VOCALTEC COMMUNICATIONS LTD
Form 20-F
June 04, 2009

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

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

For the fiscal year ended December 31, 2008

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

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, 2008

7,376,364 ORDINARY 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 [X] 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 [X] 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.

[X] 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 [X] Non-accelerated filer

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

[X] 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 [X] No

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

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

[_] Yes [_] No

2

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.

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

VocalTec, Essentra, Internet Phone, the logo Internet I Phone, are registered trademarks of VocalTec Communications Ltd. and its wholly-owned subsidiaries. Other trademarks are the property of their respective holders.

In this annual report, unless otherwise specified or unless the context otherwise requires, all references to "$" or "dollars" are to U.S. dollars and all references to "NIS" are to New Israeli Shekels. Except as otherwise indicated, financial statements of, and information regarding, VocalTec are presented in U.S. dollars.

3

INDEX

PART ONE

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 year ended December 31, 2004 and for the eleven months ended November 30, 2005, and the consolidated financial statements of the combined company for the period of December 1 through 31, 2005 and the years ended December 31, 2006, 2007 and 2008.

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, 2008 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)

	2004	2005	2006
Sales			
Products	3,719	3,668	4,738
Services	433	925	2,542
	4,152	4,593	7,280
Cost of sales			
Products	1,587	1,450	2,171
Services	22	315	563
	1,609	1,765	2,734
Inventory write off	-	639	-
Amortization of intangibles assets	206	172	392
	1,815	2,576	3,126
Gross profit	2,337	2,017	4,154
Operating expenses:			
Research and development, net	5,474	4,363	4,619
Selling and marketing	1,909	2,763	4,147
General and administrative	805	1,748	2,474
Income from sale of patents, net	-	-	-
Impairment of goodwill and intangible assets		-	-
Total net operating expenses (income)	8,188	8,874	11,240
Operating income (loss)	(5,851)	(6,857)	(7,086)

Other income, net	-	24	42
Financial income, net	165	184	32
Income (loss) before taxes on income	(5,686)	(6,649)	(7,012)
Tax benefit (taxes on income)	-	19	-
Net Income (loss)	(5,686)	(6,630)	(7,012)
Accretion of redeemable convertible Preferred shares	(3,256)	(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	(8,942)	(26,969)	(7,049)
Basic and diluted net income (loss) per Ordinary share	(24.16)	(34.05)	(1.3)
Weighted average number of Ordinary shares used in computing net loss per share-basic and diluted	370	792	5,436

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

	2004	2005	2006
Cash and cash equivalents and short term deposits	9,260	5,138	8,954
Working capital	9,595	925	8,196
Total assets	13,538	22,442	24,587
Total liabilities	2,878	9,579	6,049
Redeemable convertible Preferred shares	54,557	-	-
Capital stock	116	132	213
Accumulated deficit	(42,568)	(66,854)	(73,903)
Total shareholders' equity (deficiency)	(43,897)	12,863	18,538
Number of Ordinary shares outstanding	370,059	4,661,627	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 could have an effect on our financial condition, cash flow and results of operations. We are subject to various risks resulting from changing economic, political, industry, business and financial conditions. The principal risk factors affecting our operations are described below.

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 $7.1 million and $14.4 million in 2006 and 2007, respectively and a profit 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, has recently 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 2009 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 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:

- 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.

- 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.

- As a result of our long sales cycle (described below under "OUR ESSENTRA 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.

- Increased competition, from new service providers and companies such as Skype, which offer cheap, or even free, telephony, causing financial pressure on our customers.

- Macro economic conditions, including worldwide recessions, causing our potential customers to be more conservative with their capital expenditures.

- 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 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.

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 the first quarter of 2009, resulting 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 already been feeling the effect of such recession, primarily in Russia, 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:

- 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;

- Longer sales processes and a need for increased efforts to secure projects;

- Potential adverse impact on our customers' and prospective customers' ability to pay, when due, amounts payable to us; and

- 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.

Any of the above could adversely affect our business, financial condition, operating results and cash flow. These economic conditions also impact our ability to forecast orders and revenues and our ability to provide guidance for our performance.

