

MAGICJACK VOCALTEC LTD
Form 10-Q
May 09, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended March 31, 2013

OR

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

For transition period from _____ to _____

Commission file number: 000-27648

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

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

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

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

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

Yes ☒ No ☐

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

post such files).

Yes ☒ No ☐

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

Large Accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting Company ☐

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

Yes ☐ No ☒

There were 18,551,520 shares of ordinary shares with no par value outstanding at April 30, 2013.

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DEFINITIONS

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

- references to “magicJack VocalTec,” the “Company,” “we,” “us” or “our” are to magicJack VocalTec Ltd., a company organized under the laws of the State of Israel (the “Registrant”), and its subsidiaries;
- references to “ordinary shares”, “our shares” and similar expressions refer to the Registrant’s Ordinary Shares, no par value;
- references to “\$” or “dollars” are to U.S. dollars and all references to “NIS” are to New Israeli Shekels. Except as otherwise indicated, financial statements of, and information regarding, magicJack VocalTec are presented in U.S. dollars;
 - references to the “Exchange Act” are to the Securities Exchange Act of 1934, as amended;
 - references to “NASDAQ” are to the NASDAQ Global Stock Market; and
 - references to the “SEC” are to the United States Securities and Exchange Commission.

PART I – FINANCIAL INFORMATION

ITEM 1. Consolidated Financial Statements

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

	March 31, 2013 (Unaudited)	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$40,247	\$18,959
Marketable securities, at fair value	8,634	19,390
Accounts receivable, net of allowance for doubtful accounts and billing adjustments of \$21,718 and \$20,498, respectively	5,035	6,004
Inventories	5,142	5,340
Deferred costs	7,170	7,066
Deferred tax assets, current	1,843	1,114
Deposits and other current assets	957	1,411
Total current assets	69,028	59,284
Property and equipment, net	2,308	2,348
Intangible assets, net	15,211	16,136
Goodwill	32,304	32,304
Deferred tax assets, non-current	9,831	9,831
Deposits and other non-current assets	829	864
Total assets	\$129,511	\$120,767
LIABILITIES AND CAPITAL DEFICIT		
Current liabilities:		
Accounts payable	\$7,758	\$3,651
Accrued expenses and other current liabilities	7,779	13,569
Deferred revenue, current portion	74,272	67,038
Total current liabilities	89,809	84,258
Deferred revenue, net of current portion	53,700	58,165
Other non-current liabilities	3,958	3,114
Total liabilities	147,467	145,537
Commitments and contingencies (Note 9)		
Capital deficit:		
Ordinary shares, No par value; 100,000 shares authorized; 24,728 shares issued and outstanding	108,048	108,048
Additional paid-in capital	1,630	1,729
Accumulated other comprehensive loss	(2,213)	(1,494)
Treasury stock (6,176 and 6,018 shares, respectively)	(95,495)	(93,541)
Accumulated deficit	(29,926)	(39,512)
Total capital deficit	(17,956)	(24,770)

Total liabilities and capital deficit	\$ 129,511	\$ 120,767
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See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended March 31,	
	2013	2012
	(Unaudited)	(Unaudited)
Net revenues	\$36,877	\$37,587
Cost of revenues	11,143	15,560
Gross profit	25,734	22,027
Operating expenses:		
Advertising	2,814	8,704
General and administrative	6,818	6,834
Research and development	862	658
Total operating expenses	10,494	16,196
Operating income	15,240	5,831
Other income (expense):		
Gains on investments	527	597
Interest and dividend income	156	251
Interest expense	(93)	(119)
Fair value (loss) gain on common equity put options	(1,047)	1,656
Other income, net	1	10
Total other (expense) income	(456)	2,395
Income before income taxes	14,784	8,226
Income tax expense	5,198	30
Net income	\$9,586	\$8,196
Income per ordinary share:		
Basic	\$0.51	\$0.39
Diluted	\$0.51	\$0.39
Weighted average ordinary shares outstanding:		
Basic	18,685	21,092
Diluted	18,694	21,240

See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended March 31,	
	2013	2012
	(Unaudited)	(Unaudited)
Net income	\$9,586	\$8,196
Other comprehensive income (loss):		
Reclassification of unrealized loss on marketable securities to gain on investments	362	272
Net unrealized (loss) gain on marketable securities	(1,081)	191
Comprehensive income	\$8,867	\$8,659

See accompanying notes to condensed consolidated financial statements.

