MAGICJACK VOCALTEC LTD
Form 10-Q
August 09, 2016

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 June 30, 2016

OR

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

For transition period from __________ to __________

Commission file number: 000-27648

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

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

12 HAOMANUT STREET, 1ST 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

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

Large Accelerated filer	Accelerated filer
Non-accelerated filer (do not check if a smaller reporting company)	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 15,855,362 ordinary shares with no par value outstanding at July 31, 2016.

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DEFINITIONS

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

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

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PART I – FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

	June 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 46,681	$ 78,589
Investments, at fair value	447	367
Accounts receivable, net of allowance for doubtful accounts and billing adjustments of $536 and $455, respectively	2,627	2,925
Inventories	4,430	5,723
Deferred costs	1,822	2,097
Prepaid income taxes	852	2,747
Deposits and other current assets	2,752	2,655
Total current assets	59,611	95,103
Property and equipment, net	3,773	3,302
Intangible assets, net	31,419	6,687
Goodwill	47,485	32,304
Deferred tax assets, non-current	29,829	30,689
Deposits and other non-current assets	887	751
Total assets	$ 173,004	$ 168,836
LIABILITIES AND CAPITAL EQUITY		
Current liabilities:		
Accounts payable	$ 1,549	$ 1,086
Accrued expenses and other current liabilities	6,369	6,284
Deferred revenue, current portion	50,389	52,554
Total current liabilities	58,307	59,924
Deferred revenue, net of current portion	47,484	50,146
Other non-current liabilities	12,369	11,098
Total liabilities	118,160	121,168
Commitments and contingencies (Note 9)		
Capital equity		
Ordinary shares, No par value; 100,000 shares authorized; 25,037 and 25,036 shares issued at June 30, 2016 and December 31, 2015, respectively	111,774	111,773
Additional paid-in capital	14,750	14,573
Treasury stock (9,182 and 9,426 shares at June 30, 2016 and December 31, 2015, respectively)	(123,023)	(126,772)
Retained earnings	51,647	48,094
Total magicJack VocalTec, LTD. shareholders's equity	55,148	47,668

Noncontrolling interest	(304)	-
Total capital equity	54,844	47,668
Total liabilities and capital equity	$ 173,004	$ 168,836

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 Months Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Net revenues	$25,301	$25,410	$49,000	$50,922
Cost of revenues	9,838	8,669	18,047	18,136
Gross profit	15,463	16,741	30,953	32,786
Operating expenses:				
Marketing	1,758	1,833	2,979	4,583
General and administrative	8,252	7,311	17,187	15,011
Research and development	1,247	1,168	2,347	2,330
Total operating expenses	11,257	10,312	22,513	21,924
Operating income	4,206	6,429	8,440	10,862
Other income (expense):				
Interest and dividend income	9	6	16	17
Interest expense	-	(23)	-	(57)
Other (expense) income, net	2	(6)	(5)	(6)
Total other income (expense)	11	(23)	11	(46)
Income before income taxes	4,217	6,406	8,451	10,816
Income tax expense (benefit)	1,702	(546)	5,202	2,556
Net income	2,515	6,952	3,249	8,260
Net loss attributable to noncontrolling interest	304	-	304	-
Net income attributable to common shareholders	$2,819	$6,952	$3,553	$8,260
Net Income per common share:				
Basic	$0.18	$0.39	$0.23	$0.46
Diluted	$0.18	$0.39	$0.22	$0.46
Weighted average ordinary shares outstanding:				
Basic	15,853	17,694	15,750	17,781
Diluted	15,872	17,721	15,914	17,816

See accompanying notes to condensed consolidated financial statements.

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Net income	$2,515	$6,952	$3,249	$8,260
Other comprehensive income (loss):				
Comprehensive loss attributable to noncontrolling interest	304	-	304	-
Comprehensive income attributable to common shareholders	$2,819	$6,952	$3,553	$8,260

See accompanying notes to condensed consolidated financial statements.

