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VOCALTEC COMMUNICATIONS LTD

Form 20-F

May 12, 2010

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

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(B) OR (G) OF THE  
SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended December 31, 2009

OR

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

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE  
SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report \_\_\_\_\_

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

Commission file number: 2-0-27648

VOCALTEC COMMUNICATIONS LTD.  
(Exact name of registrant as specified in its charter and  
translation into English)

STATE OF ISRAEL  
(Jurisdiction of incorporation or organization)

60 MEDINAT HAYEHUDIM STREET  
HERZLIYA 46140  
ISRAEL  
(Address of principal executive offices)

JOSHUA DI-NUR, PHONE: +972-9-9703824, FACSIMILE: +972-9-9558175  
ADDRESS: 60 MEDINAT HAYEHUDIM STREET, HERZLIYA 46140, ISRAEL  
(Name, Telephone, E-Mail and/or Facsimile number and Address of  
Company Contact Person)

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

NONE.

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

ORDINARY SHARES, PAR VALUE OF NIS 0.13  
Title of each class

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

NONE

The number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2009

5,810,898 ORDINARY SHARES, EXCLUDING 1,673,549 TREASURY SHARES,  
PAR VALUE NIS 0.13 PER SHARE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes  No

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 ninety (90) days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerate filer  Accelerate filer  Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financial Reporting Standards as issued by the International Accounting Standards Board

Other

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act)

Yes  No

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

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

Yes       No

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### PRELIMINARY NOTE

THIS ANNUAL REPORT CONTAINS HISTORICAL INFORMATION AND FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 WITH RESPECT TO THE BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF VOCALTEC. THE WORDS "ANTICIPATE," "BELIEVE," "ESTIMATE," "EXPECT," "INTEND," "MAY," "PLAN," "PROJECT" AND "SHOULD" AND SIMILAR EXPRESSIONS, AS THEY RELATE TO VOCALTEC OR ITS MANAGEMENT, ARE INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS. SUCH STATEMENTS REFLECT THE CURRENT VIEWS AND ASSUMPTIONS OF VOCALTEC WITH RESPECT TO FUTURE EVENTS AND ARE SUBJECT TO RISKS AND UNCERTAINTIES. MANY FACTORS COULD CAUSE THE ACTUAL RESULTS, PERFORMANCE OR ACHIEVEMENTS OF VOCALTEC TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, PERFORMANCE OR ACHIEVEMENTS THAT MAY BE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS, INCLUDING, AMONG OTHERS, CHANGES IN THE TELECOMMUNICATIONS AND VOIP MARKETS AND IN GENERAL ECONOMIC AND BUSINESS CONDITIONS, LOSS OF KEY CUSTOMERS AND UNPREDICTABLE SALES CYCLES, COMPETITIVE PRESSURES, MARKET ACCEPTANCE OF NEW PRODUCTS, INABILITY TO MEET EFFICIENCY AND COST REDUCTION OBJECTIVES, CHANGES IN BUSINESS STRATEGY AND VARIOUS OTHER FACTORS, BOTH REFERENCED AND NOT REFERENCED IN THIS ANNUAL REPORT. THESE RISKS ARE MORE FULLY DESCRIBED UNDER "ITEM 3.D - KEY INFORMATION - RISK FACTORS" OF THIS ANNUAL REPORT. SHOULD ONE OR MORE OF THESE RISKS OR UNCERTAINTIES MATERIALIZE, OR SHOULD UNDERLYING ASSUMPTIONS PROVE INCORRECT, ACTUAL RESULTS MAY VARY MATERIALLY FROM THOSE DESCRIBED HEREIN AS ANTICIPATED, BELIEVED, ESTIMATED, EXPECTED, INTENDED, PLANNED OR PROJECTED. VOCALTEC DOES NOT INTEND OR ASSUME ANY OBLIGATION TO UPDATE THESE FORWARD-LOOKING STATEMENTS. ANY FORWARD-LOOKING STATEMENTS IN THIS ANNUAL REPORT ARE MADE AS OF THE DATE HEREOF, AND WE UNDERTAKE NO OBLIGATION TO PUBLICLY UPDATE OR REVISE ANY FORWARD-LOOKING STATEMENTS, WHETHER AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE, EXCEPT AS REQUIRED BY LAW.

### DEFINITIONS

In this annual report, unless the context otherwise requires:

- o references to "VocalTec," "we," "us" or "our" are to VocalTec Communications Ltd., a company organized under the laws of the State of Israel (the "Registrant"), and its wholly-owned subsidiaries.
- o references to "ordinary shares", "our shares" and similar expressions refer to the Registrant's Ordinary Shares, par value NIS 0.13 per share.
- o references to "\$" or "dollars" are to U.S. dollars and all references to "NIS" are to New Israeli Shekels. Except as otherwise indicated, financial statements of, and information regarding, VocalTec are presented in U.S. dollars.
- o references to the "Companies Law" are to Israel's Companies Law, 5759-1999, as currently amended;
- o references to the "Exchange Act" are to the Securities Exchange Act of 1934, as amended;

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- o references to "NASDAQ" are to the Nasdaq Stock Market; and
- o references to the "SEC" are to the United States Securities and Exchange Commission.

### USE OF TRADE NAMES

VocalTec, Essentra, TdSOFT, TdGATE, TdVIEW, PLUG & TALK, SmartFMC, and SmartIMS are registered trademarks of VocalTec Communications Ltd. and its wholly-owned subsidiaries. Other trademarks are the property of their respective holders. These trademarks are important to our business. Although we have omitted the "(R)" and "TM" trademark designations for such trademarks in this annual report, all rights to such trademarks are nevertheless reserved.

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#### SIGNATURES

PART ONE.

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

3.A. SELECTED FINANCIAL DATA

In November 2005, VocalTec Communications Ltd., or the Company or VocalTec, acquired all of the issued and outstanding ordinary shares of Tdsoft Ltd., a privately-held company organized in Israel ("Tdsoft"), and as consideration issued to the Tdsoft shareholders ordinary shares of VocalTec constituting, immediately following such issuance, 75% of the issued and outstanding share capital of VocalTec (the "business combination"). The business combination was accounted under U.S. generally accepted accounting principles ("GAAP") as a reverse acquisition and therefore we are presenting in this report the consolidated financial statements of Tdsoft for the eleven months ended November 30, 2005, the consolidated financial statements of the combined company for the month of December 2005, and for the years ended December 31, 2006, 2007, 2008 and 2009.

Our historical consolidated financial statements are prepared in accordance with U.S. GAAP and are presented in U.S. dollars. Historical information as of and for the three years ended December 31, 2009 is derived from our consolidated financial statements, which have been audited by Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global.

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

STATEMENT OF OPERATIONS DATA - YEAR ENDED DECEMBER 31ST  
(IN THOUSANDS OF U.S. DOLLARS, EXCEPT PER SHARE DATA)

	2005	2006	2007
	-----	-----	-----
Sales			
Products	3,668	4,738	3,006
Services	925	2,542	2,748
	-----	-----	-----
	4,593	7,280	5,754
	-----	-----	-----

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Cost of sales			
Products	1,450	2,171	2,027
Services	315	563	523
	-----	-----	-----
	1,765	2,734	2,550
Inventory write off	639	-	459
Amortization of intangibles assets	172	392	385
	-----	-----	-----
	2,576	3,126	3,394
	-----	-----	-----
Gross profit	2,017	4,154	2,360
	-----	-----	-----
Operating expenses:			
Research and development, net	4,363	4,619	4,567
Selling and marketing	2,763	4,147	4,736
General and administrative	1,748	2,474	1,992
Income from sale of patents, net	-	-	-
Impairment of goodwill and intangible assets	-	-	5,437
	-----	-----	-----
Total net operating expenses (income)	8,874	11,240	16,732
	-----	-----	-----
Operating income (loss)	(6,857)	(7,086)	(14,372)
Other income, net	24	42	-
Financial income, net	184	32	230
	-----	-----	-----
Income (loss) before taxes on income	(6,649)	(7,012)	(14,142)
Tax benefit (taxes on income)	19	-	(37)
	-----	-----	-----
Net Income (loss)	(6,630)	(7,012)	(14,179)
	-----	-----	-----
Accretion of redeemable convertible Preferred shares	(348)	-	-
Induced conversion of convertible Preferred shares	(17,406)	-	-
	-----	-----	-----
Cumulative dividend on convertible Preferred shares	(2,585)	-	-
	-----	-----	-----
Dividend in respect of reduction in exercise price of certain warrants	-	(37)	-
	-----	-----	-----
Net income (loss) attributable to common shareholders	(26,969)	(7,049)	(14,179)
	=====	=====	=====
Basic and diluted net income (loss) per Ordinary share	(34.05)	(1.3)	(1.92)
	-----	-----	-----
Weighted average number of Ordinary shares used in computing net loss per share-basic and diluted	792	5,436	7,376

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BALANCE SHEET DATA - YEAR ENDED DECEMBER 31  
(IN THOUSANDS OF U.S. DOLLARS, EXCEPT SHARE DATA)

	2005 -----	2006 -----	2007 -----
Cash and cash equivalents and short term deposits	5,138	8,954	4,496
Working capital	925	8,196	657
Total assets	22,442	24,587	14,328
Total liabilities	9,579	6,049	8,621
Capital stock	132	213	213
Accumulated deficit	(66,854)	(73,903)	(88,116)
Total shareholders' equity	12,863	18,538	5,707
Number of Ordinary shares outstanding	4,661,627	7,376,364	7,376,364

### 3.B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

### 3.C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

### 3.D. RISK FACTORS

Many factors and uncertainties could have an effect on our financial condition, cash flow, results of operations or future performance. We are subject to various risks resulting from changing economic, political, industry, business and financial conditions. The most significant risk factors affecting our operations are described below.

#### RISKS RELATED TO OUR BUSINESS

VOCALTEC INCURRED SIGNIFICANT HISTORICAL OPERATING LOSSES AND THERE IS NO ASSURANCE THAT THE COMPANY WILL NOT CONTINUE TO INCUR OPERATING LOSSES IN THE FUTURE.

Since its incorporation in 1989, VocalTec (prior to the business combination) had limited sales and has incurred significant operating losses. The company had operating losses of \$14.4 million and \$3.2 million in 2007 and 2009, respectively and operating income of \$ 3.7 million in 2008, and may continue to incur operating losses in the future due to, among other reasons, the fact that the Company operates in new target markets and sells to new customers, is active in a market with typically long sales cycles (primarily for its recently acquired mobile VoIP products), has started selling not only its products on a stand-alone basis but also in conjunction with third party products as a broader solution, has not yet obtained substantial credibility and market share of its VoIP equipment in some of these markets and had not yet gained experience with such new third party products. To achieve profitability and increased sales levels, the Company must, among other things, establish and increase market demand and acceptance of its products, respond effectively to competitive pressures, offer high quality customer service and support, introduce advanced versions and enhancements of its products as well as new products that meet market needs on a timely basis, and constantly increase operational efficiency.

The Company may incur operating losses again in 2010 and thereafter, if revenues are insufficient to cover sales and marketing, research and development, administrative and other expenses. If revenue levels do not increase sufficiently, operating results will be adversely affected because any reduction in expenses may not sufficiently cover a reduction in revenues. There is no

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assurance that the Company will achieve or sustain significant sales or profitability in the future.

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

Our operating results have fluctuated and may continue to fluctuate from period to period for a number of reasons. Due to the past volatility of the market for telecommunication equipment, we cannot predict the impact on our revenues or results of operations that any deterioration in such market may have.

There are several market conditions that could continue to cause our customers and potential customers to be conservative in their spending:

- o Networks that are based on old Time Division Multiplexing, or TDM, equipment which has been used by telecommunications carriers for several decades, are still operating and generating revenues.

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- o Large and mid-size carriers are showing an increased interest in migrating their TDM-based, Public Switch Telephone Networks, or PSTNs, to VoIP softswitch-based networks, in order to enable advanced, IP-based services and save costs, but there is still uncertainty with respect to the extent and timing of shifting PSTNs to VoIP softswitch networks.
- o As a result of our long sales cycle (described below under "OUR ESSENTIA PRODUCTS GENERALLY HAVE A LONG SALES CYCLE, WHICH INCREASES OUR COSTS IN OBTAINING ORDERS, REDUCES THE PREDICTABILITY OF OUR EARNINGS AND REQUIRES HIGH WORKING CAPITAL"), we may need extended time to build up an order backlog.
- o Increased competition, from new service providers and companies such as Skype, which offer cheap, or even free, telephony, causing financial pressure on our customers.
- o Macro economic conditions, including worldwide recessions, causing our potential customers to be more conservative with their capital expenditures.
- o Evolving new technologies which may cause our customers to delay their deployment plans and wait for these new technologies to mature.

These and other factors make the forecasting of sales inherently uncertain. Significant annual and quarterly fluctuations in our results of operations may also be caused by, among other factors, the timing and composition of orders from our customers, reduced prices for our products, the economic viability and credit-worthiness of our customers, the collectability of our receivables, the timing of new product announcements and releases of new products by us and by our competitors.

Our future results may also be affected by our ability to continue to develop, introduce and deliver enhanced and new products in a timely manner, to offer new products at competitive prices, to offer existing products at lower prices, to compete with competitors that are larger than us and to anticipate and meet customer demands. There can be no assurance that sales in any particular quarter



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will not be lower than those of the preceding quarters, including comparable quarters.

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

### ADVERSE MACRO ECONOMIC CONDITIONS IN THE MARKETS IN WHICH VOCALTEC OPERATES COULD IMPACT VOCALTEC'S RESULTS OF OPERATIONS.

Adverse macro economic conditions and further deterioration in the global economic environment, such as a recession or economic slowdown in the markets in which we operate, may lead to a reduction in the level of demand from our customers for existing and new products and services. In difficult economic conditions consumers may seek to reduce discretionary spending by reducing their use of our products and services. Similarly, under these conditions the significant customers that we serve may delay purchasing decisions, full implementation of services or reduce their use of our services. In addition, adverse economic conditions may lead to an increased number of our customers that are unable to pay for existing or additional services. If these events were to occur, it could have a material adverse effect on our results of operations.

### GLOBAL RECESSION AND CONTINUED CREDIT CONSTRAINTS COULD ADVERSELY AFFECT US.

The downturn in the global economy that accelerated during the second half of 2008 and early 2009, which resulted in a weakness of the global credit markets, failures or material business deterioration of investment banks, commercial banks and other financial institutions and intermediaries worldwide and significant reductions in asset values across businesses, households and individuals, combined with other financial and economic indicators, have resulted in a global recession. We have been feeling the effect of such recession, where certain transactions have been terminated or put on hold due to the inability of prospective customers to finance the purchase of our products and services. If these conditions continue or worsen, they may result in reduced demand or funding for projects incorporating our products and solutions, longer sales cycles for our projects or termination of contracted projects by our and prospective customers, which may adversely affect our results of operations. In addition, risks of widespread insolvency, mass unemployment and the deterioration of various sectors of the economies where we operate have increased due to the global economic downturn. Any further slowdown in the development of these economies or any reduction in the investment budgets of local companies which may lead to termination of contracts could have a material adverse effect on our business, financial condition, results of operations or prospects. Among other things, we might face:

- o Potential declines in orders for our customer service and support solutions and in our revenues from such solutions due to reduced or postponed orders or other factors caused by economic challenges faced by our customers and prospective customers;
- o Longer sales processes and a need for increased efforts to secure projects;

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- o Potential adverse impact on our customers' and prospective customers' ability to pay, when due, amounts payable to us; and
- o Potential re-evaluation by our customers and prospective customers of approved or contracted projects in order to address budget reductions or other impacts and factors of the current economic conditions by such customers and prospective customers.

Although the global economy showed signs of recovery by the end of 2009, should the incipient recovery falter, the outlook for our operations may worsen, and the occurrence of any of the above could adversely affect our business, financial condition, operating results and cash flow. These economic conditions may also impact our ability to forecast orders and revenues and our ability to provide guidance for our performance.

CUSTOMARILY WE DO NOT HAVE LONG TERM CONTRACTS IN PLACE WITH CUSTOMERS.

In certain of the geographical locations in which we are active, we typically sell products pursuant to purchase orders that customers can, in extreme situations only, cancel or defer on short notice without incurring a significant penalty. Any significant cancellations or deferrals could adversely affect our business, financial condition and results of operations. In addition, cancellations or deferrals could cause us to hold excess inventory, which could reduce our profit margins and restrict our ability to fund our operations.

THERE IS NO ASSURANCE THAT WE WILL BE SUCCESSFUL IN OBTAINING AND MAINTAINING A SUFFICIENT MARKET SHARE FOR OUR PRODUCTS. IN ADDITION, WE HAVE BEEN ENCOUNTERING VARIOUS CHALLENGES AFFECTING THE SALE OF OUR PRODUCTS.

Since the consummation of the business combination with Tdsoft in November 2005, the Company has been focusing its development efforts on the Essentra line of products. The Essentra product solutions were already deployed by several customers and are carrying live traffic; however, certain elements of the products are still subject to additional development and adaptations and have not yet been used extensively by customers, which prevents us from demonstrating a proven track record and wide deployment references, which are crucial for our growth and expansion to larger carriers. Furthermore, unlike the companies' first generation of products, which were unique and the first of their kind to be introduced to the telecommunications market, the Essentra products compete with existing, comparable products of various companies, some of which have certain advantages over us, including larger financial resources, access to prospective customers and an established market for their products.

Our products must comply with various international and domestic regulations and standards defined by regulatory agencies. If we do not comply with existing or evolving industry standards and other regulatory requirements or if we fail to obtain in a timely manner any required domestic or foreign regulatory approvals or certificates, we will not be able to sell our products where these standards or regulations apply, which may harm our business. Moreover, distribution partners or customers may require us, or we may otherwise deem it necessary or advisable, to alter our products to address actual or anticipated changes in the regulatory environment. Our inability to alter our products to address these requirements and any regulatory changes could have a material adverse effect on our business, financial condition, and operating results.

Maintaining and increasing our revenues are dependent, among other things, upon the ability of our products to meet market and customer requirements. To this end, we are involved in a continuous process to evaluate changing market demands and customer requirements, and to develop and introduce new products, features and applications to meet such changing demands and requirements. In addition, prospective customers may require product features and capabilities that are not included in our current product offerings. The introduction of new or enhanced

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products also requires that we carefully manage the transition from our older products as we ensure the continued provision of maintenance and other services for our older products.

A number of risks are inherent in this process, including the fact that we may not successfully anticipate market requirements or complete the development or introduction of these products and that the development of new technologies and products is increasingly complex and uncertain. This can result in delays in the introduction of new technologies and products, and requires close collaboration and continued technological advancement involving multiple software design teams and outside suppliers of key components. The failure of any one of these elements could cause new products to fail to meet specifications, market requirements or customer demands, or to miss delivery schedules. If we fail to develop products and offer services that satisfy customer requirements, or if we fail to effectively manage the transition from our older products to our new or enhanced products, our ability to create or increase demand for our products would be seriously harmed and we may lose current and prospective customers, thereby harming our business.

Deployment, sale and marketing of products in certain countries may subject us to environmental and other regulations including, in some instances, the requirement to provide to customers the ability to return products at the end of their useful life.

Further, our results could be adversely affected by factors such as lack of market acceptance of our products, delays in product development, and delays in customer purchases of products in anticipation of the introduction of new products and the rapidly changing landscape of emerging standards.

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

Due to the fact that we have been developing and offering new products, some of which are targeted at new customers in new markets, we have encountered and expect to continue to encounter various challenges. In addition, while seeking midsize carriers, we offer solutions to alternative small carriers as well, raising the need for flexibility and competitiveness within a wide range of solutions. Also, our solutions have to be inter-operable with offerings of various third parties, which results in a more complex and expensive development and upgrading of the products. Furthermore, in recent years we have witnessed an increasing competition in the VoIP market, resulting in declining prices, as VoIP has become more of a mainstream technology. One of the main challenges in penetrating the market with the products offered by VocalTec relates to the ability to provide a broad, and to a certain extent complete, solution, which includes third party elements.

Therefore, there is no assurance that we will be successful in obtaining and maintaining a sufficient market share for the existing Essentra products and our future products.

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OUR BUSINESS DEPENDS TO A CERTAIN EXTENT ON THE ABILITY OF OUR CHANNELS AND BUSINESS PARTNERS WHO PURCHASE OUR PRODUCTS TO ACHIEVE BROAD MARKET ACCEPTANCE FOR THEIR PRODUCTS. IF THESE CHANNELS AND BUSINESS PARTNERS DO NOT SUCCEED IN SELLING THEIR PRODUCTS, THIS WILL REDUCE DEMAND FOR OUR PRODUCTS AND OUR REVENUES WILL BE ADVERSELY AFFECTED.

In many cases our products are sold through channels, i.e., vendors, systems integrators and business partners, who repackage or resell our products, under varying types of OEM or reseller arrangements, to communications service providers (rather than us selling our products directly to these service providers).

To continue this method of sales, we will have to allocate resources to train vendors, systems integrators and business partners as to the use of our products, resulting in additional costs and additional time until sales by such vendors, systems integrators and business partners are made feasible. Our business depends to a certain extent upon the success of such channels and the broad market acceptance of their products. To the extent that our channels are unsuccessful in selling their products, and as a result, our products, our revenues and operating results will be adversely affected.

Many factors out of our control could interfere with our ability to market, license, implement or support our products with any of our channels, which in turn could harm our business. These factors include, but are not limited to, a change in the business strategy of our channels, the introduction of competitive product offerings by other companies that are sold through one or more of our channels, potential contract defaults by one or more of our channels or changes in ownership or management of one or more of our channels. Some of our competitors may have stronger relationships with our channels than we do, and we have limited control, if any, as to whether those channels implement our products rather than our competitors' products or whether they devote resources to market and support our competitors' products rather than our offerings. Also, the loss of or reduction in sales by these channels could reduce our revenues. If we fail to maintain relationships with these channels, fail to develop new channels, fail to effectively manage, train, or provide incentives to existing channels or if these channels are not successful in their sales efforts, sales of our products may decrease and our operating results would suffer.

OUR ESSENTRA PRODUCTS GENERALLY HAVE A LONG SALES CYCLE, WHICH INCREASES OUR COSTS IN OBTAINING ORDERS, REDUCES THE PREDICTABILITY OF OUR EARNINGS AND REQUIRES SIGNIFICANT WORKING CAPITAL.

Our Essentra products are technologically complex and are typically intended for use in solutions that may be critical to the business of our customers. Prospective customers for such products generally must make a significant commitment of resources to test and evaluate products and to integrate them into their solutions. As a result, the sales process for such products is long and often subject to delays associated with lengthy approval processes that typically accompany the design and testing of our solutions. The sales cycles of our products to new customers currently average 6 to 12 months from the time we make a proposal to a customer until the time the customer begins using the relevant product in production mode. The sales cycle for our recently acquired mobile VoIP solution is typically even longer and ranges between 12 and 18 months. This requires us to invest significant resources to make sales, which increases our costs in obtaining orders and reduces the predictability of our sales. In addition, in some cases we need to finance the equipment that we install in our customers' premises during the period of installment, testing and approval of the equipment, which requires us to allocate working capital for the period of such financing. Furthermore, in many cases the sale of our products is conditioned upon a trial period during which the products are installed at the customers' premises, which installation requires an investment by us of capital and manpower, without assurance that the customers will in fact purchase the

products.

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Long sales cycles also subject us to risks not usually encountered by companies whose products have short sales cycles, complicating our planning processes and reducing the predictability of our earnings. These risks include:

- o a pre-sale process that includes traveling, demonstrations, technical and commercial sessions, and trial procedure intended for defining customers' needs, all of which involve additional costs;
- o the potential cancellation of orders based on our customers' changing budgetary constraints;
- o the shift in orders expected between quarters because of the timing of our customers' procurement decisions; and
- o changes in organizational structure and decision makers within our customers necessitating that we establish new relationships and effectively restart the sales process.

BECAUSE MANY OF OUR CURRENT AND PLANNED PRODUCTS ARE HIGHLY COMPLEX, THEY MAY CONTAIN DEFECTS OR ERRORS THAT ARE DETECTED ONLY AFTER DEPLOYMENT IN COMMERCIAL APPLICATIONS. MOREOVER, OUR CUSTOMERS MAY BUNDLE OUR PRODUCTS WITH THE PRODUCTS OF OTHER PROVIDERS THAT CONTAIN DEFECTS THAT ARE WHOLLY UNRELATED TO OUR PRODUCTS. IN EITHER INSTANCE, IF THIS OCCURS, IT COULD HARM OUR REPUTATION AND RESULT IN REDUCED REVENUES OR INCREASED EXPENSES.

Our products are highly complex and may contain undetected defects, errors or failures. These products are deployed in complex and versatile networks, which include complex equipment of other vendors. Although we invest heavily in testing our products, we cannot simulate and test all potential events and cases relating to the operation of our products, and as a result, in some cases our customers may discover errors after the products have been deployed. The occurrence of any defects, errors or failures could result in:

- o product returns, repairs or replacements;
- o cancellation of and reduction in orders;
- o uncollectible accounts receivable and delays in collecting accounts receivable;
- o diversion of our resources;
- o legal actions by our customers or our customers' end users;
- o adverse effect to our reputation;
- o increased insurance costs; and
- o other losses to us, our customers or the end users of our products.

Any of these occurrences could also result in the loss of or delay in market acceptance of our products and loss of sales, which would harm our business and adversely affect our results of operations. There can be no assurance that, despite testing by us or by our customers, errors will not be found in our products after commencement of commercial deployment. We have from time to time

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experienced defects in our products and may experience defects in the future. We may in the future incur costs associated with support services. Moreover, as our solutions grow in complexity, this risk may intensify over time and may result in increased expenses.

In addition, our customers may bundle, incorporate or connect our products into or to complex systems that contain errors or defects that may be unrelated to our products. Such occurrences may result in undue delays or cancellations of the implementation of our customers' bundled products and services. In such cases, our reputation could be harmed and our results of operations could be adversely affected, which could result in reduced revenues or increased expenses.

IF OUR RELATIONSHIP WITH ANY OF OUR KEY CUSTOMERS IS TERMINATED, OUR REVENUES WILL DECLINE AND OUR BUSINESS WILL BE ADVERSELY AFFECTED.

During 2009, Mobitel, Deutsche Telekom and Inline, accounted for 35%, 14% and 10%, respectively, of our revenues.

If our relationship with any of these customers is terminated, or if either of these key customers reduces purchases of our products or maintenance or replaces existing equipment in its networks with competing products, then our business, financial condition and results of operations would be materially adversely affected. In the past, we were adversely affected by the termination of relationships with key customers, as well as reductions in orders from key customers. The impact of the termination or reduction of our key customer relationships would be intensified if we were unable to establish and increase sales to other customers in order to offset this termination or reduction.

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WE DEPEND TO A CERTAIN DEGREE ON THIRD PARTIES FOR THE SUPPLY AND QUALITY OF HARDWARE AND SOFTWARE ELEMENTS REQUIRED FOR THE MARKETING OF OUR PRODUCTS, AND ANY DELAY OR DISRUPTION IN THE SUPPLY OF THESE PRODUCTS WILL ADVERSELY AFFECT OUR RESULTS. IN ADDITION, INACCURATE ESTIMATES OF OUR INVENTORY/PURCHASING REQUIREMENTS COULD ADVERSELY AFFECT OUR RESULTS OF OPERATIONS. FURTHERMORE, ERRORS OR DEFECTS IN OTHER VENDORS' PRODUCTS WITH WHICH OUR PRODUCTS ARE INTEGRATED COULD ADVERSELY AFFECT THE MARKET ACCEPTANCE OF OUR OFFERINGS AND EXPOSE US TO PRODUCT LIABILITY CLAIMS FROM OUR CUSTOMERS.

As many times our customers require from us a "complete solution", that comprises, in addition to our Essentra Software, various third party elements, we depend on such third-party partners for the successful marketing of our products (including IBM, Dialogic, AudioCodes and various other suppliers for Operating System software, SIP and SS7 software, as well as additional software and other elements). If we overestimate our purchasing requirements, we could have excess inventory, which would increase our costs and result in write-downs harming our operating results. If we underestimate our requirements, we may not have an adequate supply, which could result in delays in shipments and revenues. We currently do not have long-term supply contracts with our third-party suppliers and they are not required to supply us with products for any specified periods, in any specified quantities or at any set price, except as may be specified in a particular purchase order. Because the key components of our products are complex and often require integration into our solutions, in the event of a disruption or delay in supply or an inability to obtain products, we may not be able to develop an alternate source in a timely manner, at favorable prices, or at all.

Following the sale and installation of our products, we rely on our hardware and

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software suppliers (to varying extents) for maintenance and support services that we provide to our customers. To that end, our agreements with our suppliers include obligations of our suppliers to provide us with certain levels of maintenance and support, as well as restrictions on the right of the supplier to discontinue the product or the support services we purchase from them.

In addition, manufacturing problems may occur with these third parties. A supplier may supply us with products and components that do not meet our quality, quantity or cost requirement, or may cease to provide support with respect to the hardware and software purchased by the Company; therefore, we face the risk of inadequate supply, price increases, late deliveries, poor quality and failure in the availability and level of support and maintenance, as any supplier may terminate its relationship with us. If we were to lose our relationship with any of such suppliers, the lead time required to qualify new suppliers could be several months. Also, if we lose our relationship with any of such suppliers or these suppliers are otherwise unable to satisfy our volume and delivery schedule requirements, it may be difficult to locate alternative suppliers that are able to develop, manufacture, deliver and provide products, service and maintenance with respect to the specialized components we need for our products in the desired lead times and quality.

Furthermore, if we experience quality problems from any of our component suppliers, it could take us a significant amount of time to identify the problem as associated with a particular component, ascertain whether this is as a result of a design or a manufacturing flaw and either correct the problem, if possible, replace the components or find an alternate source of supply. Any such quality problem or delay could, in addition to causing us lost sales, detrimentally affect our reputation in the market and cause us to incur additional costs as a result of the recall and replacement of affected products.

Also, our dependence on third party suppliers of hardware significantly limits our ability to compete successfully with some of our competitors, which supply themselves the hardware components that are used in their solutions and therefore have the flexibility of making more competitive offers to potential customers.

Finally, because our products are generally used together with other vendors' software and hardware products, our products must integrate successfully with such products. As a result, when our customers encounter problems, it may be difficult to identify the product that caused the problem. System errors, whether caused by our products or those of another vendor, could adversely affect the market acceptance of our products, and any necessary revisions could cause us to incur significant expenses. Regardless of the source of these errors or defects, we will need to divert the attention of engineering personnel from our product development efforts to address errors or defects detected. These errors or defects could cause us to incur service or repair costs, liability claims or lags or delays. Moreover, the occurrence of errors or defects, whether caused by our products or the products of another vendor, may significantly harm our relations with customers, or result in the loss of customers, harm our reputation and impair market acceptance of our products.

Therefore, one of our strategies is to provide our customers with a full solution, by assembling and integrating with our products third parties' technologies and products. Such strategy warrants the allocation of technological and human resources, which may disrupt our ongoing business, disproportionately occupy the time and attention of our management and employees, increase our expenses and adversely affect our results of operations. Furthermore, we may not successfully integrate the various components or offer the full solution with such integrated technologies on a timely basis or at competitive prices, and there can be no assurance that we will not suffer from design and quality challenges in connection with the integration of the technologies and products. Furthermore, some of our competitors also offer such

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a "full solution", and we do not know if we will be able to compete successfully in this market.

THERE IS NO ASSURANCE THAT DEVELOPING NEW TECHNOLOGIES AND PRODUCTS WILL NOT CAUSE DELAYS IN OUR DELIVERY CAPABILITIES.

We continually seek to develop new products and invest in new technologies. A number of risks are inherent to this process. We may not successfully anticipate market requirements or complete the development or introduction of these new technologies and products. The development of new technologies and products is increasingly complex and uncertain. This can result in delays in the introduction of new technologies and products, and requires close collaboration and continued technological advancement involving multiple hardware and software design teams and outside suppliers of key components. The failure of any one of these elements could cause new products to fail to meet specifications, market requirements or customer demands, or to miss delivery schedules. In addition, if we fail to develop products and offer services that satisfy customer requirements, our ability to create or increase demand for our products would be seriously harmed and we may lose current and prospective customers, thereby harming our business.

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EXPECTED BENEFITS FROM THE ACQUISITION OF THE ASSETS OF OUTSMART LTD. MAY NOT BE REALISED

We acquired substantially all of the assets of Outsmart Ltd. in 2009 (described below under Item 4.A. "History and Development of the Company"), which is expected to deliver benefits resulting from the anticipated growth potential of the relevant markets by enabling us to accelerate the growth of our business and to establish our presence within the mobile telecom arena. However, there is no assurance as to the successful integration of the business acquired by us or the extent to which the anticipated benefits resulting from the acquisition will be achieved.

ADDITIONAL RISKS RELATED TO THE ACQUISITION OF THE ASSETS OF OUTSMART LTD.

The majority of risk factors mentioned and detailed above are relevant also to the Outsmart activity, products and solutions. Nevertheless, some are referred to here once again.

1. New customer type: VocalTec has traditionally marketed its products to operators of wire-line telephony services. The technology and solutions developed by Outsmart are primarily targeted towards mobile service providers. Although this provides us with a market opportunity there is no assurance that we will be successful in penetrating this new customer type. Our failure to successfully penetrate these customers may have adverse affect on our operating results.
2. Longer sales cycles: as mentioned above, the sales cycle for VocalTec's Essentra products is typically 6 to 12 months. The expected sales cycle for Outsmart's products is typically longer and is in the range of 12-18 months. This increases our costs in obtaining orders, reduces the predictability of our earnings and requires high working capital.
3. Plug N' Talk USB Device: certain of the solutions marketed and sold by Outsmart include a uniquely designed USB device. This device was originally manufactured for Outsmart in China and it is expected that



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future purchases, should they be required, will also be made in China. This carries with it certain risks including:

- a. We do not currently have a standing agreement with the original manufacturer of the device. Should we need to manufacture with the original manufacturer we would need to reestablish this relationship with this supplier and agree and renew our commercial understandings. In the unlikely event that we should fail to reach an agreement with this supplier we would need to identify and locate an alternative supplier. This may potentially carry with it additional costs as well as affect our ability to deliver products in a timely manner.
- b. Manufacturing problems may occur with our supplier. A supplier may supply us with products and components that do not meet our quality, quantity or cost requirement, or may cease to provide support with respect to the hardware and software purchased by the Company; therefore, we face the risk of inadequate supply, price increases, late deliveries, poor quality and failure in the availability and level of support and maintenance, as any supplier may terminate its relationship with us. If we were to lose our relationship with our supplier, the lead time required to qualify new suppliers could be several months. Also, if we lose our relationship with any of such suppliers or these suppliers are otherwise unable to satisfy our volume and delivery schedule requirements, it may be difficult to locate alternative suppliers that are able to develop, manufacture, deliver and provide products, service and maintenance with respect to the specialized components we need for our products in the desired lead times and quality. Furthermore, if we experience quality problems from our suppliers, it could take us a significant amount of time to identify the problem as associated with a particular component, ascertain whether this is as a result of a design or a manufacturing flaw and either correct the problem, if possible, replace the components or find an alternate source of supply. Any such quality problem or delay could, in addition to causing us lost sales, detrimentally affect our reputation in the market and cause us to incur additional costs as a result of the recall and replacement of affected products. See also "Item 3.D - RISK FACTORS ADDITIONAL RISKS RELATED TO THE ACQUISITION OF THE ASSETS OF OUTSMART LTD."
- c. We may be required to implement design changes to the device in order to meet customer requirements and in order to keep abreast of evolving market advances. This may cause us to rethink the original design concepts and we may be required to design and manufacture a newer generation of the device. This process may carry with it additional costs and may affect our ability to deliver products in a timely manner. Moreover, should the original manufacturer not be able to supply in accordance with the new design, or should we not be able to reach an agreement regarding the terms and conditions for the new design, we will be required to find and alternative supplier, this may carry with it additional costs.
- d. The SIM-based USB Dongle's design and concept is not patent protected and is therefore open to replication by our competitors. This risk is mitigated by the fact that the

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dongle, being on the client side, must work in conjunction with a backend server, also developed and marketed by VocalTec.

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WE HAVE NO BACK-TO-BACK LIABILITY INSURANCE AGAINST DAMAGES RESULTING FROM THE INTEGRATION OF THIRD PARTY COMPONENTS, WHICH MAY LEAVE US VULNERABLE TO FUTURE CLAIMS WE WILL BE UNABLE TO SATISFY.