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 generally 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.

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 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.

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.

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. 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.

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:

- 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;

- the potential cancellation of orders based on our customers' changing budgetary constraints;

- the shift in orders expected between quarters because of the timing of our customers' procurement decisions; and

- 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:

- product returns, repairs or replacements;

- cancellation of and reduction in orders;

- uncollectible accounts receivable and delays in collecting accounts receivable;

- diversion of our resources;

- legal actions by our customers or our customers' end users;

- adverse effect to our reputation;

- increased insurance costs; and
- 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 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 2008, Mobifon-2000, Deutsche Telekom and ITI accounted for 26%, 15% and 14%, 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.

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 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 service and maintenance, 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 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.

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 "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.

OUR MANAGEMENT HAS IDENTIFIED MATERIAL WEAKNESSES IN OUR INTERNAL CONTROL OVER FINANCIAL REPORTING. UNTIL WE REMEDY SUCH MATERIAL WEAKNESSES, THERE IS A REASONABLEPOSSIBILITY THAT OUR FINANCIAL STATEMENTS MAY BE MISSTATED.

As disclosed in Item 15T of this annual report, our management performed an assessment of our disclosure controls and procedures and our internal controls over financial reporting as of the end of the period covered by this annual report and determined that we had material weaknesses with respect to the financial statement close process.

Although we have taken remedial steps in connection therewith, until we are able to completely remedy such material weaknesses or if we are not successful in remedying such material weaknesses, there is a reasonable possibility that a material misstatement of the Company's annual financial statements will not be prevented or detected on a timely basis, which could require a restatement of the Company's annual financial statements and cause investors to lose confidence in our reported financial information. This could lead to a decrease in the price of our shares.

In addition, if we fail to finalize implementing the improvements of our system of internal controls, we may not be able to accurately report our future financial results and our management may not be able to conclude that we have effective disclosure controls and procedures and effective internal controls over financial reporting as required by the Sarbanes-Oxley Act.

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 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:

- 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;

- we may have difficulty retaining the key personnel of the acquired company;

- 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

- 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, large one-time write-offs, such as acquired in-process research and development costs, 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 the USD declines in value in relation to the NIS, it will become more expensive for us to fund our operations in Israel. During 2005, the exchange rate of the U.S. dollar to the NIS increased; this trend reversed in 2006, and continued to further decrease in 2007 and in the first half of 2008, reversing again towards the end of 2008.

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.

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 lossesagain.

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 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 is in international markets. In addition, a small, but growing 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 involve the issuance of a letter of credit, and consequently, if a contract is not completed, our margins from such contracts may be lower.

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.

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 Israeli Companies Law of 1999, or 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:

- the judgment was rendered by a court which was, according to the laws of the state of the court, competent to render the judgment;
- the judgment may no longer be appealed;
- 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
- 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:

- the judgment was obtained by fraud;
- there is a finding of lack of due process;
- the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel;
- 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
- 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.

WE ARE A FOREIGN PRIVATE ISSUER AND YOU WILL RECEIVE LESS INFORMATION ABOUT US THAN YOU WOULD FROM A DOMESTIC U.S. CORPORATION.

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.

THERE IS A SIGNIFICANT POSSIBILITY THAT FOR THE TAX YEAR ENDED DECEMBER 31, 2008 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 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, 2008. Therefore, there is a significant possibility that we were a PFIC in 2008 and we may continue to be a PFIC in 2009 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 "Chief Scientist" or "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 Chief Scientist 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 Chief Scientist.

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 Chief Scientist. 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:

- 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 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

- 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 2009. 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. 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. 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.

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

Generally, all non-exempt male adult citizens and permanent residents of Israel under the age of 40 (or older, for citizens with certain 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.

WE MAY NOT BE DEEMED IN COMPLIANCE WITH NASDAQ LISTING REQUIREMENTS IN ORDER TO MAINTAIN THE LISTING OF OUR SHARES ON THE NASDAQ CAPITAL MARKET

A company must continue to comply with several requirements in order to remain listed on Nasdaq. One of the requirements is that a company maintain a $1.00 minimum bid price (the "Minimum Bid Price Requirement").