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

	Ordinary Shares		Additional Paid-in	Treasury Stock		Retained	Noncontrolling	Total Capital
	Number	Amount	Capital	Number	Amount	Earnings	Interest	Equity
Balance, January 1, 2016	25,036	$111,773	$ 14,573	(9,426)	$(126,772)	$48,094	$ -	$47,668
Exercise of ordinary share options	1	1	-	-	-	-	-	1
Share-based compensation	-	-	2,250	-	-	-	-	2,250
Issuance of ordinary shares	-	-	(140)	11	140	-	-	-
Issuance of shares for acquisition	-	-	(1,933)	233	3,609	-	-	1,676
Net income	-	-	-	-	-	3,553	(304)	3,249
Balance, June 30, 2016 (unaudited)	25,037	$111,774	$ 14,750	(9,182)	$(123,023)	$51,647	$ (304)	$54,844

See accompanying notes to condensed consolidated financial statements.

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

	For the Six Months Ended June 30, 2016	2015
Cash flows from operating activities:		
Net income	$3,249	$8,260
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts and billing adjustments	152	71
Share-based compensation	2,250	2,700
Depreciation and amortization	2,182	2,024
Increase (release) of uncertain tax positions	1,187	(294)
Deferred income tax provision	935	2,999
Interest expense - non-cash	-	57
Change in operating assets and liabilities		
Accounts receivable	713	1,561
Inventories	1,595	(1,136)
Deferred costs	275	599
Prepaid Income taxes	1,912	6,104
Deposits and other current assets	(431)	(380)
Other non-current assets	(40)	(13)
Accounts payable	455	(1,596)
Income taxes payable	-	(559)
Accrued expenses and other current liabilities	(1,016)	(1,956)
Deferred revenue	(4,999)	(2,595)
Other non-current liabilities	(70)	(2,171)
Net cash provided by operating activities	8,349	13,675
Cash flows from investing activities:		
Purchase of investments	(80)	-
Purchases of property and equipment	(159)	(548)
Acquisition of Broadsmart	(40,019)	-
Net cash used in investing activities	(40,258)	(548)
Cash flows from financing activities:		
Purchase of treasury stock	-	(5,151)
Repurchase of ordinary shares to settle withholding liability	-	(94)
Payment of other non-current liabilities	-	(1,500)
Proceeds from exercise of ordinary share options	1	-
Net cash provided by (used in) financing activities	1	(6,745)
Net (decrease) increase in cash and cash equivalents	(31,908)	6,382
Cash and cash equivalents, beginning of period	78,589	75,945
Cash and cash equivalents, end of period	$46,681	$82,327

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 Six Months Ended June 30, 2016	2015
Supplemental disclosures:		
Interest paid	$-	$-
Income taxes paid	$1,240	$3,200
Non-cash investing and financing activities:		
Ordinary shares issued for acquisition of Broadsmart	$1,676	$-

See accompanying notes to condensed consolidated financial statements.

NOTE 1 –DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business

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

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

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

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

During the first quarter of 2016, the Company created a new subsidiary, magicJack SMB, Inc. Through this subsidiary, the Company intends to provide easy-to-buy, simple-to-use VOIP services to small businesses at disruptive prices. The Company is currently in the final stages of product development for its first SMB product offering and expects to begin sales in the third quarter of 2016.

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, 2015. 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, 2015 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

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

Approximately 90% of the Company’s revenues in the three and six months ended June 30, 2016 and 2015 were from sales to customers located in the United States. The majority of the Company’s revenues recognized were generated from sales of the magicJack product line and from the software access right that accompanies these products, which were $19.5 million and $21.9 million for the three months ended June 30, 2016 and 2015, respectively, and $39.6 million and $43.7 million for the six months ended June 30, 2016 and 2015, respectively. The Company also provides its customers with the ability to make prepaid calls using the magicJack devices and magicJack APP by purchasing prepaid minutes. Revenues generated from the usage of prepaid minutes were $1.5 million and $2.1 million for the three months ended June 30, 2016 and 2015, respectively, and $3.2 million and $4.4 million for the six months ended June 30, 2016 and 2015, respectively.