The testing, marketing and sale of a full solution, which includes third party products and elements integrated together by us, entails an inherent risk of product liability claims, and we cannot assure you that substantial product liability claims will not be asserted against us. We have no back-to-back product liability insurance from the third parties we purchase products and components from. In the event we are forced to expend significant funds on defending product liability actions, and in the event those funds come from operating income and are not sufficiently covered by such back-to-back liability undertakings from such third parties, it could materially adversely affect our ability to attract new customers and retain existing customers. In addition, claims of this kind could divert management time and attention and could result in significant cost to investigate and defend, regardless of the merits of any of these claims. The filing of any claims of this kind may also damage our reputation and decrease demand for our products.

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

Our success is dependent, to a significant extent, upon our proprietary technology. We currently rely on a combination of trade secret, patent, copyright and trademark law, together with non-disclosure, contractual licensing restrictions, and invention assignment agreements, to establish and protect the proprietary rights and technology used in our products. There can be no assurance, however, that such measures will provide commercially significant protection for our proprietary technology, that competitors will not develop products with features based upon, or otherwise similar to, our products or that we will be able to prevent competitors from selling similar products. Specifically, our ability to adequately protect our proprietary rights in Ukraine (where a portion of our research and development operations is outsourced to subcontractors) is unclear due to the political instability in such country and the fact that the protection of intellectual properties in eastern European countries has traditionally been difficult to achieve. The sale of a major part of our patent portfolio during 2008 (See Item 4.A - "History and Development of the Company") has weakened our ability to protect our proprietary technology.

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

WE MAY NOT BE ABLE TO ENFORCE AGAINST OUR EMPLOYEES AND SUBCONTRACTORS COVENANTS NOT TO COMPETE AND THEREFORE MAY BE UNABLE TO PREVENT OUR COMPETITORS FROM

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BENEFITING FROM THE EXPERTISE OF SOME OF OUR FORMER EMPLOYEES AND SUBCONTRACTORS.

We currently have non-competition clauses in the employment agreements of nearly all of our employees, including all of our key employees. The provisions of such clauses prohibit our employees, if they cease working for us, from directly competing with us or working for our competitors. Israeli case law requires employers seeking to enforce non-compete undertakings against former employees to demonstrate that the competitive activities of the former employees will cause harm to one of a limited number of material interests of the employer recognized by the courts (for example, the confidentiality of certain commercial information or a company's trade secrets). In the event that any of our employees chooses to work for one of our competitors, we may be unable to prevent our competitors from benefiting from the expertise our former employees obtained from us, if we cannot demonstrate to the court that we would be harmed.

Additionally, our ability to enforce non-compete covenants against our sub-contractors in Ukraine, where we conduct a portion of our research and development operations, is unclear.

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

Third parties have asserted patent infringement and other claims against us from time to time. A number of these claims were directed at certain basic and fundamental components of our products. There can be no assurance that third parties will not assert such claims against us in the future or that such present and future claims will not be successful. In addition, third parties may in the future assert patent infringement and other claims against us in connection with components used in our products that are manufactured by our suppliers. Patents relating to basic technologies in the communications and multimedia areas have been recently allowed and patents may be filed in the future which relate to basic technologies incorporated in our products. Also, from time to time there have been claims challenging the ownership of open source software against companies that incorporate open source software into their products. We use certain open source software in our products and may use more open source software in the future. As a result, we could be subject to suits by parties claiming ownership of what we believe to be open source software. We would incur substantial costs and would experience diversion of management resources with respect to the defense of any claims relating to proprietary rights, and this could have a material adverse effect on our business, financial condition and results of operations. Furthermore, parties making such claims could secure a judgment awarding substantial damages, as well as injunctive or other equitable relief which could effectively block our ability to make, use, sell, distribute or otherwise license our products in the United States or any other jurisdiction. Such a judgment could have a material adverse effect on our business, financial condition and results of operations. Litigation, which is generally costly and time-consuming, may be necessary to determine the scope and validity of others' proprietary rights or to enforce any patents issued to us, in judicial or administrative proceedings. In the event a claim relating to proprietary technology or information is asserted against us, we may seek licenses for such intellectual property. There can be no assurance, however, that licenses could be obtained on commercially reasonable terms, if at all, or that the terms of any offered licenses will be acceptable to us. The failure to obtain the necessary licenses or other rights could preclude the sale, manufacture or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition or results of operations. The cost of responding to any such claim may be material, whether or not the assertion of such claim is valid.

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

In recent years, the telecommunications market has experienced consolidation. One of our business strategies is to pursue strategic partnerships, alliances, mergers and/or acquisitions of complementary businesses, products and technologies. Pursuit of such strategies requires significant investments in management time and attention, and we have limited experience in the consummation of strategic partnerships, alliances, mergers and acquisitions and in the post-transaction integration.

Mergers with or acquisitions of companies involve a number of risks including the difficulty of assimilating the operations and personnel of the merged or acquired companies and of maintaining uniform standards, controls and policies. There can be no assurance that technology or rights acquired by us will be incorporated successfully into products we introduce or market, that such products will achieve market acceptance or that we will not encounter other problems in connection with such acquisitions.

Such acquisitions may expose us to additional risks, including the following:

- o we may find that the acquired company, asset or technology does not further our business strategy, that we overpaid for the company, asset or technology or that the economic conditions underlying our acquisition decision have changed;
- o we may have difficulty retaining the key personnel of the acquired company;
- o our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically or culturally diverse enterprises; and
- o we may experience significant problems or liabilities associated with product quality, technology and legal contingencies relating to the acquired business or technology, such as intellectual property or employment matters.

In addition, if we proceed with one or more significant acquisitions or investments in which the consideration includes cash, we are likely to be required to use a substantial portion of our available cash. To the extent we issue securities as consideration in such acquisitions, existing shareholders might be diluted and earnings per share might decrease. In addition, acquisitions and investments may result in the incurrence of debt, and restructuring charges.

WE MAY BE ADVERSELY AFFECTED IF THE EXCHANGE RATE FLUCTUATIONS DECREASE OUR EARNINGS AND IF WE ARE NOT ABLE TO HEDGE OUR CURRENCY EXCHANGE RISKS EFFECTIVELY.

A significant portion of our sales are made outside of Israel in United States Dollars (USD) and we incur a significant portion of our expenses in New Israeli Shekels (NIS). The cost of our operations in Israel, as expressed in USD, is influenced by the extent to which any increase in the rate of inflation is not offset by the devaluation of the NIS in relation to the USD. Inflation in Israel may have the effect of increasing the USD cost of our operations in Israel. If

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the USD declines in value in relation to the NIS, it will become more expensive for us to fund our operations in Israel. During 2006, the exchange rate of the U.S. dollar to the NIS decreased. In 2007, the exchange rate of the U.S. dollar to the NIS continued to further decrease and this trend continued in the first half of 2008, reversing again towards the end of 2008 and in 2009. We engage in currency hedging activities from time to time with respect to our NIS expenses (mainly salaries), however, if we are not able to hedge our currency exchange risks effectively, we may not be well protected from adverse effects due to the impact of inflation in Israel.

In addition, as of now, most of our global sales have been in U.S. dollars and have not been adversely affected by foreign currency fluctuations. If global business conditions require us to sell our solutions in other local currencies, our sales may be adversely affected by devaluation of local currencies against the U.S. dollar. If, on the other hand, such local currencies' value increases against the U.S. dollar, our sales (in U.S. dollar terms) will be positively affected.

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

The competition in the VoIP equipment for the communications market is very strong. Our competitors include several VoIP equipment vendors. Many of our competitors are larger than we are, and can offer more comprehensive solutions either on their own or by partnering with others. In addition, many of our competitors have greater name recognition, larger installed customer bases, broader product offerings, and significantly greater financial, technical and marketing resources than we do. Finally, some of these competitors are not dependent, as we are, on third parties for the supply and quality of components required for the operation of their products. Such competition may result in a reduction in prices. Even if we reduce the prices of our products, there can be no assurance that we will be able to compete successfully and effectively for deals against our competitors' product offerings. Furthermore, if we reduce our prices below current levels due to competition, we may incur operating losses again.

In the future, additional competitors may include companies that currently provide computer software products and services, such as telephone, media and cable television. The ability of some of our competitors to bundle other enhanced services and other products with VoIP products could give these competitors an advantage over us.

WE ARE DEPENDENT UPON THE CONTINUED EMPLOYMENT OF KEY PERSONNEL.

Our future success depends to a significant extent upon the continued active participation of our directors, senior executive officers, management members and other key employees. The loss of the services of any such person may adversely affect the development and sales of our products and the management of our company and could have a material adverse effect on our business and results of operations. These persons are not bound by employment agreements for any specific term. Our success is also dependent upon our continuing ability to attract and retain highly qualified personnel and key engineers and sales and marketing personnel to perform research and development, commercialize products, and perform the sales and marketing functions required to bring these products to the market. There can be no assurance that we will continue to attract and retain such personnel. Even if we are successful in hiring additional qualified sales and engineering personnel, we will incur additional costs and our

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operating results, including our gross margin, may be adversely affected.

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

The majority of our sales are in international markets. In addition, a material portion of our research and development operations is outsourced to subcontractors in Ukraine. There are certain risks inherent in conducting business in international markets, including unexpected changes in regulatory requirements, export restrictions, homologation certifications, tariffs and other trade barriers, difficulties in staffing and managing foreign operations, longer payment cycles, credit-worthiness of potential customers, the impact of recessions on economies worldwide, reduced protection for intellectual property, preference for locally produced products, and potentially adverse tax consequences resulting from changes in tax laws and political instability, all of which can adversely impact the success of our international operations. There can be no assurance that one or more of such factors will not have a material adverse effect on our international operations and, consequently, on our business, financial condition and results of operations.

A significant part of our sales is targeted towards developing countries in Africa. Some of these countries are prone to suffer from political instability and general instability conditions, affecting our ability to do business in an efficient manner or collect amounts owed to us. Such instability may have a significant impact on our performance. In addition, a part of our sales is targeted in the Former Soviet Union. Such sales do not usually involve the issuance of a letter of credit, and consequently, if a contract is not completed, our margins from such contracts may be lower.

In addition, the legal systems in some of the countries in which we operate remain less than fully developed, particularly with respect to property rights, the protection of foreign investment and bankruptcy proceedings, generally resulting in a lower level of legal certainty or security for foreign investment than in more developed countries. We may encounter difficulties in enforcing court judgments or arbitral awards in some countries in which we operate among other reasons because those countries may not be parties to treaties that recognize the mutual enforcement of court judgments. Although VocalTec believes that the long term growth potential in developing markets is strong, legal obstacles could have a material adverse effect on the implementation of VocalTec's growth plans and its operations in such countries.

WE ARE SUBJECT TO ECONOMIC POLICY RISKS AND UNCERTAINTIES IN THE COUNTRIES IN WHICH WE OPERATE OR PROPOSE TO OPERATE. ANY DETERIORATION OR DISRUPTION OF THE ECONOMIC ENVIRONMENT AND BUSINESS CLIMATE IN THOSE COUNTRIES MAY HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS, FINANCIAL CONDITION, RESULTS OF OPERATIONS OR PROSPECTS.

In recent years, many of the countries in which we operate, or propose to operate, have implemented measures aimed at improving the business environment and providing a stable platform for economic development. For example, several Eastern European countries, such as Ukraine and Kazakhstan, have implemented free-market economic reforms. Others, such as South Africa, have attempted to reinforce political stability and improve economic performance after recent periods of political instability. Our business strategy was developed partly on the assumption that this modernization, restructuring and upgrading of the business climate in the developing countries will continue, and will support the creation of an additional client base in such countries. This trend will not necessarily continue, particularly in light of the recent economic downturn.

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RISKS RELATING PRIMARILY TO OUR INCORPORATION AND LOCATION IN ISRAEL

CERTAIN PROVISIONS OF OUR ARTICLES OF ASSOCIATION AND ISRAELI LAW COULD DELAY, HINDER OR PREVENT A CHANGE IN OUR CONTROL.

Our Articles of Association contain provisions which could make it more difficult for a third party to acquire control of us, even if that change would be beneficial to our shareholders. Specifically, our Articles of Association provide that our board of directors is divided into three classes, each serving a three-year term. In addition, certain provisions of the Companies Law could also delay or otherwise make more difficult a change in our control. The provisions of the Companies Law relating to mergers and acquisitions are discussed in greater detail in "ITEM 10 - Additional Information".

IT MAY BE DIFFICULT TO PURSUE AN ACTION IN THE U.S. OR TO ENFORCE A U.S. JUDGMENT, INCLUDING ACTIONS OR JUDGMENTS BASED UPON THE CIVIL LIABILITY PROVISIONS OF THE U.S. FEDERAL SECURITIES LAWS, AGAINST US AND OUR EXECUTIVE OFFICERS AND DIRECTORS, OR TO ASSERT U.S. SECURITIES LAWS CLAIMS IN ISRAEL.

Most of our directors and officers are not residents of the United States and most of their assets and our assets are located outside the United States. Without consent to service of process, additional procedures may be necessary to serve individuals who are not U.S. residents. Therefore, it may be difficult to serve process on those directors and officers who are not U.S. residents, in order to commence any lawsuit against them before a U.S. court, including an action based on the civil liability provisions of U.S. federal securities laws.

An investor also may find it difficult to enforce a U.S. court judgment in an Israeli court, including a judgment based on federal securities laws. In accordance with the Israeli Law on Enforcement of Foreign Judgments, 5718-1958, and subject to certain time limitations, an Israeli court may declare a foreign civil judgment enforceable only if it finds that:

- o the judgment was rendered by a court which was, according to the laws of the state of the court, competent to render the judgment;
- o the judgment may no longer be appealed;
- o the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and
- o the judgment is executory in the state in which it was given.

Even if these conditions are satisfied, an Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel. An Israeli court will also not declare a foreign judgment enforceable if:

- o the judgment was obtained by fraud;
- o there is a finding of lack of due process;
- o the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel;
- o the judgment is in conflict with another judgment that was given in the same matter between the same parties and that is still valid; or

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- o at the time the action was instituted in the foreign court, a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

An investor may also find it difficult to bring an original action in an Israeli court to enforce liabilities based upon the U.S. federal securities laws against us, or against our directors and officers. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws and rule that Israel is not the most appropriate forum in which to bring such a claim. In addition, even if an Israeli court agrees to hear such a claim, it may determine that Israeli law, and not U.S. law, is applicable to the claim. If U.S. law is found to be applicable, the content of applicable U.S. law must be proved as a fact, which can be a time-consuming and costly process.

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WE ARE A FOREIGN PRIVATE ISSUER AND YOU WILL RECEIVE LESS INFORMATION ABOUT US THAN YOU WOULD FROM A DOMESTIC U.S. CORPORATION. IN ADDITION, WE HAVE OPTED OUT FROM CERTAIN NASDAQ MARKETPLACE LISTING REQUIREMENTS.

As a "foreign private issuer", we are exempt from certain rules under the Exchange Act that impose certain disclosure and procedural requirements in connection with proxy solicitations under Section 14 of the Exchange Act. In addition, our directors, executive officers and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions of Section 16 of the Exchange Act and the rules thereunder with respect to their purchases and sales of our shares. In addition, we are not required to file periodic reports and financial statements with the SEC as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. As a result, you may not be able to obtain some information relating to us as you would for a domestic U.S. corporation. Also, as a "foreign private issuer" listed on the Nasdaq Global Market, we may follow home country practice with regard to certain matters instead of complying with the relevant Nasdaq Marketplace Rules, including distribution of annual and quarterly reports to shareholders, approval of related party transactions, composition of the board of directors, approval of compensation of executive officers, director nomination process and regularly scheduled meetings at which only independent directors are present and obtaining shareholder approval for certain dilutive events (such as the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company). We have previously informed Nasdaq that we will follow Israeli practice in lieu of complying with Nasdaq Marketplace Rules 5605(e) (2) (requiring companies to adopt a formal written charter or board resolution addressing the company's nominations process), 4350(c) (2) (Regularly scheduled meetings of the company's independent directors) and 5635(c) (Regarding the establishment of or a material amendment to a stock option or purchase plan or other equity compensation arrangement). In April 2010, we notified Nasdaq that we will follow Israeli practice in lieu of complying with Nasdaq Marketplace Rule 5635 (Shareholder Approval). See also "Item 10 - Additional Information - Certain Listing Requirements of Nasdaq".

THERE IS A SIGNIFICANT POSSIBILITY THAT FOR THE TAX YEAR ENDED DECEMBER 31, 2009 WE WILL BE CHARACTERIZED AS A PASSIVE FOREIGN INVESTMENT COMPANY. THIS MAY HAVE AN ADVERSE TAX IMPACT TO UNITED STATES HOLDERS.

As more fully described in "Item 10.E - Additional Information - Taxation and



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Government Programs", we could be characterized, for United States federal income tax purposes, as a passive foreign investment company ("PFIC"). Such characterization could result in adverse United States tax consequences to U.S. Holders (as defined in "Item 10.E- Additional Information - Taxation and Government Programs"). Our status as a PFIC could cause, among other things, any gain recognized on the sale or disposition of our ordinary shares to be treated as ordinary income for U.S. Holders and potential adverse tax treatment of certain distributions. The determination of whether our ordinary shares constitute shares of a PFIC is made annually and is based upon the composition of our income and assets, including the income and assets of certain entities in which we hold at least a 25% interest. If either 75% of our gross income or 50% of our gross assets are considered to be "passive", this may result in us being a PFIC. The value of our gross assets will generally be determined by the average value of our ordinary shares plus our liabilities. If the standard valuation method of using the average trading value of our ordinary shares were to be used, this would result in us being a PFIC for the tax year ended December 31, 2009. Therefore, there is a significant possibility that we were a PFIC in 2009 and we may continue to be a PFIC in 2010 if the average trading value of our shares does not significantly change or the percentage of our passive assets is significantly reduced. In view of this significant possibility, U.S. Holders are urged to consult their tax advisors for guidance and should also consider making certain tax election with respect to our ordinary shares that may help to minimize adverse U.S. federal income tax consequences. For a further discussion of the consequences of our possible PFIC status, please refer to "Item 10.E - Additional Information - Taxation and Government Programs".

CERTAIN BENEFITS AVAILABLE TO US FROM ISRAELI GOVERNMENT PROGRAMS MAY BE DISCONTINUED OR REDUCED AT ANY TIME, WHICH WOULD LIKELY INCREASE OUR NET RESEARCH AND DEVELOPMENT EXPENSES.

We benefit from participation by the Office of the Chief Scientist of the State of Israel (the "OCS") in certain of our research and development projects. To be eligible for these participations, we must continue to meet certain conditions. There can be no assurance that such participations will be continued at their current levels or otherwise. The termination or reduction of the participation of the OCS in research and development projects is likely to increase our net research and development expenses or limit or terminate certain research and development projects. In addition, our royalty payment obligation towards the OCS will continue even if we receive no additional, or reduced, grants from the OCS.

THE GRANTS WE HAVE RECEIVED FROM THE ISRAELI GOVERNMENT FOR CERTAIN RESEARCH AND DEVELOPMENT EXPENDITURES RESTRICT OUR ABILITY TO MANUFACTURE PRODUCTS AND TRANSFER TECHNOLOGIES OUTSIDE OF ISRAEL AND REQUIRE US TO SATISFY SPECIFIED CONDITIONS. IF WE FAIL TO SATISFY THESE CONDITIONS, WE MAY BE REQUIRED TO REFUND GRANTS PREVIOUSLY RECEIVED TOGETHER WITH INTEREST AND PENALTIES.

Our research and development efforts have been financed, in part, through grants that we have received from the OCS. We, therefore, must comply with the requirements of the Israeli Law for the Encouragement of Industrial Research and Development, 1984 and related regulations, or the Research Law.

Under the Research Law, the discretionary approval of an OCS committee is required for any transfer of technology or manufacturing of products developed with OCS funding. OCS approval is not required for the export of any products resulting from the research or development. There is no assurance that we would receive the required approvals for any proposed transfer. Such approvals, if granted, may be subject to the following additional restrictions:

- o we could be required to pay the OCS a portion of the consideration we receive upon any transfer of such technology to an entity that is not Israeli. Among the factors that may be taken into account by the OCS

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in calculating the payment amount are the scope of the support received, the royalties that were paid by us, the amount of time that elapsed between the date on which the know-how was transferred and the date on which the grants were received, as well as the sale price; and

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- o the transfer of manufacturing rights could be conditioned upon an increase in the royalty rate and payment of increased aggregate royalties and payment of interest on the grant amount.

These restrictions may impair our ability to sell our company, technology, assets or to outsource manufacturing outside of Israel. The restrictions will continue to apply even after we have repaid the full amount of royalties payable for the grants.

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

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

Accordingly, political, economic and military conditions in Israel may directly affect our business. Since the establishment of the State of Israel in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. During the summer of 2006, Israel was engaged in an armed conflict with Hezbollah, a Lebanese Islamist Shiite militia group and political party. This conflict involved missile strikes against civilian targets in northern Israel, and negatively affected business conditions in Israel. In the winter of 2008, Israel was engaged in an armed conflict against the Hamas organization in the Gaza strip, which was intended to eliminate or significantly reduce missile attacks on Israeli towns in close and mid proximity to the Gaza strip, which have been occurring continuously since 2001. Although Israel has entered into various agreements with Egypt, Jordan and the Palestinian Authority, there has been an increase in unrest and terrorist activity, which began in September 2000 and has continued with varying levels of severity into 2010. The election in 2006 of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council and the tension between the different Palestinian fractions may create additional unrest and uncertainty. In addition, Israel faces threats from more distant neighbors, in particular, the Islamic Republic of Iran, an ally of Hezbollah and Hamas. Furthermore, several countries, principally in the Middle East, still restrict doing business with Israel and Israeli companies, and additional countries may impose restrictions on doing business with Israel and Israeli companies if hostilities in Israel increase. Such restrictions may seriously limit our ability to sell our products to customers in those countries. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel, could adversely affect our operations and product development, cause our revenues to decrease and adversely affect the share price of publicly traded companies having operations in Israel, such as us.

CERTAIN OF OUR EMPLOYEES MAY BE OBLIGATED TO PERFORM MILITARY RESERVE DUTY.

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Generally, all non-exempt male adult citizens and permanent residents of Israel under the age of 40 (or older, for citizens with certain military occupations) are obligated to perform annual military reserve duty, usually up to a period of one month. Additionally, all such persons are subject to being called to active duty at any time under emergency circumstances. In the event of severe unrest or other conflict, individuals could be required to serve in the military for extended periods of time. In response to increases in terrorist activity, including armed conflicts, there have been periods of significant call-ups of military reservists in recent years. Although we have operated effectively under these circumstances since we began operations, no assessment can be made as to the full impact of these requirements on our workforce or business if conditions should change, and we cannot predict the effect on us of any expansion of these obligations.

UNDER CURRENT ISRAELI LAW, WE MAY NOT BE ABLE TO ENFORCE COVENANTS NOT TO COMPETE, AND, THEREFORE, WE MAY BE UNABLE TO PREVENT COMPETITORS FROM BENEFITING FROM THE EXPERTISE OF SOME OF OUR FORMER EMPLOYEES.

In general, we have entered into non-competition agreements with our employees in Israel. These agreements prohibit our employees, if they cease working for us, from competing directly with us or working for our competitors for a limited period. Under current law, we may be unable to enforce these agreements, and it may be difficult for us to restrict our competitors from gaining the expertise that our former employees gained while working for us. For example, Israeli courts have required employers seeking to enforce non-compete undertakings of a former employee to demonstrate that the competitive activities of the former employee will harm one of a limited number of material interests of the employer that have been recognized by the courts, such as the secrecy of a company's confidential commercial information or its intellectual property. If we cannot demonstrate that harm would be caused to our material interests, we may be unable to prevent our competitors from benefiting from the expertise of our former employees.

### ITEM 4. INFORMATION ON THE COMPANY

#### 4.A. HISTORY AND DEVELOPMENT OF THE COMPANY.

Our corporate name is VocalTec Communications Ltd. for both legal and commercial purposes.

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VocalTec was organized under the laws of the State of Israel in 1989 and is subject to the Companies Law. In November 2005, we consummated the business combination with Tdsoft and the shareholders of Tdsoft, pursuant to which the Company acquired all of the issued and outstanding share capital of Tdsoft and as consideration issued to the Tdsoft shareholders ordinary shares that constituted, immediately following such issuance, 75% of the issued and outstanding share capital of the Company. Following consummation of the transaction, Tdsoft became a wholly owned subsidiary of the Company. Tdsoft was organized under the laws of the State of Israel in April 1994. Our principal executive offices are located at 60 Medinat HaYehudim Street, Herzliya Pituach, 46140, Israel, and the telephone number at that location is +972-9-970-3888. Our website is <http://www.vocaltec.com>. The information contained on the web site is not a part of this annual report.

We are a provider of carrier-class voice-over-IP and Convergence solutions for fixed and wireless communication service providers. We provide trunking, peering

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and residential/enterprise VoIP application solutions that enable flexible deployment of next-generation networks (NGNs), as well as VoIP and IN solution targeted specifically at Mobile service providers. We develop, market and support advanced telecom solutions that enable the deployment and smooth migration of telephony networks from legacy networks to next generation, packet-based networks and the implementation of Greenfield next generation telecom networks. Designed for carriers, our standards-based solutions handle call control, media relay, signaling and security within state-of-the-art NGN and Mobile networks. Our SIP-based solutions support a variety of other protocols, including Megaco/H.248, MGCP, H.323, SIGTRAN M3UA/IUA, SS7, MAP, INAP and CAMEL and incorporate key elements of the IMS/TISIPAN (IP Multimedia Subsystem) architecture.

Our Essentra product line was designed to replace legacy products and simplify the deployment of NGN networks and the migration of networks to new, SIP-based networks. During 2005 and 2006, there were initial deployments and field trials of the Essentra products, including Essentra CX, EX, BAX and OSS, to new and existing customers. Tdsoft's sales of products in 2005 included the TdGATE and TdMAX access gateways as well as other legacy products that were a range of broadband and narrowband access gateways. Tdsoft products were discontinued in 2007 as described further below.

Following completion of the business combination with Tdsoft in November 2005, the combined company focused on completing the integration of the companies' operations, including product development, marketing, sales, customer support, finance and administration. After careful analysis of the companies' core strengths, management decided to focus on providing VoIP solutions for carriers, by leveraging the VocalTec brand and the combined capabilities of both VocalTec and Tdsoft under the Essentra brand and product line. In addition, management identified carriers in several geographic areas, including Russia, the Commonwealth of Independent States ("CIS"), Africa, Latin America and South East Asia, as the Company's targeted growth markets. As part of the post business combination integration process, management allocated substantial resources to complete the integration, enhance our brand and market recognition, further develop our Essentra products, increase our market share in the target segments and improve our operational efficiencies. During this same period the company strove to develop an integrated gateway combining the functionality of several Essentra elements into one integrated platform. This product was discontinued before product launch as detailed further below.

During 2006, we completed two financing rounds, raising an aggregate net amount of \$11.6 million.

Towards the end of 2007, we discontinued the development of a hardware-based media platform, which we had intended to complement our solution. The underlying reason was our decision to focus our development on software solutions and rely on off-the-shelf third-party media platforms, or computing platforms as needed. This decision further decreased our dependency on suppliers of hardware components and served to improve our cost structure.

In May 2008, we sold to Karo Millennium J.P. L.L.C. 11 patents and certain patent-related rights, out of our portfolio of 22 patents. With the consummation of the transaction and the payment of all transaction-related expenses, including payment to the OCS, we retained net profit amounting to approximately \$8.8 million. In December 2008, we sold to Masinolli Fund L.L.C. four patents and certain patent-related rights, out of our remaining portfolio of 11 patents. With the consummation of the transaction and the payment of all transaction-related expenses, we retained net profit amounting to approximately \$6.1 million. We were granted a geographically unlimited, non-exclusive license to use the sold patents and other patent-related rights in connection with the development and marketing of our products.

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In December 2009, we acquired substantially all of the assets and assumed certain of the liabilities of Outsmart Ltd., an Israeli private company and a pioneer and provider of telecommunications convergence solutions, in consideration for the payment of \$185,000 and the issuance of our ordinary shares having an aggregate value of \$100,000. For full information about this transaction, please refer to the full text of the form of the Asset Purchase Agreement, which is an exhibit to this annual report and is incorporated herein by reference.

Founded in 2001, Outsmart is a mobile solutions provider of convergence technologies. Outsmart offers its flagship product, the Plug `n Talk(TM) solution that allows mobile operators to reach out across national borders to tap into new user segments. Based on its Smart Convergence Platform, Outsmart enables operators to converge between mobile and VoIP. Pursuant to the purchase agreement, we purchased substantially all of Outsmart's assets, including, but not limited to, Outsmart's technology and intellectual property, as well as certain of its customer and partner contracts. In addition and pursuant to the agreement, we engaged certain of Outsmart's personnel in order to enable a continued development and support and an uninterrupted transition to Outsmart's customers and partners, so purchased.

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Outsmart's mobile VoIP and Intelligent Network products are a strategic addition to our existing portfolio of VoIP solutions. The combined portfolio, places us in a position of a provider of VoIP solution and applications to both fixed line and mobile service providers.

In 2009, our sales increased by approximately 5%, with gross margins increasing to 64%, while also decreasing level of operating expenses along the year, compared to gross margins of 57% in 2008, excluding amortization of intangible assets.

**CAPITAL EXPENDITURES:** The Company's capital expenditures for fiscal year 2009 were \$0.1 million compared to \$0.3 million in 2008. These expenditures were primarily for hardware and software.

**CAPITAL EXPENDITURES CURRENTLY IN PROGRESS:** During the first quarter of 2010 and through the date of this annual report on Form 20-F, the Company had capital expenditures in an aggregate amount of approximately \$40,000, primarily for hardware and software. The capital expenditures currently in progress are being financed by the Company through the use of internal sources. Currently, the Company has no capital divestitures in progress.

#### 4.B. BUSINESS OVERVIEW

Over a decade after first being introduced by VocalTec, Voice over IP (VoIP) technology has become part of the telecom mainstream. The demand for legacy, TDM based equipment is declining and all aspects of telephony, including networking, transport, control and services, are being gradually migrated to IP and to Voice over IP (VoIP). While most incumbent carriers are planning their migration strategy from the existing circuit switched network (which is the technology used during the last three decades), to VoIP next generation networks, new (Greenfield) carriers, without legacy networks and migration considerations, are deploying new networks based solely on VoIP.

As the "first name in VoIP", we gained our experience over the last 13 years in deploying carrier-based VoIP solutions based on H.323 and SIP protocols. For additional information, see Item 4.A - "History and Development of the Company."

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Following consummation of the business combination with Tdsoft in November 2005, we continue to develop and sell products and provide support and maintenance services to carriers and service providers that are deploying and/or migrating their network to NGNs, or building new VoIP networks. Our solutions provide carriers with call control, interfaces to legacy telephone systems, and interconnect solutions (peering) with other VoIP NGNs and residential/enterprise telephony services. Our solutions enable carriers and service providers to reduce both capital and operating expenses and provide a platform for them to increase their revenues through the delivery of IP-based residential and enterprise voice services, national and international long distance and peering services, Voice over Broadband, Voice over WiMAX and Hosted Enterprise (IP Centrex) solutions, thereby helping them to retain and expand their customer base.

In addition to the above, and as a direct result of the acquisition of certain of Outsmart's assets, VocalTec now has solutions that better address the needs of Wireless Service Providers (Mobile and WiMAX) when connecting their subscribers to their core IP/VoIP or legacy GSM networks. The primary market for these solutions is therefore those wireless service providers looking to provide their customers a VoIP-based experience. Today, the main mobile VoIP offering is a less expensive mechanism for providing cheaper international calls from mobile phones. Mobile VoIP, as a way to extend voice capabilities using a dual-mode phones and other mobile internet devices, is emerging as a promising new application. Moreover, WiMAX players are also poised to start adding mobile VoIP to their growing data offerings.

### REQUIREMENTS FOR THE NEW VOICE INFRASTRUCTURE SOLUTIONS

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

- o Carrier class equipment that complies with telecommunications carriers' quality standards;
- o Assured voice quality at a similar level to traditional TDM based voice;
- o Scalable solutions that support incremental growth from entry level deployments to massive global networks;
- o Interoperability with PSTN/PLMN networks, supporting the full range of traditional telephone signaling variants;
- o Mediation and peering capabilities between the various networks, to allow for seamless delivery of voice/multimedia services;
- o Simple and rapid installation, deployment and support.

### THE VOCALTEC SOLUTION

We develop, market and sell a variety of carrier-grade VoIP solutions for telecommunications service providers.

We believe that our particular advantages are:

- o A wide product offering and solutions that enable fast deployment of VoIP networks and solutions;

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- o Mediation between the core VoIP network and various other networks, supporting a variety of connections including:
  - o Peering with other VoIP networks;
  - o Connecting to Legacy Public Switched Telephony Networks (PSTNs) and Public Land Mobile Networks (PLMNs);
  - o Connecting with a variety of Access equipment and devices.
- o Strong telecom signaling and signaling conversion technology and know-how;
- o A modular flexible approach to building a variety of network solutions to fixed-line and wireless operators;
- o Significant SIP, H248, MGCP, SS7 and H.323 experience, resulting from deployments in a large number of carrier networks worldwide;
- o Flexible deployment options enabling cost-effective entry points as well as the ability to efficiently grow the network;
- o Multi-tiered service provisioning and management for hosted services, enabling carriers to offer services to non-facility based carriers;
- o Simple installation processes and ease of use and operation;
- o A large eco-system of fully interoperable solution partners complementing our own products and enabling the provision of a wide VoIP offering and applications;
- o More than thirteen years of experience in developing and deploying VoIP products and networks.

### THE ESSENTRA PRODUCT SUITE

Designed for easy integration in multi-vendor environments, VocalTec's best-of-breed solutions handle call control, media processing, signaling and security within state-of-the-art next generation networks. VocalTec's SIP-based solutions support a variety of protocols, including SIP, Megaco/H.248, MGCP, H.323, SIGTRAN M3UA/IUA, SS7, INAP, MAP and other protocols, incorporating key elements of the IMS/TISIPAN (IP Multimedia Subsystem) architecture.

The Essentra product suite is a modular set of open and highly focused VoIP products for next generation network operators. Essentra products can be deployed individually or in any combination of groupings in order to provide tailored and cost-effective solutions for each carrier's specific service application needs. It enables carriers to seamlessly integrate state-of-the-art network components from VocalTec and third party vendors to create best-of-breed network solutions, and allows service providers to offer VoIP interconnection services, as well as services to residential, SOHO/SME and mobile customers over any broadband access infrastructure.

Essentra is a scalable, carrier-grade SIP-based solution for carriers looking to deploy a reliable packet-based solution. Leveraging our extensive global experience in implementing large packet tandem networks, Essentra offers high quality voice services, carrier grade reliability and maximum service flexibility. Essentra enables quick and simple deployment of VoIP networks as well as the smooth migration of legacy networks to packet-based environments, while maintaining seamless connectivity to PSTN/PLMN networks.

### VOCALTEC PRODUCT OFFERINGS

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The Essentra product family includes several major elements required when implementing VoIP networks:

### 1. ESSENTRA VOIP

**ESSENTRA CX MEDIA GATEWAY CONTROLLER:** Essentra CX enables providers of National and International Long Distance services as well as VoIP providers to build and/or migrate their infrastructure to packet-based VoIP networks, with seamless connectivity to PSTN/SS7 services. This is a scalable, carrier-grade SIP-based media gateway controller.

**ESSENTRA EX PEERING MANAGER:** Essentra EX facilitates peering between SIP and/or H.323 networks. It addresses carriers' requirements in the areas of protocol interworking, security and intelligent voice routing.

**ESSENTRA BAX APPLICATION SERVER:** Essentra BAX enables the delivery of residential and hosted enterprise VoIP services over a wide variety of broadband access infrastructures. With a cost effective entry point and the capability of scaling up to large numbers of subscribers over time, it allows service providers to take advantage of evolving IP opportunities.

**ESSENTRA OSS OPERATION SUPPORT SERVER:** a centralized, web-based management system, enabling remote management, service configuration, monitoring and provisioning of Essentra Elements.