Under the Nasdaq Marketplace Rules, a failure to meet the continued listing requirement for minimum bid price on the Nasdaq Capital Market shall be determined to exist only if the deficiency continues for a period of 30 consecutive business days. On March 20, 2009, Nasdaq suspended the Minimum Bid Price Requirement until July 19, 2009.

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 recently been moved to various rules upon Nasdaq's revision of its Marketplace Rules). We requested a hearing on the determination to suspend trading in 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 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.

As indicated above, enforcement of these rules is scheduled to resume on July 19, 2009. There is no assurance that we will timely, or at all, comply with the foregoing Nasdaq listing requirements. If we fail to be in compliance with such Nasdaq listing requirements, our shares will be de-listed from the Nasdaq Capital Market, resulting in the loss of liquidity to our shareholders and potentially an adverse effect to the price of our shares.

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. 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.

We are a provider of carrier-class voice-over-IP solutions for communication service providers. We provide trunking, peering and residential/enterprise VoIP application solutions that enable flexible deployment of next-generation networks (NGNs). 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 networks. Our SIP-based solutions support a variety of other protocols, including Megaco/H.248, MGCP, H.323, SIGTRAN M3UA/IUA and SS7 and incorporate key elements of the IMS/TISPAN (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, the Company 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, 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 $8.8 million. 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 $6.1 million.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.

In 2008, the Company's sales increased by approximately 6%, with gross margins, excluding amortization of intangible assets increasing to 57%, while also decreasing level of operating expenses along the year.

CAPITAL EXPENDITURES: The Company's capital expenditures for fiscal year 2008 were $0.3 million compared to $0.2 million in 2007. These expenditures were primarily for hardware and software.

CAPITAL EXPENDITURES CURRENTLY IN PROGRESS: During the first quarter of 2009 and through the date of this annual report on Form 20-F, the Company had capital expenditures in an aggregate amount of approximately $20,000, 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 in deploying carrier-based VoIP solutions based on H.323 and SIP protocols; this for the past 13 years. For additional information, see "4.A - History and Development of the Company."

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.

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:

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

- A wide product offering and solutions that enable fast deployment of VoIP networks;
- Mediation between the core VoIP network and various other networks, supporting a variety of connections including:
  - Peering with other VoIP networks;
  - Connecting to Legacy Public Switched Telephony Networks (PSTNs);
  - Connecting with a variety of Access equipment.
- Strong telecom signaling and signaling conversion technology and know-how;

- A modular flexible approach to building a variety of network solutions to fixed line operators and lately also to wireless carriers;
- Significant SIP, H248, MGCP, SS7 and H.323 experience, resulting from deployments in a large number of carrier networks worldwide;
- Flexible deployment options enabling cost-effective entry points as well as the ability to efficiently grow the network;
- Multi-tiered service provisioning and management for hosted services, enabling carriers to offer services to non-facility based carriers;
- Simple installation processes and ease of use and operation;
- A large eco-system of fully interoperable solution partners complementing our own products and enabling the provision of a wide VoIP offering and applications;
- More than twelve 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 and SS7, incorporating key elements of the IMS/TISPAN (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 and SOHO/SME customers over any broadband access infrastructure.

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

VOCALTEC PRODUCT OFFERINGS

The Essentra product family includes three major elements required when implementing a VoIP network: (i) trunking; (ii) peering, and (iii) applications.

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.

Using Essentra products, a variety of NGN 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.

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.

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 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

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:

- 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.

- H323 Products, including VoIP Gateways, Gatekeapers 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 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 and other software and hardware components. 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.

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, we also added the Mobile operators to our target customers by offering a new set of Essentra based network solutions. 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, 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. Audiocodes is an example of one such reseller partner with which we saw sales increasing during 2008.

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 two 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.

23

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. Our prime focus is on the TISPAN IMS family of standards, as most of our customers are fixed line carriers.

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, and application elements, our competitive landscape includes providers of softswitches ("trunking"), application servers ("application") and session border controllers ("peering"). Our principal competitors include Huawei, Veraz Networks, Cirpack (now part of Thomson Technology), Cisco Systems and Sonus Networks Inc. as Softswitch vendors; Broadsoft and NetCentrex (part of Comverse Technologies) as application server vendors; and AcmePacket and Genband as session border controller vendors.