Basis of Consolidation

The Company’s unaudited condensed consolidated financial statements include the accounts of magicJack VocalTec and its wholly-owned subsidiaries. The results of Broadsmart Global, Inc. have been included since March 17, 2016. Refer to Note 14 – “Acquisition of Business,” for further details. 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 six months ended June 30, 2016 may not be indicative of the results for the entire year ending December 31, 2016. 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, 2015 filed on March 15, 2016.

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 lower net income.

Net Revenues

Net revenues consists of revenue from sales of magicJack devices to retailers, wholesalers or directly to customers, access right renewal fees, fees charged for shipping 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 sales returns and allowances.

Revenue Recognition

magicJack Devices and Renewal Access Revenue

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

Sales Return Policy

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

Returns from retailers are accepted on an authorized basis for devices deemed defective. The Company may offer certain retailers the limited right to return any unsold merchandise from their initial stocking orders. The Company estimates potential returns under these arrangements at point of sale and re-estimates potential returns on a quarterly basis. For the three and six months ended June 30, 2016 and 2015, the Company's estimates of returns and actual returns from initial stocking orders have not been materially different.

Prepaid Minutes and Access and Wholesale Charges

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

UCaaS Revenue

The Company recognizes revenues from sales of its hosted services in the period the services are provided over the term of the respective customer agreements. Customers are billed monthly in advance for these recurring services and in arrears for one time service charges and other certain usage charges. Revenues from sales of hardware and network equipment are recognized in the period that the equipment is delivered. Revenue from the sale of equipment purchased but not yet delivered and installed is deferred and recognized in the period that the hardware or equipment is put into service.

Deferred Revenues

Deferred revenues consist of billings and payments for magicJack devices, sales of access rights received in advance of revenue recognition, billings and payments for equipment purchased by customers, but not yet delivered and sales of maintenance services in advance of revenue recognition. The Company bills and collects in advance for magicJack devices, which include the access right for the software to access its servers for an initial access right period in order to obtain free domestic local and long distance broadband telephone service. Equipment revenue is generally recognized upon delivery and maintenance services revenue is generally recognized ratably over the period during which the services are performed. Deferred revenues to be recognized over the next twelve months are classified as current and included in deferred revenue, current portion in the Company's consolidated balance sheets. The remaining amounts are classified as non-current in the consolidated balance sheets and included in deferred revenue, net of current portion.

Cost of Revenues

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

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

Costs incurred for shipping and handling and credit card charges are included in cost of revenues and are expensed as incurred. Costs for shipping and handling and credit card charges were $0.8 million and $0.9 million for the three months ended June 30, 2016 and 2015, respectively, and $1.8 million for the six months ended June 30, 2016 and 2015, respectively.

Marketing Expenses

Marketing expenses of $1.8 million for the three months ended June 30, 2016 and 2015, respectively, and $3.0 million and $4.6 million for the six months ended June 30, 2016 and 2015, respectively, consist primarily of advertising media buys for television commercials, Internet advertising and print advertising, as well as marketing related personnel costs and other marketing projects including sponsorships. Marketing costs are expensed when incurred. A break-down of marketing expense by category is as follows (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2016	2015	2016	2015
Advertising media buys	$751	$1,206	$1,416	$3,163
Marketing personnel related	199	387	387	925
Other marketing projects	808	240	1,176	495
Total Marketing Expense	$1,758	$1,833	$2,979	$4,583

Research and Development Expenses

The Company's research and development activities consist primarily of the design and development of its proprietary software used in the magicJack devices, magicJack APP and its servers, as well as the development of new products and applications for use in its broadband service offerings. The Company accounts for research and development costs in accordance with applicable accounting pronouncements. These pronouncements specify that costs incurred internally in researching and developing a product should be charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all costs should be capitalized until the product is available for general release to customers. The Company has determined that technological feasibility for its products is reached after all high-risk development issues have been resolved through internal and customer base testing. Generally, new products offered to customers and improvements to the Company's servers are placed in service on attainment of technological feasibility. The Company has not capitalized any of its research and development activities and related costs. Research and development expenses were $1.3 million and $1.2 million for the three months ended June 30, 2016 and 2015, respectively, and $2.4 million and $2.3 million for the six months ended June 30, 2016 and 2015, respectively.