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### 2. ESSENTRA CONVERGENCE

**CONVERGENCE PLATFORM:** The Smart Convergence Platform integrates SIP-based telephony (VoIP) into the mobile core network. It offers end-users one identity, from one telephone number, across many devices. The platform enables operators to converge networks such as mobile, fixed and IP Multi-Media Systems (IMS). The Smart Convergence Platform delivers a seamless end-user experience between fixed and mobile networks.

The Convergence Platform serves as the underlying infrastructure for various applications and services including such services as:

**PLUG N' TALK:** a service allowing VoIP devices to be connected as an extension to a PLMN network and offering a variety of options to communicate over a PC with all the benefits of a mobile device and mobile network services. Users can enjoy a selection of choices including PC-to-PC, PC-to-phone or phone-to-PC calls. As part of the solution, VocalTec markets a softphone preloaded on a variety of devices, such as a USB memory stick, which provides the user with the same user experience, phone number, services (voice, video, SMS and MMS) and bill available on any standard mobile handset.

**VCCPLUS:** Providing a rich and seamless handover experience between mobile and WiFi networks for Dual Mode Handset users. The one phone service presents a Dual Mode Handset with seamless and bi-directional handover between mobile & WiFi-based on 3GPP VCC standards.

**PC CLIENT:** a SIP-based VoIP client application, intended for installation on any PC and offering a variety of end-user services including voice, video, SMS and MMS.

### 3. ESSENTRA IN



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ESSENTRA IN encompasses a variety of Intelligent Network (IN) services offered by VocalTec. These are enabled via the deployment of the solution as a Service Control Point (SCP), an advanced IN solution providing both traditional IN as well as Next Generation services. It enables handling many session types and events including voice, SMS and other value-added services.

MUTILINE: the Multiline service provides mobile users with multiple lines operating simultaneously on a single mobile handset via a regular SIM card. Subscribers can own multiple identities for both incoming and outgoing calls on a single device instead of carrying around two or more handsets. The implementation for business travelers includes the provision of a virtual-visiting-country-number enabled on the home-country device; in this manner the business traveler benefits from multiple lines on his single device. Other service implementations for the Multiline applications are also supported.

Using Essentra products, a variety of network solutions may be offered, to OEMs, resellers, existing carriers and emerging operators.

The following are some examples of such solutions:

### VOICE OVER BROADBAND / CLASS 5 REPLACEMENT

Essentra(TM) BAX application server can be quickly and easily deployed and integrated in the service provider's network. End users connect to the service through SIP-based Integrated Access Devices (IAD), SIP Phones, soft-phones, SIP-enabled PDAs as well as Megaco endpoints such as Multi Service Access Nodes providing legacy subscriber services. The VoIP telephone service includes traditional subscriber calling features (e.g., call waiting, call forward), new IP-enabled features (e.g., conferencing, "do not disturb") as well as web-based self-provisioning tools. Essentra BAX functions as a comprehensive Class 5 softswitch for both residential and enterprise users.

### SOHO, SME AND CORPORATE HOSTED SERVICES

Essentra BAX application server supports a powerful IP Centrex service, which allows the service provider to offer its enterprise customers a wide array of enterprise telephony features from a single central location. In this manner, multiple enterprise customers, whether small or large and whether local or global in nature with distributed locations, can enjoy the benefits of VoIP telephony. One numbering plan across the entire corporation and short dialing within all corporate offices create the look and feel of one single office PBX. The rich feature set and supported executive desk telephone stations offer a solution that can compete with advanced PBX services.

### VOIP BASED WHOLESALE CARRIERS AND INTERNATIONAL LONG DISTANCE CARRIERS

The Essentra suite may be used to build/migrate a wholesale carrier network to an NGN based solution. Using the Essentra EX Peering Manager and the Essentra CX Media Gateway Controller, plus additional optional Essentra elements, a carrier grade VoIP network may be built providing the needs of such carriers. Essentra EX allows for un-matched connectivity to other peer IP networks, providing the required protocol mediation, security and routing schemes to allow for the appropriate network termination at any given time. Essentra CX enables such carriers to carry traffic to the PSTN using the SS7 PSTN protocol, which is commonly used for Network to Network connectivity.

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### NATIONAL LONG DISTANCE

Building a National Class 4 packet-based network entails the replacement of existing tandem switches. Replacing the core TDM network results in traffic and bandwidth optimization as well as reduced OpEx.

With Essentra, service providers can easily build their next-generation network or migrate their existing tandem network to a packet-based infrastructure. Essentra CX is the core of VocalTec's solution for national Class 4 networks. Essentra CX is a feature-rich Media Gateway Controller offering seamless connectivity to PSTN services.

Essentra CX can be deployed in various configurations suited for both centralized and distributed networks. Offered in conjunction with a wide range of Media Gateway density options, the solution allows service providers to optimize their deployment and their upfront CapEx investment.

The solution's flexibility and proven interoperability makes it ideal for service providers building a packet-based core network

Other Essentra elements, such as the Essentra EX, enable Peering and session control towards peer VoIP network, as well as the definition of dynamic routing plans for optimized revenue management, thereby effectively completing this solution.

### INTERNATIONAL GATEWAY

The VocalTec International Gateway offering enables quick and simple deployment of International gateways providing significant economies in terms of network utilization and routing plan management. The solution features seamless connectivity between PSTN (TDM) and IP-based networks. It further provides comprehensive IP-to-IP peering capabilities, enabling traffic to pass directly between VoIP networks while bypassing the PSTN/PLMN. These intelligent and flexible routing capabilities allow carriers to change call routes dynamically in response to business requirements, enabling them to find the best termination peers and thereby optimize their cost structure through the implementation of flexible business models.

The ability to support both packet and legacy circuit traffic eliminates the need for additional investment in legacy infrastructures and allows the service provider to maintain a competitive service in today's ever-changing business environment.

### VOICE OVER WIMAX

As the adoption of VoIP technology and services continues to grow, we now see a large number of service providers looking to deliver VoIP services over wireless infrastructures, WiMAX primary among them. WiMAX technology is quickly gaining ground with service providers looking to take advantage of evolving IP opportunities.

The ability to efficiently provide widespread broadband internet together with quality VoIP services is paramount to the successful implementation of these network solutions.

VocalTec, a pioneer in VoIP technologies, brings to market a robust and comprehensive Voice over WiMAX offering designed to assist this new generation of service providers meet their business objectives.

A clear advantage of the VocalTec solution is that it offers the service provider a complete end-to-end VoIP solution containing all elements required for the successful implementation of a Voice over WiMAX service. VocalTec's

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packaged solution enables WiMAX providers to deploy a voice solution in record time while benefiting from a cost-effective offering conducive to significant cost savings and quick ROI.

The solution includes all main components of the Essentra solution suite; Essentra BAX being the Class 5 feature server and the Essentra CX and Essentra EX, each enabling connectivity to other networks; the PSTN and other VoIP networks respectively.

Specifically designed with WiMAX deployments in mind, the solution is both compact and cost-effective, allowing service providers to launch a service while controlling their capital expenditures. The solution is easily scalable in accordance with the service provider's business objectives and capabilities

### MOBILE SOLUTIONS FOR BUSINESS TRAVELLERS AND OVERSEAS WORKERS

Operators currently face two significant challenges: introducing new services in an effort to increase average revenue per user or target new market segments. The VocalTec solution allows operators to benefit from both. With immigration continually rising and expatriates forming entire subcultures within a given country, VocalTec offers the operator an opportunity to access this previously untapped market.

The telecommunications traffic pattern of these expatriates and immigrants represent a large number of potential new minutes and revenue that until now have been off the operator's radar screen. VocalTec enables the operator to venture beyond its borders and attract new traffic by tapping into this revenue generating traffic pattern.

The solution incorporates the Essentra Convergence Platform interfacing to the operator's core GSM network on the one side, while providing a fully standard SIP-based VoIP extension on the other. Coupled with the VocalTec PC-client application (whether stand-alone or in conjunction with the VocalTec USB dongle), the solution offers the travelling user a complete mobile user experience (on his PC) including the support of value-added-services and allowing the user to maintain the same identity and number.

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### LEGACY PRODUCTS

In the past, VocalTec and Tdsoft developed and marketed products that used TDM, ATM and H.323 technologies. These products were sold in the past to a number of carriers, who are still requiring support and maintenance services for these products.

The Company's primary legacy products include:

- o ATM Gateways, including primarily the TdGATE(tm) 3X00. The TdGATE 3X00 is a Voice over Broadband Gateway that allows service providers to provide ISDN and telephony services over Broadband access infrastructure based on ATM AAL2 standards.
- o H323 Products, including VoIP Gateways, Gatekeepers and network management solutions. VoIP Gateways include the VocalTec GW2000 and GW480 carrier grade Gateways, providing TDM to VoIP interconnection. The VocalTec VA Gatekeeper used to manage a network of Gateways and enable routing management of such networks and the VNM network management software, used to manage the network and provide element

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management and OSS functions to such networks.

### THIRD PARTY ELEMENTS INCLUDED IN OUR SOLUTIONS

In many cases, our customers expect us to provide a wide solution that is comprised of third party software and hardware elements. We are dependent on the following suppliers of hardware and software elements that are integrated into or complement our solutions: AudioCodes Ltd. for the supply of media gateways; Dialogic for the supply of SS7 signaling software and boards; IBM for X series servers and BladeCenter technology, and various other suppliers for Operating System Software, SIP software, SS7 Software, Voice engine technology, and other software and hardware components with respect to both our wireline and wireless solutions. If our relationship with any of these suppliers is terminated, then we will need to invest time and resources to integrate our products with the hardware and software components of alternative suppliers. See Item 3.D - "Key Information - Risk Factors - WE DEPEND TO A CERTAIN DEGREE ON THIRD PARTIES FOR THE SUPPLY AND QUALITY OF HARDWARE AND SOFTWARE ELEMENTS REQUIRED FOR THE MARKETING OF OUR PRODUCTS, AND ANY DELAY OR DISRUPTION IN THE SUPPLY OF THESE PRODUCTS WILL ADVERSELY AFFECT OUR RESULTS. IN ADDITION, INACCURATE ESTIMATES OF OUR INVENTORY/PURCHASING REQUIREMENTS COULD ADVERSELY AFFECT OUR RESULTS OF OPERATIONS. FURTHERMORE, ERRORS OR DEFECTS IN OTHER VENDORS' PRODUCTS WITH WHICH OUR PRODUCTS ARE INTEGRATED COULD ADVERSELY AFFECT THE MARKET ACCEPTANCE OF OUR OFFERINGS AND EXPOSE US TO PRODUCT LIABILITY CLAIMS FROM OUR CUSTOMERS".

Notwithstanding the foregoing, our dependency on the foregoing suppliers is less than the dependency we had on suppliers of hardware components for our hardware-based products, since our Essentra products are based on Linux and general-purpose IBM servers.

In addition, our dependency on Dialogic for signaling software has been reduced due to the support of the standard protocol SIGTRAN that is used in both our Essentra CX and on Dialogic components (SIGTRAN is a standards-based protocol, which is also available from other signaling gateway vendors). In developing our past H.323 products, we were required to support a proprietary protocol provided by Dialogic, which was significantly harder to replace.

In addition to the above third party VoIP products, we also offer a wider portfolio of third-party products through which we can offer a complete turn-key solution to our customers, beyond our current eco-system of VoIP solutions.

Other third-party elements relate also to the USB device currently marketed by VocalTec. This solution, previously marketed and sold by Outsmart, includes a uniquely designed USB device. This device was originally manufactured for Outsmart in China and it is expected that future purchases, should they be required, will also be made in China. This carries with it certain risks including supplier management, manufacturing, possible design changes and more. See Item 3.D - "Key Information - Risk Factors- ADDITIONAL RISKS RELATED TO THE ACQUISITION OF OUTSMART LTD.".

### MARKETING, SALES AND DISTRIBUTION

We market and distribute our products both directly and via multiple distribution channels, and our main target customers include fixed-line national and international long distance carriers, competitive local exchange carriers (CLEC), VoBB providers, incumbent local exchange carriers (ILEC), alternative VoIP telephony carriers (such as Vonage) and Internet Telephony Service Providers (ITSPs). Lately, and more so pursuant to the acquisition of Outsmart's assets, we also added the Mobile operators to our target customers by offering a new set of solutions for Mobile operators. We target both carriers with an existing infrastructure as well as those Greenfield carriers building new VoIP networks.

As of the business combination with Tdsoft, we have increased our sales and marketing efforts, in order to enhance and leverage the VocalTec brand, and in order to penetrate specific geographic areas in which we believe our products can be successfully sold. Such areas include primarily Russia, Commonwealth of Independent States (CIS), Africa, Latin America and South East Asia. As part of these efforts, we reached agreements with a large number of local agents and distributors/Systems Integrators that assist us in the marketing of our products. These efforts resulted in new customer acquisitions and serve as a platform for further sales into each such target market.

In addition, we are continuously making efforts to establish relationships with channel partners, including resellers and other vendors, in order to leverage their market presence and increase our market reach and sales.

The sales cycles for our solutions are typically long as is common to the telecommunications market and the nature of our products and solutions. Once purchased by our end user customers, our solutions require installation in the network. After installation, the system usually enters into a service period of twelve to eighteen months. We offer three primary maintenance and service agreements, which are renewed on an annual basis. The standard service is a 9X5 support service (i.e. during regular business hours), including fixing of errors and faulty hardware replacement. The premium service includes a 24X7 support service and versions updates, while the premiumplus service also includes restricted eligibility to new product versions released.

#### INDUSTRY STANDARDS

We recognize that standards are important for interoperability and for providing the means for market growth. Over the years, we have taken an active role in international standards bodies and we continuously strive to keep abreast of evolving standards and specifications.

We actively support important communications standards in our products, including IETF SIP, ITU-T H.323, SS7, ISDN, MEGACO, MGCP, SIGTRAN, RADIUS and others, and work closely with our carrier customers and equipment manufacturers in ensuring standards are correctly and uniformly implemented. The Essentra product suite was designed to meet the IMS specifications, which are being adopted by both wireless and fixed line operators. We consider our products to be IMS-TISPAN-ready.

#### COMPETITION

Our market is highly competitive and rapidly evolving, and is characterized by evolving standards, new alliances and consolidation. Since the Essentra solution combines trunking, peering, mobile and application elements, our competitive landscape includes providers of softswitches ("trunking"), application servers ("application") and session border controllers ("peering") as well as those providers offering network and service convergence solutions. Our principal competitors include Huawei, ZTE, Veraz Networks, Cirpack (now part of Thomson Technology), Cisco Systems, Iskratel and Sonus Networks Inc. as Softswitch vendors; Broadsoft, and NetCentrex (part of Comverse Technologies) as application server vendors; AcmePacket and Genband as session border controller vendors; and Nokia Siemens Networks, Mavenir and Counterpath as providers of VoIP-to-mobile convergence services.

Many of our competitors are difficult to compete with, as they are larger than we are, have stronger brand recognition, have greater long-term resources and

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can sustain larger price reductions for their products.

We believe that in such a rapidly changing market, key competitive factors include time to market, technology and experience, reputation, a broad base of users, strategic alliances, key reference customers, interoperability, product performance, product features and ease of use, price, customer support, distribution channels and the ability to respond quickly to emerging opportunities.

### EFFECTS OF GOVERNMENTAL REGULATIONS

See "Item 10.E - Additional Information - Taxation and Government Programs".

### 4.C. ORGANIZATIONAL STRUCTURE

We are organized under the laws of the State of Israel. As of December 31, 2009, none of our subsidiaries (a list of which is provided for informational purposes only in Exhibit 8 to this annual report) is significant.

### 4.D. PROPERTY, PLANTS AND EQUIPMENT

Our headquarters are located in Herzliya Pituach, Israel. We currently pay a total annual rental amount of approximately \$468,000. These facilities are used for management, administration, operations, marketing, sales, research and development, and testing. We maintain car leases, and our total liability for early termination of the leases is approximately \$38,000. In the upcoming months we will move our offices to a new location in Netanya, Israel, and will occupy 6,500 square feet pursuant to a 6-year lease agreement expiring in April 2016. We will pay a total annual rental amount of approximately \$80,000 pursuant to the lease terms regarding such premises. For additional information about this lease, please refer to the summary of the lease agreement between the Company and Ayalot Property Investments (Natanya) Ltd., dated March 15, 2010 which is an exhibit to this annual report and is incorporated herein by reference.

### ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

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### ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE FOLLOWING DISCUSSION OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES INCLUDED ELSEWHERE IN THIS ANNUAL REPORT. THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS MAY DIFFER SIGNIFICANTLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE FUTURE RESULTS TO DIFFER SIGNIFICANTLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED BELOW AND ELSEWHERE IN THIS ANNUAL REPORT, PARTICULARLY THOSE DESCRIBED ABOVE UNDER "ITEM 3.D - KEY INFORMATION - RISK FACTORS".

#### OVERVIEW

We are a provider of carrier-class multimedia and voice-over-IP (VoIP) solutions for fixed line and wireless communication service providers. We develop and market an extensive VoIP offering that enables the flexible deployment of next-generation networks (NGNs). Partnering with prominent system integrators,

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resellers and equipment manufacturers, we serve an installed base of leading service providers. Designed for easy integration in multi-vendor environments, our solutions handle call control, media processing, signaling and security within state-of-the-art NGN networks. Our SIP-based solutions support a variety of protocols, including Megaco/H.248, MGCP, H.323, Sigtran, ISUP, MAP, INAP and CAMEL and incorporate various elements of the IMS/TISPAN (IP Multimedia Subsystem) architecture.

We believe that continued investment in research and development is essential to remain competitive in the marketplace and is directly related to the timely development of new and enhanced products. Specifically, in order to bring our future products to maturity and thereafter increase sales, we are allocating significant resources to research and development activities, including outsourcing certain research and development assignments. We expect to participate only in OCS royalty bearing programs but we cannot make any assurances that we will be awarded any future grants.

Growth in the fixed line VoIP market is being driven largely by new entrants and service providers looking to reduce operational costs and easily add new, advanced services to their offering. In the wireless space, growth in VoIP is driven by WiMAX providers gradually adding voice to their broadband offering as well as by mobile providers currently deploying packet-based solutions primarily as a means to reduce service costs associated with their international calling and roaming offerings. While there are favorable industry trends that we believe create an opportunity for us, the ultimate demand for our products will depend upon the magnitude and timing of capital spending on VoIP infrastructure by telecommunications service providers and our ability to penetrate the market with new products and gain market share. The economic downturn experienced in 2009, in fact lead to communications service providers adopt a more cautious approach to capital spending.

We plan to increase our market share in the growing VoIP market, with an obvious focus on our target geographies. In 2006, we started selling our products in new regions, including Russia, Africa and Vietnam. In late 2006, we started selling our products also to resellers/systems integrators, resulting in an increase in the number of transactions. In 2007, while continuing to sell our solutions to the markets discussed above, we also began selling our solutions to Latin America both directly and through resellers/systems integrators. In 2008, while continuing to sell our solutions in Europe and North America, we focused our marketing efforts in the Former Soviet Union, Latin America and Africa. This continued through 2009, where we saw further growth in our activity in Russia and the Former Soviet Union as well as in the African region. We continued developing the markets of Latin America and South East Asia. These represent our current target markets.

Our consolidated financial statements are prepared in accordance with U.S. GAAP, and are the basis for the discussion and analysis of our results of operations, liquidity and capital resources. Our functional and reporting currency is the U.S. Dollar, which is the currency of the primary economic environment in which our consolidated operations are conducted. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in currencies other than dollars (including NIS) are re-measured in dollars in accordance with the principles set forth in ASC 830, "Foreign Currency Matters". Our reported amounts of assets, liabilities, revenues and expenses and the related disclosure of contingent assets and liabilities are based on certain estimates and judgments made in the preparation of our financial statements, which estimates and judgments are revised periodically as required. Our estimates and assumptions are based on factors such as analysis of prior years' experience, trends within the Company and the telecommunications industry, and general economic conditions. However, actual results may differ from our estimates and assumptions as a result of varying market and economic conditions, and may result in lower revenues and bigger operating losses.

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### REVENUES

In 2009, we had sales of \$6.4 million, compared to \$6.1 million in 2008. Through 2009, we generated our revenues from sales of our products (primarily the Essentra family products) and related services. Sales of products accounted for 66% of our revenues in 2009 compared to 65% in 2008.

In late 2006, we began marketing and selling our products also through resellers/systems integrators and partners. We sell our products to such resellers/systems integrators/partners for a consideration that is generally lower than the prices to end customers. As a result of the sale to resellers/system integrators, we gain access to a broader range of customers, resulting in a larger amount of transactions.

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Sales to most of our customers are generally made under short-term non-cancelable purchase orders. Although our customers may provide us with forecasts, our ability to predict revenues in any future period is limited and subject to change based on demand for our customers' equipment.

We market and sell our products worldwide. The percentages of our revenues by geographic area for the periods indicated were as follows:

	YEAR ENDED DECEMBER 31,		
	2007	2008	2009
	%	%	%
Russia	28	51	24
Germany	23	16	15
Italy	15	11	5
Iceland	3	1	1
Europe - other	11	1	1
Americas (principally United States)	6	6	5
Asia	2	3	4
Israel	3	6	7
Africa and Middle East	9	5	38
	-----	-----	-----
	100%	100%	100%
	-----	-----	-----

We attribute revenues to the geographic area where the customer, or its business unit that makes the purchase, is based.

### CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and the results of operations is based on our consolidated financial statements that have been prepared in accordance with US GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, inventories accounting for stock-based compensation and taxation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and



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liabilities that are not readily apparent from other sources.

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

### IMPAIRMENT OF LONG-LIVED ASSETS

The long-lived assets and finite-lived intangible assets of the Company and its subsidiaries are reviewed for impairment in accordance with ASC 360-10-35, "Property, Plant and Equipment-Subsequent Measurement", when events or changes in circumstances indicate that the carrying amount of an asset (or an asset group) may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds its estimated fair values.

We use the income approach in order to determine the fair value of intangible assets, as no quoted price in active market exists for such assets. The income approach requires management to predict forecasted cash flows, including estimates and assumptions related to revenue growth rates and operating margins, future economic and market conditions. Our estimates of market segment growth and our market segment share and costs are based on historical data, various internal estimates and certain external sources, and are based on assumptions that are consistent with the plans and estimates we are using to manage the underlying business. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

As required by ASC 820, "Fair Value Measurements", starting January 1, 2009, the Company applies assumptions that marketplace participants would consider in determining the fair value of long lived assets (or assets groups).

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### REVENUE RECOGNITION

The Company generates revenues from licensing the rights to use its software products, from the sale of its systems and from providing maintenance, engineering and support services, and in addition, from providing system integration and products arrangements for which revenues are generated on a fixed price basis. The Company's products are sold both to end users and to resellers, who are considered end-users for the purpose of revenue recognition.

Revenue from licensing of software products and systems is recognized when all the following criteria (which is outlined in ASC 985-605, "Software Revenue Recognition"), are met: persuasive evidence of an arrangement exists, the product has been delivered, no significant obligation to the customer remains, the sales price is fixed or is determinable and collectability is reasonably assured. The Company does not grant a right of return to its customers.

Due to a limited number of separate support services and maintenance contracts consummated through 2007-2009, VSOE is not attainable to support allocation of services and maintenance revenues. Accordingly, recognition of revenues from bundled software arrangements are recognized ratably over the period of the last

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delivered element in the arrangement, which is typically the customer support and maintenance service period, provided that all other revenue recognition criteria are met.

When an arrangement provides for acceptance of the product by the customer, revenue is only recognized when such acceptance is received from the customer.

In certain cases, when the Company sells its products through resellers in new and emerging market channels for which no comparable history has been established, the Company recognizes revenues only when all obligations to the end user have been completed, and provided all other revenue recognition criteria have been met.

Revenues from arrangements including training and installation services are recognized only after the services are performed.

Revenues from software maintenance and technical support contracts are recognized on a straight-line basis over the term of the maintenance and support arrangement.

Revenues from system integration long-term projects are generated from fixed-price contracts according to which the time between the signing of the contract and the final customer acceptance is usually over one year. Such contracts require significant customization for each customer specific needs and, as such, revenues from these type of contracts are recognized in accordance with ASC 605-35, "Construction-Type and Production-Type Contracts," using contract accounting based on the percentage of completion method.

Sales under long-term fixed-price contracts which provide for a substantial level of development efforts in relation to total contract efforts are recorded using the cost-to-cost method of accounting as the basis to measure progress toward completing the contract and recognizing revenues. According to this method, revenues and profit are recorded based on the ratio of costs incurred to estimated total costs at completion.

A number of internal and external factors may affect the Company's costs estimates, including labor rates, estimated future prices of material, revised estimates of uncompleted work, efficiency variances, linkage to indices and exchange rates, customer specifications and testing requirement changes. If any of the above factors were to change, or if different assumptions were used in estimating progress cost and measuring progress towards completion, it is possible that materially different amounts would be reported in the Company's consolidated financial statements. Changes in estimates due to changes in estimates resulting from differences between actual performance and original forecasts are recorded in the results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of similar services, and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2009, there was no provision for losses.

The Company believes that the use of the percentage of completion method is appropriate as it has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and the terms of settlement, including in cases of termination for convenience. In all cases the Company expects to perform its contractual obligations and its customers are

expected to satisfy their obligations under the contract.

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

As of December 31, 2009, the Company adjusted the estimates of a project that was signed with one of its major customers during the year. Such adjustments were required in order to address a delay in the progress in this project. The Company does not expect any loss from this project. As of the date of this report, a material progress was achieved and the project is supposed to continue as planned.

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#### INCOME TAXES

The Company accounts for income taxes and uncertain tax positions in accordance with ASC 740, "Income Taxes". ASC 740 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value. As of December 31, 2009, a full valuation allowance was provided by the Company. See Note 15 to the Financial Statements for the impact of an amendment ASC No. 740, Accounting for Uncertainty in Income Taxes.

On January 1, 2007, the Company adopted an amendment to ASC 740-10 (originally issued as "FIN 48"). The amendment contains a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. The Company accrues interest and penalties related to unrecognized tax benefits in its provision for income tax. The Company recognized an increase of approximately \$ 34 in the liability for unrecognized tax benefits, which was accounted for as an increase to the January 1, 2007 balance of the accumulated deficit. See also Note 15 to the Financial Statements.

#### SHARE-BASED COMPENSATION

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation - Stock Compensation". ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statements.

The Company estimated the value of equity employee stock options on the date of grant using a Black-Scholes option-pricing valuation model. The fair value of stock options awards, as determined on the date of grant, is affected by several factors including our stock price, our stock price volatility, risk-free

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interest rate, expected dividends and the expected term of the options. If such factors change and we employ different assumptions for future grants, our compensation expense may differ significantly from what we have recorded in the current period.

In addition, ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

In the future, if the number of equity awards that are forfeited by employees is lower than expected, the expenses recognized in such future periods will be higher.

The Company recognizes compensation expenses for the value of its awards granted based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures.

### 5A. OPERATING RESULTS

YEAR ENDED DECEMBER 31, 2009 COMPARED TO YEAR ENDED DECEMBER 31, 2008

#### SALES

In 2009, we had sales of \$6.4 million, compared to \$6.1 million in 2008, an increase of \$0.3 million, or 5%. Through 2009, we generated our revenues from sales of our products (primarily the Essentra family of products), from providing system integration and products arrangements on a fixed price basis, and from the sale of maintenance, support and other services. Sales of products accounted for 66% of our revenues in 2009, whereas sales of services accounted for 34% of our revenues in 2009. Sales in 2009 included an amount of \$2.2 million to a significant customer that was accounted for under contract accounting and recognized based on the percentage to completion method. As of December 31, 2009, we adjusted the estimates of this project in order to address a delay in the project's progress. As of the date of this annual report, most of the reasons for the delay were resolved.

Due to a limited number of separate support services and maintenance contracts consummated during such years, and since the Company began providing its services through distributors and integrators (resulting in inconsistencies of the portion of the contracts that is attributed to services), the Company was unable to establish VSOE (as defined under "Revenue Recognition" above) with respect to the support services and maintenance provided by the Company subsequent to January 1, 2007. Accordingly, revenues from bundled software arrangements in 2007 through 2009 are recognized ratably over the last deliverable element in the arrangement, which is typically the support and maintenance service period, assuming all other revenue recognition criteria are met. Revenues from system integration long-term projects are recognized in accordance with ASC 605-35, "Construction-Type and Production-Type Contracts," using contract accounting based on the percentage of completion method. For additional information on our revenue recognition policies, see Note 2(j) to the financial statements attached to this annual report.

In 2009, we continued selling our products also to resellers/systems integrators and partners. We sell our products to such resellers/systems integrators/partners for a consideration that is lower than the prices to end customers. As a result of the sale to resellers/systems integrators, we gain

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access to a broader range of customers, resulting in a larger amount of transactions. We expect to continue selling our products through such channels.

In 2009, we continued selling our Essentra family of products as part of solutions consisting also of certain hardware that we purchase from third parties, resulting in a continuous increase in sales.

To date, we have derived a substantial portion of our revenues from a relatively small number of customers (including resellers/systems integrators and partners). Each of the following customers accounted for more than 10% of our revenues for the periods indicated:

	YEAR ENDED DECEMBER 31,		
	2007	2008	2009
Deutsche telecom	22%	15%	14%
Mobifon 2000	12%	26%	*
Integrated Networks	10%	*	*
ITI	*	14%	*
Inline	*	*	10%
Mobitel	*	*	35%

\* less than 10%

Total sales to the foregoing major customers accounted for 44%, 55% and 59% of our total revenues for the years ended December 31, 2007, 2008 and 2009, respectively.

In 2009, the Company focused its marketing efforts in the Former Soviet Union, Africa, Latin America and South-East Asia. The Company expects to continue focusing on these target markets in 2010.

### COST OF SALES

Cost of sales in 2009 was \$2.3 million, or 36% of sales, compared with \$2.9 million, or 48% of sales (including an amortization of acquired intangibles in the amount of \$0.3 million), in 2008. The effect of the amortization of acquired intangibles as a percentage from sales in 2008 was 5% and in 2009 0%. Cost of products was \$1.8 million in 2009 and \$2.0 million in 2008. Cost of services was \$0.6 million in 2009 and in 2008.

The decrease in the cost of sales in 2009 compared to 2008 resulted mainly from a higher percentage of software included in product revenues.

Cost of our sales consists primarily of the cost of hardware components, salaries and other related expenses of our employees who are engaged in the production and support of our products and royalties paid by us to licensors of software and to the OCS.

In 2009, gross margins were 64%. In 2008, gross margins were 52%, including amortization of acquired intangibles, which decreased the gross margins from 57%.

### OPERATING EXPENSES

#### RESEARCH AND DEVELOPMENT, NET

Research and development costs, net, were \$2.1 million in 2009, including a \$0.4 million OCS grant, compared with \$4.2 million in 2008, including a \$0.1 million

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OCS grant, representing 32% and 68% of sales in 2009 and 2008, respectively. Research and development costs, net, consist principally of salaries and benefits for software and hardware engineers and sub-contractors, related facilities' costs and activities and expenses associated with computer, software and other equipment used in software and hardware development and testing. Research and development costs, net, in 2009 and 2008 included stock-based compensation amounts of \$120,000 and \$357,000, respectively, due to recognition of expense for share based payments accounted for under ASC 718. None of our software or hardware development costs have been capitalized during any of the reported periods, as the amount of software and hardware development costs eligible for capitalization incurred between the completion of both: (1) product design and (2) either of a working model or a detailed program design and the point of time the product is available for general release, has been insignificant. The decrease in research and development costs in absolute numbers in 2009 compared to 2008 resulted mainly from a material decrease in the total operating expenses of the Company (mainly salaries and other employee-related overhead expenses) in 2009 compared to 2008, in addition to a decrease in the total number of R&D employees in Israel and a measured migration of certain R&D activities towards our less costly offshore development activity.

We believe that continued investment in research and development is essential to remain competitive in the marketplace and is directly related to the timely development of new and enhanced products. Specifically, in order to bring our future products to maturity and thereafter increase sales, we are allocating significant resources to research and development activities, including outsourcing certain research and development assignments.

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Our research and development efforts in 2009 have been financed primarily from internal resources, in addition to a grant made by the OCS. In previous years we also participated, and we may participate in the future, in OCS royalty-bearing programs. Pursuant to the terms of the OCS royalty-bearing program, we are required to pay royalties of between 3.5% and 4.5% of sales of products and related services developed in any project partially funded by the OCS, up to an amount of 100% of the grant obtained. For grants received under programs approved subsequent to January 1, 1999, royalties are payable up to 100% of the grant obtained plus interest at the annual rate of Libor applicable to U.S. dollar deposits. We may apply in future years for additional grants from the OCS; however, there is no assurance that we will be awarded any such future grants.

Our research and development expenses in 2009 and 2008 were net of participation from the OCS. In 2009 and 2008, participation received or accrued from the OCS was \$0.4 million and \$0.1 million, respectively. In 2009, we paid or accrued royalties to the OCS in an aggregate amount of approximately \$225,000 compared with \$208,000 in 2008. As of December 31, 2009, our contingent liability to the OCS amounted to approximately \$22 million. During 2008, we recorded an aggregate income of \$14.9 million, resulting from the sale of 15 of our patents and certain patent-related rights. For more information, please see "Item 4.A. History and Development of the Company" above.

### SELLING AND MARKETING

In 2009, selling and marketing expenses were \$3.0 million, or 48% of sales, compared with \$3.6 million, or 58% of sales in 2008. Selling and marketing expenses include salaries and benefits, sales commissions, travel expenses and related costs for our sales and marketing personnel. Selling and marketing expenses in 2009 and 2008 included stock-based compensation amounting to

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\$127,000 and \$263,000, respectively, due to recognition of expense for share based payments accounted for under ASC 718. Selling and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows and other market development programs. The decrease in selling and marketing costs in absolute numbers in 2009 compared to 2008 resulted mainly from a material decrease in the total operating expenses of the Company (mainly salaries and other employee-related overhead expenses) in 2009 compared to 2008.

### GENERAL AND ADMINISTRATIVE

In 2009, general and administrative expenses were \$2.1 million, or 34% of sales, compared with \$2.7 million, or 44% of sales, in 2008. General and administrative expenses consist principally of salaries and benefits, outside legal, accounting and consultant fees, travel expenses and related costs for management, directors' fees, directors and officers insurance, finance, logistics, human resources, communication, information systems and administrative personnel. General and administrative expenses in 2009 and 2008 included stock-based compensation amounting to \$680,000 and \$532,000, respectively, due to recognition of expense for share based payments accounted for under ASC 718. General and administrative expenses also include expenses associated with computing equipment and software used in the administration operations. The decrease in general and administrative costs in absolute numbers in 2009 compared to 2008 resulted mainly from a material decrease in the total operating expenses of the Company (mainly salaries and other employee-related overhead expenses) in 2009 compared to 2008.

### IMPAIRMENT OF GOODWILL AND INTANGIBLE ASSETS

In 2008, we recorded approximately \$4.0 million in expenses relating to impairment of goodwill and intangible assets. Under ASC 350, Intangibles-Goodwill and Others, goodwill is tested for impairment at least annually (or more frequently if impairment indicators arise). Under ASC 360, "Property, Plant and Equipment-Subsequent Measurement", amortizable long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company performed an impairment test mainly due to the fact that in addition to its losses, as of December 31, 2008, the Company's market capitalization was lower than the Company's shareholders' equity as of such date. No impairment of intangible assets was recorded in 2009, due to the fact that, among others, the Company's market capitalization was higher than the Company's shareholders' equity.

### FINANCE INCOME, NET

Finance income, net, in 2009 consisted principally of interest income received in connection with our bank deposits, less bank charges and currency differences between the NIS and US dollar. In 2009, finance income, net, was \$132,000, or approximately 2% of sales, compared to \$90,000, or 1.5% of sales, in 2008. The increase from 2008 to 2009 is mainly due to changes in currency exchange rates between the US dollar and NIS.

