and optimize the marketing of our magicJack products. During 2018, we have refocused on our magicJack for Business (“mJB”) product offerings for small businesses, making improvements to our web-site buy-flow and integration with our internal provisioning systems, to enable new small business customers to buy our product directly from our website, and have their purchased products and services configured and shipped without the need for any agent contact. We have also maintained efforts to improve our mJB mobile app, offering improved HD voice quality and user account management. Additionally, we continue to focus on customer care and satisfaction, introducing new free feature enhancements based on user feedback, such as functionality to allow our customers to screen out incoming calls from automated dialers (“robo-caller”), and functionality to enable our customers to instantly renew their service plans. During the first quarter our Better Business Bureau rating improved to A+. We believe that because of our brand

awareness, and our vertically integrated operations and Competitive Local Exchange Carrier (“CLEC”) network with significant excess capacity, we can effectively compete for residential and small business customers. We remain firm in our belief that there will continue to be solid demand for our low priced, unlimited phone service, whether through our magicJack devices, our mobile apps, our small business offerings or a combination of all three.

In our Enterprise segment, we are maintaining our efforts to improve the segment’s operating results and bolster integration efforts. We continue to focus on improving customer churn and expanding sales channels and sales for the Enterprise segment. UCaaS business is down from the prior year as revenues from new customers were not enough to offset the loss of Broadsmart’s second largest customer during the second half of 2017. Our ability to limit customer churn and continue to expand our sales channels are critical to the future success of the Enterprise segment.

Throughout the Company, we continue our work to consolidate operations, control costs and eliminate redundant functions across our business lines.

## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash generated from operations, cash on hand and investments. As of September 30, 2018, we had cash and cash equivalents of \$62.1 million, investments of \$0.4 million and net accounts receivable of \$2.2 million. Our accounts payable at September 30, 2018 were \$2.9 million.

During the nine months ended September 30, 2018, we generated operating cash flows of \$9.6 million, as compared to \$0.3 million for the nine months ended September 30, 2017. The \$9.3 million improvement reflects savings in marketing and general and administrative expenses, primarily related to lower media spend and costs incurred in the prior year that were not incurred in the current year related to; investments in the SMB and Enterprise segments, costs associated with executive management turn-over, the strategic process and management's response to activist shareholder initiatives. Additionally, we made a payment of \$3.1 million for estimated income taxes in the nine months ended September 30, 2017 compared to payments of \$1.8 million in the nine months ended September 30, 2018. These cost savings were partially offset by lower revenues in the Core Consumer magicJack business during the nine months ended September 30, 2018. Net income for the nine months ended September 30, 2018 was \$9.2 million as compared to a net loss of (\$22.2) million for the nine months ended September 30, 2017.

We currently believe that available funds and cash flows generated by operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months. If we decide to make future acquisitions, we may require new sources of funding, including debt, equity financing or some combination thereof. There can be no assurances that we will be able to secure additional sources of funding or that such additional sources of funding will be available to us on acceptable terms.

### Cash Flow – Operating Activities

Net cash provided by operating activities was \$9.6 million for the nine months ended September 30, 2018. Net cash provided by operating activities was \$0.3 million for the nine months ended September 30, 2017.

During the nine months ended September 30, 2018, net cash provided by operating activities was primarily attributable to:

- \$9.2 million of net income, which included \$6.0 million in non-cash items, consisting primarily of (i) \$2.6 million of depreciation and amortization expense, and (ii) \$2.8 million of stock-based compensation expense; and

- Changes in operating assets and liabilities of (i) a \$0.3 decrease in accounts payable, (ii) a \$1.2 million decrease in accrued expenses and other current liabilities, and (iii) a \$5.7 million decrease in deferred revenue/contract liabilities. These items were partially offset by (i) a \$1.1 million decrease in prepaid income taxes and (ii) a \$0.5 million decrease in deposits and other current assets.

During the nine months ended September 30, 2017, net cash provided by operating activities was primarily attributable to:

- (\$22.2) million of net loss, which included \$31.0 million in non-cash items, consisting primarily of (i) \$31.5 million impairment loss on intangible assets, including goodwill, of the Enterprise reporting unit, (ii) \$3.4 million of depreciation and amortization expense, (iii) \$2.1 million of stock-based compensation expense, and (iv) a \$1.8 million increase in uncertain tax positions, partially offset by a \$7.9 million deferred income tax benefit; and

- Changes in operating assets and liabilities of (i) a \$2.5 million increase in prepaid income taxes, (ii) a \$0.7 million increase in deposits and other current assets, (iii) a \$9.4 million decrease in deferred revenue, (iv) a \$2.4 million decrease in accrued expenses and other current liabilities, and (v) a \$1.0 million decrease in other non-current

liabilities. These items were partially offset by (i) a \$0.6 million decrease in accounts receivable, ii) a \$2.3 million decrease in inventory levels, iii) a \$2.0 million decrease in receivable from earnout escrow and iv) a \$0.6 million increase in accounts payable.

#### Cash Flow – Investing Activities

No significant cash was used in or provided by financing activities for the nine months ended September 30, 2018. Net cash used in investing activities was \$1.1 million for the nine months ended September 30, 2017, primarily related to purchases of software licenses.

#### Cash Flow –Financing Activities

No significant cash was used in or provided by financing activities for the nine months ended September 30, 2018 and 2017.

#### Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements as of September 30, 2018.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

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

Exposure to Interest Rates

The primary objective of our investment activities is to preserve our capital until it is required to fund operations while at the same time maximizing the income we receive from our investments without incurring investment market volatility risk. Our investment income is sensitive to the general level of United States interest rates. In this regard, changes in the United States interest rates affect the interest earned on our cash and cash equivalents. Due to the short-term nature of our cash and cash equivalent holdings, a 10% movement in market interest rates would not materially impact the total fair value of our portfolio as of September 30, 2018.

Exposure to Exchange Rates

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

Exposure to Equity and Derivative Prices

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

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2018, there were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

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

ITEM 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017.

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

Not applicable.

ITEM 3. Defaults Upon Senior Securities

Not applicable.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

Not applicable.

ITEM 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u>   |
|--------------------|--|
| <u>3.1</u>         | <u>Amended and Restated Articles of Association (incorporated by reference to Exhibit 3.1 to the Company's Annual Report on Form 10-K filed with the SEC on April 2, 2013)</u>       |
| <u>10.1</u>        | <u>Amendment No. 1 to Agreement and Plan of Merger (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q filed with the SEC on May 10, 2018)</u> |
| <u>31.1</u>        | <u>Certification of CEO of magicJack VocalTec Ltd. required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934.</u>                                       |
| <u>31.2</u>        | <u>Certification of CFO of magicJack VocalTec Ltd. required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934.</u>                                       |
| <u>32.1</u>        | <u>Certification of CEO of magicJack VocalTec Ltd. required by Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934.</u>  |
| <u>32.2</u>        | <u>Certification of CFO of magicJack VocalTec Ltd. required by Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934.</u>  |

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SIGNATURES

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

magicJack VocalTec Ltd.  
(Registrant)

By: /s/ Don C. Bell, III

Dated: November 9, 2018 Don C. Bell, III  
President and Chief Executive Officer

By: /s/ Thomas Fuller

Dated: November 9, 2018 Thomas Fuller  
Executive Vice President and Chief Financial Officer

Exhibit Index

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

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

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

32.2 Certification  
of CFO of  
magicJack

VocalTec  
Ltd.  
required by  
Rule  
13a-14(b) or  
Rule  
15d-14(b)  
of the  
Securities  
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Act of 1934.