Earnings per Ordinary Share

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

Cash and Cash Equivalents

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

Allowance for Doubtful Accounts and Billing Adjustments

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

Investments

Investments are held in interest bearing time deposits with terms longer than three months from the date of acquisition.

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 and U.S. government notes.

The Company places its cash and cash equivalents in high quality financial institutions and management believes that the Company is not exposed to any significant risk on its cash accounts. The Company maintains accounts with various banks and brokerage organizations and constantly monitors the creditworthiness of these institutions. Cash accounts at each U.S. bank are insured by the Federal Deposit Insurance Corporation or FDIC up to $250 thousand in the aggregate and may exceed federally insured limits. Cash accounts at each Israeli bank are not insured. The Company has never experienced any losses related to these balances. At June 30, 2016, the Company had cash and cash equivalents totaling $46.7 million, which included (i) $46.5 million in U.S. financial institutions, and (ii) $0.2 million in an Israeli financial institution.

The Company’s non-interest bearing cash balances in U.S. banks which included $1.9 million in one individual financial institution, were fully insured except for $221 thousand that exceeded insurance limits at June 30, 2016. The Company had money market accounts with financial institutions with balances totaling approximately $44.1 million at June 30, 2016.

No telecommunication carrier accounted for more than 10% of gross accounts receivable at June 30, 2016. One telecommunication carrier accounted for approximately 11% of gross accounts receivable at December 31, 2015. For the three and six months ended June 30, 2016 and 2015, no telecommunications carrier accounted for more than 10% of the Company’s total net revenues.

One U.S. retail customer accounted for approximately 11% and 14% of gross accounts receivable at June 30, 2016 and December 31, 2015, respectively. For the three and six months ended June 30, 2016 and 2015, no retailer accounted for more than 10% of the Company’s total net revenues.

Fair Value

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

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

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

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

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

When available, the Company uses quoted market prices to determine fair value, and it classifies such measurements within Level 1. Fair value measurements are classified according to the lowest level input or value-driver that is significant to the valuation. Fair value includes the consideration of nonperformance risk. Nonperformance risk refers to the risk that an obligation (either by a counterparty or the Company) will not be fulfilled. For the Company's financial assets traded in an active market (Level 1), the nonperformance risk is included in the market price. The Company’s assets and liabilities measured on a recurring basis at fair value may include marketable securities and time deposits. As of June 30, 2016 and December 31, 2015, all of them are Level 1 instruments. The fair value of Level 2 securities is estimated based on observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The carrying amounts of the Company’s financial instruments, including cash and cash equivalents, accounts payable and accrued expenses are expected to approximate fair value because of their immediate availability, near term maturities or potential interest payments at settlement.

Inventories

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

Property, Equipment and Depreciation Expense

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

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

Long-lived assets, such as property, plant and equipment, and intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management believes there is no impairment at June 30, 2016.

Intangible Assets

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

Goodwill

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired. Goodwill and other intangible assets with indefinite lives are not amortized to operations, but instead are reviewed for impairment at least annually, or more frequently if there is an indicator of impairment. Indicators include, but are not limited to: sustained operating losses or a trend of poor operating performance and a decrease in the Company’s market capitalization below its book value. The Company’s valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record impairment charges in the future. With the acquisition of Broadsmart in March 2016 and the founding of the SMB business during the first quarter of 2016, management will be evaluating each of these new business lines separately and has determined that the Company now has three reportable segments – “Consumer,” “Enterprise” and “SMB”. Refer to Note 15 - “Segment Reporting” for further details.

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

If the two-step goodwill impairment test is required to be performed, under the first step, the fair value of a reporting unit is compared with its carrying value (including goodwill). If the fair value of a reporting unit is less than its carrying value, the Company proceeds to step two of the goodwill impairment test. Under step two, an impairment loss is recognized for any excess of the carrying amount of a 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 a 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 a reporting unit’s goodwill. Fair value of a reporting unit is determined using a discounted cash flow analysis. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its implied fair value.