### TAXES ON INCOME, TAX REFUNDS AND TAX BENEFITS

In 2009, VocalTec and Tdsoft had two and four, respectively, Approved Enterprise programs under the Law for the Encouragement of Capital Investments, 1959. Such programs are eligible for certain tax benefits for the first several years in which they generate taxable income. Income derived from an Approved Enterprise is subject to a zero tax rate for two years and up to an additional eight years of a reduced corporate tax rate of 25% until the earlier of (i) seven to ten consecutive years, commencing in the year in which the specific Approved Enterprise first generates taxable income (which income is not offset by deductions attributable to the other sources), (ii) twelve years from

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

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As of December 31, 2009, we had net operating loss carryforwards in Israel of approximately \$192 million (\$141 million allocated to VocalTec and \$51 million allocated to Tdsoft). This net-operating loss may be carried forward and offset against future taxable income under applicable tax laws. Management currently believes that since the Company has a history of losses, it is more likely than not that the operating losses will not be utilized. As a result, the Company provides full valuation allowance to completely reduce the deferred tax assets. As of December 31, 2009, valuation allowance amounted to approximately \$35 million comprised mostly from carry forward loss. We also had an aggregate net-operating loss carryforwards in the U.S. of approximately \$9 million, which may not be carried forward and offset against future taxable income due to change of control in the Company following the merger between Vocaltec and Tdsoft in November 2005 (for additional information, see Item 10E - "taxation and government programs"). Tax benefits, which apply to us under Israeli law, do not apply to any income generated by any of our other subsidiaries.

### NET INCOME (LOSS)

Net loss in 2009, was \$2.5 million, compared with a net income of \$3.7 million in 2008, including income from sale of patents in the amount of \$14.9 million and impairment of goodwill and intangible assets in the amount of \$4.0 million.

Our financial statements are reported in dollars and the vast majority of our sales are made in U.S. dollars. Most of our expenses are in NIS and dollars. The cost of our operations in Israel, as expressed in dollars, is influenced by the extent to which any increase/decrease in the rate of inflation in Israel is not offset by the appreciation/depreciation of the NIS in relation to the dollar. In 2009, the rate of inflation in Israel was 3.9% and the rate of appreciation of the NIS in relation to the dollar was 0.7%.

YEAR ENDED DECEMBER 31, 2008 COMPARED TO YEAR ENDED DECEMBER 31, 2007

### SALES

In 2008, we had sales of \$6.1 million, compared to \$5.8 million in 2007, an increase of \$0.3 million, or 6%. Through 2008, we generated our revenues from sales of our products (primarily the Essentra family of products) and from the sale of maintenance, support and other services. Sales of products accounted for 65% of our revenues in 2008, whereas sales of services accounted for 35% of our revenues in 2008. Due to a limited number of separate support services and maintenance contracts consummated during such years, and since the Company began providing its services through distributors and integrators (resulting in inconsistencies of the portion of the contracts that is attributed to services), the Company was unable to establish VSOE with respect to the support services and maintenance provided by the Company subsequent to January 1, 2007. Accordingly, revenues from bundled software arrangements in 2007 and 2008 were recognized ratably over the last deliverable element in the arrangement, which is typically the support and maintenance service period, assuming all other revenue recognition criteria are met. The increase in our revenues from the sale of products resulted from the deferral of approximately \$2.7 million of revenues from 2007 to 2008, due to the Company's inability for the first time to establish VSOE during 2007. The decrease in revenues from the sale of services



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in 2008 compared to 2007 resulted mainly from cancellation of a yearly support contract from one of our major customers.

In 2008, we continued selling our products also to resellers/systems integrators and partners. We sell our products to such resellers/systems integrators/partners for a consideration that is lower than the prices to end customers. As a result of the sale to resellers/systems integrators, we gain access to a broader range of customers, resulting in a larger amount of transactions.

In 2008, we continued selling our Essentra family of products as part of solutions consisting also of certain hardware that we purchase from third parties, resulting in an increase in sales (some of which were deferred from 2007, as described above).

In 2008, while continuing to sell our solutions in Europe and North America, the Company focused its marketing efforts in the Former Soviet Union, Latin America and Africa.

### COST OF SALES

Cost of sales in 2008 was \$2.9 million, or 48% of sales (including an amortization of acquired intangibles in the amount of \$0.3 million), compared with \$3.4 million, or 59% of sales (including an amortization of acquired intangibles in the amount of \$0.4 million and inventory write-off in the amount of \$0.5 million), in 2007. The effect of the amortization of acquired intangibles as a percentage from sales was 5% in 2008 compared with 15% effect of the amortization of acquired intangibles and inventory write off in 2007. Cost of products was \$2.0 million in 2008 and 2007. Cost of services was \$0.6 million in 2008 compared with \$0.5 million in 2007.

The decrease in the cost of sales in 2008 compared to 2007 resulted from the inventory write-off in 2007, which also explains the decrease in the cost of sales as a percentage of sales in 2008 compared to 2007.

Cost of our sales consists primarily of the cost of hardware components, salaries and other related expenses of our employees who are engaged in the production and support of our products and royalties paid by us to licensors of software and to the OCS.

In 2008, gross margins were 52%, including amortization of acquired intangibles, which affected the gross margins by 5%. In 2007, gross margins were 41%, including amortization of acquired intangibles and an inventory write-off, which affected the gross margins by 15%.

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### OPERATING EXPENSES

#### RESEARCH AND DEVELOPMENT, NET

Research and development costs, net, were \$4.2 million in 2008, compared with \$4.6 million in 2007, representing 68% and 79% of sales in 2008 and 2007, respectively. Research and development costs, net, consist principally of salaries and benefits for software and hardware engineers and sub-contractors, related facilities' costs and activities and expenses associated with computer, software and other equipment used in software and hardware development and testing. Research and development costs, net, in 2008 and 2007 included stock-based compensation amounts of \$357,000 and \$353,000, respectively, due to

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recognition of expense for share based payments accounted for under ASC 718. None of our software or hardware development costs have been capitalized during any of the reported periods, as the amount of software and hardware development costs eligible for capitalization at this stage has historically been insignificant. The decrease in research and development costs in absolute numbers in 2008 compared to 2007 resulted mainly from a material decrease in the number of R&D employees in 2008 compared to 2007, offset by a decrease in OCS grants.

Our research and development efforts in 2008 have been financed primarily from internal resources. In previous years, we participated only in OCS of Israel royalty-bearing programs. Pursuant to the terms of the OCS royalty-bearing program, we are required to pay royalties of between 3.5% and 4.5% of sales of products and related services developed in any project partially funded by the OCS, up to an amount of 100% of the grant obtained. For grants received under programs approved subsequent to January 1, 1999, royalties are payable up to 100% of the grant obtained plus interest at the annual rate of Libor applicable to U.S. dollar deposits.

Our research and development expenses in 2008 and 2007 were net of participation from the OCS. In 2008 and 2007, participation received or accrued from the OCS was \$0.1 million and \$0.8 million, respectively. In 2008, we paid or accrued royalties to the OCS in an aggregate amount of approximately \$208,000 compared with \$175,000 in 2007. As of December 31, 2008, our contingent liability to the OCS amounted to approximately \$22 million. During July 2008, the Company consummated the sale of 11 of its patents for an aggregate selling price of \$12.5 million. On July 13, 2008, the OCS approved the consummation of the foregoing sale, subject to the payment to the OCS of approximately \$2.08 million, leading to net proceeds of \$10.4 million. During December 2008, the Company consummated the sale of four of its patents for an aggregate selling price of \$7.0 million. The OCS approved the consummation of the foregoing sale, with no royalty payment obligation.

### SELLING AND MARKETING

In 2008, selling and marketing expenses were \$3.6 million, or 58% of sales, compared with \$4.7 million or 82% of sales in 2007. Selling and marketing expenses include salaries and benefits, sales commissions, travel expenses and related costs for our sales and marketing personnel. Selling and marketing expenses in 2008 and 2007 included stock-based compensation amounting to \$263,000 and \$224,000, respectively, due to recognition of expense for share based payments accounted for under ASC 718. Selling and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows and other market development programs. The decrease in selling and marketing expenses in absolute numbers in 2008 compared to 2007 resulted primarily from decrease in travel, marketing and subsidiaries-related expenses.

### GENERAL AND ADMINISTRATIVE

In 2008, general and administrative expenses were \$2.7 million, or 44% of sales, compared with \$2.0 million, or 35% of sales, in 2007. General and administrative expenses consist principally of salaries and benefits, outside legal, accounting and consultant fees, travel expenses and related costs for management, directors' fees, directors and officers insurance, finance, logistics, human resources, communication, information systems and administrative personnel. General and administrative expenses in 2008 and 2007 included stock-based compensation amounting to \$532,000 and \$552,000, respectively, due to recognition of expense for share based payments accounted for under ASC 718. General and administrative expenses also include expenses associated with computing equipment and software used in the administration operations. The increase in general and administrative expenses in absolute numbers resulted primarily from the increase in professional services and salary expenses.

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### IMPAIRMENT OF GOODWILL AND INTANGIBLE ASSETS

In 2008, we recorded approximately \$4.0 million in expenses relating to impairment of goodwill and intangible assets, compared to approximately \$5.4 million in 2007. Under Statement of ASC 350, "350 Intangibles--Goodwill and Other" (formerly FAS 142), goodwill is tested for impairment at least annually (or more frequently if impairment indicators arise). Under Statement of ASC 360, "Property, plant and equipment" (formerly FAS 144), amortizable long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company decided to use an income approach instead of the market price of the Company's shares mainly due to the fact that in addition to its losses, as of December 31, 2008 and 2007, the Company's market capitalization was lower than the Company's shareholders' equity as of such date.

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### INCOME FROM SALE OF PATENTS, NET

During 2008, we recorded an aggregate income of \$14.9 million, resulting from the sale of 15 of our patents and certain patent-related rights. Income from sales of patents is included in operating expenses due to the fact that the patents are a direct result of the Company's current operations.

### FINANCE INCOME, NET

Finance income, net in 2008 consisted principally of interest income received in connection with our bank deposits, less bank charges and currency differences between the NIS and US dollar. In 2008, finance income, net was \$90,000, or approximately 1.5% of sales, compared to \$230,000, or 4% of sales, in 2007. The decrease from 2007 to 2008 is mainly due to decrease in interest income from bank deposits attributed to material decrease in interest rates during these years.

### TAXES ON INCOME, TAX REFUNDS AND TAX BENEFITS

As of December 31, 2008, we had net operating loss carryforwards in Israel of approximately \$194 million (\$141 million allocated to VocalTec and \$53 million allocated to Tdsoft). This net-operating loss may be carried forward and offset against future taxable income under applicable tax laws. Management believes that since the Company has a history of losses, it is more likely than not that the operating losses will not be utilized. As a result, the Company provides full valuation allowance to completely reduce the deferred tax assets. As of December 31, 2008, valuation allowance amounted to approximately \$48 million comprised mostly from carry forward loss. We also had an aggregate net-operating loss carryforwards in the U.S. of approximately \$9 million, which may not be carried forward and offset against future taxable income due to change of control in the Company following the merger between Vocaltec and Tdsoft in November 2005 (for additional information, see Item 10E - "taxation and government programs"). Tax benefits, which apply to us under Israeli law, do not apply to any income generated by any of our other subsidiaries.

### NET INCOME (LOSS)

Net income in 2008, including net income of \$14.9 million from the sales of our patents, was \$3.7 million. Without the proceeds from the sales of our patents, we had a net loss of \$11.2 million in 2008, compared with a net loss of \$14.2 million in 2007.

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Our financial statements are reported in dollars and the vast majority of our sales are made in U.S. dollars. Most of our expenses are in New Israeli Shekels (NIS) and dollars. The cost of our operations in Israel, as expressed in dollars, is influenced by the extent to which any increase/decrease in the rate of inflation in Israel is not offset by the appreciation/depreciation of the NIS in relation to the dollar. In 2008, the rate of inflation in Israel was 3.8% and the rate of appreciation of the NIS in relation to the dollar was 1.1%.

### 5B. LIQUIDITY AND CAPITAL RESOURCES

During the past three years, we covered our cash flow requirements with cash proceeds from sales of patents, operating revenues and grants from the OCS.

As of December 31, 2009, we had approximately \$10.6 million in cash and cash equivalents and bank deposits, comprised of \$7.5 million in cash and cash equivalents and \$3.1 million in bank deposits. As of December 31, 2008, we had approximately \$15.0 million in cash, cash equivalents and bank deposits.

As of December 31, 2009, we had working capital of approximately \$7.8 million, compared with \$10.1 million as of December 31, 2008. The net decrease in working capital during 2009 resulted primarily from the decrease in cash and cash equivalents and bank deposits during 2009.

Net cash used in operating activities was \$4.1 million, \$4.3 million and \$3.9 million for the years ended December 31, 2009, 2008 and 2007, respectively. Net cash provided by investing activities was \$7.1 million, \$4.8 million and \$2.5 million for the years ended December 31, 2009, 2008 and 2007, respectively. Net cash used in financing activities was \$0.6 million in 2009.

The Company had no net cash generated by financing activities in 2008 and 2007.

We anticipate that operating expenses may exceed revenues, net of cost of sales in 2010 and possibly beyond if we do not sufficiently increase sales and reduce our costs. We believe that our current cash and cash equivalents balances, together with future estimated cash flows from operations and grants from the OCS, if received, are sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

Capital expenditures in 2009 were approximately \$64,000, compared with \$269,000 in 2008 and \$178,000 in 2007.

We maintained annual car leases in the amount of approximately \$313,000 in 2009, and our total liability for early termination of the leases is in the amount of up to approximately \$38,000.

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### INVENTORY AND RECEIVABLES

Inventories as of December 31, 2009 were \$63,000, compared to \$38,000 as of December 31, 2008.

Trade receivables are from sales of our products, primarily to telecommunications systems integrators, resellers and service providers. Trade receivables are presented at gross value less reserve for doubtful accounts of \$0 as of December 31, 2009 and 2008. Trade receivables, net, as of December 31, 2009 and 2008 were \$0.2 million.

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Prepaid expenses and other receivables were \$0.5 million as of December 31, 2009 and 2008.

### IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS STILL NOT EFFECTIVE FOR THE COMPANY AS OF DECEMBER 31, 2009

In October 2009, the FASB issued an update to ASC 985-605, "Software-Revenue Recognition" (originally issued as EITF 09-3). In accordance with the update to the ASC, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the scope of the software revenue recognition guidance. In addition, hardware components of a tangible product containing software component are always excluded from the software revenue guidance. The mandatory adoption is on January 1, 2011. The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. In such case the Company must also adopt the amendment to ASC 605-25 with respect to multiple-elements arrangements prior to January 1, 2011. The Company does not expect the adoption of the update to have a material impact on the Company's consolidated financial condition or results of operations.

In October 2009, the FASB issued an update to ASC 605-25, "Revenue recognition - Multiple-Element Arrangements", that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements to:

- o Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- o Require an entity to allocate revenue in an arrangement using estimated selling prices ("ESP") of deliverables if a vendor does not have vendor-specific objective evidence of selling price ("VSOE") or third-party evidence of selling price ("TPE");
- o Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and
- o Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. The Company is currently evaluating the impact on its consolidated results of operations and financial condition.

### 5C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

#### INTELLECTUAL PROPERTY

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

We have filed numerous patent applications in the United States and other countries with respect to certain technologies employed in our products. Some of those applications have already registered and we have the rights to use these

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registered patents, either under a non-exclusive license, or by owning these patents. Still, we have not recently filed any new patent application in the United States or elsewhere. In addition, we have filed trademark applications in the United States and other countries with respect to trademarks associated with us, and our products. Some of those applications have already been registered and we own those registered trademarks.

During 2008, the Company entered into a patent purchase agreement, pursuant to which the Company agreed to sell 15 patents and certain patent-related rights, out of the Company's portfolio of 22 patents, and the Company was granted with a geographically unlimited, non-exclusive license to use the sold patents and other patent-related rights in connection with the development and marketing of its products. Generally, we enter into non-disclosure and invention assignment agreements with our employees, and into non-disclosure agreements with our consultants, subcontractors and distributors and channel partners. However, there can be no assurance that such measures will protect our proprietary technology, that competitors will not develop products with features based upon, or otherwise similar to, our products or that we will be able to enjoin competitors from selling similar products.

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

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

VocalTec, Essentra, TdSOFT, TdGATE, TdVIEW, PLUG & TALK, SmartFMC, and SmartIMS are trademarks or registered trademarks of VocalTec and its fully-owned subsidiaries. All other trademarks or registered trademarks used in this Annual Report are the property of their respective owners.

### RESEARCH AND DEVELOPMENT

We believe that our ability to enhance our current products, develop and introduce new products on a timely basis, maintain technological competitiveness and meet customer requirements is essential to our future success. Accordingly, we devote and intend to continue to devote a significant portion of our personnel and financial resources to research and development. Notwithstanding, our investment in Research and Development may vary in accordance with our operating results. We also intend to continue seeking and maintaining close relationships with our customers in order to remain responsive to their needs. We have an educated and experienced research and development team that specializes in telecommunications and networking, computer and networking

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software, communications protocols and VoIP application software development. We seek to employ highly qualified technical personnel in order to maintain and expand our technological expertise.

The Company may engage in the future in joint research and development projects with third parties. The ownership of any intellectual or other proprietary property developed in such projects shall be negotiated between the Company and the relevant third party.

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

### 5D. TREND INFORMATION

We believe that our business is subject to the following trends:

#### TRENDS IN THE COMMUNICATIONS INDUSTRY

**REGULATION AND COMPETITION:** Service providers worldwide are facing an increasing array of challenges given the ongoing regulatory changes and technological advances in the communications industry. Global deregulation is promoting competition to incumbent service providers from both new entrants and operators, such as wireless, satellite, Internet and cable television service providers. At the same time, end user demands are rapidly evolving. While in the past, communications traffic consisted primarily of traditional voice communications and basic data traffic, such as email and facsimiles, in recent years, with the wide acceptance of the Internet and broadband infrastructure, end users are increasingly seeking fast, personalized, content-rich, easy-to-use communications and are relying on these applications in both their professional and personal lives. Accordingly, this trend is increasing demand for high-speed access services, including IP-based voice, video, data and wireless services.

The combination of competitive pressures and end user demands is placing pressure on service providers to add new services to their existing offerings quickly, with the flexibility to continue to add functionality and to scale as needed. Many new and incumbent service providers presently offer a bundle of voice, video and data services to end users, often referred to as "triple-play, or "multi-play". For example, these services may include both traditional and enhanced voice services, broadcast television and on-demand video, and high-speed Internet access delivered over a converged broadband connection to the home or office. Operators also are increasingly adding wireless to the triple-play bundle, referred to as "quad-play", which has contributed to consolidation in the service provider market. The bundling of services enables service providers to generate new sources of revenue and enhance customer relationships.

The initial capital costs and ongoing operating expense associated with the deployment of new services are considerable. Many service providers have significant investments in their existing network infrastructures, which may consist of disparate media, such as copper, coax and fiber, as well as numerous protocol families based on Internet Protocol, or IP, Asynchronous Transfer Mode, or ATM, and Time Division Multiplexing, or TDM. Service providers generally seek to maximize their return on investment by leveraging existing infrastructure to offer new services. This has increased the demand both for upgrades to existing equipment and for cost-effective new equipment that supports disparate media and numerous protocol families.

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**INVESTMENT MADE IP INFRASTRUCTURES:** As voice, video and data traffic travels over communications network infrastructure, it typically passes through the core and access networks before arriving at the customer premise, or destination. The growing demand for Internet bandwidth over the last decade prompted service providers to make significant capacity investments in the core network, which is the part of the network that is responsible for transporting large volumes of traffic between and within cities. Service providers have also made significant investments in upgrading the core network to a mostly IP-based infrastructure to more efficiently manage the increased data traffic. This is an ongoing transformation that is expected to continue in the coming years.

The access network is located between the core network and the customer premise and is integral to the aggregation and distribution of network services and to the creation of new services. Service providers have begun looking for ways to efficiently enable the deployment of new services with ever-increasing bandwidth requirements, such as video or bundled services. To complement the investments made in the core network and to combine voice, video and data over a common network, service providers are increasingly seeking to upgrade access infrastructures based on IP technologies. Increasingly, the use of IP as a transport technology to combine voice, video and data over a common network is emerging as the principal network architecture for service providers. The demand for broadband connectivity to the Internet led incumbent local exchange carriers to offer broadband over copper to the residential market. This was offered using ADSL technology. The fast deployment of ADSL opened up an opportunity for alternative carriers to offer voice over this broadband connection, bypassing the need for any permission from the provider of the ADSL service. In addition, new wireless technologies today provide an alternative low cost method of offering broadband access services. The initial adoption of wireless broadband technologies, such as WiMAX is a good example of this. WiMAX technology is said to facilitate the deployment of a broadband access infrastructure by omitting the need to drive cables underground; this is conducive to both a quicker and more cost-effective deployment. Alternative and Greenfield carriers are looking to WiMAX technology for the delivery of both a data and video/voice service. A similar trend can be seen amongst mobile service providers, who have made tremendous investments in the upgrade of their infrastructures in order to provide mobile broadband services. The availability of innovative bandwidth consuming services, as well as the increasing availability and penetration of Internet and broadband capable devices, serves as a significant driver for these network upgrades.

The availability of broadband services is a very significant factor in the ability to offer Essentra BAX as a service delivery platform for providing Class 5 Voice over Broadband (VoBB) services. Various market research firms estimate that in 2011 approximately 15% of all wire-line telephone lines will implement Voice over Broadband (VoBB) technology. The mobile VoIP space is very much a nascent market still showing negligible penetration. Market research estimates YoY growth rates over or close to 100% with mobile VoIP users reaching almost 300 million by 2013.

**CONVERGENCE OF VOICE AND DATA:** The maturing of VoIP technology and the advantages of an IP network is leading to the convergence of data and voice networks and the offering of a mix of data and voice services over a single packet-based IP network. This trend is expected to change telephony network deployment and operation by removing all territorial/localized networks and the localization aspect of the telephone number and possibly even replacing traditional telephone numbers with an alternative personal ID. Converged networks will reduce the cost of deployment of telephony switching equipment. Converged networks will also reduce the cost of operation as the same packet-based network will serve voice and data. Softswitch technology is at the heart of this evolution. The softswitch will not only replace the legacy TDM switch, but it will no longer be an integral part of each and every neighborhood. Fewer high capacity softswitches will serve larger populations.



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The physical location of the softswitch will not be related to the subscribers that it will serve. Massive efforts and large projects are planned by most telephony service providers, which are expected to result in around 200 million telephony lines connected to softswitches by 2011 (according to a 2009 report by Infonetics Research). Essentra product family aims at this market, which is expected to grow (according to the same report) by an annual average of around 20 million users per annum.

**WIRELINE AND MOBILE CONVERGENCE AND IMS:** A new network architecture known as IMS (Internet Multimedia Subsystem) has been designed by the 3GPP (3rd Generation Partnership Project) to deliver IP-based service to end-users. This will be the network architecture for the mobile third generation migration to packetized voice. The unique abilities of IMS to offer fast implementations of new services and the comfortable handling of access networks led the industry to consider the adoption of IMS also for the wireline business, especially for VoIP technology. In a few years, we expect to start experiencing IMS offering Fixed-Mobile Convergence (FMC), where the same handset will be used in both fixed and mobile networks and offer identical services to the consumer. This will be the final step in convergence of all multimedia fixed and mobile networks, offering a single service platform to all terminals, whether a computer, a PDA, a wireline phone or a mobile phone. Essentra architecture has followed the guidelines of IMS/TISPAN, and more adjustments will be needed as implementation of IMS continues.

As mentioned above the mobile VoIP market is still very much a nascent one. The acquisition of some of Outsmart's assets enhances VocalTec's portfolio of VoIP solutions and extends them to the mobile space, placing VocalTec in a better position to target this market. Although there is no certainty that we will be successful in the penetration of this market, it is viewed as an interesting growth opportunity.

**INCREASING NEED FOR VOIP INTERCONNECTION:** With the dramatic rise in Broadband infrastructures throughout the world, service provider and end-user demand for VoIP is growing rapidly. Established global telecommunications service providers such as British Telecom, AT&T and KDDI have joined new entrants such as Skype and Vonage, as well as cable operators such as Comcast and Cablevision in offering IP telephony services. Currently, there are hundreds of VoIP providers operating throughout the world. Some offer stand-alone telephony service, while others bundle VoIP with Internet access and video service for a full triple play suite. With this tremendous growth come a variety of challenges for carriers and service providers as they either build out their networks or migrate from legacy TDM technology to an IP-based infrastructure.

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Traditional fixed-line service providers are not the only ones migrating to IP; several leading mobile operators have announced plans to convert to an IP-based infrastructure in the coming years. The growing implementation of IP communications, coupled with the emerging fixed-mobile convergence over IP, is driving the need for more sophisticated infrastructure solutions that can facilitate smooth deployments and transitions.

Unlike traditional telephony service, there is no single global standard for VoIP. As such, VoIP implementations are based on a variety of different standards, making VoIP networks essentially a growing number of islands. In order to ensure a successful VoIP roll out and generate steady revenues for providers, these islands need to be connected to one another in a manner that is secure, reliable and seamless. While traditional architecture was once an effective way in which to connect multiple islands, it is becoming increasingly

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necessary for carriers to rely on IP-based solutions for VoIP interconnection. The ability for VoIP networks to interconnect directly one to the other is of paramount importance in the further adoption of VoIP technology. VoIP interconnect traffic is expected to grow significantly in coming years.

**HOSTED SERVICES FOR ENTERPRISES:** Carriers have usually not succeeded to offer more than basic services to enterprises. The basic services included E1/T1 trunking with PRI, or Primary Rate Interface (an ISDN link between customer premises, usually a PBX, and the Class 5 switch) and DID, or Direct Inward Dialing (which allows one to call a person's office telephone extension from an outside telephone service). Centrex services have been offered by carriers, mainly in the US, since the early 1980's, but never became a significant business. Softswitch technology combined with application servers offering a rich PBX-type set of features and the trends of outsourcing such services, lead to the re-evaluation of the potential of the new IP-based Centrex services. The availability of web based self-care services encourages carriers to offer IP-Centrex as a competing service to IP-PBX solutions. IP technology adds the ability to combine IP-Centrex with VPN to effectively interconnect multiple corporate offices from one central location. Considering this, Essentra offers rich Centrex features combined with VPN capability and corporate level provisioning tools. The expected size of the IP-Centrex market is currently unclear, but the feature set is becoming a must in most softswitch deployments.

**CONSOLIDATION:** In recent years, we have witnessed a consolidation in our industry. Large service providers are acquiring other service providers, and large equipment vendors are acquiring smaller vendors, in order to leverage the benefits of synergies and size and to provide their customers with a more complete solution. We expect this trend to continue in the future.

**THE APP STORE PHENOMENON:** Mobile applications stores have emerged as popular handset operating systems compete to attract developers. Apple clearly enjoys the current lead, with over 100,000 applications and 2 billion downloads reported as of the end of 2009. This trend towards a decoupling of the application from the service provider environment may potentially become a disruptive phenomenon further enhancing their competitive environment vis-a-vis alternative service providers such as Skype and Google. The market has already seen mobile providers taking a stand whether against or in favor of this trend. What seems obvious is that mobile providers cannot remain indifferent and must define their mobile VoIP strategy. VocalTec stands to benefit from this as the trend may act as a trigger and driver for mobile providers to accelerate their mobile VoIP agendas.

**OTHER TRENDS:** In addition to the foregoing, we have identified the following trends:

(i) VoIP networks have emerged in many business segments, in both the carrier and the enterprise markets. Due to reasons such as security, protocol variance and other reasons, these networks are still not linked to each other using native IP. This has created an opportunity, which the Company is planning to leverage using the Essentra EX Peering Manager and derivatives of that product, to provide products that meet the need of VoIP interconnect. This transition is due in part to the fact that being connected using IP is more cost-effective than being connected through the PSTN; Essentra EX facilitates routing between disparate networks and enables optimizing use of network resources and costs;

(ii) Adoption of a standard IMS (IP Multimedia Subsystem) architecture by carriers and vendors, including mobile and fixed carriers and networks, resulting in a new definition of telecom infrastructure, focusing on IP multimedia service implementation. The Company is continuously looking at the evolution of IMS and is investigating the further alignment of its solutions with the functional description described in the standard;

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(iii) Convergence between fixed and mobile networks, both on the infrastructure and the service and business aspects, with respect to which the Company offers a solution providing some of the elements in an FMC-type (fixed mobile convergence) implementation. This trend is characterized by the unification of infrastructures (including unification at the infrastructure and service layers). The Essentra Convergence Platform offers VocalTec the ability to provide solutions and services for this market segment.

(iv) One of the major trends apparent in the IT industry today is the move towards services in the cloud computing and to new service models, such as SaaS (Software as a Service). Cloud computing is a style of computing in which dynamically scalable and often virtualized resources are provided as a service over the Internet. With the ever growing bandwidth available in the market, hosting applications in the network becomes virtually like placing them next door, within the company premises. The financial crisis gives another reason for CAPEX/OPEX reduction and cloud computing supports that, by allowing for more efficient use of elastic computing resources. The company has made initial inroads into this and has deployed its Essentra BAX solution in a cloud computing environment. The solution is currently used primarily for pre-sales and demonstration purposes, and the company is looking at this both as a technology driver to gain scaling out and modular growth of its solutions and for the possible adaptation of new business models.

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### 5E. OFF-BALANCE SHEET ARRANGEMENTS

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

### 5F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

CONTRACTUAL OBLIGATIONS -----	PAYMENT DUE BY PERIOD (IN THOUSANDS OF DOLLARS)				
	TOTAL -----	LESS THAN 1 YEAR -----	2-3 YEARS -----	4-5 YEARS -----	MORE THAN 5 YEARS -----
CONTRACTUAL OBLIGATIONS					
Uncertain tax positions (1)	739	739	-	-	-
Operating Lease Obligations	597	177	160	160	100
Accrued severance pay (2)	1,030	-	-	-	1,030

(1) Uncertain income tax position under ASC 740, "Income Taxes". are due upon settlement and we are unable to reasonably estimate the ultimate amount or timing of settlement. See Note 15(i) in our Consolidated Financial Statements for further information regarding the Company's liability under ASC 740.

(2) As of December 31, 2009 we had \$826,000 in severance pay funds to cover such liabilities.

### ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

#### 6.A. DIRECTORS AND SENIOR MANAGEMENT

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The following sets forth certain information regarding our directors and executive officers as of the filing date of this annual report:

NAME	POSITION
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Ido Gur	President and Chief Executive Officer
Ilan Rosen (1)	Chairman of the Board of Directors
Robert Wadsworth	Director
Yoseph Dauber (1) (2)	External Director
Tsipi Kagan (1) (2)	External Director
Eran Dariel (2)	Director
Joshua Di-nur	Chief Financial Officer

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(1) Member of the Compensation Committee

(2) Member of the Audit Committee

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

IDO GUR was appointed as the Company's President and Chief Executive Officer on September 1, 2008. Mr. Gur has gained extensive experience in the management of global technology companies. Prior to joining VocalTec, Mr. Gur spent three years at ECI Telecom, a global provider of telecommunications equipment, as Executive Vice President Global Sales & Marketing. Prior to that, Mr. Gur spent one year as EVP Sales & Marketing at Corrigent Networks. Before joining Corrigent Networks, Mr. Gur spent seven years at ECI Telecom in various Marketing & Sales positions. Mr. Gur holds an M.Sc. degree in physics from Tel Aviv University, Israel.

ILAN ROSEN was appointed as Chairman of our Board of Directors in November 2005 (following and pursuant to the business combination). Mr. Rosen serves as a special advisor to HarbourVest Partners LLC since March 2003 and is a board member of Ozarot Ltd., an asset management company. Between 1989 and 1993, Mr. Rosen served on various boards of directors as a Business Manager at Polar Investments Ltd. From 1993 to 1996, he served as President of Adsha Development & Investments Ltd., an Israeli investment company that was listed on the Tel Aviv Stock Exchange, and in that capacity served on various boards of directors. From November 1996 through January 2004, Mr. Rosen served as Vice President of Teledata Networks (formerly ADC Telecommunications, Israel and prior thereto Teledata Communications Ltd.) and in that capacity, in addition to serving as chairman of the board of Tdsoft, Mr. Rosen served on the board of directors of each of G-Connect Ltd., VManage Ltd., Mind CTI Ltd. and various other companies. Mr. Rosen received a B.Sc. (cum laude) in mechanical engineering from Tel Aviv University in 1979, and an MBA from Tel Aviv University in 1986.

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ROBERT M. WADSWORTH was appointed as a director of VocalTec in November 2005 (following and pursuant to the business combination). Mr. Wadsworth joined HarbourVest Partners in 1986 and is a managing director who focuses on direct investments. Mr. Wadsworth manages many of HarbourVest's investment activities in both the industrial and information technology sectors. He is currently a director of Network Engines, Inc., and Trintech Group PLC, which are public companies. He is also a director of Akibia, AWS Convergence (Weatherbug), Camstar Systems, Kinaxis, and several other private companies. Mr. Wadsworth's

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prior experience includes management consulting with Booz, Allen & Hamilton, where he specialized in the areas of operations strategy and manufacturing productivity. He received a BS (magna cum laude) in Systems Engineering and Computer Science from the University of Virginia in 1982 and an MBA (with distinction) from Harvard Business School in 1986. Mr. Wadsworth serves as a Trustee of the University of Virginia School of Engineering & Applied Science and the Dana Hall School.

YOSEPH DAUBER has served as a director of VocalTec since August 2003. In October 2009, Mr. Dauber was appointed for a second three-year term as an external director. Mr. Dauber has served as a director of NICE Systems Ltd. since April 2002. Mr. Dauber also serves on the board of directors of Delek Group. Mr. Dauber is currently the Chairman of Kcps Manof Fund. Until January 2009, Mr. Dauber served as a director of Clal Insurance Holdings Company. From September 2003 and until November 2008 he served as a member of the board of directors of Bank Hapoalim. Mr. Dauber has also served on the board of directors of Lodzia Rotex Ltd. and Afcon Industries Ltd. Mr. Dauber has joined Bank Hapoalim towards the end of 1973. On July 1988 he became a member of the Board of Management. Beginning 2001 until June 2002, he was Deputy Chairman of the Board of Management and joint Managing Director of Bank Hapoalim. From 2002 to 2003, he served as Chairman of the Israel Maritime Bank Ltd. Mr. Dauber holds a Bachelor's degree in Economics and Statistics from the Hebrew University in Jerusalem and a Masters degree in Law from Bar Ilan University.

TSIPI KAGAN was appointed as an external director of VocalTec in October 2008. Since November 2008 Ms. Kagan has served as the Chief Financial Officer of Xjet Ltd., a private company developing and manufacturing equipment for the production of solar cells. From 2003 to August 2008 Ms. Kagan has served as the Chief Financial Officer of Radvision Ltd., a communications equipment developer. From 2000 to 2003, Ms. Kagan served as the Chief Financial Officer of Phone-Or Ltd., a developer of optical microphones and sensors. From 1994 to 2000, Ms. Kagan served as a Senior Manager at Ernst & Young, Israel. Prior to joining Ernst & Young, Ms. Kagan served as a Public Accountant at Miller, Kaplan, Arase & Co., Los Angeles. Ms. Kagan holds a BA in Accounting and Economics from Tel Aviv University and a Certificate of Advanced Accounting Studies from Tel Aviv University.

ERAN DARIEL has served as a director of VocalTec since December 31, 2008. Mr. Dariel is the co-founder, and since late 2007 has been serving as President and CEO, of XSIGHTS-Media, a software and service provider delivering fully integrated solutions to print media-owners and advertisers. From 2002 until mid 2005, Mr. Dariel served as the Executive VP & General Manager of the Lightscape Optical Network Business Unit of ECI Telecom. From 2000 until 2002, Mr. Dariel served as the President and CEO of Lightscape Networks (a wholly-owned subsidiary of ECI Telecom). From 1992 until 1999, Mr. Dariel held the following positions in the Optical Division of ECI Telecom: Director, System Architecture; AVP, Technology & System Architecture; and VP, Marketing & Business Development. Prior to joining ECI Telecom, Mr. Dariel served as a project manager at Atari Computers and at Silicom. Mr. Dariel holds an MSc. degree in Electronics and Computer Engineering from Ben Gurion University and a BSc. degree in Electronics and Computer Engineering from Ben Gurion University.