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

	Ordinary Shares		Accumulated		Treasury Stock		Accumulated	Total
	Number	Amount	Additional Paid-in Capital	Other Comprehensive Loss	Number	Amount	Deficit	Capital Deficit
Balance, January 1, 2013	24,728	\$ 108,048	\$ 1,729	\$ (1,494)	(6,018)	\$ (93,541)	\$ (39,512)	\$ (24,770)
Treasury stock issued to settle liability	-	-	(99)	-	32	499	-	400
Purchase of treasury stock	-	-	-	-	(190)	(2,453)	-	(2,453)
Unrealized loss on marketable securities	-	-	-	(719)	-	-	-	(719)
Net income	-	-	-	-	-	-	9,586	9,586
Balance, March 31, 2013 (unaudited)	24,728	\$ 108,048	\$ 1,630	\$ (2,213)	(6,176)	\$ (95,495)	\$ (29,926)	\$ (17,956)

See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended March 31,	
	2013	2012
	(Unaudited)	(Unaudited)
Cash flows from operating activities:		
Net income	\$9,586	\$8,196
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts and billing adjustments	1,237	2,622
Share-based issuance to settle liability	400	225
Depreciation and amortization	1,163	629
Deferred income tax provision	23	24
Interest expense - non-cash	93	119
Gain on investments	(527)	(597)
Fair value loss (gain) on common equity put options	1,047	(1,656)
Contributed services	-	20
Change in operating assets and liabilities		
Accounts receivable	(268)	(3,500)
Inventories	198	1,439
Deferred costs	(104)	(1,423)
Deposits and other current assets	454	(581)
Deposits and other non-current assets	17	155
Accounts payable	4,107	(3,710)
Accrued expenses and other current liabilities	(3,568)	2,494
Deferred revenue	2,769	19,707
Other non-current liabilities	(1)	-
Net cash provided by operating activities	16,626	24,163
Cash flows from investing activities:		
Purchases of investments	-	(24,462)
Proceeds from sales of investments	10,564	23,192
Purchases of property and equipment	(84)	-
Acquisition of intangible assets	(114)	(1,013)
Net cash provided by (used in) by investing activities	10,366	(2,283)
Cash flows from financing activities:		
Purchase of treasury stock	(5,704)	(4,882)
Proceeds from sale of common equity put options	-	1,561
Proceeds from exercise of ordinary share options	-	659
Net cash used in financing activities	(5,704)	(2,662)
Net increase in cash and cash equivalents	21,288	19,218
Cash and cash equivalents, beginning of period	18,959	12,961
Cash and cash equivalents, end of period	\$40,247	\$32,179

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

	For the Three Months Ended March 31,	
	2013	2012
	(Unaudited)	(Unaudited)
Supplemental disclosures:		
Interest paid	\$-	\$-
Income taxes paid	\$1,913	\$2
Non-cash investing and financing activities:		
Ordinary shares issued for purchase of intangible asset	\$-	\$400

See accompanying notes to condensed consolidated financial statements.

MAGICJACK VOCALTEC LTD. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Information as of March 31, 2013 and for the Three Months Periods
Ended March 31, 2013 and 2012 is Unaudited

NOTE 1 –DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

magicJack VocalTec Ltd. and its Subsidiaries (the “Company”) is a cloud communications leader that is the inventor of voice-over-Internet-Protocol (“VoIP”), the softphone, the magicJack®, the magicJack PLUSTM and other magicJack products and services. magicJacks weigh about one ounce and plug into the USB port on a computer or into a power adapter and high speed Internet source, providing users with complete phone service for home, enterprise and while traveling. The Company charges as low as \$20 a year for a right (the “access right”) to access its servers, and the Company's customers then continue to have the ability to obtain free telephone services. The Company also provides additional products and services, which include voice apps on smart phones, as well as the magicJack PLUS, which is a standalone magicJack that 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 Company's products and services allow users to make and/or receive free telephone calls to and from anywhere in the world where the customer has broadband access to the Internet, and allow customers to make free calls back to the United States and Canada from anywhere legally permitted in the world.

magicJack VocalTec is a vertically integrated group of companies. The Company owns a micro processor chip design company, an appserver and session border controller company, a wholesale provider of VoIP services, a softphone company, and the developer and provider of the magicJack product line. The Company intends to expand these existing platforms to allow its customers to use search, shopping, click-to-call and other services via the Internet through intellectual property rights pending and proprietary technologies. The Company also wholesales telephone service to VoIP providers and telecommunication carriers.