In connection with the Company’s annual goodwill impairment analysis, as of October 1, 2015, the annual measurement date, the Company’s analysis did not indicate any impairment of goodwill has occurred. Management believes there is no impairment at June 30, 2016.

Share-based Compensation

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

Business Combinations

The Company accounts for business combinations using the acquisition method of accounting. The acquisition method of accounting requires that the purchase price, including the fair value of contingent consideration, of the acquisition be allocated to the assets acquired and liabilities assumed using the fair values determined by management as of the acquisition date. Goodwill as of the acquisition date is measured as the excess of consideration transferred over the net of the acquisition date fair values of assets acquired and the liabilities assumed. While the Company uses its best estimates and assumptions as part of the purchase price allocation process to accurately value assets acquired and liabilities assumed at the acquisition date, the Company’s estimates are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, the Company records adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill to the extent the Company identifies adjustments to the preliminary purchase price allocation. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded to the consolidated statements of operations. The Company includes the results of all acquisitions in its Consolidated Financial Statements from the date of acquisition. Acquisition related transaction costs, such as banking, legal, accounting and other costs incurred in connection with an acquisition, are expensed as incurred in general and administrative expense.

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

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax basis of assets and liabilities and their book basis using enacted tax rates. Any changes in enacted tax rates or tax laws are included in the provision for income taxes in the period of enactment. The Company’s net deferred tax assets consist primarily of foreign net operating loss carry-forwards and timing differences between recognition of income for book and tax purposes. The Company records a valuation allowance to reduce the net deferred tax assets to the amount that it estimates is more-likely-than-not to be realized. The Company periodically reviews the composition of its deferred tax assets and related valuation allowances and will make adjustments if available evidence indicates that it is more likely than not a change in the carrying amounts is required. The Company decreased the valuation allowance by $0.3 million and $0.6 million during the three and six months ended June 30, 2016, respectively. The Company increased the valuation allowance by $0.7 million and $0.5 million during the three and six months ended June 30, 2015, 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 there is a greater than 50% likelihood that a tax benefit will be sustained, the Company has recorded the largest amount of tax benefit that may potentially be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions that the Company estimates there is a 50% or less likelihood that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. The Company revised its liability for uncertain tax positions by an increase of $1.2 million in the three and six months ended June 30, 2016, due primarily to an increase in uncertain tax positions related to various state issues and the revaluation impact of certain Israeli uncertain tax positions. No adjustments were made to the liability for uncertain tax positions during the three and six months ended June 30, 2015.

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 2016 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 June 30, 2016, the estimated annual effective income tax rate is expected to approximate 34.9%, 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.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers.” The standard requires entities to recognize revenue through the application of a five-step model, which includes identification of the contract, identification of the performance obligations, determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue as the entity satisfies the performance obligations. On July 9, 2015, the FASB deferred the effective dates of the standard by one year. As a result, the standard will be effective for annual and interim periods beginning after December 15, 2017. Companies may adopt the standard as early as the original effective date (i.e. annual reporting periods beginning after December 15, 2016). Early adoption prior to that date is not permitted. The standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or a modified retrospective adoption, meaning the standard is applied only to the most current period presented. In March 2016, the FASB issued ASU 2016-08 to provide clarification regarding the application of the principal-versus-agent guidance. In April 2016, the FASB issued ASU 2016-10 to clarify the guidance for identifying performance obligations and accounting for licenses of intellectual property. In May 2016, the FASB also issued ASU 2016-12, which provides narrow scope improvements and technical expedients on assessing collectibility, presentation of sales taxes, evaluating contract modifications and completed contracts at transition and the disclosure requirement for the effect of the accounting change for the period of adoption. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows, and financial statement disclosures.