JOSHUA DI-NUR joined VocalTec in September 2008 as Chief Financial Officer. Mr. Di-nur's career includes a variety of high-level finance positions in Israel (in public and private companies) as well as General Management positions outside of Israel (USA and China). Mr. Di-nur is also an executive and personal coach. Prior to joining VocalTec, Mr. Di-nur held a number of key positions, including President of ECI China Ltd., a Chinese subsidiary of ECI Telecom (2007-2008); Vice President and CFO of ECI Ltd., the Optical Network Division of ECI Telecom (2001-2007); Vice President and CFO of Pelephone Communication Ltd. (1999-2001); President and CEO of Degem Systems wholly owned subsidiary in the USA, and prior thereto Vice President and CFO, of Degem Systems Ltd., an industrial public

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entity in the field of systems in technological trainings (1987-1996); Vice President and CFO of InterPharm Laboratories Ltd., then a NASDAQ-listed pharmaceutical company (1983-1987), Vice President and CFO of Pecker Plada Group, an industrial public company in the field of steel and ceramic tiles (1980-1983), and Vice President and CFO of Periclase Dead Sea Ltd., a subsidiary of Israel Chemical Ltd (1973-1980). Mr. Di-nur is a certified Public Accountant and received a B.A. in Economics and Accounting from Tel-Aviv University.

### 6.B. COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS

The aggregate compensation paid to VocalTec's directors and executive officers as a group during the fiscal year ended December 31, 2009 was approximately \$0.6 million in salaries, directors' fees and bonuses. No additional amounts were set aside or accrued by the Company or its subsidiaries in 2009 to provide pension retirement or similar benefits to the directors and executive officers.

During the fiscal year ended December 31, 2009, the following options were granted to Eran Dariel: 15,385 options to purchase ordinary shares at an exercise price per share equal to \$5.93, 8,615 options to purchase ordinary shares at an exercise price per share equal to \$3.308, and 40,000 options to purchase ordinary shares, at an exercise price per share equal to \$0.285 (being the average closing price of the Company's shares over the 30-day period prior to the date on which Mr. Dariel joined the Company's Board, being December 31, 2008). The abovementioned options are exercisable for a period of twelve months following such time on which Eran Dariel ceases from being a director of the Company. In addition, 20,000 options to purchase ordinary shares at an exercise price per share equal to \$1.85 were granted to Joshua Di-Nur pursuant to the terms of the Company's 2003 Amended Master Stock Option Plan.

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### 6.C. BOARD PRACTICES

#### INTRODUCTION.

Our board of directors presently consists of five members. Pursuant to the Companies Law, the board of directors retains all of the powers in running our Company that are not specifically granted to our shareholders. Pursuant to the Companies Law and our Articles of Association, a resolution proposed at any meeting of the directors, at which a quorum is present, shall be adopted if approved by a vote of at least a majority of the directors present at the meeting. A quorum of directors is at least a majority of the directors then in office who are lawfully entitled to participate in the meeting (until otherwise unanimously decided by the directors). The board of directors may elect one director to serve as the chairman of the board of directors to preside at the meetings of the board of directors, and may also remove that director as chairman. Minutes of the meetings are recorded and kept at our offices. The board of directors may, subject to the provisions of the Companies Law, delegate any or all of its powers to committees, each consisting of one or more directors (except the audit committee, which must consist of at least three directors and include all of the external directors), and it may, from time to time, revoke such delegation or alter the composition of any such committees. Unless otherwise expressly provided by the board of directors, the committees shall not be empowered to further delegate such powers. The composition and duties of our audit committee are more fully described in "10.B - Memorandum and Articles of Association".

#### TERMS OF DIRECTORS.

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The period during which our directors and senior management have each served in their respective offices is set forth in "Item 6 - Directors, Senior Management and Employees - Directors and Senior Management". The expiration date of the terms of office of our directors are as follows: (a) Eran Dariel - at the annual shareholders meeting in 2010 (at which time he may be re-appointed as a director); (b) Robert Wadsworth - at the annual shareholders meeting to be held in 2011 (at which time he may be re-appointed as a director); (c) Ilan Rosen - at the annual shareholders meeting in 2012 (at which time he may be re-appointed as a director); (d) Tsipi Kagan, who was elected as an external director in October 2008, will serve in such position for three years and may then be appointed for an additional three-year term as an external director; and (e) Yoseph Dauber, who was re-elected for his final office as an external director in November 2009, will serve in such position for three years.

There are no service contracts between us or any of our subsidiaries and our directors in their capacity as directors providing for benefits upon termination of employment, except for the termination provisions included in the employment agreement of Ido Gur, our President and Chief Executive Officer, which provide for: (i) entitlement to receive salary and benefits as provided for in the employment agreement, during the 180 day notice period, (ii) the right to have options granted continue to vest in accordance with their terms during the duration of the 180 day notice period, (iii) any event that under the terms of the employment agreement causes acceleration of vesting prior to termination of employment shall indeed cause the acceleration if it takes place during the 180 day notice period, (iv) the date upon which such acceleration of vesting shall be effected shall be the date upon which the 180 day notice period would have expired as if Mr. Gur were to continue to be employed by the Company for the duration of such notice period, and (v) the exercise period after termination of employment shall be deemed to commence on the date upon which the 180 day notice period would have expired as if Mr. Gur were to continue to be employed by the Company for the duration of the notice period. Prior to the expiry of two years of continuous employment, Mr. Gur will be entitled to exercise all of his vested options during the period of up to 12 months commencing on the expiry of the 180-day notice period. After the expiry of at least two years of continuous employment, Mr. Gur will be entitled to exercise all of his vested options including the options the vesting of which was accelerated, in the period up to the expiry of 18 months commencing on the expiry of the 180 day notice period.

In November 2005, we entered into new indemnification agreements with our directors, in which the Company undertook to indemnify the directors for the matters and in the circumstances described in such indemnification agreements, in an aggregate amount of up to \$4 million, provided that if such amount is insufficient to cover all amounts to which such persons are entitled pursuant to such undertaking of the Company, such amount shall be allocated among the indemnified persons pro rata to the amounts to which they are so entitled. All the indemnification agreements provide protection against personal liability due to an act performed or failure to act in the capacity as a director or officer. In November 2007, our Board determined that in light of the expansion of the Company's business, it is appropriate to increase the indemnification coverage under the directors and officers insurance policy from US\$5,000,000 per event and in the aggregate to US\$10,000,000 per event and in the aggregate. Such increase was approved by our shareholders at the annual shareholders meeting held on November 29, 2007.

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

- o the chairman of the board of directors;

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- o any controlling shareholder or a relative of a controlling shareholder; and
- o any director employed by the Company or who provides services to the Company on a regular basis.

### AUDIT COMMITTEE

Our audit committee is comprised of Yoseph Dauber, Tsipi Kagan and Eran Dariel. We believe that Mr. Dauber and Ms. Kagan qualify as audit committee financial experts (as such term is defined under the Exchange), and that each of them and Eran Dariel qualifies as an independent director (as such term is defined under the Nasdaq rules). The purpose of the audit committee is to provide assistance to the Board of Directors in fulfilling its legal and fiduciary obligations with respect to matters involving the accounting, auditing, financial reporting and internal control functions of VocalTec and its subsidiaries as well as complying with the legal requirements under Israeli law and the Sarbanes-Oxley Act of 2002. The following are examples of functions within the authority of the audit committee:

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

In addition, the approval of the audit committee is required to effect specified actions and transactions with office holders, controlling shareholders and third parties in which an office holder or controlling shareholder has a personal interest (as such term is interpreted under Israeli law).

An audit committee may not approve an action or a transaction with an office holder or a controlling shareholder or an entity in which either of them has a personal interest unless at the time of approval the two external directors are serving as members of the audit committee and at least one of the external directors is present at the meeting in which an approval is granted.

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

Our compensation committee is comprised of Yoseph Dauber, Tsipi Kagan and Ilan Rosen, and meets several times per year regarding option grants and general compensation issues relating to our employees.

For additional information, see Item 10.B - "Memorandum and Articles of Association."



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### NASDAQ EXEMPTION FOR A FOREIGN PRIVATE ISSUER

We are a foreign private issuer within the meaning of Nasdaq Marketplace Rule 5000(a)(18), since we are incorporated in the State of Israel and we meet the other criteria set forth for a "foreign private issuer" under Rule 3b-4(c) under the Exchange Act.

Pursuant to Nasdaq Marketplace Rule 5615(a)(3), a foreign private issuer may follow home country practice in lieu of certain provisions of the Nasdaq Marketplace Rule 5600 series and certain other Nasdaq Marketplace Rules. Please see Item 16.G - "Corporate Governance" for a description of the manner in which we rely upon home country practice in lieu of Nasdaq listing requirements. Please also see Item 3.D - Risk Factors - "WE ARE A FOREIGN PRIVATE ISSUER AND YOU WILL RECEIVE LESS INFORMATION ABOUT US THAN YOU WOULD FROM A DOMESTIC U.S. CORPORATION. IN ADDITION, WE HAVE OPTED OUT FROM CERTAIN NASDAQ MARKETPLACE LISTING REQUIREMENTS".

### 6.D. EMPLOYEES

As of December 31, 2009, we employed 40 full-time employees and 6 part-time employees, of whom 21 were employed in research and development, 15 were employed in sales and marketing, 9 were employed in general and administrative, and 1 was employed in operations. All of these employees were based in our facilities in Israel. As of December 31, 2008, we employed 48 full-time employees and 4 part-time employees, of whom 24 were employed in research and development, 18 were employed in sales and marketing, 9 were employed in general and administrative, and 1 was employed in operations. All of these employees were based in our facilities in Israel. As of December 31, 2007, we employed 60 full-time employees and 4 part-time employees, of whom 33 were employed in research and development, 20 were employed in sales and marketing, 9 were employed in general and administrative, and 2 were employed in operations. All of these employees were based in our facilities in Israel.

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We are subject to Israeli labor laws and regulations with respect to our Israeli employees. These laws principally concern matters such as pensions, paid annual vacation, paid sick days, length of the workday and work week, minimum wages, overtime pay, insurance for work-related accidents, severance pay and other conditions of employment. Our employees are not represented by a labor union. We believe that our relations with our employees are good. Neither our employees nor we are parties to any collective bargaining agreements, except for provisions of such agreements that are applicable to the industry in which the Company is engaged by virtue of expansion orders of the Israeli Ministry of Labor and Welfare issued under applicable Israeli laws.

### 6.E. SHARE OWNERSHIP

As of May 7, 2010, other than Mr. Ido Gur, none of the individuals listed in "Item 6 - Directors, Senior Management and Employees - Directors and Senior Management" owned beneficially 1% or more of our ordinary shares, and each such person's individual share ownership has not been previously disclosed to shareholders or otherwise made public. Mr. Gur has been granted options to purchase 1,106,400 ordinary shares of the Company, which constitutes as of May 7, 2010, 19.04% of the Company's outstanding ordinary shares, at the following exercise prices: \$0.50 per share with respect to 442,560 options, \$1.00 per share with respect to 442,560 options, and \$3.00 per share with respect to 221,280 options. The number of options to vest is allocated as follows: 40% to

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the options with an exercise price of \$0.50, 40% to the options with an exercise price of \$1.00, and 20% to the options with an exercise price of \$3.00. 25% of the total amount granted shall vest and become exercisable twelve (12) months after the date of the grant, and 6.25% of the total amount granted shall vest and become exercisable every three (3) months (quarter) thereafter for twelve (12) quarters, in each case, provided that Mr. Gur continues to be employed by the Company at the applicable date of vesting, which period of employment includes the 180 day notice period. The options are subject to certain acceleration events provided for in Mr. Gur's employment agreement and option agreement. Prior to the expiry of two years of continuous employment, Mr. Gur will be entitled to exercise all of his vested options during the period of up to 12 months commencing as of the expiry of the 180 day notice period. After the expiry of at least two years of continuous employment, Mr. Gur will be entitled to exercise all of his vested options including the options the vesting of which was accelerated, in the period up to the expiry of 18 months commencing as of the expiry of the 180 day notice period.

On February 15, 2006, we filed with the U.S. Securities and Exchange Commission a registration statement on Form S-8, pursuant to which we registered for resale all of the shares underlying our amended 2003 Master Stock Option Plan that had not been registered previously. As of the date hereof, the Company has registered for resale an aggregate of 1,038,462 (reflecting the 1-for-13 reverse split effected on November 25, 2005) ordinary shares that have been or may in the future be granted under the Company's option plans. Options generally have a term of seven (7) years. However, options granted prior to December 13, 2005 have a term of ten (10) years. Earlier termination may occur if the employee's employment with us is terminated or if certain corporate changes or transactions occur. Our board of directors determines the grant and the exercise price at the time the options are granted upon recommendation of the Compensation Committee.

The Company's shareholders approved at the extraordinary general meeting of shareholders held on April 11, 2007, an annual increase of the number of ordinary shares underlying the Company's 2003 Amended Master Stock Option Plan by such number of ordinary shares that shall equal 3% of the issued and outstanding share capital of the Company, on a fully diluted basis, at the time of the relevant increase, starting in 2008 (each such increase to be effected immediately following the annual general meeting of the Company's shareholders in the relevant year). Such 3% increase replaced in 2008 the previous annual increase of 180,000 shares that was approved by the Company's shareholders at the annual general meeting held on August 21, 2006 (which was in effect for 2007).

The exercise price per share is determined by the Board, or the Compensation Committee, and is usually granted at the approximate fair market value of the shares on the date of grant, as determined by the closing price of our ordinary shares as reported by Nasdaq on the business day prior to the date of grant.

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

The aforementioned description is only a summary of the Company's 2003 Amended Master Stock Option Plan and is qualified in its entirety by reference to the full text of the plan, previously filed with the SEC on February 15, 2006 as Exhibit 99.2 to the Company's registration statement on Form S-8 (File Number 333-131870).

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### ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

#### 7.A. MAJOR SHAREHOLDERS

The following table sets forth, as of May 7, 2010 (unless otherwise noted below), the number of our ordinary shares, which constitute our only voting securities, beneficially owned by (i) all shareholders known to us to own more than five percent (5%) of our outstanding ordinary shares, and (ii) all of our directors and executive officers as a group. The data presented is based on information provided to us by the holders or disclosed in public filings with the SEC.

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Beneficial ownership of shares is determined under rules of the SEC and generally includes any shares for which a person exercises sole or shared voting or investment power. The table below includes the number of shares underlying options, warrants or other convertible securities that are exercisable or convertible within 60 days after the date hereof. The percentage of outstanding ordinary shares is based on 5,866,470 ordinary shares outstanding as of the date hereof (excluding 1,673,549 shares of treasury stock).

Except where otherwise indicated, and except pursuant to community property laws, we believe, based on information furnished by such owners, that the beneficial owners of the shares listed below have sole investment and voting power with respect to such shares. The shareholders listed below do not have any different voting rights from any of our other shareholders.

NAME AND ADDRESS -----	ORDINARY SHARES BEN ----- NUMBER -----
HarbourVest International Private Equity Partners III - Direct Fund L.P. (1)	1,218,444
The Israeli Aircraft Industries Workers' Provident Fund (2)	420,000
Various entities affiliated with Apex (3)	416,675
Officers and directors as a group (6 persons) (4)	671,828

(1) Includes 88,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(2) Includes 180,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(3) Includes 360,000 ordinary shares underlying outstanding warrants that are currently exercisable.

(4) In accordance with Rule 13d-3 under the Exchange Act, the percentage shown represents ordinary shares underlying outstanding options that are either currently exercisable or will become exercisable for VocalTec shares within 60 days of the date hereof.

On March 2, 2009, the Company purchased an aggregate of 1,673,549 of our shares, constituting approximately 22.7% of our issued and outstanding share capital immediately prior to such purchase, from our largest shareholder as of such date, Cisco Systems International B.V. As a result of such purchase, the purchased shares became dormant shares, conferring no rights on the Company, and the amount of our outstanding shares has decreased by such number of purchased

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shares, resulting in the holdings of our major shareholders listed above increasing significantly compared to their holdings in the years prior to the repurchase.

Our major shareholders do not have different voting rights from each other or from other shareholders.

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

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

### 7.B. RELATED PARTY TRANSACTIONS

None.

### 7.C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

## ITEM 8. FINANCIAL INFORMATION

### 8.A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

Our consolidated financial statements are set forth in Item 18 of this document.

#### EXPORT SALES

Export sales of VocalTec in 2009 were \$5.9 million or 93% of sales compared with export sales in 2008 which were \$5.7 million or 94% of sales, and with \$5.6 million or 98% of sales in 2007.

#### LEGAL PROCEEDINGS

From time to time, we are involved in various routine legal proceedings incidental to the ordinary course of our business. We do not believe that the outcome of these pending legal proceedings will have a material adverse effect on our business or consolidated financial condition or profitability. For additional information, see note 8b. to the attached consolidated Financial Statements.

#### DIVIDENDS

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

### 8.B. SIGNIFICANT CHANGES

Except as disclosed elsewhere in this annual report, there have been no other significant changes since the date of our consolidated financial statements included in this annual report.

## ITEM 9. THE OFFER AND LISTING

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### 9.A. OFFER AND LISTING DETAILS

Through May 7, 2010, for the periods indicated, the high and low reported trading prices on the close of trading of our ordinary shares as reported by Nasdaq were as follows:

	HIGH -----	LOW -----
2005	24.7	3.45
2006	10.95	3.07
2007	4.09	0.82
2008	0.79	0.15
2009	2.15	0.18
2008		
First Quarter	0.79	0.37
Second Quarter	0.65	0.45
Third Quarter	0.52	0.22
Fourth Quarter	0.33	0.15
2009		
First Quarter	0.41	0.18
Second Quarter	1.40	0.33
Third Quarter	2.02	0.80
Fourth Quarter	2.15	1.56

#### MOST RECENT SIX MONTHS

December 2009	1.98	1.58
January 2010	1.72	1.45
February 2010	1.55	1.31
March 2010	1.52	1.36
April 2010	1.63	1.40
May 2010 (through May 7, 2010)	1.54	1.41

#### RECORD HOLDERS

Based upon a review of the information provided to us by our transfer agent, as of May 7, 2010, 5,866,470 of our ordinary shares were issued and outstanding. At such date, the last reported sale price of the ordinary shares was \$1.44 per share, and the ordinary shares were held by 248 record holders. Of those 248 record holders, 28 are shown on our records as having United States addresses. We believe that as of May 7, 2010 approximately 95.88% of our outstanding ordinary shares were held in the United States.

### 9.B. PLAN OF DISTRIBUTION

Not applicable.

### 9.C. MARKETS

Our ordinary shares were initially quoted on the Nasdaq National Stock Market on February 7, 1996 under the symbol "VOCLF," which was changed to "VOCL" on April 20, 1999. Our ordinary shares were quoted on the Nasdaq Stock Market from October 17, 2000 until December 2002, under the symbol "VOCL". In December 2002,

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we transferred to the Nasdaq Capital Market (formerly: Nasdaq SmallCap), in July 2003 we transferred back to the Nasdaq National Market and in April 2005, due to the fact that we no longer satisfied the minimum stockholders' equity continued listing requirement of the Nasdaq National Market, we transferred back to the Nasdaq Capital Market, where our shares continue to be listed under the trading symbol VOCL. In August 2005, we were notified by Nasdaq Capital Market that we were not in compliance with its minimum stockholders' equity standard listing requirements. On November 25, 2005, following the consummation of the transaction with Tdsoft, and in order for our shares to continue to be listed on the Nasdaq Capital Market, we effected a 1-for-13 reverse split of our issued and outstanding share capital, resulting in the par value of our ordinary shares being increased to NIS 0.13 per share. On November 28, 2005, the Nasdaq Capital Market informed us that we complied with all initial listing requirements of the Nasdaq Capital Market. Our shares traded on the Nasdaq Capital Market under the symbol "VOCLD" from November 28, 2005 through December 27, 2005 and under the symbol "VOCL" since December 28, 2005. On February 5, 2008, the Nasdaq Capital Market sent us a Staff Deficiency Letter, indicating that we have failed to comply with the minimum bid price requirement for continued listing set forth in Nasdaq's old Marketplace Rule 4320(e)(2)(E)(ii) (which has recently been changed to Nasdaq Marketplace Rule 5550(a)(2)). The letter provided that we have until August 4, 2008 to regain compliance, i.e., that the bid price of our shares close at \$1.00 per share or more for a minimum of 10 consecutive business days during the period ending on August 4, 2008. We did not succeed in complying with such requirement by August 4, 2008. According to a letter received from the Nasdaq Capital Market on August 7, 2008, we were not eligible for an additional 180-calendar day compliance period (since we did not meet the Nasdaq Capital Market initial listing criteria set forth in old Marketplace Rule 4310(c)) (which has been moved to various rules upon Nasdaq's revision of its Marketplace Rules). We requested a hearing on the determination to suspend trading of our shares before a Nasdaq Listing Qualifications Panel. Such hearing was scheduled for October 2, 2008 and at such time we requested to postpone it until after the Extraordinary General Meeting of our shareholders was scheduled to be held (October 16, 2008) in which our shareholders were going to be asked to authorize a reverse split of our shares which would have resulted in our share price reaching the minimum bid price requirement for continued listing. We anticipated that as a result, the scheduled hearing would be rendered unnecessary. Our request for such postponement was not granted, and further to the hearing which was held on October 2, 2008, we proceeded with the Extraordinary General Meeting of our shareholders which was eventually held on October 16, 2008. At the Extraordinary General Meeting, our shareholders authorized our management to affect a reverse stock split to such extent that will be determined by our management to be necessary to enable us to comply with the foregoing listing requirement of the Nasdaq Capital Market; however, before the final ratio of the reverse stock split was determined by our management based on the closing price of the Company's shares on the Nasdaq Capital Market on the day of the Extraordinary General Meeting, we were informed by Nasdaq that Nasdaq has extended its suspension of the rules requiring a minimum \$1.00 closing bid price and a minimum market value of publicly held shares. Enforcement of these rules was scheduled to be resumed on August 3, 2009. On August 2, 2009, the Company submitted its Plan of Compliance to the Nasdaq Stock Market. On August 24, 2009, the Company notified the Nasdaq Stock Market that the bid price of the Company's shares closed at above \$1.00 per share over the 10 consecutive trading days through August 20, 2009, and requested that the Nasdaq Listing Qualifications Panel conclude that, based on the foregoing, the Company has regained compliance with the minimum bid price for continued listing set forth in Nasdaq's Marketplace Rule 4320(e)(2)(E)(ii) (which has been changed to Nasdaq Marketplace Rule 5550(a)(2)), and as such, is no longer subject to the de-listing of its securities from The Nasdaq Capital Market. On August 25, 2009, the Nasdaq Office of General Counsel, Hearings, notified the Company that the Nasdaq Hearing Panel has determined to grant the Company's request to remain listed on the Nasdaq Stock Market, subject to certain conditions as specified in such letter. To date, the Company has sustained compliance with the Nasdaq Capital Market's

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continued listing standards, and believes that in the long term it will continue sustaining compliance with such continued listing standards.

### 9.D. SELLING SHAREHOLDERS

Not applicable.

### 9.E. DILUTION

Not applicable.

### 9.F. EXPENSES OF THE ISSUE

Not applicable.

## ITEM 10. ADDITIONAL INFORMATION

### 10.A. SHARE CAPITAL

Not applicable

### 10.B. MEMORANDUM AND ARTICLES OF ASSOCIATION

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

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### OBJECTS AND PURPOSES

The objects and purposes of our company are to engage in any legal occupation and/or business.

### RIGHTS, PREFERENCES AND RESTRICTIONS UPON SHARES

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

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

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

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Our Articles of Association provide that directors are elected by an ordinary resolution of a general meeting of our shareholders. Our ordinary shares do not have cumulative voting rights in the election of directors. Accordingly, the holders of ordinary shares representing more than 50% of the voting power in our company have the power to elect all directors. However, our board of directors (other than the external directors) is divided into three classes, the members of each of which are elected until the annual general meeting of our shareholders held in the third year after their appointment.

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

Under the Companies Law, the disclosure requirements that apply to an office holder and are described below under "Approval of Related Party Transactions Under Israeli Law" also apply to a controlling shareholder of a public company. A shareholder that holds more than 50% of the voting rights in a public company is deemed to be a controlling shareholder. A shareholder that holds more than 25% of the voting rights in a public company may also be deemed to be a controlling shareholder, for purposes of approval of certain related party transactions, if there is no other shareholder holding more than 25% of the voting rights at such time. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company, in such order, provided that either (i) the shareholder approval includes the approval of the holders of at least one third of the shares of shareholders having no personal interest in the transaction who vote at the meeting (abstained votes are disregarded), or (ii) the total number of shares of shareholders having no personal interest in the transaction who vote against the transaction does not exceed one percent of the aggregate voting rights in the company.

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

- o Any amendment to the Articles of Association;
- o An increase in the company's authorized capital;
- o A merger; or
- o Approval of certain transactions with control persons and other related parties, which require shareholder approval.

A shareholder has the general duty to refrain from depriving other shareholders of their rights. Any controlling shareholder, any shareholder that knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, under the provisions of the Articles of Associations, has the power to appoint an office holder in the company, is under a duty to act in fairness towards the company. The Companies Law does not describe the substance of this duty (except by providing that the remedies generally available upon a breach of contract will be available also in the event of a breach of the duty to act with fairness) and such substance has not yet been adjudicated by Israeli courts.



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### MODIFICATIONS OF SHARE RIGHTS

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

### SHAREHOLDERS MEETINGS AND RESOLUTIONS

We are required to hold an annual general meeting of our shareholders once every calendar year, but no later than 15 months after the date of the previous annual general meeting. All meetings other than the annual general meeting of shareholders are referred to as extraordinary general meetings. Extraordinary general meetings may be called by our board whenever it sees fit, at such time and place, within or without the State of Israel, as the board may determine. In addition, the Companies Law provides that the board of a public company is required to convene an extraordinary meeting upon the request of (a) any two directors of the company or one quarter of the company's board of directors or (b) one or more shareholders holding, in the aggregate, (i) at least five percent of the outstanding shares of the company and at least one percent of the voting power in the company or (ii) at least five percent of the voting power in the company.

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

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

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

### LIMITATION ON OWNERSHIP OF SECURITIES

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

### MERGERS AND ACQUISITIONS; TENDER OFFERS; ANTI-TAKEOVER PROVISION

The Companies Law includes provisions allowing corporate mergers. These

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provisions require that the board of directors of each company that is party to the merger approve the transaction. In addition, the shareholders of each company must approve the merger by a vote of the majority of the company's shares, present and voting on the proposed merger at a shareholders' meeting, called on at least 35 days' prior notice. In determining whether the requisite majority has approved the merger, shares held by the other party to the merger or any person holding at least 25% of such other party, are excluded from the vote. If the merger would have been approved but for the exclusion of the votes of certain shareholders as provided above, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of a company, if the court holds that the merger is fair and reasonable, taking into account the valuation of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger, and the court may also provide instructions to assure the rights of creditors. In addition, a merger may not be completed unless at least 50 days have elapsed from the date that a notice of the merger was filed with the Israel Registrar of Companies and at least 30 days have elapsed from the date that shareholder approval of both merging companies was obtained. Notwithstanding the foregoing, a merger is not subject to shareholders approval if (i) the target company is a wholly-owned subsidiary of the acquiring company and (ii) the acquiring company is issuing to the shareholders of the target company up to 20% of its share capital and no person will become, as a result of the merger, a control person, subject to certain limitation relating to the counting of the votes, at a meeting of the shareholders of a company that is a party to the merger, of any entity or person that is either the other party to the merger or a control person thereof.

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The Companies Law also provides that, except in certain circumstances set forth in the Companies Law, the acquisition of shares in a public company must be made by means of a special tender offer if, as a result of the acquisition, the purchaser would become a 25% shareholder of the company. The rule does not apply if there already is another 25% shareholder of the company. Similarly, the law provides that an acquisition of shares in a public company must be made by means of a special tender offer if, as a result of the acquisition, the purchaser would become a 45% shareholder of the company, unless there already is a 45% shareholder of the company. These requirements do not apply if, in general, the acquisition (1) was made in a private placement that received the approval of the company's shareholders; (2) was from a 25% or greater shareholder of the company which resulted in the acquirer becoming a 25% or greater shareholder of the company, or (3) was from a 45% or greater shareholder of the company which resulted in the acquirer becoming a 45% or greater shareholder of the company. The tender offer must be extended to all shareholders, but the offeror is not required to purchase more than 5% of the company's outstanding shares, regardless of how many shares are tendered by shareholders (if more shares are tendered than proposed by the purchaser to be purchased, the purchaser will purchase from all tendering shareholders the amount of shares proposed to be purchased, on a pro rata basis). The tender offer may be consummated only if (i) at least 5% of the company's outstanding shares will be acquired by the offeror, and (ii) the number of shares tendered in the offer exceeds the number of shares, the holders of which objected to the offer.

In addition, the Companies Law provides that if, following any acquisition of shares of a public company, the purchaser would hold 90% or more of the shares of the company, such acquisition must be made by means of a full tender offer

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for all of the target company's shares. An acquirer who wishes to eliminate all minority shareholders must do so by means of a full tender offer and acquire such amount of shares that will cause him to hold more than 95% of the outstanding shares of the target company. If less than 5% of the outstanding shares are not tendered, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. The Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the full tender offer, the acquirer may not acquire tendered shares if by doing so the acquirer would own more than 90% of the outstanding shares of the target company.

Our Articles of Association contain provisions that could delay, defer or prevent a change in our control. These provisions include advance notice requirements and a staggered board. Under the advance notice requirements, shareholders seeking to propose items for inclusion on the agenda for a general meeting of shareholders, must submit those items in writing to our corporate secretary not less than 60 days (or not less than 90 days for the nomination of candidates for election of directors) and not more than 120 days prior to the particular meeting. The staggered board provisions of our Articles of Association are described above under "Item 6.C - Directors, Senior Management and Employees - Board Practices"

### BOARD PRACTICES

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

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

Under our Articles of Association, our board of directors (other than external directors) is classified into three classes. Each class has a nearly equal number of directors, as determined by the board of directors. . The terms for these classes of directors will expire at the annual shareholder meetings in 2010, 2011 and 2012. According to recent amendments to our Article of Association, which amendments were approved at the annual shareholder's meeting held at November 2009, one class of directors shall hold office initially for a term expiring at the annual meeting of shareholders to be held in the year following the date on which such amendments to the Articles of Association became effective, another class to hold office initially for a term expiring at the annual meeting of shareholders to be held in the second year following the date on which such amendments to the Articles of Association became effective, and another class to hold office initially for a term expiring at the annual meeting of shareholders to be held in the third year following the date on which such amendments to the Articles of Association became effective, with the members of each class to hold office until their successors are elected and qualified. At each shareholders' meeting, the successors of each class of directors whose term expired at that meeting are elected to hold office for a term expiring at the annual shareholders meeting held in the third year following the year of their election. The staggered board structure may not be amended without the approval of the greater of holders of not less than 75% of the voting power represented at a shareholders' meeting in person or by proxy and voting thereon.

A recent change to the Companies Law requires that every candidate for the position of board member of a public company fill out a qualification statement prior to the submission of his/her appointment as a director of the company to

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the approval of the company's shareholders, and further requires from each of the directors already in office at the effective time of this change to the Companies Law, to fill out the qualification statement prior to the first annual general meeting of shareholders of the company, which is to take place after the effective date of this change. Such qualification statement shall provide that the candidate possesses the necessary qualifications and has the ability to dedicate the appropriate time for the purpose of performing his/her service as a director in the company.

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### EXTERNAL DIRECTORS

We are subject to the provisions of the Companies Law. Under the Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public in or outside of Israel are required to appoint at least two external directors. Certain regulations promulgated under the Companies Law set out the conditions and criteria for a director qualifying as having a "financial and accounting expertise" or a "professional qualification". A director with financial and accounting expertise is a director who, due to his or her education, experience and skills, possesses capabilities relating to and an understanding of business and accounting matters and financial statements, which enable him or her to understand in depth the company's financial statements and to initiate a debate regarding the manner in which the company's financial information is presented. A director who meets a professional qualification is a director who satisfies one of the following requirements: (i) the director holds an academic degree in either economics, business administration, accounting, law or public administration, (ii) the director either holds another academic degree or has obtained other higher education in the company's primary field of business or in an area that is relevant to his or her position, (iii) the director has at least five (5) years of experience serving in one of the following capacities or an aggregate of at least five (5) years of experience in two or more of the following capacities: (a) a senior business management position of a company with a substantial scope of business, (b) a senior position in the primary field of business of the company or (c) a senior public administration position. A proposed external director must submit to the company a declaration as to his or her compliance with the requirements for his or her election as an external director (including with respect to such person's financial and accounting expertise or professional qualification). At least one of the external directors should have a "financial and accounting expertise" and the other external directors should have a "professional qualification". The board of directors should determine the minimum number of directors who should have financial and accounting expertise in addition to at least one external director. In determining such number, the board of directors shall consider, among other things, the type and size of the company and the scope and complexity of its operations. The Companies Law provides that a person may not be appointed as an external director if the person or the person's relative, partner, employer or any entity under the person's control, has, as of the date of the person's appointment to serve as external director, or had, at any time during the two years preceding that date, any affiliation with the company, any entity controlling the company or any entity controlled by the company or by the controlling entity of the company. The term "affiliation" includes:

- o an employment relationship;
- o a business or professional relationship maintained on a regular basis;
- o control; and

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- o service as an office holder (other than as a director that has been appointed as an external director of a company that is intending to consummate its initial public offering).

"Office holder" is defined as a director, general manager, chief business manager, deputy general manager, vice general manager, executive vice president, vice president, other manager directly subordinate to the general manager or any other person assuming the responsibilities of any of the foregoing positions, without regard to such person's title.

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

External directors are to be elected by a majority vote at a shareholders' meeting, provided that either (i) the shareholder approval includes the approval of the holders of at least one third of the shares of non-controlling shareholders who vote at the meeting (disregarding abstentions) or (b) the total number of shares of non-controlling shareholders who vote against the transaction does not exceed one percent (1%) of the aggregate voting rights in the company.

The initial term of an external director is three years, and he or she may be reelected to one additional term of three years. External directors may be removed from office only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. If an external directorship becomes vacant, our board of directors is required under the Companies Law to call a shareholders' meeting immediately to appoint a new external director. Each committee of a company's board of directors that has the power to exercise discretion of the board is required to include at least one external director, and all external directors have to be members of the company's audit committee. If at the time of appointment of an external director all of the members of the board of directors are of one gender, the appointed external director must be of the other gender.

External directors are entitled to compensation as provided in regulations promulgated under the Companies Law and are otherwise prohibited from receiving any other compensation, directly or indirectly, from the company.

### INDEPENDENT DIRECTORS

We are subject to the rules of Nasdaq applicable to listed companies. Under the Nasdaq rules, a majority of our board of directors must be comprised of independent directors and we are required to appoint a minimum of three independent directors. The independence standard under the Nasdaq rules excludes current employees, former employees of a company or of any of its affiliates for a period of three years after cessation of employment, as well as any immediate family member of an executive officer of a company or of any of its affiliates. All of our current directors meet the independence standards of the Nasdaq rules and we currently comply with the foregoing requirements.

In addition, a change to the Companies Law in 2008 allows us to include in our Articles of Association a provision indicating the number of independent directors who shall serve on our board of directors. The independence standard of an independent director under the Companies Law refers to the standard under the Companies Law of an external director (see description above), whose nomination shall have been approved by the audit committee, and who shall not have served as a director in a company for a period exceeding nine consecutive years. Alternatively, we may include in our Articles of Association a provision regarding the number of independent directors, which provision shall state that if there is no controlling shareholder in the company, the majority of the board of directors shall be comprised of independent directors (including the external directors) and if there is a controlling shareholder in the company, then at least one third of the board of directors shall be comprised of independent directors.

The Companies Law restricts a company from appointing its independent directors as officers, employees or service providers, whether directly or indirectly, including through an independent director's wholly-owned corporation, unless two years have passed since the termination of his or her position as an independent director in the company.

We have not yet amended our Articles of Association so as to include either of the aforementioned provisions.

#### AUDIT COMMITTEE

See Item 6.C - "Directors, Senior Management and Employees - Board Practices".

#### INTERNAL AUDITOR

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

#### APPROVAL OF RELATED PARTY TRANSACTIONS UNDER ISRAELI LAW

The Companies Law imposes a duty of care and a duty of loyalty on all of a company's office holders (as defined under "External Directors" above), including directors and executive officers. The duty of care requires an office holder to act with the level of care that a reasonable office holder in the same position would have acted under the same circumstances. The duty of care includes a duty for an office holder to use reasonable means to obtain:

- o information regarding the advisability of a given action submitted for his or her approval or performed by him or her by virtue of his or her position; and
- o all other important information pertaining to such action.