The Company was incorporated in the State of Israel in 1989 and is domiciled in Netanya, Israel.

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-K. 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, 2012. Management believes, however, that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included.

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

The Company prepares its unaudited condensed consolidated financial statements on the basis of being a single reporting entity. Over 90% of the Company's revenues in the three months ended March 31, 2013 and 2012 were derived from sales to customers located in the United States. The majority of the Company's revenues were generated from sales of the magicJack product line and from the software access right that accompanies these products, which were \$32.1 million and \$28.9 million for the three months ended March 31, 2013 and 2012, respectively. The Company also provides its customers the ability to make prepaid calls using the magicJack, magicJack PLUS and magicJack APP by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were \$3.2 million and \$5.8 million for the three months ended March 31, 2013 and 2012, respectively. In February 2012, the Company made an operational change which allowed it to identify the point in time when prepaid minutes expire under the terms of service and approximately \$3.0 million attributable to prepaid minutes that expired between February 2008 and February 2012 were reversed from deferred revenue and recognized as revenue during the quarter ended March 31, 2012 since such amounts were considered earned. As a result, the Company's diluted earnings per ordinary share for the three months ended March 31, 2012 were increased by approximately \$0.15 per ordinary share.

The Company has evaluated all subsequent events through the date the accompanying unaudited consolidated financial statements were issued.

Basis of Consolidation

The Company's unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries, YMax Corporation, YMax Communications Corp., magicJack Holdings Corporation, magicJack, LP, SJ Labs, Inc., Tiger Jet Network, Inc., VocalTec Communications, LLC ("VocalTec US", formerly Stratus Telecommunications, LLC), and Predictive Marketing, LLC and B Kruse and Associates, LLC (collectively, "Dialmaxx"). All intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications may have been made to prior period financial statement amounts to conform to the current presentation. The results for the three months ended March 31, 2013 may not be indicative of the results for the entire year. 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, 2012 filed on April 2, 2013.

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. Significant estimates include allowances for billing adjustments and doubtful accounts, the recoverability of long-lived assets and goodwill, income tax valuation allowance (and related matters), the expected forfeitures of ordinary share options and estimates of likely outcomes related to certain contingent liabilities.

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

Revenues

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

Revenue Recognition

magicJack and magicJack PLUS Revenue

The Company recognizes revenues from sales and shipping of direct sales of the magicJack and magicJack PLUS over the period associated with the initial 12-month access right period. Customers may purchase access rights for continued use of its software to access the Company's servers for additional years either when the original purchase is made, or at any time thereafter. The revenue associated with the access right for additional years is deferred and recognized ratably over the extended access right period.

Sales Return Policy

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

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. The Company estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the three months ended March 31, 2013 and 2012, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

Telephony Services Revenue

Telephony revenue is recognized as minutes are used. Telephony revenue is generated from the usage of prepaid minutes, fees for origination of calls to 800-numbers and access fees charged to other telecommunication carriers on a per-minute basis for Interexchange Carriers (“IXC”) calls terminated on the Company’s servers. Revenues from access fee charges to other telecommunication carriers are recorded based on rates set forth in the respective state and federal tariffs, less a provision for billing adjustments of \$1.2 million and \$2.2 million for the three months ended March 31, 2013 and 2012, respectively.

Deferred Revenues

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

Cost of Revenues

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

Direct costs of purchased telecommunications hardware are charged to cost of sales as products are delivered and the related sale is recognized. Direct costs associated with software development until the technological feasibility has been established, modifications to customer specifications, warranty and maintenance service, and upgrades are charged to expense as incurred. All telecommunication hardware is provided by third-party original equipment manufacturers, which also provide the products’ warranties. The Company does not support or enhance these warranties.

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were \$1.4 million and \$2.1 million for the three months ended March 31, 2013 and 2012, respectively.

Allowance for Doubtful Accounts and Billing Adjustments

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

Marketable Securities and Other Investments

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

Securities sold, not yet purchased are considered liabilities, and are included in accrued expenses and other current liabilities in the accompanying unaudited condensed consolidated balance sheets. These liabilities are recorded at fair value with any unrealized gains and losses recognized as gains or losses on investments in the Company's unaudited condensed consolidated statements of operations as the Company is liable for the current market price as of the balance sheet date.