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

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

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

In March 2016, the FASB issued ASU 2016-09, “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting”. ASU 2016-09 simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for the Company beginning January 1, 2018 for both interim and annual reporting periods. The Company is currently evaluating the guidance to determine the potential impact on the Company’s financial condition, results of operations and cash flows.

NOTE 3 – INVESTMENTS

Investments consist of time deposits with maturity dates of greater than 90 days totaling $447 thousand and $367 thousand at June 30, 2016 and December 31, 2015, respectively.

The fair value of time deposits at June 30, 2016 and December 31, 2015 was determined based on its face value, which approximates its fair value and is a Level 1 input.

There was no realized gain or loss on investments for the three and six months ended June 30, 2016 and June 30, 2015.

NOTE 4 – INVENTORIES

Inventories are comprised of the following (in thousands):

	June 30, 2016	December 31, 2015
Raw materials	$1,250	$ 1,498
Finished goods	3,180	4,225
Total	$4,430	$ 5,723

Raw materials represent components used in the manufacturing of the magicJack devices, held by the Company or by a Chinese manufacturer on consignment. Finished 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. The Company wrote-off approximately $3 thousand and $82 thousand of obsolete inventory during the three months ended June 30, 2016 and June 30, 2015, respectively and $80 thousand and $102 thousand of obsolete inventory during the six months ended June 30, 2016 and June 30, 2015, respectively.

NOTE 5 – PROPERTY AND EQUIPMENT

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

	Estimated Useful Lives (in years)	June 30, 2016	December 31, 2015
Switches	3 - 15	$9,346	$ 8,606
Computers	3	2,743	2,707
Furniture	5 - 7	160	257
Leasehold-improvements	*	808	701

Accumulated depreciation	(9,284)	(8,969)
Total	$3,773	$ 3,302

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

Depreciation expense for the three months ended June 30, 2016 and 2015 was $0.3 million and $0.2 million, respectively. Depreciation expense for the six months ended June 30, 2016 and 2015 was $0.5 million and $0.4 million, respectively.

NOTE 6 – INTANGIBLES ASSETS

As of June 30, 2016 and December 31, 2015, the Company had intangible assets with carrying values of $31.4 million and $6.7 million, respectively. Identified intangible assets not subject to amortization consisted of tradename and domain names with combined carrying value of $3.4 million and $1.2 million as of June 30, 2016 and December 31, 2015, respectively. Identified intangible assets with finite lives subject to amortization consist of the following (in thousands):

	Estimated	June 30, 2016				December 31, 2015			
	Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net	Weighted-Average Life	Gross Carrying Amount	Accumulated Amortization	Net	Weighted-Average Life
Technology	3 - 17	$3,110	$(2,766)	$344	4.66	$4,930	$(4,497)	$433	4.83
Intellectual property rights	3 - 17	14,161	(10,209)	3,952	5.10	14,161	(9,623)	4,538	5.36
Covenants not-to-compete and not-to-sue	2 - 5	2,185	(2,095)	90	3.67	2,085	(1,911)	174	0.42
Tradename	3 - 6	321	(321)	-	-	321	(321)	-	-
Customer relationships	5 - 16	22,600	(1,172)	21,428	10.50	500	(500)	-	-
Backlog	1	800	(800)	-	-	800	(800)	-	-
Software License	10	885	(36)	849	9.75	-	-	-	-
Process know how	5	1,100	(32)	1,068	6.58	-	-	-	-
Other		470	(193)	277	2.5	470	(138)	332	3.00
Total		$45,632	$(17,624)	$28,008		$23,267	$(17,790)	$5,477	

Amortization expense for the three months ended June 30, 2016 and 2015 was $1.1 million and $0.8 million, respectively. Amortization expense for the six months ended June 30, 2016 and 2015 was $1.7 million and $1.6 million, respectively. Based on the carrying value of identified intangible assets recorded at June 30, 2016, and assuming no subsequent impairment of the underlying assets, the amortization expense for the future fiscal years is expected to be as follows (in thousands):

Fiscal Year	Amortization Expense
Six months ending December 31, 2016	$ 2,006
2017	