The duty of loyalty generally requires an office holder to act in good faith and for the benefit of the company, and includes a duty to:

- o refrain from any conflict of interest between the performance of his or her duties for the company and his or her personal affairs;

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- o refrain from any activity that is competitive with the company;
- o refrain from exploiting any business opportunity of the company to receive a personal gain for himself or herself or others; and
- o disclose to the company any information or documents relating to a company's affairs that the office holder has received due to his or her position as an office holder.

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

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

Under the Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder includes a shareholder that holds 25% or more of the voting rights in a public company if no other shareholder owns more than 50% of the voting rights in the company. A shareholder that holds more than 25% of the voting rights in a public company may also be deemed to be a controlling shareholder, for purposes of approval of certain related party transactions, if there is no other shareholder holding more than 25% of the voting rights at such time. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company, in that order, provided that either (i) the shareholder approval includes the approval of the holders of at least one third of the shares of shareholders having no personal interest in the transaction who vote at the meeting (votes abstained are disregarded) or (ii) the total number of shares of shareholders having no personal interest in the transaction who vote against the transaction does not exceed one percent (1%) of the aggregate voting rights in the company.

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Under the Companies Law, the entering by a company into a contract with a non-controlling director as to the terms of his office requires the approval of the board of directors followed by the approval of the shareholders of the company, and in a public company, the transaction requires the approval of the audit committee followed by the approval of the board of directors and the shareholders of the company.

### DISCLOSURE OF PERSONAL INTERESTS OF AN OFFICE HOLDER.

The Companies Law requires that an office holder of a company disclose to the company promptly, and, in any event, not later than the first board meeting at which the transaction is discussed, any direct or indirect personal interest that he or she may have and all related material information known to him or her relating to any existing or proposed transaction by the company.

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If the transaction is an "extraordinary transaction", the office holder must also disclose any personal interest held by:

- o the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of such people; or
- o any corporation in which the office holder is a 5% or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager.

Under the Companies Law, an "extraordinary transaction" is a transaction:

- o other than in the ordinary course of business;
- o that is not on market terms; or
- o that is likely to have a material impact on a company's profitability, assets or liabilities.

If a transaction is an "extraordinary transaction", first the audit committee and then the board of directors, in that order, must approve the transaction. Under specific circumstances, shareholder approval may also be required. A director who has a personal interest in the approval of a transaction that is submitted to approval of the audit committee or the board of directors generally may not be present during the deliberations and shall not take part in the voting of the audit committee or of the board of directors on such transaction. Notwithstanding the above, a director may be present at a deliberation of the audit committee and the board of directors and may take part in the voting, if the majority of the members of the audit committee or the board of directors, as the case may be, have a personal interest in the approval of the transaction, in which case the transaction shall also require the approval of the shareholders of the company.

Each person listed in the table under "Directors and Senior Management" in Item 6A above is considered an office holder under the Companies Law.

### EXEMPTION, INSURANCE AND INDEMNIFICATION OF DIRECTORS AND OFFICERS

Consistent with the provisions of the Companies Law, our Articles of Association include provisions permitting us to procure insurance coverage for our office holders, exempt them from certain liabilities and indemnify them, to the maximum extent permitted by law. Under the Companies Law, indemnification of, and procurement of insurance coverage for our office holders must be approved by our audit committee and our board of directors and, with respect to directors, by our shareholders.

### EXEMPTION

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

- o a breach by the office holder of his duty of loyalty, unless the office holder acted in good faith and had a reasonable basis to



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believe that the act would not prejudice the company;

- o a breach by the office holder of his duty of care, if such breach was done intentionally or in disregard of the circumstances of the breach or its consequences, other than a breach committed solely by negligence;

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- o any act or omission done with the intent to derive an illegal personal benefit; or
- o any fine levied against the office holder as a result of a criminal offense.

### OFFICE HOLDER INSURANCE

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

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

### INDEMNIFICATION OF OFFICE HOLDERS

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

- o a financial liability imposed on him in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court concerning an act performed in his capacity as an office holder;
- o reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him by a court, in proceedings we institute against him or instituted on our behalf or by another person, or in a criminal charge from which he was acquitted, or in which he was convicted of an offence that does not require proof of criminal intent; or
- o reasonable litigation expenses, including attorneys' fees, expended by the office holder as a result of an investigation or proceeding instituted against him by an authority authorized to conduct such investigation or proceeding, provided that (i) no indictment (as defined in the Companies Law) was filed against such office holder as a result of such investigation or proceeding, and (ii) no financial liability as a substitute for the criminal proceeding (as defined in the Companies Law) was imposed upon him as a result of such investigation or proceeding or if such financial liability was imposed, it was imposed with respect to an offence that does not require proof of criminal intent.

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Under the Companies Law, our Articles of Association may also include a provision authorizing us to grant in advance an undertaking to indemnify an office holder, provided that the undertaking is limited to such events which the board of directors shall deem to be likely to occur in light of the operations of the Company at the time that the undertaking to indemnify is made and for such amounts or criteria which the board of directors may, at the time of the giving of such undertaking to indemnify, deem to be reasonable under the circumstances. Such undertaking shall set forth such events which the board of directors shall deem to be likely to occur in light of the operations of the Company at the time that the undertaking to indemnify is made, and the amounts and/or criteria which the board of directors may, at the time of the giving of such undertaking to indemnify, deem to be reasonable under the circumstances; and a provision authorizing us to retroactively indemnify an office holder.

The foregoing description includes only a summary of certain provisions of our Articles of Association and is qualified in its entirety by reference to the full text of such document which was previously filed with the SEC on June 20, 2007 as Exhibit 1 to the Company's Annual Report on Form 20-F for the year ended December 31, 2006 and is incorporated herein by reference.

### THRESHOLD FOR DISCLOSURE OF SHARE OWNERSHIP

We are subject to the rules of the US Securities and Exchange Commission, and our shareholders are subject to the requirements under Section 13 of the Exchange Act with respect to disclosure of their holding percentage in the Company. Under such Section and the rules promulgated thereunder, each of our shareholders that owns 5% or more of our outstanding share capital must file with the US Securities and Exchange Commission a form disclosing such shareholder's holding percentage and certain other information (and provide us with a copy of such form).

### CERTAIN LISTING REQUIREMENTS OF NASDAQ

We have previously notified Nasdaq that we will follow Israeli practice in lieu of complying with Nasdaq Marketplace Rules 5605(e)(2) (requiring companies to adopt a formal written charter or board resolution addressing the company's nominations process), 4350(c)(2) (Regularly scheduled meetings of the company's independent directors) and 5635(c) (Regarding the establishment of or a material amendment to a stock option or purchase plan or other equity compensation arrangement). Under Israeli law, the nominations process is conducted by the full board of directors. Similarly, under Israeli law all matters that are subject to the approval of a company's board of directors are discussed by the full board of directors. Finally, under Israeli law, the board of directors has the authority to establish stock option or purchase plans or other equity compensation arrangements, and to adopt material amendments to such plans. In April 2010, we notified Nasdaq that we will follow Israeli practice in lieu of complying with Nasdaq Marketplace Rule 5635 (Shareholder Approval). We notified Nasdaq that (i) under Israeli law, if a publicly-held company issues securities constituting more than 20% of such company's issued share capital immediately prior to such issuance and the consideration received by such company for the issued securities is not on market terms or is in a form other than cash or marketable securities, then if as a result of such transaction there will be created a "material shareholder" in such company, the transaction requires approval by such company's shareholders, and (ii) under the Companies Law, a private offering will be deemed to be on market terms if the board of directors of the company determines that the private offering is on market terms, unless it is proven otherwise. We also notified Nasdaq that Israeli publicly-held companies whose securities are listed solely on a non-Israeli stock exchange or whose securities were offered publicly only outside of Israel, such as the Company, are not subject to the foregoing requirement with respect to shareholder approval and therefore the Company may not be required to obtain

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shareholder approval for certain issuances of shares in excess of 20% of the outstanding shares of the Company, as would be required in certain circumstances by the Nasdaq rules.

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### 10.C. MATERIAL CONTRACTS NOT IN THE ORDINARY COURSE OF BUSINESS

We have not entered into any material contract, other than contracts entered into in the ordinary course of business, or as otherwise described herein in Item 4.A. "History and Development of the Company " above.

### 10.D. EXCHANGE CONTROLS

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

Non-residents of Israel who purchase our securities with non-Israeli currency will be able to repatriate dividends (if any), liquidation distributions and the proceeds of any sale of such securities, into non-Israeli currencies at the rate of exchange prevailing at the time of repatriation, provided that any applicable Israeli taxes have been paid (or withheld) on such amounts.

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

### 10.E. TAXATION AND GOVERNMENT PROGRAMS

THE FOLLOWING IS A SUMMARY OF THE CURRENT TAX STRUCTURE, WHICH IS APPLICABLE TO COMPANIES IN ISRAEL, WITH SPECIAL REFERENCE TO ITS EFFECT ON US AND OUR GROUP COMPANIES. THE FOLLOWING ALSO CONTAINS A DISCUSSION OF MATERIAL ISRAELI AND U.S. TAX CONSEQUENCES TO OUR SHAREHOLDERS AND GOVERNMENT PROGRAMS FROM WHICH WE, AND SOME OF OUR GROUP COMPANIES, BENEFIT. THE FOLLOWING ALSO CONTAINS A DISCUSSION OF CERTAIN ISRAELI AND U.S. TAX CONSEQUENCES TO PERSONS PURCHASING OUR ORDINARY SHARES. TO THE EXTENT THAT THE DISCUSSION IS BASED ON NEW TAX LEGISLATION, WHICH HAS YET TO BE SUBJECT TO JUDICIAL OR ADMINISTRATIVE INTERPRETATION, THERE CAN BE NO ASSURANCE THAT THE VIEWS EXPRESSED IN THE DISCUSSION WILL ACCORD WITH ANY SUCH INTERPRETATION IN THE FUTURE. THE DISCUSSION IS NOT INTENDED AND SHOULD NOT BE CONSTRUED AS LEGAL OR PROFESSIONAL TAX ADVICE AND IS NOT EXHAUSTIVE OF ALL POSSIBLE TAX CONSIDERATIONS.

IN JULY 2002, THE ISRAELI PARLIAMENT APPROVED A LAW ENACTING EXTENSIVE CHANGES TO ISRAEL'S TAX LAW (THE "TAX REFORM LEGISLATION") GENERALLY EFFECTIVE JANUARY 1, 2003. AMONG THE KEY PROVISIONS OF THE TAX REFORM LEGISLATION WERE (I) CHANGES WHICH MAY RESULT IN THE IMPOSITION OF TAXES ON DIVIDENDS RECEIVED BY AN ISRAELI COMPANY FROM ITS FOREIGN SUBSIDIARIES; AND (II) THE INTRODUCTION OF THE "CONTROLLED FOREIGN CORPORATION" CONCEPT ACCORDING TO WHICH AN ISRAELI COMPANY MAY BECOME SUBJECT TO ISRAELI TAXES ON CERTAIN INCOME OF A NON-ISRAELI SUBSIDIARY IF THE SUBSIDIARY'S PRIMARY SOURCE OF INCOME OR PROFIT IS PASSIVE INCOME (SUCH AS INTEREST, DIVIDENDS, ROYALTIES, RENTAL INCOME OR CAPITAL GAINS). AN ISRAELI COMPANY THAT IS SUBJECT TO ISRAELI TAXES ON THE INCOME OF ITS NON-ISRAELI SUBSIDIARIES MAY RECEIVE A CREDIT FOR CERTAIN INCOME TAXES PAID/WITHHELD OR THAT WILL BE PAID/WITHHELD BY THE SUBSIDIARY IN ITS COUNTRY OF

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RESIDENCE, ACCORDING TO THE TERMS AND CONDITIONS DETERMINED IN THE ISRAELI TAX ORDINANCE.

THE FOLLOWING SUMMARY IS INCLUDED HEREIN AS GENERAL INFORMATION ONLY AND IS NOT INTENDED AS A SUBSTITUTE FOR CAREFUL TAX PLANNING. ACCORDINGLY, EACH INVESTOR SHOULD CONSULT HIS OR HER OWN TAX ADVISOR AS TO THE PARTICULAR TAX CONSEQUENCES TO SUCH INVESTOR OF THE PURCHASE, OWNERSHIP OR SALE OF AN ORDINARY SHARE, INCLUDING THE EFFECT OF APPLICABLE STATE, LOCAL, FOREIGN OR OTHER TAX LAWS AND POSSIBLE CHANGES IN TAX LAWS.

### ISRAEL CORPORATE TAX CONSIDERATIONS

#### GENERAL CORPORATE TAX STRUCTURE

The regular rate of corporate tax, which Israeli companies were subject to in 2009 was 26% (such tax rate has been reduced to 25% in 2010, 24% in 2011, 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter). In 2009, Israeli companies were generally subject to Capital Gains Tax at a rate of 25% for their capital gains (other than capital gains from the sale of listed securities derived by corporations whose taxable income was determined immediately before the 2006 Tax Reform was published, pursuant to part B of the Israeli Income Tax Law (Inflationary Adjustments), 5745-1985, or pursuant to the Income Tax Regulations (Rules on Bookkeeping by Foreign Invested Companies and Certain Partnership and Determination of their Chargeable Income), 1984, or the Dollar Regulations, which were subject to the regular corporate tax rate). As of 2010, Israeli companies will be subject to the regular corporate tax rate for such gains. However, the effective rate of tax payable by a company (such as ours) which derives income from an "Approved Enterprise" (as further discussed below) may be considerably lower.

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Following an additional amendment to the Israeli Tax Ordinance (the "ITO"), which came into effect on January 1, 2009, an Israeli corporation may elect a 5% rate of corporate tax (instead of 25%) for income from dividend distributions received from a foreign subsidiary which is distributed and used in Israel in 2009, or within one year after actual receipt of the dividend, whichever is later. The 5% tax rate is subject to various conditions, which include, inter-alia, conditions with regard to the identity of the corporation that distributes the dividends, the source of the dividend, the nature of the use of the dividend income, and the period during which the dividend income will be used in Israel.

#### LAW FOR THE ENCOURAGEMENT OF CAPITAL INVESTMENTS, 1959

GENERAL. Certain of our production and development facilities have been granted approved enterprise status pursuant to the Law for the Encouragement of Capital Investments, 1959 (the "Investment Law"). The Investment Law provides that a capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry and Trade of the State of Israel, or the Investment Center, be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, e.g., the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific Approved Enterprise.

Subject to certain provisions concerning income and subject to the Alternative

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

TAX BENEFITS. Taxable income of a company derived from an Approved Enterprise is subject to corporate income tax at the rate of up to 25% (rather than the tax rates referred to under "General Corporate Tax Structure" above) for a certain period of time. The benefit period is a period of 7 years commencing in the year in which the Approved Enterprise first generates taxable income. The benefits may be shorter as it is limited to 12 years from the commencement of production of the Approved Enterprise or 14 years from the date of approval, whichever is earlier. Under certain circumstances (as further detailed below), the benefit period may extend to a maximum of 10 years from the commencement of the benefit period. A company which operates under more than one approval or that has capital investments which are only partly approved (such as a company being designated as a Mixed Enterprise), may have an effective company tax rate that is the result of a weighted combination of the various applicable rates.

A company owning an Approved Enterprise which was approved after April 1, 1986, may elect to forego the entitlement to grants or state guarantees and apply for an alternative package of tax benefits. These benefits provide that undistributed income from the Approved Enterprise is fully tax exempt from corporate tax for a defined period, which ranges between 2 and 10 years from the first year of taxable income, subject to the limitations described above, depending principally upon the geographic location within Israel and the type of the approved enterprise. Upon expiration of such period, the Approved Enterprise is eligible for a beneficial tax rate (25% or lower in the case of a Foreign Investment Company (the "FIC"), as described below), for the remainder of the otherwise applicable period of benefits, as described above.

A company which qualifies as a FIC is a company, like us, in which more than 25% of the share capital (in terms of shares, rights to profit, voting and appointment of directors) and of the combined share and loan capital is owned, directly or indirectly, by non-residents of Israel and is therefore entitled to further tax benefits relating to its approved enterprises. Such a company will be eligible for an extension of the period of tax benefits for its approved enterprises (up to 10 years) and further tax benefits, should the level of non - Israeli ownership in it increase above 49%.

The company tax rate applicable to income earned from Approved Enterprise programs (currently, for programs in which an application for an Approved Enterprise status was submitted before December 31, 2004) in the benefit period by a FIC is as follows:

PERCENTAGE OF NON-ISRAELI OWNERSHIP -----	TAX RATE -----
Over 25% but less than 49%	25%
49% or more but less than 74%	20%
74% or more but less than 90%	15%
90% or more	10%

Entitlement to these benefits is subject to the final ratification of the Investment Center, and is conditioned upon fulfillment of all terms of the approved program. However, there can be no assurance that our group companies which enjoy Approved Enterprise benefits will obtain approval for additional Approved Enterprises, or that the provisions of the Investment Law will not change with respect to future approvals, or that the above-mentioned shareholding portion will be reached for each subsequent year. In the event of our failure to comply with these conditions, the tax and other benefits could be canceled, in whole or in part, and we might be required to refund the amount of

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the canceled benefits, together with the addition of Israeli Consumer Price Index (the "CPI") linkage difference and interest. We believe that our Approved Enterprise substantially complies with all such conditions at present, but there can be no assurance that it will continue to do so.

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

A company that pays a dividend out of income derived from the Approved Enterprise(s) during the tax exemption period will be required to recapture the deferred corporate income tax applicable to the amount distributed (grossed up to reflect such tax) at the rate which would have been applicable had such company not elected the Alternative Package. This rate is generally 10% to 25%, depending on the extent to which non-Israeli shareholders hold such company's shares.

The dividend recipient is taxed at the reduced rate applicable to dividends from Approved Enterprises (generally 15% as compared to 25% for individuals or an exemption for companies), if the dividend is distributed during the tax benefit period or within 12 years after this period. However, the limitation does not apply if the company qualifies as a FIC. This tax must be withheld by such company at source, regardless of whether the dividend is converted into foreign currency.

Subject to certain provisions concerning income subject to Mixed Enterprises, all dividends are considered to be attributable to the entire enterprise and the effective tax rate on the dividend is the result of a weighted combination of the various applicable tax rates. However, such company is not obliged to distribute exempt retained profits under the Alternative Package, and such company may generally decide from which year's profits to declare dividends.

Each application to the Investment Center is reviewed separately, and a decision as to whether or not to approve such application is based, among other things, on the then prevailing criteria set forth in the Investment Law, on the specific objectives of the applicant company set forth in such application and on certain financial criteria of the applicant company. Accordingly, there can be no assurance that any such application by any of our group companies will be approved. In addition, the benefits available to an Approved Enterprise are conditional upon the fulfillment of certain conditions stipulated in the Investment Law and its regulations and the criteria set forth in the certificate of approval, as described above. In the event that these conditions are violated, in whole or in part, a company with an Approved Enterprise would be required to refund the amount of tax benefits, with the addition of the Israeli CPI linkage differences and interest.

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

Where withholding tax is paid by our company to the country of residence of the purchaser/licensee, such tax would generally be creditable by our company for

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Israeli income tax purposes, pursuant to any relevant income tax treaty and under Israeli law against income derived from the same source. However, where we do not have taxable income for Israeli tax purposes because of the application of a tax exemption available to an Approved Enterprise or because of losses for tax purposes, we would have no Israeli tax liability against which to credit the foreign tax withheld and paid by us. Furthermore, under Israeli law, we cannot carry forward such unused credit to future tax years in the case of exempt income or have limited ability to carry forward such credit in the case of taxable income.

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

Notwithstanding the foregoing, on March 29, 2005, the Israeli Parliament passed an amendment to the Investment Law, which revamps the Israeli tax incentives for future industrial and hotel investments (the "2005 amendment"). A tax "holiday" package can now be elected for up to 15 years for a "Privileged Enterprise" as defined in the 2005 amendment, if certain conditions are met, without needing to obtain approval. The extent of the tax benefits available depends upon the level of foreign investment.

The 2005 amendment became effective on April 1, 2005. Taxpayers may, under certain conditions, claim Privileged Enterprise status for new and expanded enterprises with respect to 2004 or subsequent years, unless the Investment Center granted such taxpayer Approved Enterprise status prior to December 31, 2004.

Subject to certain conditions, various alternative tax-only benefit packages can now be elected with respect to investments in a "Privileged Enterprise", without prior approval. Companies in industry or tourism in Israel may elect between:

- o Tax "holiday" package - for a "Privileged Enterprise": a tax exemption applies to undistributed profits for 2 to 15 years depending on the geographical location of the "Privileged Enterprise" and the level of foreign ownership. Company tax rates of between 10% and 25% apply to distributed exempt profits or profits derived subsequent to the exempt period. The total period of tax benefits is 7 to 15 years, or

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- o Grant / Reduced tax package - for an "Approved Enterprise": Fixed asset grants of between 10% and 24% for enterprises in a development area and reduced company tax rates between 0% and 25% for 7 to 15 years.

Dividend withholding tax also applies at a rate of 4% or 15% depending on the package selected.

### GRANTS UNDER THE LAW FOR THE ENCOURAGEMENT OF INDUSTRIAL RESEARCH AND DEVELOPMENT, 1984

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

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portions over a three-year period.

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

Generally, the Research Law requires that the manufacturing of any product developed through research and development funded by the Israeli Government shall be in Israel. It also provides that know-how from the research and development that is used to produce the product may not be transferred to third parties without the approval of a research committee of the OCS. Such approval is not required for the export of any products resulting from such research and development.

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

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

In March 2005, an amendment to the Research Law was enacted. One of the main modifications included in the amendment was an authorization to the research committee to allow transfer outside of Israel of know-how derived from an approved program and the related manufacturing rights. Essentially, the research committee may approve transfer of know-how in limited circumstances as follows:

- o in the event of a sale of the know-how itself to a non-affiliated third party, provided that upon such sale the owner of the know-how pays to the OCS a certain amount of cash payment set forth in the Research Law. In addition, the amendment provides that if the purchaser of the know-how gives the selling Israeli company the right to exploit the know-how by way of an exclusive, irrevocable and



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unlimited license, the research committee may approve such transfer in special cases without requiring the payment of such amount.

- o in the event of a sale of the company which is the owner of the know-how, pursuant to which the company ceases to be an Israeli company, provided that upon such sale the owner of the know-how pays to the OCS a certain cash payment set forth in the Research Law.
- o in the event of an exchange of know-how such that in exchange for the transfer of know-how outside of Israel, the recipient of such know-how transfers know-how to the company in Israel such that the OCS is convinced that the benefit to the Israeli economy as a result of such exchange is greater than the benefit without such exchange.

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Another provision in the amendment concerns the transfer of manufacture rights. The research committee may, in special cases, approve the transfer of manufacture or of manufacturing rights of a product developed within the framework of the approved program or which results therefrom, outside of Israel.

If the research committee does approve a transfer of manufacturing rights out of Israel, the aggregate total of royalties payments under the royalties regulations increases to an amount of 120%-300% of the grants, depending on the portion of manufacture transferred. The rates of royalties may also increase upon "export of manufacturing rights".

### LAW FOR THE ENCOURAGEMENT OF INDUSTRY (TAXES), 1969

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

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

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

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

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depreciation exceed 100% of the cost of the asset.

In addition, Industrial Companies may (i) amortize the cost of purchased know-how and patents over an eight-year period for tax purposes, (ii) elect to file consolidated tax returns with additional related Israeli Industrial Companies and (iii) deduct expenses related to public offerings in equal amounts over three years.

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

### EMPLOYEE STOCK OPTIONS

Effective from January 1, 2003, the Tax Reform Legislation enables a company to grant options through one of three tax tracks:

- (a) the income tax track through a trustee pursuant to which the optionee pays income tax rate (according to the marginal tax rate of the optionee - up to 46% tax in 2009) plus payments to the National Insurance Institute and health tax on the profit gained upon the earlier to occur of the transfer of the options or the underlying shares from the trustee to the optionee or the sale of the options or the underlying shares by the trustee, and the company may recognize expenses pertaining to the options for tax purposes. The options (or upon their exercise, the underlying shares) must be held by a trustee for a period of 12 months commencing from the end of the year in which the options were granted. Options that were granted following January 1, 2006 must be held by a trustee for a period of 12 months commencing on the date on which the options were granted; or
- (b) the capital gains tax track through a trustee pursuant to which the optionee pays capital gains tax at a rate of 25% on the profit upon, the earlier to occur of the transfer of the options or the underlying shares from the trustee to the optionee or the sale of the options or the underlying shares by the trustee (in this track the optionee is not required to make payments to the National Insurance Institute and health tax) and the Company may not recognize expenses pertaining to the options for tax purposes. Options (or upon their exercise, the underlying shares) granted prior to January 1, 2006, must be held by a trustee for either (i) a period of 30 months commencing from the end of the year in which the options were granted or (ii) for a period of 24 months commencing on the date on which the options were granted, at the optionee's discretion and deposited with the trustee. Options that were granted following January 1, 2006 must be held by a trustee for a period of 24 months commencing on the date on which the options were granted and deposited with the trustee; or
- (c) the income tax track without a trustee pursuant to which the optionee pays income tax rate (according to the marginal tax rate of the optionee up to 46% tax in 2009) plus payments to the National Insurance Institute and health tax on the profit upon the sale of the underlying shares, and the company may not recognize expenses pertaining to the options for tax purposes.

In accordance with the provisions of the Tax Reform Legislation, if a company has selected the capital gains track, the company must continue granting options

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under the selected capital gains track until the end of the year following the year in which the first grant of options under that trustee track will be made. Notwithstanding the above, the company may at any time also grant options under the provisions of the income tax track without a trustee.

The above rules apply only to employees, including officer holders but excluding controlling shareholders.

### TAXATION OF OUR SHAREHOLDERS

#### CAPITAL GAINS

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is the portion of the total capital gain that is equivalent to the increase of the relevant asset's purchase price, which is attributable to the increase in the Israeli CPI between the date of purchase and the date of sale. Foreign residents who purchased an asset in foreign currency may request that the inflationary surplus be computed on the basis of the devaluation of the NIS against such foreign currency. The real gain is the excess of the total capital gain over the inflationary surplus. The inflationary surplus accumulated from and after December 31, 1993, is exempt from any capital gains tax in Israel while the real gain is taxed at the applicable rate discussed below. Dealers in securities in Israel are taxed at regular tax rates applicable to business income.

Pursuant to the Convention Between the Government of the United States of America and the Government of Israel with respect to Taxes on Income (the "U.S.-Israel Tax Treaty"), the sale, exchange or disposition of ordinary shares by a person who qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty and who is entitled to claim the benefits afforded to such resident by the U.S.-Israel Tax Treaty (called a Treaty U.S. Resident) will not be subject to Israeli capital gains tax unless (a) such Treaty U.S. Resident is an individual and was present in Israel for more than 183 days during the relevant taxable year or (b) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of the voting power of a company during any part of the 12-month period preceding such sale, exchange or disposition. A sale, exchange or disposition of shares by a Treaty U.S. Resident who is an individual and was present in Israel for more than 183 days during the relevant taxable year or who holds, directly or indirectly, shares representing 10% or more of the voting power of a company at any time during such preceding 12-month period would be subject to such Israeli tax, to the extent applicable, unless the aforementioned exemption from capital gain tax for shares listed on the Tel-Aviv Stock Exchange (the "TASE") or on a recognized stock exchange outside of Israel applies; however, in the event that under the U.S.-Israel Tax Treaty and the Israeli tax law a Treaty U.S. Resident will be subject to capital gain tax in Israel, such Treaty U.S. Resident would be permitted to claim a credit for the Israeli taxes paid against the U.S. federal income tax imposed on the sale, exchange or disposition, subject to the limitations under U.S. law applicable to foreign tax credits. The U.S.-Israel tax treaty does not relate to U.S. state or local taxes. For non-U.S. residents, the purchaser of securities may be required to withhold a maximum of 20% tax on all amounts received for the sale of our securities, for so long as the capital gain from such a sale is not exempt from Israeli capital gains tax, and unless a different rate is provided in a treaty between Israel and the seller's country of residence.

On January 1, 2006, the Law for Amendment of the Income Tax Ordinance (Amendment No. 147), (the "Tax Reform"), came into effect, thus imposing capital gains tax at a rate not to exceed 20% on gains derived by an individual on or after January 1, 2006 from the sale of securities in Israeli companies. The aforesaid does not apply to the sale of securities by an individual who is classified as a "significant shareholder" in the Company (one who holds, directly or indirectly,

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alone or together with another, at least 10% in one or more of the means of control in the Company - either at the time of sale of the securities or at any time during the 12 months that preceded the above stated sale), in which case the rate of tax in respect of the capital gains will not exceed 25%. Furthermore, this tax rate does not apply to: (1) dealers in securities; (2) shareholders that report in accordance with the Income Tax Law (Inflationary Adjustment)-1985; or (3) shareholders who acquired their shares prior to an initial public offering. The capital gains tax rate imposed on gains (other than capital gains from the sale of listed securities) derived by corporations in 2009 is 25% (see discussion above). As of 2010, such gains derived by corporations will be subject to the regular corporate tax rate as detailed above. The tax basis of shares acquired prior to January 1, 2003, will be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003.

Non-Israeli residents will be exempt from Israeli capital gains tax on any gains derived from the sale of shares publicly traded on the TASE or on a recognized stock exchange outside of Israel, provided such shareholders did not acquire their shares prior to an initial public offering and provided that the profits were not derived from a permanent establishment in Israel. However, non-Israeli corporations selling such securities, including U.S. resident corporations, will not be entitled to such an exemption if an Israeli resident (i) has a controlling interest of 25% or more in the non-Israeli corporation, or (ii) is the beneficiary which is directly or indirectly entitled to 25% or more of the revenues or profits of the non-Israeli corporation. Notwithstanding the foregoing, dealers in securities in Israel are taxed at regular tax rates applicable to business income. In any event, the provisions of the Tax Reform do not affect the exemption from capital gains tax for gains accrued before January 1, 2003 from a sale of securities in Israeli companies publicly traded on the TASE or on a recognized stock exchange outside of Israel.

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### WITHHOLDING TAX

Nonresidents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. We are generally required to withhold income tax at the rate of 20% on all distributions of dividends, although, with respect to U.S. taxpayers, according to the U.S.-Israel Tax Treaty, if the dividend recipient is a corporation that holds 10% or more of our voting stock for a certain period prior to the declaration and payment of the dividend, we are only required to withhold at a 12.5% rate. Notwithstanding the foregoing, with regard to dividends generated by an Approved Enterprise, we are required to withhold income tax at the rate of 15%. If the dividend is attributable partly to income derived from an Approved Enterprise, and partly to other sources of income, the withholding rate will be a blended rate reflecting the relative portions of the two types of income. The withheld tax is the final tax in Israel on dividends paid to non-residents who do not conduct business in Israel.

### ESTATE AND GIFT TAX

Israel presently has no estate or gift tax.

### UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS

The following discussion of United States federal income tax considerations is based on the United States Internal Revenue Code of 1986, as amended (the

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

### TAXATION OF U.S. HOLDERS

For purposes of this discussion, a "U.S. Holder" means any beneficial owner of our ordinary shares who, for United States federal income tax purposes, is: (i) a citizen or resident of the United States; (ii) a corporation or entity treated as a corporation organized in or under the laws of the United States or any state thereof or the District of Columbia; (iii) an estate the income of which is subject to United States federal income taxation regardless of source; or (iv) a trust, if a United States court is able to exercise primary supervision over its administration and one or more United States persons have the authority to control all of its substantial decisions or a trust that was in existence on August 20, 1996 and validly elected to continue to be treated as a domestic trust. A "Non-U.S. Holder" is any beneficial owner other than a U.S. Holder. If a partnership or any other entity or arrangement treated as a partnership holds our ordinary shares, the United States federal income tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. If you are a partner in a partnership holding our ordinary shares, you should consult your tax advisor.

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

REDUCED TAX RATES FOR CERTAIN DIVIDENDS

REDUCED TAX RATES FOR CERTAIN DIVIDENDS. Subject to the discussion below under "Passive Foreign Investment Company Status", for taxable years before January 1, 2011, a dividend paid by us to certain shareholders will be taxed at the preferential tax rates applicable to long-term capital gains if (a) we are a "qualified foreign corporation" (as defined below), (b) the U.S. Holder receiving such dividend is an individual, estate, or trust and (c) such dividend is paid on our ordinary shares that have been held by such U.S. Holder for more than 60 days during the 120-day period beginning 60 days before the "ex-dividend date" (i.e., the first date that a purchaser of such Share will not be entitled to receive such dividend).

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Generally, we may be considered a "qualified foreign corporation" (a "QFC") if we are eligible for the benefits of a comprehensive income tax treaty with the United States which includes an information exchange program that the IRS determines is satisfactory. However, even if we are so eligible, we will not be treated as a QFC if we were a PFIC for the taxable year during which we paid a dividend or for the preceding taxable year. As discussed below, we do not believe that we should be considered a PFIC for any tax year through and including the tax year ended December 31, 2007 and thus for those years we expect to be a QFC. However, for the tax year ended December 31, 2009 there is a significant possibility that we could be considered a PFIC and thus we may not be considered a QFC for the tax year 2009 and potentially not for any following taxable year.

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

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

DISPOSITIONS. In general, any gain or loss recognized by a U.S. Holder on the sale or other disposition of our ordinary shares will be United States-source income or loss for purposes of the United States foreign tax credit limitation, except in certain limited situations (typically only applicable to sales through a permanent establishment in Israel) where the gain may be re-sourced. U.S. Holders should consult their tax advisors regarding the application of the United States foreign tax credit limitation to gain or loss recognized on the disposition of our ordinary shares and the treatment of any foreign currency gain or loss on any NIS received in respect of the sale or other disposition of our ordinary shares.

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### PASSIVE FOREIGN INVESTMENT COMPANY STATUS

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

The asset test generally requires a company to determine the value of its passive assets as a percentage of the value of its total assets. For a publicly traded corporation, such as us, the total value of its assets will generally be treated as equal to the sum of (i) the average value of its outstanding stock plus (ii) its liabilities. In most cases, the average value of the outstanding stock is determined based on its trading value, although in certain cases it may be possible for a corporation to demonstrate a different value if it can support that the average trading value of its stock does not reflect its real fair market value and can further support an alternative valuation.

IF THE STANDARD VALUATION METHOD OF USING THE AVERAGE TRADING VALUE OF OUR ORDINARY SHARES WERE TO BE USED, THIS WOULD RESULT IN US BEING A PFIC FOR THE TAX YEAR ENDED DECEMBER 31, 2009. THEREFORE, THERE IS A SIGNIFICANT POSSIBILITY THAT WE WERE A PFIC IN 2009 AND WE MAY CONTINUE TO BE A PFIC IN 2010 IF THE AVERAGE TRADING VALUE OF OUR SHARES DOES NOT SIGNIFICANTLY CHANGE OR THE PERCENTAGE OF OUR PASSIVE ASSETS IS SIGNIFICANTLY REDUCED. IN VIEW OF THIS SIGNIFICANT POSSIBILITY, U.S. HOLDERS ARE URGED TO CONSULT THEIR TAX ADVISORS FOR GUIDANCE.

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

- o gain recognized by the U.S. Holder upon the disposition of, as well as income recognized upon receiving certain dividends on, our ordinary shares would be taxable as ordinary income;
- o the U.S. Holder would be required to allocate such dividend income and/or disposition gain ratably over such holder's entire holding period for such ordinary shares;

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- o the amount allocated to each year other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as applicable, and an interest charge would be imposed with respect to the resulting tax liability;
- o the U.S. Holder would be required to file an annual return on IRS Form 8621 regarding distributions received on, and gain recognized on dispositions of, our ordinary shares; and
- o any U.S. Holder who acquired our ordinary shares upon the death of a U.S. Holder would not receive a step-up of the income tax basis to fair market value of such shares. Instead, such U.S. Holder

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beneficiary would have a tax basis equal to the decedent's basis, if lower.

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

### QEF election

A U.S. Holder that owns ordinary shares may elect, provided that the Company provides such person with certain information, to have the Company treated, with respect to that person, as a "Qualified Electing Fund" or QEF. (A U.S. Holder who makes a QEF election with respect to the Company is referred to herein as an "Electing Shareholder"). The QEF election is made on a shareholder-by-shareholder basis, applies to all ordinary shares held or subsequently acquired by the Electing Shareholder and can only be revoked with consent of the United States Internal Revenue Service. The QEF Election must be made by a shareholder on or before the due date (with regard to extensions) for such person's tax return for the taxable year for which the election is made and, once made, will be effective for all subsequent taxable years of such person unless revoked.