Common Equity Put Options

Common equity put option (“put option”) contracts sold in connection with the Company’s share repurchase program may expire unexercised or be assigned to the Company on or before the contract expiration date. Put option contracts exercised result in the Company purchasing its ordinary shares. Put option contracts outstanding at the end of a period are liabilities under ASC Subtopic 480-10, “Distinguishing Liabilities from Equity,” and are included in accrued expenses and other current liabilities in the Company’s unaudited condensed consolidated balance sheets. These liabilities are marked-to-market at the unadjusted quoted prices in active markets for identical assets, which are Level 1 inputs. Any unrealized gains or losses are recognized as fair value gains (losses) on common equity put options in the Company’s unaudited condensed consolidated statements of operations.

Certain Risks and Concentrations

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

The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the FDIC up to \$250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at each Israeli bank are not insured. We have never experienced any losses related to these balances. At March 31, 2013, the Company had cash and cash equivalents totaling \$40.2 million, which included (i) \$40.0 million in U.S. banks, and (ii) \$0.2 million in an Israeli financial institution.

The Company’s non-interest bearing cash balances in U.S. banks, which included \$4.5 million in one individual financial institution, were fully insured, except for \$2.6 million that exceed insurance limits at March 31, 2013. The Company had money market accounts with a brokerage institution with balances totaling approximately \$35.5 million, which is covered by Securities Investor Protection Corporation (SIPC). The Company places its cash and cash equivalents with high quality financial institutions and management believes the Company is not exposed to any significant risk on its cash accounts.

One telecommunication carrier accounted for approximately 66% and 63% of gross accounts receivable at March 31, 2013 and December 31, 2012, respectively. For the three months ended March 31, 2013 and 2012, no telecommunication carrier accounted for more than 10% of the Company’s total net revenue.

No U.S. retail customer accounted for more than 10% of gross accounts receivable at March 31, 2013 and December 31, 2012. For the three months ended March 31, 2013 and 2012, no retailer accounted for more than 10% of the Company’s total net revenue.

Fair Value

GAAP establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company’s assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

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

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

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

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

When available, the Company uses quoted market prices to determine fair value, and it classifies such measurements within Level 1. Fair value measurements are classified according to the lowest level input or value-driver that is significant to the valuation. Fair value includes the consideration of nonperformance risk. Nonperformance risk refers to the risk that an obligation (either by a counterparty or the Company) will not be fulfilled. For the Company's financial assets traded in an active market (Level 1), the nonperformance risk is included in the market price. The Company's assets and liabilities measured on a recurring basis at fair value may include marketable securities, securities sold, not yet purchased, and common equity put options in the Company's own stock. As of March 31, 2013 and December 31, 2012, all of them are Level 1 instruments, except for debt securities, which are level 2 instruments. The fair value of Level 2 securities is estimated based on observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts payable and accrued expenses are expected to approximate fair value because of their immediate availability, near term maturities or potential interest payments at settlement.

In connection with the Company's purchase of certain intangible assets during June 2011, the Company made payments of \$1.5 million in May 2011 and May 2012, respectively, and is required to make non-interest bearing annual future payments of \$1.5 million for each of the next three years, beginning May 31, 2013. The liability for such payments has been discounted at a rate of 10% to a total fair value of \$ \$4.0 million and \$3.9 million at March 31, 2013 and December 31, 2012, respectively, with \$1.5 million included in accrued expenses and other current liabilities at March 31, 2013 and December 31, 2012, and \$2.5 million and \$2.4 million included in other non-current liabilities in the Company's March 31, 2013 and December 31, 2012 unaudited condensed consolidated balance sheets, respectively. The Company believes that the \$4.0 million carrying value at March 31, 2013 approximates fair value based on observable market inputs other than quoted prices for similar traded debt securities, which are Level 2 instruments. The \$0.5 million unamortized discount at March 31, 2013 is being amortized using the effective interest method and recorded as interest expense in the Company's unaudited condensed consolidated statements of operations.