An Electing Shareholder generally will be required to include currently in gross income its pro rata share of the Company's annual ordinary earnings and net capital gains, if any, in any taxable year that the Company is a PFIC. Any income inclusion will be required whether or not such shareholder owns ordinary shares for an entire taxable year or at the end of the Company's taxable year. The amount that the Electing Shareholder will have to include in income will be determined without regard to the Company's prior year losses or the amount of cash distributions, if any, received from the Company. Electing Shareholders will be required to pay tax currently on such income, unless an election is made to defer such payment and the shareholder pays an interest charge.

An Electing Shareholder is required to make an annual information statement which would include information as to its pro rata share of ordinary earnings and net capital gains, calculated under U.S. tax principles, and as to distributions on such ordinary shares. If, in the future, we determine that we are or were a PFIC, we may attempt to assist such shareholder with the gathering of the information required to make such information statement, but we are not required to do so. Electing Shareholders should be aware that the information required may not be freely available.

So long as an Electing Shareholder's QEF election is in effect with respect to the entire holding period for its ordinary shares, any gain or loss realized by such shareholder on the sale or exchange of such ordinary shares held as capital assets ordinarily would be a capital gain or loss and taxable to such shareholder in the same manner as if the shares were not shares in a PFIC.

U.S. Holders will be permitted to make retroactive elections in particular circumstances, including if the U.S. Holder had a reasonable belief that the Company was not a PFIC and filed a protective election. U.S. Holders should consult their tax advisors as to the consequences of making a protective QEF election or other consequences of making the QEF election.



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In the event that we were deemed to be a PFIC for any taxable year and a U.S. Holder failed to make a QEF election for the first taxable year that we were a PFIC and such U.S. Holder owned our ordinary shares, the U.S. Holder could obtain treatment similar to that afforded a shareholder who has made a timely QEF election by making a QEF election and a deemed sale election or "purging election" for the same taxable year. If a purging election is made, the U.S. Holder will be treated as if it had sold our ordinary shares for their fair market value on the last day of the taxable year and will recognize gain, but not loss, on such deemed sale in accordance with the general PFIC rules, including the interest charge provisions described above. Thereafter, the U.S. Holder's interest will be treated as an interest in a qualified electing fund.

### Mark-to-market election

A U.S. Holder generally may make a mark-to-market election with respect to shares of "marketable stock" of a PFIC. The term "marketable stock" generally includes stock of a PFIC that is "regularly traded" on a "qualified exchange or other market". Generally, a "qualified exchange or other market" means (i) a national securities exchange which is registered with the United States Securities and Exchange Commission or the national market system established pursuant to Section 11A of the United States Securities Exchange Act of 1934 or (ii) a foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and that has the following characteristics: (a) the exchange has trading volume, listing, financial disclosure, surveillance and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly, market, and to protect investors, and the laws of the country in which the exchange is located and the rules of the exchange ensure that such requirements are actually enforced and (b) the rules of the exchange effectively promote active trading of listed stocks. A class of stock is "regularly traded" on a qualified exchange or other market for any calendar year during which such class of stock is traded (other than in de minimis quantities) on at least 15 days during each calendar quarter, subject to special rules for an initial public offering. In the event that our shares do not qualify as "marketable stock" for these purposes, a U.S. Holder will not be eligible to make a mark-to-market election.

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As with a QEF election, a mark-to-market election is made on a shareholder-by-shareholder basis, applies to all ordinary shares held or subsequently acquired by a U.S. Holder and can only be revoked with consent of the United States Internal Revenue Service (except to the extent the ordinary shares no longer constitute "marketable stock"). As a result of a mark-to-market election, in any taxable year that the Company is a PFIC, a U.S. Holder would generally be required to report gain or loss annually to the extent of the difference between the fair market value of the ordinary shares at the end of the taxable year and such U.S. Holder's adjusted tax basis of the ordinary shares at that time. Any gain under this computation, and any gain on an actual disposition of the ordinary shares, would be treated as ordinary income. Any loss under this computation, and any loss on an actual disposition of ordinary shares, generally would be treated as ordinary loss to the extent of the cumulative net mark-to-market gain previously included. Any remaining loss from marking ordinary shares to market will not be allowed, and any remaining loss from an actual disposition of ordinary shares generally would be capital loss. The U.S. Holder's tax basis in the ordinary shares is adjusted annually for any gain or loss recognized under the mark-to-market election.

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Unless either (i) the mark-to-market election is made with respect to the taxable year in which the U.S. Holder's holding period for the ordinary shares commences or (ii) a QEF election has been in effect for such person's entire holding period, any mark-to-market gain for the election year generally will be subject to the general rules applicable to the disposition of shares of a PFIC, discussed above.

U.S. HOLDERS OF OUR ORDINARY SHARES SHOULD CONSULT THEIR TAX ADVISORS ABOUT THE PFIC RULES, INCLUDING THE POSSIBILITY, AND ADVISABILITY OF, AND THE PROCEDURE AND TIMING FOR MAKING A QEF OR MARK-TO-MARKET ELECTION IN CONNECTION WITH THEIR HOLDING OF ORDINARY SHARES, INCLUDING OPTIONS TO ACQUIRE OUR ORDINARY SHARES.

### CONTROLLED FOREIGN CORPORATION STATUS

We have not determined whether we meet the definition of a controlled foreign corporation ("CFC") for United States federal income tax purposes. We would be a CFC if U.S. persons each owning (directly, indirectly or by attribution) 10% or more of the voting power of our shares ("10% Shareholders") own in the aggregate more than 50% of the voting power or value of our shares. If we were a CFC, 10% Shareholders could have adverse consequences, including being required to include a portion of our undistributed income as constructive dividends in taxable income each year.

U.S. HOLDERS OF OUR ORDINARY SHARES WHO MAY BE 10% SHAREHOLDERS SHOULD CONSULT THEIR INDEPENDENT TAX ADVISORS ABOUT THE CFC RULES.

### TAXATION OF NON-U.S. HOLDERS

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

### BACKUP WITHHOLDING AND INFORMATION REPORTING

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

### 10.F. DIVIDENDS AND PAYING AGENTS

Not applicable.

10.G. STATEMENT BY EXPERTS

Not applicable.

10.H. DOCUMENTS ON DISPLAY

We are subject to certain of the information reporting requirements of the Exchange Act. As a "foreign private issuer" we are exempt from the rules and regulations under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act, with respect to their purchase and sale of our shares. In addition, we are not required to file reports and financial statements with the Securities and Exchange Commission as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the Securities and Exchange Commission an annual report on Form 20-F containing financial statements audited by an independent accounting firm, within 180 days after the end of each fiscal year.

You may read and copy any document we file with the SEC at its public reference facilities at, 100 F Street, N.E., Room 1580, Washington, D.C. 20549 and at the SEC's regional offices at 233 Broadway, New York, NY 10279 and Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, IL 60661. You may also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. The SEC also maintains a web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the SEC. The address of this web site is <http://www.sec.gov>. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference facilities.

10.I. SUBSIDIARY INFORMATION

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Since the majority of our revenues are paid in or linked to U.S. dollars, we believe that inflation and fluctuations in the NIS/U.S. dollar exchange rate have no material effect on our revenues. Inflation in Israel and U.S. dollar exchange rate fluctuations, however, have some influence on our expenses and, as a result, on our net income. The cost of our Israel operations, as expressed in U.S. dollars, is influenced by the extent to which any increase in the rate of inflation in Israel is not offset, or is offset on a lagging basis, by a devaluation of the NIS in relation to the U.S. dollar.

A significant portion of our expenditures are employee compensation-related. Salaries are paid in NIS. The devaluation of the NIS against the U.S. dollar decreases employee compensation expenditures as expressed in dollars proportionally. As a result, we sometimes use derivative financial instruments in our investment portfolio to hedge foreign currency or other types of market risks. We place our investments in instruments that meet high credit quality standards. We generally invest cash in time deposit. We do not expect any material loss with respect to our investment portfolio.

Our results of operations are affected by a devaluation of the NIS against the U.S. dollar. A devaluation of the NIS in relation to the U.S. dollar will have the effect of decreasing the U.S. dollar value of our assets, mostly current

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assets, to the extent of the underlying value of which is NIS-based. Such a devaluation would also have the effect of reducing the dollar amount of any of our liabilities which are payable in NIS, unless such payables are linked to the dollar.

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

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

FAIR MARKET VALUE ON DECEMBER 31 (IN THOUSANDS, EXCEPT INTEREST RATES AND DURATION)			
	2007 -----	2008 -----	2009 -----
Total Portfolio	5,035	15,544	10,582
Average Interest Rate	4.7%	1.69%	0.40%
Average Duration (Month)	0.25	2.74	3.23
Cash Equivalents (up to three months maturity)	5,035	5,644	7,689
Average Interest Rate	4.7%	0.03%	0.22%
Short Term Investments (three-twelve months maturity)	-	9,900	2,890
Average Interest Rate	-%	2.63%	1.2%

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### ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

### PART TWO.

### ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

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

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

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

### ITEM 15T. CONTROLS AND PROCEDURES

#### 15T.A. EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The Company's management has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e)

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and 15d-15(e) under the Exchange Act) as of December 31, 2009, the end of the period covered by this annual report. We maintain disclosure controls and procedures designed to ensure that the information required to be disclosed by us in filings and submissions under the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified by the SEC's rules and forms, and that information required to be disclosed by us in reports that we file or submit under the Exchange Act is accumulated and communicated to management to allow timely decisions about required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and our management applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our management concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of December 31, 2009.

### 15T.B. MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- o pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;
- o provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- o provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with general accepted accounting principals. Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2009. Based on such assessment, our management concluded that, as of December 31, 2009, our internal control over financial reporting was effective.

Our financial statements have been audited by Kost, Forer, Gabbay & Kasierer (a Member of Ernst & Young Global), an independent registered public accounting firm.

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THIS ANNUAL REPORT DOES NOT INCLUDE AN ATTESTATION REPORT OF OUR REGISTERED PUBLIC ACCOUNTING FIRM REGARDING INTERNAL CONTROL OVER FINANCIAL REPORTING. MANAGEMENT'S REPORT WAS NOT SUBJECT TO ATTESTATION BY OUR REGISTERED PUBLIC ACCOUNTING FIRM PURSUANT TO TEMPORARY RULES OF THE SECURITIES AND EXCHANGE COMMISSION THAT PERMIT US TO PROVIDE ONLY MANAGEMENT'S REPORT IN THIS ANNUAL REPORT.

### 15T.C. ATTESTATION REPORT OF REGISTERED PUBLIC ACCOUNTING FIRM

Not applicable.

### 15T.D. CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) that occurred during the period covered by this annual report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### ITEM 16. RESERVED

#### ITEM 16.A. AUDIT COMMITTEE FINANCIAL EXPERT.

The Company's audit committee is comprised of Yoseph Dauber, Tsipi Kagan and Eran Dariel. We believe that Mr. Dauber and Ms. Kagan qualify as audit committee financial experts as such term is defined in Item 16.A of the Form 20-F. See Item 6.C - "Directors, Senior Management and Employees - Board Practices", and that each of them and Eran Dariel qualifies as an independent director, as defined in the applicable NASDAQ rules.

#### ITEM 16.B. CODE OF ETHICS.

We have adopted a written code of ethics that applies to our principal executive officer, principal financial officer, executive vice president global sales, principal controller, treasurer and to persons performing similar functions. A copy of our code of ethics was filed with our annual report on Form 20-F for the year ended December 31, 2003 as Exhibit 11.

We have also adopted updated written standards of business conduct that apply to all directors, officers and employees. A copy of our standards of business conduct was filed with our annual report on Form 20-F for the year ended December 31, 2008 as Exhibit 11(c). During 2006, our board of directors adopted certain amendments to the insider trading policy included in such standards of business conduct. A copy of the amended insider trading policy was filed as an exhibit to our annual report on Form 20-F for the year ended December 31, 2006.

#### ITEM 16.C. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Our audit committee is responsible for the oversight of our independent auditors' work. The audit committee's policy is to pre-approve all audit and non-audit services provided by our auditors. These services may include audit services, audit-related services, tax services and other services, as further described below. The audit committee sets forth the basis for its pre-approval in detail, listing the particular services or categories of services which are pre-approved, and setting forth a specific budget for such services. Additional services may be pre-approved by the audit committee on an individual basis. Our audit committee pre-approval policies and procedures for audit and non-audit services were filed as an exhibit to our annual report on Form 20-F for the year ended December 31, 2003.

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The auditors of VocalTec billed for the following fees for audit and audit-related services in 2008 and 2009 (in thousands of U.S. dollars):

SERVICES RENDERED -----	YEAR ENDED DECEMBER 31,			
	2008		2009	
	FEES	PERCENTAGES	FEES	PERCENTAGES
Audit (1)	99	51%	104	75%
Audit-related (2)	-	-	-	-
Tax (3)	53	27%	15	11%
Other (4)	42	22	19	14%
Total	194	100%	138	100%

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

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

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

(4) Other fees relate to consulting services.

All of the services referred to in clauses (2), (3) and (4) above were approved by the audit committee of VocalTec.

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

None.

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

None.

#### ITEM 16F: CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT

None.

#### ITEM 16.G: CORPORATE GOVERNANCE

Except as otherwise indicated, the Company is in compliance with corporate governance standards as currently applicable to the Company under Israeli, U.S., SEC and Nasdaq laws and regulations. We are not in compliance with Nasdaq Marketplace Rules 5605(e)(2) (requiring companies to adopt a formal written charter or board resolution addressing the company's nominations process), 5605(b)(2) (Regularly scheduled meetings of the company's independent directors) and 5635(c) (Regarding the establishment of or a material amendment to a stock option or purchase plan or other equity compensation arrangement). Under Israeli law, the nominations process is conducted by the full board of directors.

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Similarly, under Israeli law, all matters that are subject to the approval of a company's board of directors are discussed by the full board of directors. Finally, under Israeli law, the board of directors has the authority to establish stock option or purchase plans or other equity compensation arrangements, and to adopt material amendments to such plans.

Furthermore, we have elected to follow our home country practice in lieu of the requirements set forth in Nasdaq Marketplace Rule 5250(d)(1) which require a domestic United States company to make available to its shareholders a copy of its annual report containing its audited financial statements in one of three specific ways. Instead of distributing copies of our annual report by mail, furnishing an annual report in accordance with Rule 14a-16 under the Exchange Act or posting our annual report on our website and undertaking to provide a hard copy thereof free of charge upon request, we simply make our annual report available to shareholders via our website (<http://www.vocaltec.com>).

Moreover, in April 2010, we notified Nasdaq that we will follow Israeli practice in lieu of complying with Nasdaq Marketplace Rule 5635 (Shareholder Approval). We notified Nasdaq that (i) under Israeli law, if a publicly-held company issues securities constituting more than 20% of such company's issued share capital immediately prior to such issuance and the consideration received by such company for the issued securities is not on market terms or is in a form other than cash or marketable securities, then if as a result of such transaction there will be created a "material shareholder" in such company, the transaction requires approval by such company's shareholders, and (ii) under the Companies Law, a private offering will be deemed to be on market terms if the board of directors of the company determines that the private offering is on market terms, unless it is proven otherwise. We also notified Nasdaq that Israeli publicly-held companies whose securities are listed solely on a non-Israeli stock exchange or whose securities were offered publicly only outside of Israel, such as the Company, are not subject to the foregoing requirement with respect to shareholder approval and therefore the Company may not be required to obtain shareholder approval for certain issuances of shares in excess of 20% of the outstanding shares of the Company, as would be required in certain circumstances by the Nasdaq rules.

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PART THREE.

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

VOCALTEC COMMUNICATIONS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2009

IN U.S. DOLLARS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF  
VOCALTEC COMMUNICATIONS LTD.

We have audited the accompanying consolidated balance sheets of VocalTec Communications Ltd. ("the Company") and its subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's and its subsidiaries' internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's and its subsidiaries' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2009 and 2008, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2t to the consolidated financial statements, effective January 1, 2009, the Company changed its method of accounting for business combinations

Tel-Aviv, Israel  
March 18, 2010

KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

	NOTE	200
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents		\$ 7
Short term bank deposits		3
Restricted cash		
Trade receivables (net of allowance for doubtful accounts of \$ 0 as of December 31, 2009 and 2008)		
Prepaid expenses and other accounts receivable	3	
Severance pay funds		
Inventories	4	
Work in progress		
		-----
TOTAL current assets		12
		-----
SEVERANCE PAY FUNDS		
		-----
PROPERTY AND EQUIPMENT, NET	5	
		-----
IDENTIFIABLE INTANGIBLE ASSETS	6	
		-----
TOTAL assets		\$ 13
		=====

The accompanying notes are an integral part of the consolidated financial statements.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

NOTE

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LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:

Trade payables  
Accrued expenses and other accounts payable  
Accrued severance pay  
Deferred revenues

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TOTAL current liabilities

LONG-TERM LIABILITIES:

Accrued severance pay  
Other long-term liabilities

TOTAL long-term liabilities

TOTAL liabilities

COMMITMENTS AND CONTINGENCIES

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SHAREHOLDERS' EQUITY:

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Share capital

Ordinary shares of NIS 0.13 par value: Authorized - 150,000,000  
shares at December 31, 2009 and 2008; Issued - 7,484,447 and  
7,376,364 shares at December 31, 2009 and 2008, respectively;  
Outstanding - 5,810,898 and 7,376,364 shares at December 31, 2009  
and 2008, respectively

Other comprehensive income

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Additional paid-in capital

Treasury stock (1,673,549 and 0 shares as of December 31, 2009 and  
2008, respectively)

Accumulated deficit

TOTAL shareholders' equity

The accompanying notes are an integral part of the consolidated financial  
statements.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

-----  
U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

	NOTE	2009
	-----	-----
Sales:	12	
Products		\$ 4,218
Services		2,189
		-----
		6,407
		-----
Cost of sales:		
Products		1,768
Services		569
		-----
		2,337
		-----
Inventory write-off		-
Amortization of intangible assets		-
		-----
		2,337
		-----
Gross profit		4,070
		-----
Operating expenses:		
Research and development, net	13	2,056
Selling and marketing		3,044
General and administrative		2,147
Income from sale of patents, net		-
Impairment of goodwill and intangible assets		-
		-----
TOTAL net operating expenses (income)		7,247
		-----
Operating income (loss)		(3,177)
Financial income, net	14	132
		-----
Income (loss) before taxes on income (tax benefit)		(3,045)
Taxes on income (tax benefit)	15	(590)
		-----
Net income (loss)		\$ (2,455)
		=====
Net income (loss) attributable to Ordinary shareholders		\$ (2,455)
		=====
Basic and diluted net income (loss) per Ordinary share		\$ (0.41)
		=====
Weighted average number of Ordinary shares used in computing net income (loss) per Ordinary share - basic and diluted		6,000,590
		=====

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The accompanying notes are an integral part of the consolidated financial statements.

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### VOCALTEC COMMUNICATIONS LTD. AND ITS SUBSIDIARIES

#### STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

	ORDINARY SHARES	
	NUMBER	AMOUNT
Balance as of January 1, 2007	7,376,364	\$ 213
Stock based compensation related to options issued to employees	-	-
Other comprehensive income related to unrealized gain on derivative instruments	-	-
Cumulative effect of FIN 48 adoption (codified in ASC 740)	-	-
Reversal of a provision for issuance expenses	-	-
Net loss	-	-
	-----	-----
Total comprehensive income (loss)		
Balance as of December 31, 2007	7,376,364	213
Stock based compensation related to options issued to employees	-	-
Other comprehensive income related to unrealized gain on derivative instruments	-	-
Net income	-	-
	-----	-----
Total comprehensive income (loss)		
Balance as of December 31, 2008	7,376,364	213
Stock based compensation related to options issued to employees	-	-
Shares buy back from major shareholder	(1,673,549)	-
Stock options exercise by employees and directors	52,404	1
Shares issued in a business combination	55,679	2
Other comprehensive income related to unrealized gain on derivative instruments	-	-
Net loss	-	-
	-----	-----
Total comprehensive income (loss)		
Balance as of December 31, 2009	5,810,898	\$ 216

The accompanying notes are an integral part of the consolidated financial statements.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

	YEAR ENDED D	
	2009	2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ (2,455)	\$ 3
Adjustments required to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	301	
Impairment of goodwill and intangible assets	-	3
Increase (decrease) in accrued severance pay, net	(315)	
Compensation expenses related to shares and options issued to employees	936	1
Bargain purchase in a business combination	(47)	
Gain on sale of equipment	-	
Capital gain from sale of patents	-	(14)
Decrease in trade receivables, net	15	
Decrease (increase) in prepaid expenses and other accounts receivable	(53)	1
Decrease (increase) in inventories and work in progress	(787)	
Increase (decrease) in trade payables	(856)	
Increase (decrease) in accrued expenses and other liabilities	(1,247)	
Increase (decrease) in deferred revenues	428	(1)
Net cash used in operating activities	(4,080)	(4)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(64)	
Purchase of assets in business combination	(185)	
Proceeds from sale of property and equipment	-	17
Proceeds from sale of patents	-	(2)
Payments related to sale of patents	-	(9)
Investment in short term deposit	-	
Investment in restricted cash	-	
Proceeds from redemption of short-term deposit and restricted cash	7,382	
Net cash provided by investing activities	7,133	4
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Shares buy back from shareholder	(669)	
Proceeds from issuance of shares upon exercise of stock options by employees	36	
Net cash used in financing activities	(633)	
Increase (decrease) in cash and cash equivalents	2,420	
Cash and cash equivalents at the beginning of the year	5,090	4

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Cash and cash equivalents at the end of the year	\$ 7,510	\$ 5
	=====	=====
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Cash paid during the year for income taxes	\$ 36	\$
	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 1:- GENERAL

- a. VocalTec Communications Ltd. ("VocalTec") and its subsidiaries ("the Company"), is a global provider of carrier-class Voice-over-IP and Convergence solutions for fixed and wireless service providers. A pioneer in VoIP technology since 1994, VocalTec develops and markets an extensive VoIP offering enabling the flexible deployment of next-generation networks (NGNs). Partnering with prominent system integrators and equipment manufacturers, VocalTec serves an installed base of dozens of leading carriers worldwide.
- b. The Company derived revenues from several major customers - see Note 13.
- c. In May 2008, the Company signed a Patent Purchase Agreement (PPA) for the sale of selected patents to Karo Millennium J.P. L.L.C. Pursuant to the agreement, the Company sold 11 patents and certain patent-related rights, out of the Company's portfolio of 22 patents. With the consummation of the transaction and the payment of all transaction-related expenses, including payment to the Office of the Chief Scientist ("OCS"), the Company retained net profit amounting to approximately \$ 8,800.

In December 2008, the Company signed an additional PPA for the sale of certain patents to Masinolli Fund L.L.C. Pursuant to the agreement, the Company sold 4 patents and certain patent-related rights, out of the Company's remaining portfolio of 11 patents. With the consummation of the transaction and the payment of all transaction-related expenses, the Company retained net profit amounting to approximately \$ 6,100.

The Company was granted a geographically unlimited, non-exclusive license to use the sold patents and other patent-related rights in connection with the development and marketing of its products. Upon completion of the sale of the four patents, the Company retained a patent portfolio comprising seven additional patents as well as several trademarks, including the "Internet Phone" trademark and Internet domain name.

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d. Acquisitions of business:

In December 2009, the Company acquired certain assets and assumed certain liabilities of Outsmart Ltd., a provider of telecommunications convergence solutions. The Outsmart network products enables the Company to offer its customers a larger portfolio of VOIP solutions. The assets acquired and liabilities assumed included technology, property and equipment, customer contracts and customer relations. The purchase price was paid in cash and shares. The fair value of the shares' portion of the consideration was based on the shares' average closing market price during the five (5) business days that ended on (and included) the business day prior to the acquisition date. According to the purchase agreement the seller may be entitled to future payments subject to certain conditions relating to future sales in 2010 and 2011. Since at the closing date such payment is remote, the Company did not record any liability that is associated with such potential future payments.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 1:- GENERAL (CONT.)

The acquisition was accounted for under the acquisition method of accounting and, accordingly, the purchase price was allocated to the assets acquired and liabilities assumed based on their fair values as of the acquisition date, as follows:

		WEIGHTED AVERAGE USEFUL LIFE -----
Fair value of assets acquired		
Property and equipment	\$ 85	
Technology	316	7
Customer relations	28	7
Deferred revenue	(30)	2
Long term liabilities	(77)	
	-----	
	322	
	-----	
Fair value of consideration transferred:		
Cash	185	
Ordinary shares (55,679 shares)	90	
	-----	
	275	
	-----	
Excess of fair value of assets over cost ("bargain purchase")	\$ 47	
	=====	



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Bargain purchase: the excess of the estimated fair value of the assets acquired and liabilities assumed over the fair value of the consideration transferred for the business combination, resulting from the seller's business situation prior to the agreement date, was recorded as a deduction from operating expenses.

The value assigned to the majority of the tangible assets, intangible assets and liabilities is determined using an income approach. This method starts with a forecast of all of the expected future net cash flows associated with the asset and then involves adjusting the forecast to present value by applying an appropriate discount rate that reflects the risk factors associated with the cash flow streams. Values have been determined as follows:

Technology - the fair value of the technology was estimated by using the income approach, based on the expected results of the acquired technology. The income approach projects the expected future net cash flows associated with the asset and then adjusts the forecast to present value by applying an appropriate discount rate that reflects the risk factors associated with the cash flow streams.

Customer relations - the value was estimated using the income approach and based on expected operating results related to existing customers of the acquired business during the estimated useful life of the product acquired.

Deferred revenue - the amount was based on the estimated cost of the obligations and liabilities assumed under certain agreements, including warranty and maintenance. Some of these contracts were paid in advance to the seller, and the Company has a commitment to provide warranty and maintenance pursuant to the contract.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 1:- GENERAL (CONT.)

Long term liabilities - this liability is associated with the obligation for future payment of royalties to the Office of the Israeli Chief Scientist ("OCS"). The fair value of such liability was determined using income approach and was based on the OCS contractual a percentage from the estimated future revenues of the Company, that will be subject to such royalties (see Note 8a).

According to the agreement, the seller will be entitled to receive a percentage from revenues resulting from the acquired assets, above a certain amount. The Company estimates the probability of that situation to occur to be very low, and therefore, no contingent liability was recorded.

Actual and Pro Forma impact of Acquisition:

The results of Outsmarts operations from the date of acquisition were

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immaterial, and have not been included in the consolidated statement of operation due to the proximity of the acquisition to year end.

The following table presents supplemental pro forma information required by ASC 805, "Business Combination", as if the acquisition of the Outsmart business had occurred on January 1, 2009 for the year ended December 31, 2009 and January 1, 2008 for the year ended December 31, 2008:

	UNAUDITED PRO FORMA CONSOLIDATED RESULTS	
	YEAR ENDED DECEMBER 31,	
	2009	2008
Revenues	\$ 7,929 =====	\$ 7,648 =====
Income from continuing operations attributable to ordinary shareholders	(3,298) =====	(919) =====
Basic and diluted income (loss) per share attributable to Ordinary shareholders	(0.55) =====	(0.12) =====

The unaudited pro forma consolidated results were prepared using the acquisition method of accounting and are based on the historical financial information of the Company and the Outsmart business, reflecting both in 2009 and 2008 the Company's and Outsmart business' results of operations. The historical financial information has been adjusted to give effect to the pro forma events that are: (i) directly attributable to the acquisition, (ii) factually supportable and (iii) expected to have a continuing impact on the combined results. The unaudited pro forma consolidated results are not necessarily indicative of what the Company's consolidated results of operations actually would have been had it completed the acquisition on January 1, 2009 and on January 1, 2008. In addition, the unaudited pro forma consolidated results do not purport to project the future results of operations of the combined company nor do they reflect the expected realization of any cost savings associated with the acquisition. The unaudited pro forma consolidated results reflect primarily the following pro forma pre-tax adjustments:

- (1) Additional amortization expense (approximately \$ 34 in 2009 and 2008) related to the fair value of identifiable intangible assets acquired.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 1:- GENERAL (CONT.)

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- (2) Additional depreciation expense (approximately \$ 28 in 2009 and 2008) related to the fair value of identifiable intangible assets acquired.
- (3) Elimination of \$ 80 of costs incurred in 2009, which are directly attributable to the acquisition, and which do not have a continuing impact on the combined company's operating results. Included in these costs are advisory, legal and other costs incurred by the Company

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States ("U.S. GAAP"). The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are:

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reported period. The most significant assumptions are employed in estimates used in determining values of intangible assets, tax assets and tax liabilities, stock-based compensation costs, derivatives, as well as in estimates used in applying the revenue recognition policy related to contract accounting. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

The financial statements have been prepared in U.S. dollars ("dollar"), since the currency of the primary economic environment in which the operations of the Company and certain subsidiaries are conducted is the dollar. Most of the Company's revenues are generated in dollar. In addition, a considerable portion of the Company's costs is incurred in dollars and the Company's financing is generally obtained in dollar. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar. Accordingly, the Company's and its subsidiaries' transactions and balances denominated in dollars are presented at their original amounts. Transactions and balances in other currencies have been remeasured into dollars in accordance with the guidance in ASC 830, "Foreign Currency Matters".

Exchange gain and loss are presented in financial income net.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its directly and indirectly wholly-owned subsidiaries. As of the balance sheet date the only significant subsidiary is Tdsoft Ltd.

Intercompany transactions and balances, including profit from intercompany sales not yet realized outside the Company, have been eliminated upon consolidation.

VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

d. Cash equivalents, restricted cash and short term bank deposits:

Cash equivalents are short-term, highly liquid investments that are readily convertible to cash with original maturities of three months or less when purchased.

Restricted cash is invested in highly liquid deposits, which are used as security for guarantees provided to lessors of office premises, banks as guarantee for hedging instruments made by the Company and customers, as performance guarantees (see Note 8).

Short-term bank deposits with original maturities of more than three months but less than one year are presented as part of short-term investments. Such deposits are presented at cost including accrued interest, which approximates fair value. Interest on the deposits is recorded as financial income.

e. Inventories and work in progress:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, technological obsolescence and discontinued products in an amount equal to the difference between the cost of inventory and its estimated realizable value based upon assumptions about future demands and market conditions. Costs are determined as follows:

Components cost is determined by the average-cost method.

Hardware products are determined on the basis of direct costs, with costs measured on an average basis.

Work in progress:

- o Costs incurred on a long-term contract in progress include direct labor, material, subcontractors, other direct costs and an allocation of overheads, which represent recoverable costs incurred for production, allocable operating overhead cost.
- o Labor overhead is generally included on a basis of updated hourly rates and is allocated to the project according to the amount of hours expended. Material overhead is generally allocated to the project based on the value of direct material that is charged to the project.

Advances from customers are allocated to the applicable contract inventories and are deducted from the inventory balance.

f. Fair value measurements:

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The Company accounts for certain assets and liabilities at fair value under ASC 820, "Fair Value Measurements and Disclosures". ASC 820 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date ("exit price"). When determining the fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and consider assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance.

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VOCALTEC COMMUNICATIONS LTD.  
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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The actual value at which such financial assets could actually be sold or settled with a willing buyer or seller may differ from such estimated fair values depending on a number of factors including, but not limited to, current and future economic conditions, the quantity sold or settled, the presence of an active market and the availability of a willing buyer or seller.

As a basis for considering such assumptions, ASC 820 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value, (by maximizing the use of observable inputs and minimizing the use of unobservable inputs when measuring fair value):

LEVEL 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

LEVEL 2 - Includes other inputs that are observable, either directly or indirectly in the marketplace, such as quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets with insufficient volume or infrequent transactions, or other inputs that are observable (model-derived valuations in which significant inputs are observable), or can be derived principally from or corroborated by observable market data, and

LEVEL 3 - Unobservable inputs which are supported by little or no market activity, and that are significant to the fair value of the asset or liability.

The Company measures its foreign currency derivative instruments at fair value are classified within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

The carrying amount of cash and cash equivalents, short-term bank deposits, trade receivables, short-term bank credit and loans and trade payables approximate their fair values due to the short-term

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maturities of such instruments.

g. Property and equipment, net:

Equipment is stated at cost less accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets at the following annual rates:

	%
Computers and related equipment	33
Office furniture and equipment	6 - 25 (mainly-8%)
Leasehold improvements	Over the shorter of the term of the lease or the life of the asset )

h. Identifiable intangible assets:

Identifiable intangible assets mainly consist of patents, trade name, technology, and customer relations. These intangible assets are stated at cost net of accumulated amortization and are amortized over their useful life using the method which best reflects the applicable expected utilization pattern.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

i. Impairment of long-lived assets:

The long-lived assets and finite-lived intangible assets of the Company and its subsidiaries are reviewed for impairment in accordance with ASC 360-10-35, "Property, Plant and Equipment-Subsequent Measurement", whenever events or changes in circumstances indicate that the carrying amount of an asset (or an asset group) may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds its fair values.

During 2007 and 2009 no impairment losses were identified. During 2008, the Company recorded an impairment loss for intangible assets in the amount of 1,639.

j. Revenue recognition:

The Company generates revenues from licensing the rights to use its software products, from the sale of its systems and from providing maintenance, engineering and support services, and in addition, from providing system integration and products arrangements for which revenues are generated on a fixed price basis. The Company's products

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are sold both to end users and to resellers, who are considered end-users for the purpose of revenue recognition.

Revenue from licensing of software products and systems is recognized when all the following criteria outlined in ASC 985-605, "Software Revenue Recognition", are met: persuasive evidence of an arrangement exists, the product has been delivered, no significant obligation to the customer remains, the sales price is fixed or determinable and collectability is reasonably assured. The Company does not grant a right of return to its customers.

Where software arrangements involve multiple elements, revenue should be allocated to each undelivered element based on vendor specific objective evidence ("VSOE") of the fair value of the undelivered element. The VSOE used by the Company until the end of 2006 to allocate the arrangement fees to support services and maintenance was based on the price charged when these elements were sold separately (upon renewal). Revenues for the delivered product until the end of 2006 were recorded based on the "residual method" prescribed in ASC 985-605, whereby any discount embedded in the arrangement fee, after allocating revenue to undelivered elements which are not considered essential to the software's functionality as described above is allocated to the delivered product. Under the residual method revenue is recognized for the delivered elements when (1) VSOE of fair value exists for all the undelivered elements and (2) all revenue recognition criteria of ASC 985-605 are satisfied. Revenues allocated to the support services and maintenance (the undelivered element) are recognized ratably over the service period.

Due to a limited number of separate support services and maintenance contracts consummated during the periods presented, VSOE is not attainable to support allocation of services and maintenance revenues. Accordingly, recognition of revenues from bundled software arrangements are recognized ratably over the period of the last delivered element in the arrangement, which is typically the customer support and maintenance service period, provided that all other revenue recognition criteria are met.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

When an arrangement provides for acceptance of the product by the customer, revenue is only recognized when such acceptance is received from the Customer.

In certain cases, when the Company sells its products through resellers in new and emerging market channels for which no comparable history has been established, the Company recognizes revenues only when all obligations to the end user have been completed, and provided all other revenue recognition criteria have been met.

Revenues from arrangements including training and installation

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services are recognized only after the services are performed.

Revenues from software maintenance and technical support contracts are recognized on a straight-line basis over the term of the maintenance and support arrangement.

Revenues from system integration long-term projects are generated from fixed-price contracts according to which the time between the signing of the contract and the final customer acceptance is usually over one year. Such contracts require significant customization for each customer specific needs and, as such, revenues from these type of contracts are recognized in accordance with ASC 605-35, "Construction-Type and Production-Type Contracts," using contract accounting based on the percentage of completion method.

Sales under long-term fixed-price contracts which provide for a substantial level of development efforts in relation to total contract efforts are recorded using the cost-to-cost method of accounting as the basis to measure progress toward completing the contract and recognizing revenues. According to this method, revenues and profit are recorded based on the ratio of costs incurred to estimated total costs at completion.

A number of internal and external factors may affect the Company's costs estimates, including labor rates, estimated future prices of material, revised estimates of uncompleted work, efficiency variances, linkage to indices and exchange rates, customer specifications and testing requirement changes. If any of the above factors were to change, or if different assumptions were used in estimating progress cost and measuring progress towards completion, it is possible that materially different amounts would be reported in the Company's consolidated financial statements. Changes in estimates due to changes in estimates resulting from differences between actual performance and original forecasts are recorded in the results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of similar services, and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2009, there was no provision for losses.

The Company believes that the use of the percentage of completion method is appropriate as it has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and the terms of settlement, including in cases of termination for convenience. In all cases the Company expects to perform its contractual obligations and its customers are expected to satisfy their obligations under the contract.



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VOCALTEC COMMUNICATIONS LTD.  
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

As of December 31, 2009, the Company adjusted the estimates of a project that was signed with one of its major customers during the year. Such adjustments were required in order to address a delay in the progress in this project. The Company does not expect any loss from this project.

k. Research and development costs, net:

Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses, as incurred

l. Royalty-bearing grants:

Royalty-bearing grants from the Government of Israel and other government authority for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the research and development costs incurred. Such grants are included as a deduction of research and development costs since at the time received it is not probable the Company will generate sales from these projects and pay the royalties resulting from such sales. The Company initially records a liability on account of the royalties when the related revenues are recognized, with a corresponding charge to cost of sales.

For the grants received and deducted from the research and development costs - see Note 13.

m. Income taxes:

The Company accounts for income taxes and uncertain tax positions in accordance with ASC 740, "Income Taxes". ASC 740 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value. As of December 31, 2009, a full valuation allowance was provided by the Company. See Note 16 for the impact of an amendment ASC No. 740, Accounting for Uncertainty in Income Taxes.

On January 1, 2007, the Company adopted an amendment to ASC 740-10 (originally issued as "FIN 48"). The amendment contains a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available

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evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. The Company accrues interest and penalties related to unrecognized tax benefits in its provision for income tax. The Company recognized an increase of approximately \$ 34 in the liability for unrecognized tax benefits, which was accounted for as an increase to the January 1, 2007 balance of the accumulated deficit. See also Note 15.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

#### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

n. Accounting for stock-based compensation:

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation - Stock Compensation". ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statements.

The Company recognizes compensation expenses for the value of its awards granted based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

Expenses include stock based compensation related to employees as follows:

	YEAR ENDED DECEMBER 31,		
	2009	2008	2007
Cost of sales	\$ 9	\$ 17	\$ 18
Research and development, net	120	357	353
Selling and marketing	127	263	224
General and administrative	680	532	552
	-----	-----	-----
	\$ 936	\$ 1,169	\$ 1,147
	=====	=====	=====

The fair value of options granted is amortized over their vesting period and is estimated at the date of grant using the Black-Scholes

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options-pricing model with the following weighted average assumptions:

	YEAR ENDED DECEMBER 31,		
EMPLOYEE STOCK OPTIONS	2009	2008	2007
Expected volatility	130%	115%	120%
Risk-free interest	1.2%	2.4%	4.7%
Dividend yield	0%	0%	0%
Expected life (years)	5 years	5 years	5 years
Forfeiture rate	17.5%	12%	7.5%

The Black-Scholes option-pricing model requires a number of assumptions, of which the most significant are expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements of the Company over historical period equal to the employee's stock options expected life.

The expected option term represents the period that the Company's stock options are expected to be outstanding and was determined for plain vanilla options based on the "simplified method" permitted by SAB 107 and extended by SAB 110, as the midpoint between the vesting period and the contractual term of the options.

The Company use the "simplified method" for its plain vanilla stock options as historical experience is not available to provide a reasonable estimate of the expected term for stock option grants.

The risk-free interest rate is based on the U.S. Treasury zero-coupon bonds yield curve in effect at the time of grant, with an equivalent term to the expected term of the options.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The Company has historically not paid dividends and has no foreseeable plans to pay dividends and therefore use an expected dividend yield of zero in the option pricing model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest.

o. Severance pay:

The Company's liability for severance pay for its Israeli employees is calculated pursuant to Israel's Severance Pay Law and employment agreements based on the most recent salary of the employees (based on the "shut down method). The Company's liability for all of its

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employees is fully covered by monthly deposits with managers' insurance policies and by an accrual. The value of these managers' insurance policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these funds and includes immaterial profits.

Severance expense for the years ended December 31, 2009, 2008 and 2007 amounted to approximately \$ 282, \$ 494 and \$ 787, respectively.

p. Concentration of credit risks:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, restricted cash and trade receivables.

Cash and cash equivalents and the short term deposit are invested in U.S. dollars with major banks in Israel. Generally, these deposits may be redeemed upon demand, and bear minimal risk.

The Company's trade receivables are generally derived from sales of products and services rendered to large and solid organizations located primarily in Europe (mainly Russia), North America, and the Far East. The Company performs ongoing credit evaluations of its customers. To date the Company has not experienced any material losses in respect of its trade receivable. For new customers, the Company may require a letter of credit or upfront cash payments. An allowance for doubtful accounts is determined on specific basis in accordance with Management's estimation and historical experience.

Expense (income) resulting from the net increase (decrease) in the allowance for doubtful accounts was \$ 0, \$ (20) and \$ 40 for the years ended December 31, 2009, 2008 and 2007, respectively.

The Company entered into foreign exchange forward contracts intended to protect against the increase in value of forecasted non-dollar currency cash flows. These derivative instruments are designed to effectively hedge the Company's non-dollar currency exposure (see Note 2(q) below).

Income (expense) resulting from the hedging activities was \$ (15), \$ 18 and \$ 0 for the years ended December 31, 2009, 2008 and 2007, respectively.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

q. Derivatives and hedging activities:

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ASC 815, "Derivatives and Hedging" (formerly FAS 133, "Accounting for Derivative Instruments and Hedging Activities") requires the Company to recognize all of its derivative instruments as either assets or liabilities on the balance sheet at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship.

For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive income and reclassified into earnings in the line item associated with the hedged transaction in the period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized immediately in financial income/expense in the statement of operations.

The Company entered into derivative instrument arrangements (forward contracts) to hedge a portion of anticipated new Israeli shekel ("NIS") payroll payments. These derivative instruments are designated as cash flows hedges, as defined by ASC 815, as amended, and are all highly effective as hedges of these expenses when the salary is recorded. The effective portion of the derivative instruments is included in payroll expenses in the statements of operations. During 2009, there were no gains or losses recognized in earnings for hedge ineffectiveness.

r. Net income (loss) per share:

Basic net loss per share is computed using the weighted average number of Common shares outstanding during the period, and excludes any dilutive effects of options. Diluted net loss per share is computed using the weighted average number of Common shares plus dilutive potential shares of Ordinary stock considered outstanding during the period.

In the years ended December 31, 2009, 2008 and 2007, all outstanding stock options (2,822,509, 2,507,058 and 1,326,696, respectively) have been excluded from the calculations of diluted net earnings (loss) per share, since they would have an anti-diluted effect.

s. Treasury shares:

During 2009, the Company repurchased Ordinary shares from one of its major shareholders, and holds such shares as Treasury shares. The Company presents the cost of the repurchase as a reduction in shareholders' equity.

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

t. Adoption of new accounting policies:

(1) FASB accounting standards codification:

In June 2009, the Financial Accounting Standards Board ("FASB") issued a standard that established the FASB Accounting Standards Codification ("ASC") and amended the hierarchy of generally accepted accounting principles ("GAAP") such that the ASC became the single source of authoritative U.S. GAAP. Rules and interpretive releases issued by the SEC under authority of federal securities law are also sources of the authoritative GAAP for SEC registrants. All other literature is considered non-authoritative. New accounting standards issued subsequent to June 30, 2009 are communicated by the FASB through Accounting Standards Updates ("ASUs"). The ASC is effective for the Company from September 1, 2009. Throughout the notes to the consolidated financial statements references that were previously made to former authoritative U.S. GAAP pronouncements have been changed to coincide with the appropriate section of the ASC.

(2) Business combinations:

Effective January 1, 2009, the Company adopted the amended ASC 805, "Business Combinations" (formerly issued as FAS 141(R)). ASC 805 requires recognition of assets acquired, liabilities assumed, and non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. This ASC also requires the fair value of acquired in-process research and development ("IPR&D") to be recorded as intangibles with indefinite lives, contingent consideration to be recorded on the acquisition date, and restructuring and acquisition-related deal costs to be expensed as incurred. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in earnings.

In addition, changes in the valuation allowance related to acquired deferred tax assets and in acquired income tax position are to be recognized in earnings.

The ASC is applied prospectively for all business combinations occurring after January 1, 2009, except for changes in valuation allowance related to deferred tax assets and changes in acquired income tax position originating from business combinations that occurred prior to the effective date of this ASC, which are recognized in earnings following the adoption date.

The determination and allocation of fair values to the identifiable assets acquired and liabilities assumed is based on various assumptions and valuation methodologies requiring considerable management judgment. Management estimates of fair values are based upon market participants assumptions believed to be reasonable. The most significant variables in these valuations are discount rates, terminal values, the number of years on which to base the cash flow projections, as well as the assumptions and estimates used to determine the cash inflows and outflows. Management determines discount rates to be used based on the risk

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inherent in the related activity's current business model and industry comparisons. Terminal values are based on the expected life of products and forecasted life cycle and forecasted cash flows over that period.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Forecasted cash flows are mostly based on historical experience and information obtained from the management of the acquired companies and are deemed to be consistent with market participants highest and based use of the assets in the principal or most advantages market. Although Company's management believes that the assumptions applied in the determination are reasonable based on information available at the date of acquisition, these estimates and although they are inherently uncertain and actual results may differ from the forecasted amounts and the difference could be material.

(3) Fair value measurement of non-financial assets and liabilities:

The Company adopted the provisions of ASC 820-10, "Fair Value Measurements and Disclosures" (formerly FAS 157, "Fair Value Measurements"), with respect to non-financial assets and liabilities measured at fair value on a nonrecurring basis effective January 1, 2009. The adoption of ASC 820-10 did not have a material impact on the Company's consolidated financial statements.

u. Impact of recently issued accounting standards still not effective for the Company as of December 31, 2009:

1. In October 2009, the FASB issued an update to ASC 985-605, "Software-Revenue Recognition" (originally issued as EITF 09-3). In accordance with the update to the ASC, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the scope of the software revenue recognition guidance. In addition, hardware components of a tangible product containing software component are always excluded from the software revenue guidance. The mandatory adoption is on January 1, 2011. The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. In such case the Company must also early adopt the amendment to ASC 605-25 with respect to multiple-elements arrangements. The Company does not expect the adoption of the update to have a material impact on the Company's consolidated financial condition or results of operations.
2. In October 2009, the FASB issued an update to ASC 605-25, "Revenue recognition - Multiple-Element Arrangements", that

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provides amendments to the criteria for separating consideration in multiple-deliverable arrangements to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- Require an entity to allocate revenue in an arrangement using estimated selling prices ("ESP") of deliverables if a vendor does not have vendor-specific objective evidence of selling price ("VSOE") or third-party evidence of selling price ("TPE"); and
- Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.
- Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. The Company is currently evaluating the impact on its consolidated results of operations and financial condition.

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VOCALTEC COMMUNICATIONS LTD.  
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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

#### NOTE 3:- PREPAID EXPENSES AND OTHER ACCOUNTS RECEIVABLE

	DECEMBER 31,	
	2009	2008
Prepaid expenses *)	\$ 251	\$ 182
Government authorities	60	132
Others	148	169
	\$ 459	\$ 483

\*) As of December 31, 2009 and 2008, including \$ 193 and \$ 115, respectively, of costs of hardware products delivered to customers and not recognized as cost of sales since revenue in the related arrangements is being recognized over the period of the last deliverable element (see also Note 2j).

#### NOTE 4:- INVENTORIES

The Inventories of the Company are comprised mainly of components.



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Write-off of inventories for the years ended December 31, 2009, 2008 and 2007 amounted to \$ 0, \$ 0 and \$ 459, respectively.

### NOTE 5:- PROPERTY AND EQUIPMENT

	DECEMBER 31,	
	2009	2008
Cost *)		
Computers and related equipment	\$ 1,003	\$ 4,844
Office furniture, equipment and leasehold improvements	876	1,316
	1,879	6,160
Less - accumulated depreciation *)	1,392	5,546
	\$ 487	\$ 614
Depreciated cost	=====	=====

\*) As of December 31, 2009, includes a write off of old equipment that is not in use anymore, in the cost of \$ 4,440, that was already fully depreciated.

Depreciation expense was \$ 277, \$ 310 and \$ 411 for the years ended December 31, 2009, 2008 and 2007, respectively. All of the property and equipment is located in Israel.

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

### NOTE 6:- IDENTIFIABLE INTANGIBLE ASSETS

	DECEMBER 31,	
	2009	2008
Identifiable intangible assets		
Cost:		
Technology	\$ 3,365	\$ 3,049
Customer contracts	372	372
Customer relations	915	887
Trade name	301	301
Patents	-	80
	4,953	4,689

Accumulated amortization (including write downs):

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Technology (including \$ 1,093 write down in 2008)	3,049	3,049
Customer contracts	372	372
Customer relations (including \$ 494 write down in 2008)	887	887
Trade name (including \$ 51 write down in 2008)	165	141
Patents	-	80
	-----	-----
	4,473	4,529
	-----	-----
Total amortized cost	\$ 480	\$ 160
	=====	=====

- a. The future annual estimated amortization expense of the intangible assets in the next 5 years relating to VocalTec's amortizable intangible assets existing as of December 31, 2009, is approximately as follows:

	TOTAL AMORTIZATION -----
2010	\$ 58
2011	58
2012	73
2013	73
2014	73

- b. Amortization expenses amounted to approximately \$ 24, \$ 508 and \$ 566 for the years ended December 31, 2009, 2008 and 2007, respectively.

Due to the fact that As of December 31, 2008 and 2007, the Company's market value was substantially lower than the shareholders equity in its books, and due to the Company's loss in 2008 (excluding the income from patent sale), the Company performed impairment test of long lived operating assets, including finite-life intangible assets. As a result of the impairment test, the Company recorded an impairment loss of approximately \$ 1,639 related to intangible assets in 2008. This impairment loss is included in separate line item in the statement of operations, together with impairment loss related to impairment of goodwill (see Note 2h). In 2009, the Company identified two asset groups, its patent portfolio and all other operating assets and liabilities except the patent portfolio, as defined in ASC 360 "Property, Plant, and equipment" The fair value of the asset groups was estimated using the income approach.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 7:- ACCRUED EXPENSES AND OTHER ACCOUNTS PAYABLE

DECEMBER 31

-----  
2009                      2008

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Employees and payroll accruals	\$ 527	\$ 721
Accrued expenses	192	450
Accrued vacation pay	252	495
Tax accruals	751	1,344
Government authorities	180	133
Office lease (Note 8c)	23	118
Others	128	39
	-----	-----
	\$ 2,053	\$ 3,300
	=====	=====

NOTE 8:- COMMITMENTS AND CONTINGENCIES

- a. In connection with its research and development activities through December 31, 2009, the Company received and accrued participation payments from the Office of the Chief Scientist of the Ministry of Industry Trade and Labor in Israel ("OCS"). In return for the Government of Israel's participation, the Company is committed to pay royalties at a rate of 3.5% - 4.5% of sales of the developed product, up to 100% of the amount of grants received linked to the U.S. dollar (grants received under programs approved subsequent to January 1, 1999, are subject to interest at the annual rate of LIBOR applicable to U.S. dollar deposits).

The Company's total contingent liability for royalties payable to the OCS with respect to future sales, based on Government of Israel participations received or accrued, net of royalties paid or accrued, totaled approximately \$ 22,000 as of December 31, 2009. The obligation to pay these royalties is contingent on actual sales of the products, and in the absence of such sales, no payment is required.

Cost of sales includes royalties paid and accrued to the Government of Israel in the amount of \$ 225, \$ 208 and \$ 175 for the years ended December 31, 2009, 2008, and 2007, respectively. With respect to the sale of patents related payments to OCS.

- b. Certain claims, mainly for patent infringement and breach of contract have been made against VocalTec Ltd., Tdsoft Ltd. or its U.S. subsidiary. The Company cannot estimate the exposure amount, and in any case, these allegations have not resulted in any action brought against the Company. The Company's management does not believe that it is probable that the above mentioned allegations will result in a loss to the Company. Accordingly, no provision was recorded with respect to these allegations.

During 2008, the Company received a claim from one of its former employees in Germany, regarding his retirement conditions. The Company recorded a provision in its books in an amount deemed appropriate to cover such claim. At the beginning of 2010, the Company reached an agreement with that former employee, paid him and settled the claim.

- c. The Company's facilities in Israel are rented under operating leases with different periods ending through April 2010. The Company had a renewal option which it chose not to exercise. On March 2010, the Company signed a new operating lease agreement for a period of 6 years in another location, with additional 3 years option. Rent expense amounted to \$ 468, \$ 468 and \$ 414 for the years ended December 31, 2009, 2008 and 2007, respectively. Annual minimum rental commitments under non-cancelable leases at balance sheet date are approximately as

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follows:

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 8:- COMMITMENTS AND CONTINGENCIES (CONT.)

2010	\$	177
2011		80
2012		80
2013		80
2014		80
		-----
 Total	 \$	 497
		=====

At the end of 2008, the Company vacated the third floor of its leased building in order to cut expenses, and moved onto one floor. Since the Company is still obligated to pay rent for the third floor until the end of the contract a liability for the lease termination cost, including remaining lease rentals, reduced by probable sub lease rentals, in the amount of \$ 118 was recorded. As of December 31, 2009 the updated liability was \$ 23.

The Company also maintains motor vehicle leases. The total liability for early termination of such leases is approximately \$ 38. Motor vehicle lease expense amounted to \$ 313, \$ 464 and \$ 407 for the years ended December 31, 2009, 2008 and 2007, respectively.

- d. As of December 31, 2009, the bank placed a lien of \$ 270 from the Company's deposits as a guarantee for certain hedging instruments entered into by the Company during the year. The guarantee will expire in April 2010.
  
- e. The Company provided a bank guarantee, with respect to a certain agreement, in the total amount of \$ 1.4 million. \$ 0.9 million expired during on November 2009. The rest will expire upon completion of the project.

NOTE 9:- FAIR VALUE MEASUREMENTS

In accordance with ASC 820, the Company measures its foreign currency derivative contracts at fair value. Foreign currency derivative contracts are classified within Level 2 value hierarchy as the valuation inputs are based on quoted prices and market observable data of similar instruments.

The following table provides information by value level for financial assets and liabilities that are measured at fair value, as defined by ASC 820, on a recurring basis as of December 31, 2009.

FAIR VALUE MEASUREMENTS

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DESCRIPTION -----	FAIR VALUE -----	LEVEL 1 -----	LEVEL 2 -----	LEVEL 3 -----
Derivative asset *)	\$ -	\$ -	\$ -	\$ -
	=====	=====	=====	=====

\*) As of December 31, 2009, the Company had foreign currency derivative contracts with a fair value of \$ 0.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 10:- SHAREHOLDERS' EQUITY

a. Share capital

All Ordinary shares of the Company have the same rights. Dividends declared by the company will be distributed to shareholders in proportion to their holdings. If the Company is liquidated, after satisfying liabilities to creditors, the Company's assets will be distributed to the holders of Ordinary shares in proportion to their holdings.

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

- b. In May 2006 the Company issued in a private placement in consideration of \$ 4,591, net of issuance expenses of \$ 548, 935,000 Ordinary Shares and warrants to purchase up to 424,050 Ordinary Shares at an exercise price of \$ 7.9 per share. The warrants became exercisable 6 months after issuance and will remain exercisable until the fifth anniversary of the date of issuance.

In December 2006 the Company decided to reduce the exercise price of the warrants issued by the Company to the investors from \$ 7.9 per share to \$ 6.87 per share - the closing price of the Company's ordinary shares on the Nasdaq Capital Market at the close of business immediately prior to execution of the agreement relating to the May 2006 issuance. The antidilution benefit of \$ 37 to the warrant holders from the aforementioned reduction in the exercise price was recorded as a preferred deemed dividend to the warrant holders. As of December 31, 2009, none of these warrants were exercised into the Company's Ordinary shares.

- c. In November 2006, the Company issued in a private placement in consideration for \$ 6,998, net of issuance expenses of \$ 527, 1,750,000 Ordinary Shares and warrants to purchase up to 1,400,000 Ordinary Shares at an exercise price of \$ 5.5 per share. The warrants are exercisable during a period ending June 30, 2011. The shares were registered for trading on NASDAQ on December 4, 2006. As of December 31, 2009, none of these warrants were exercised into the Company's

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ordinary shares.

- d. On March 2, 2009, the Company repurchased an aggregate of 1,673,549 of its shares, constituting approximately 22.7% of the issued and outstanding share capital of the Company, from its largest shareholder, Cisco Systems International B.V. The share purchase was executed at a price per share of \$ 0.40, for a total aggregate purchase price of approximately \$ 669.

- e. Share option plans:

Options granted under the VocalTec amended 2003 Master Stock Option Plan generally have a term of seven (7) years. However, options granted prior to December 13, 2005 have a term of ten (10) years. Earlier termination may occur if the employee's employment with the Company is terminated or if certain corporate changes or transactions occur. The Company's board of directors determines the grant and the exercise price at the time the options are granted upon recommendation of the compensation committee.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 10:- SHAREHOLDERS' EQUITY (CONT.)

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

As of December 31, 2009, 307,703 share options out of the total pool of 3,130,212 share options are still available for future grants under the Company's existing plans, including an annual 3% increase of 304,492 share options. Options which are cancelled or forfeited before expiration become available for future grants.

A summary of the Company's share option activity under the plans is as follows:

YEAR ENDED DECEMBER 31, 2009		
NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL TERM (IN YEARS)

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Outstanding - beginning of year	2,507,058	\$	2.23	
Granted	603,000	\$	0.94	
Exercised	(52,404)	\$	0.70	
Forfeited	(235,145)	\$	2.93	
	-----			
Outstanding - end of year	2,822,509	\$	1.92	5.29
	=====			=====
Vested and expected to vest - end of year	2,118,316	\$	2.18	5.10
	=====			=====
Options exercisable - end of year	1,096,757	\$	3.09	4.56
	=====			=====

The weighted average fair values of the options granted during 2009, 2008 and 2007, were \$ 0.81, \$ 0.36 and \$ 3.32, respectively.

The total intrinsic value of options exercised for the year ended December 31, 2009 was \$50.

The total unrecognized compensation cost related to non vested options as of December 31, 2009 is \$ 1.1 million, and the weighted average period over which the cost is expected to be realized is 2.1 years.

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 10:- SHAREHOLDERS' EQUITY (CONT.)

The following table summarizes information about options outstanding and exercisable at December 31, 2009:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE		
	AMOUNT OUTSTANDING AT DECEMBER 31, 2009	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	WEIGHTED AVERAGE EXERCISE PRICES	AMOUNT OUTSTANDING AT DECEMBER 31, 2009	WEIGHTED AVERAGE EXERCISE PRICES	
\$ 0.00-0.50	1,038,560	5.80	\$ 0.35	202,050	\$ 0.43	
\$ 0.51-1.00	614,591	5.40	\$ 0.92	221,806	\$ 0.89	
\$ 1.01-3.00	459,880	6.03	\$ 2.49	92,550	\$ 2.97	
\$ 3.01-5.00	457,064	4.13	\$ 3.52	360,767	\$ 3.57	
\$ 5.01-20.00	245,350	3.77	\$ 6.03	212,520	\$ 6.05	
\$ 20.01-224.25	7,064	2.56	\$ 36.71	7,064	\$ 36.71	
	-----			-----		
	2,822,509	5.29	\$ 1.92	1,096,757	\$ 3.09	
	=====	=====	=====	=====	=====	

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### NOTE 11:- DERIVATIVE FINANCIAL INSTRUMENTS

As of December 31, 2008, the Company had forward exchange contracts for the acquisition of approximately NIS 15,150 thousand, in consideration for \$ 3,900, that matured during 2009 and the beginning of 2010. The fair value of these contracts as of December 31, 2009 and 2008 was \$ 0 and \$ 76, respectively. The purpose of the contracts was to hedge the NIS expenses during 2009 (mainly salary), by signing contracts to buy NIS amounts in previously determined exchange rates, and by that obtaining fixed expenses in US\$. The hedged amount was determined according to estimated salary and other related NIS expenses in 2009.

The activity related to the changes in net unrealized (losses) gains on cash flow hedges is as follows:

	YEAR ENDED DECEMBER	
	2009	2008
Net unrealized losses on cash flow hedges as of beginning balance	\$ 76	\$ 76
Realized losses reclassified into earnings (effective portion)	(76)	-
	-	76
Net unrealized gains (losses) on cash flow hedges as of ending balance	\$ -	\$ 76
	-	76

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### VOCALTEC COMMUNICATIONS LTD. AND ITS SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

#### NOTE 12:- GEOGRAPHIC, MAJOR CUSTOMERS AND PRODUCT LINE INFORMATION

The Company manages its business on a basis of one reportable segment. The Company follows the guidance in Statement of Financial Accounting Standards No. 131, "Disclosure about Segment of an Enterprise and Related Information".

	YEAR ENDED DECEMBER 31,		
	2009	2008	2007
Sales classified by geographic areas based on end-customer location:			
Russia	\$ 1,557	\$ 3,140	\$ 1,630
Germany	926	948	1,310
Italy	314	650	880
Iceland	59	93	150
Europe - other	86	73	640
Americas (principally United States)	327	362	350
Asia	231	162	120
Israel	472	388	140
Africa and Middle East	2,435	298	500
	-	-	-



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\$ 6,407      \$ 6,114      \$ 5,754  
 =====

YEAR ENDED DECEMBER 31,

2009	2008	2007
%		

Sales to a single customer exceeding 10%:\*)

Customer A	14	15	22
Customer B	*) -	26	12
Customer C	*) -	*) -	10
Customer D	*) -	14	-
Customer E	10	-	-
Customer F	35	-	-

\*) Less than 10%.

Total revenues from external customers on the basis of the Company's product lines are as follows:

YEAR ENDED DECEMBER 31,

	2009	2008	2007
The Essentra family	\$ 6,407	\$ 5,731	\$ 4,482
Tdgate	-	203	769
Hunt	-	180	192
Proxi	-	-	100
Tas	-	-	179
Core (software)	-	-	32
	\$ 6,407	\$ 6,114	\$ 5,754

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VOCALTEC COMMUNICATIONS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 13:- RESEARCH AND DEVELOPMENT, NET

YEAR ENDED DECEMBER 31,

	2009	2008	2007
Research and development expenses	\$ 2,417	\$ 4,231	\$ 5,340
Less- participations from:			
OCS	361	77	773

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\$ 2,056                      \$ 4,154                      \$ 4,567  
 =====                      =====                      =====

NOTE 14:- FINANCIAL INCOME, NET

	YEAR ENDED DECEMBER	
	2009	2008
Financial income :		
Interest on cash and cash equivalents, net of bank fees	\$ 82	\$ 114
Foreign currency translation adjustments, net	50	(24)
	\$ 132	\$ 90
	=====	=====

NOTE 15:- TAXES ON INCOME

a. Measurement of taxable income:

Under the Income Tax (Inflationary Adjustments) Law, 1985 ("the Israeli law"), results for tax purposes in Israel are measured in real terms, in accordance with the changes in the Israeli Consumer Price Index ("Israeli CPI"). Accordingly, until 2007, results for tax purposes were measured in terms of earnings in NIS after certain adjustments for increases in the Israeli CPI. Beginning January 1, 2008, the Inflationary Adjustments Law was repealed.

In accordance with paragraph 9(f) of SFAS No. 109, as codified in ASC 740, the Company has not provided deferred income taxes on the above differences resulting from changes in exchange rates and indexing for tax purposes.

b. Tax benefits under Israel's Law for the Encouragement of Industry (Taxation), 1969:

VocalTec Ltd. and Tdsoft Ltd. are considered each an "industrial company", as defined by the Law for the Encouragement of Industry (Taxes), 1969, and as such, are entitled to certain tax benefits, mainly the right to claim public issuance expenses and accelerated depreciation.

c. Tax benefits under the Law for the Encouragement of Capital Investments, 1959:

Certain investments of VocalTec Ltd. and Tdsoft Ltd. received "Approved Enterprise" status through the "Alternative Benefits" track, and, as such, are eligible for various benefits. VocalTec Ltd. and Tdsoft Ltd. currently have two and four "Approved Enterprise" programs, respectively. These benefits include accelerated depreciation of equipment used in the investment program, as well as a full tax exemption on undistributed income for a period of two years and reduced tax rates of 25% or less for an additional period of up to eight years (depending on the percentage of foreign ownership), commencing with the date on which taxable income is first earned. Since VocalTec Ltd. and Tdsoft Ltd. have had no taxable income since inception, the benefits period has not yet commenced.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

## NOTE 15:- TAXES ON INCOME (CONT.)

The period of tax benefits detailed above, except the full tax exemption period, is subject to a limit of 12 years from the commencement of production, or 14 years from the approval date, whichever is earlier. The entitlement to the above benefits is conditional upon VocalTec Ltd. and Tdsoft Ltd. fulfilling the conditions stipulated by the above law, regulations published there-under and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be cancelled and VocalTec Ltd. and Tdsoft Ltd. may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2009, management believes that VocalTec Ltd. and Tdsoft Ltd. are meeting all of the aforementioned conditions.

Any tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the distributing company to taxes only upon the complete liquidation of the company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the company, they would be taxed at the corporate tax rate applicable to such profits as if the company had not elected the alternative track of benefits, currently 25% for an "Approved Enterprise". As of December 31, 2009, the accumulated deficit of each company does not include tax-exempt profits earned by their "Approved Enterprise".

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 26%.

Taxable income of Israeli companies is subject to tax at the rate of 26% in 2009, 25% in 2010, 24% in 2011, 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter.

- d. VocalTec Ltd. received final tax assessment for the tax years up to 2004. Tdsoft Ltd. received final tax assessment for the tax years up to 2004. VocalTec Inc. received final tax assessment for the tax years up to 2003. Tdsoft Inc. received final tax assessment for the tax years up to 2005.
- e. VocalTec Ltd. and Tdsoft Ltd. have net operating loss carryforwards for tax purposes of approximately \$ 141,000 and \$ 51,000 as of December 31, 2009, respectively, which may be carried forward indefinitely. VocalTec Communications Inc. and Tdsoft Communications, Inc., which are subject to U.S. income taxes, have a loss for tax purposes of approximately \$ 9,000 as of December 31, 2009. These losses can be carried forward until 2025. A valuation allowance was recorded for the entire deferred tax asset in respect of the carryforward losses, due to the uncertainty regarding future realization. Management currently believes that since the Company has a history of losses it is more likely than not that the deferred tax regarding the loss carryforward will not be realized in the foreseeable future.

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Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions of the Internal Revenue code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 15:- TAXES ON INCOME (CONT.)

f. Taxes on income are comprised as follows:

	YEAR ENDED DECEMBER 31,		
	2009	2008	2007
Current taxes - domestic	\$ (590)	\$ 69	\$ 37

g. Deferred taxes on income:

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and the tax effect for carryforward losses. Significant components of the Company's deferred tax assets are as follows:

	DECEMBER 31	
	2009	2008
Deferred tax asset:		
Reserves and allowances	\$ 118	\$ 277
Net operating losses carryforward	34,575	48,357
Net deferred tax asset before valuation allowance	34,693	48,634
Valuation allowance	(34,693)	(48,634)
Net deferred tax asset	\$ -	\$ -

Management currently believes that since the Company has a history of losses, it is more likely than not that the deferred tax asset will not be utilized.

The difference between the theoretical tax computed and the actual tax expense resulted mainly from valuation allowance recorded with respect to carryforward losses and other temporary differences, primarily

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related to severance and vacation reserves.

h. Income (loss) before income taxes is comprised as follows:

	YEAR ENDED DECEMBER 31,		
	2009	2008	2007
Israel	\$ (3,056)	\$ 3,811	\$ (13,531)
Foreign	11	(34)	(611)
	\$ (3,045)	\$ 3,777	\$ (14,142)

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VOCALTEC COMMUNICATIONS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA

NOTE 15:- TAXES ON INCOME (CONT)

i. A reconciliation of the beginning and ending balances of the total amounts of gross tax benefits is as follows:

Gross unrecognized tax benefits of January 1, 2008	\$	1,235
Changes in unrecognized tax benefits as a result of tax positions taken during 2008		110
Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations		(76)
Gross unrecognized tax benefits at December 31, 2008		1,269
Changes in unrecognized tax benefits as a result of tax positions taken during 2009		33
Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations		(643)
Gross unrecognized tax benefits at December 31, 2009	\$	659

The total gross unrecognized tax benefits at December 31, 2009 is net of \$ 80 penalties and interest accrued. The total amount including interest and penalties is \$ 739.

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ITEM 19. EXHIBITS

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1. Form of an amendment to the Amended and Restated Articles of Association (which were previously filed with the SEC on June 20, 2007 as Exhibit 1 to the Company's Annual Report on Form 20-F for the year ended December 31, 2006 and incorporated herein by reference).
- 2.1 Form of Share Certificate of VocalTec Communications Ltd., previously filed with the SEC on April 21, 2006 as Exhibit 2.1 to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.
- 4.1
  - (a) 2003 Amended Master Stock Option Plan previously filed with the SEC on February 15, 2006 as Exhibit 99.2 to the Company's registration statement on Form S-8 (File Number 333-131870) and incorporated herein by reference.
    - (b) Summary of the lease agreement between Tdsoft and Limor Hugi and others dated April 26, 2004, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(b) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.
    - (c) Audit committee pre-approval policies and procedures for audit and non-audit services, previously filed with the SEC on April 2, 2004 as Exhibit 4.1(k) to the Company's Annual Report on Form 20-F for the year ended December 31, 2003, and incorporated herein by reference.
    - (d) Form of indemnification undertaking dated as of November 24, 2005 between the Company and each of Joseph Albagli, Ilan Rosen, Robert Wadsworth and Joseph Atsmon, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(g) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.
    - (e) Form of indemnification undertaking dated as of November 24, 2005 between the Company and each of Dr. Elon Ganor, Yoav Chelouche and Michal Even Chen, previously filed with the SEC on April 21, 2006 as Exhibit 4.1(h) to the Company's Annual Report on Form 20-F for the year ended December 31, 2005 (as amended on May 16, 2006) and incorporated herein by reference.
    - (f) Patent Purchase Agreement dated May 28, 2008 by and between the Company and Karo Millennium J.P., L.L.C., filed with the SEC on July 15, 2008 as Exhibit 4.1(j) to the Company's Annual Report on Form 20-F for the year ended December 31, 2007 and incorporated herein by reference.
    - (g) Patent Purchase Agreement dated December 5, 2008 by and between the Company and Masinolli Fund, L.L.C., filed with the SEC on June 4, 2009 as Exhibit 4.1(g) to the Company's Annual Report on Form 20-F for the year ended December 31, 2008 and incorporated herein by reference.
    - (h) Stock Repurchase Agreement dated March 2, 2009 by and between the Company and Cisco Systems International B.V., filed with the SEC on June 4, 2009 as Exhibit 4.1(h) to the Company's Annual Report on Form 20-F for the year ended December 31, 2008 and incorporated herein by reference.
    - (i) Form of Asset Purchase Agreement by and between the Company and Outsmart Ltd., dated December 9, 2009.

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(j) Summary of lease agreement between the Company and Ayalot Property Investments (Natanya) Ltd., dated March 15, 2010.

8. List of Subsidiaries.

11. (a) Code of ethics for our principal executive officer, principal financial officer, executive vice presidents, principal controller, treasurer and persons performing similar functions, previously filed with the SEC on April 2, 2004 as Exhibit 11 to the Company's Annual Report on Form 20-F for the year ended December 31, 2003 and incorporated herein by reference.

(b) Amended insider trading policy, previously filed with the SEC on June 20, 2007 as Exhibit 11 to the Company's Annual Report on Form 20-F for the year ended December 31, 2006 and incorporated herein by reference.

(c) Standards of Business Conduct for our directors, officers and employees, filed with the SEC on June 4, 2009 as Exhibit 11(c) to the Company's Annual Report on Form 20-F for the year ended December 31, 2008 and incorporated herein by reference.

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

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

14. Consent of Kost Forer Gabbay & Kasierer, an affiliate of Ernst & Young Global, Independent Auditors.

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### SIGNATURES

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

By: /s/ Ido Gur

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Ido Gur  
Chief Executive Officer

Date: May 12, 2010