Any unrealized gains or losses related to put option contracts sold in connection with the Company's share repurchase program are recognized as fair value gains (losses) on common equity put options in the Company's unaudited condensed consolidated statements of operations. These liabilities are marked-to-market at the unadjusted quoted prices in active markets for identical assets, which are Level 1 inputs. As of March 31, 2013, there were no common equity put options outstanding. At December 31, 2012, outstanding common equity put options had a fair value of \$2.2 million, which was included in accrued expenses and other current liabilities in the Company's unaudited condensed consolidated balance sheet.

Property, Equipment and Depreciation Expense

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

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

Long-lived assets, such as property, plant and equipment, and purchased intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management believes there is no impairment at March 31, 2013.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired. Goodwill and other intangible assets with indefinite lives are not amortized to operations, but instead are reviewed for impairment at least annually, or when there is an indicator of impairment. The Company is currently defined as one reporting unit.

The goodwill impairment test is a two-step test. Under the first step, the fair value of the reporting unit is compared with its carrying value (including goodwill). Since the Company has negative carrying value, we apply the guidance in

ASC No. 2010-28,” Intangibles-Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts,” (“ASU 2010-28”) to determine whether Step 2 is required. ASU 2010-28 modified current guidance such that Step 2 of the goodwill impairment test must be performed for reporting units with zero or negative carrying amounts if qualitative factors indicate that it is more likely than not that a goodwill impairment exists. Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit’s goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. It is Company’s policy to conduct impairment testing based on its current business strategy in light of present industry and economic conditions, as well as its future expectations.

The Company evaluates the carrying value of its goodwill annually or more frequently if impairment indicators arise. 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.

In connection with the Company's annual goodwill impairment analysis, as of October 1, 2012, the annual measurement date, the Company's analysis did not indicate any impairment of goodwill has occurred. There were no goodwill impairment indicators as of March 31, 2013.

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted rates or tax laws are included in the provision for income taxes in the period of enactment. The Company's net deferred tax assets consist of primarily foreign net operating loss carryforwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. At December 31, 2012, the Company, based on cumulative profitability over the preceding three years and expected 2013 results, released \$10.9 million of the valuation allowance recorded against its net deferred tax assets and determined that a remaining valuation allowance of \$55.4 million was necessary to reduce the net deferred tax assets to the amount that will more likely than not be realized. The Company periodically reviews the composition of its' net deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. No adjustments were made during the three months ended March 31, 2013.

The Company assesses its income tax positions and records tax benefits for all years subject to examination based upon its evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where there is greater than 50% likelihood that a tax benefit will be sustained, the Company has recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where there is 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements.

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 elimination of nontaxable items. The tax benefits of net operating loss carryforwards expected to be realized through 2013 and certain other deferred tax assets were recognized for financial reporting purposes at December 31, 2012. At March 31, 2013, the estimated annual effective tax rate is expected to approximate 35.2%, which includes state and local taxes. This rate may fluctuate due to the timing of other discrete period transactions during the remainder of the year.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") No. 2013-02, Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income ("ASU 2013-02"). ASU 2013-02 requires an entity to present, either on the face of the statement where net income is presented or in the notes to the financial statements, significant amounts reclassified out of accumulated other comprehensive income (loss) by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. Amounts that are not required to be reclassified

in their entirety to net income must be cross-referenced to other disclosures that provide additional detail. This guidance was effective on a prospective basis for the annual and interim reporting periods for the Company beginning January 1, 2013. The Company's adoption of this standard did not have a significant impact on its consolidated financial statements. The Company's accumulated other comprehensive loss is comprised of one item pertaining to the Company's unrealized gains and losses on marketable securities. Reclassification of the gains or losses occurs when the specific investments are sold.

NOTE 3 – MARKETABLE SECURITIES

The Company's marketable securities are classified as available-for-sale. As of March 31, 2013 and December 31, 2012, the available-for-sale securities consisted primarily of debt and equity securities, which are invested in the following (in thousands):

	March 31, 2013 (Unaudited)		
	Fair Value	Unrealized Gains	Unrealized Losses
Common equity securities	\$ 6,640	\$ -	\$ (2,417)
Debt securities	1,994	204	-
Total	\$ 8,634	\$ 204	\$ (2,417)

	December 31, 2012		
	Fair Value	Unrealized Gains	Unrealized Losses
Common equity securities	\$ 7,983	\$ -	\$ (1,074)
Debt securities	11,407	-	(420)
Total			