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 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. Our principal operational direct and indirect wholly-owned subsidiaries and their countries of incorporation are:

- Tdsoft Ltd. (Israel)
- Tdsoft Communications Inc. (United States)
- Tdsoft BV (Netherlands)
- VocalTec Communications, Inc. (United States)
- VocalTec Communications Deutschland GmbH (Germany)
- VocalTec Communications Hong-Kong Limited (Hong-Kong)
- VocalTec Communications Singapore PTE Ltd. (Singapore)

As of December 31, 2008, the only significant subsidiary is Tdsoft Ltd.

4.D. PROPERTY, PLANTS AND EQUIPMENT

Our headquarters are located in Herzliya Pituach, Israel, and occupy 21,500 square feet pursuant to a lease expiring during April 2010. We currently pay a total yearly rental amount of approximately $468,000. These facilities are used for management, administration, operations, marketing, sales, research and development, and testing. During the second half of 2008, we concentrated all of our operations, management and employees in one floor at the leased premises, and are currently seeking to sub-lease the remaining floor in the premises. We maintain car leases, and our total liability for early termination of the leases is approximately $57,000.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

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".

You should read the following discussion and analysis in conjunction with our audited consolidated financial statements for the year ended December 31, 2008 and notes thereto. This "Operating and Financial Review and Prospects" section contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements.

OVERVIEW

We are a provider of carrier-class multimedia and voice-over-IP (VoIP) solutions for communication service providers. We provide trunking, peering and residential/enterprise VoIP application solutions that enable flexible deployment of next-generation networks (NGNs). Partnering with prominent system integrators, 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, 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 Chief Scientist royalty bearing programs but we cannot make any assurances that we will be awarded any future grants.

Growth in the 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. 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.

We plan to increase our market share in the growing VoIP market. 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.

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 FASB Statement No. 52 - "Foreign Currency Translation". 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.

REVENUES

In 2008, we had sales of $6.1 million, compared to $5.8 million in 2007. Through 2008, we generated our revenues from sales of our products (primarily the Essentra family products) and related services. Sales of products accounted for 65% of our revenues in 2008 compared to 52% in 2007. The increase in percentage is related both to increase in product revenues and decrease in service revenues, mainly due to cancellation of a yearly support contract from one of our major customers.

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.

Sales to 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,		
	2006	2007	2008
	%	%	%
Russia	6	28	51
Germany	13	23	16
Italy	23	15	11
Iceland	4	3	1
Europe - other	14	11	1
Americas (principally United States)	11	6	6
Asia	12	2	3
Israel	7	3	6
Africa and Middle East	10	9	5
	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 and accounting for stock-based compensation. 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 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 Company's long-lived assets are reviewed for impairment in accordance with SFAS No.144, whenever events or changes in circumstances indicate that the carrying amount of an asset 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 assets. 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 the fair value of the assets. The loss is allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable. We determine fair value using widely accepted valuation techniques, including discounted cash flow. These types of analyses require us to make assumptions and estimates regarding industry economic factors and the profitability of future business strategies.

Intangible assets are comprised of acquired technology, customer contracts, customer relations, trade name and patents. All intangible assets are amortized using the straight-line method over their estimated useful life.

GOODWILL

Goodwill is measured as the excess of the cost of an acquired company over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. Goodwill is not amortized, but rather reviewed for impairment at least annually in accordance with the provisions of SFAS No. 142. The goodwill impairment test under SFAS No. 142 involves a two-step approach. Under the first step, the Company determines the fair value of each reporting unit to which goodwill has been assigned. The Company determined that it has only one reporting unit. The Company then compares the fair value of each reporting unit to its carrying value, including goodwill. The Company estimates the fair value of each reporting unit by estimating the present value of the reporting unit's future cash flows. If the fair value exceeds the carrying value, no impairment loss is recognized. If the carrying value exceeds the fair value, the goodwill of the reporting unit is considered potentially impaired and the second step is completed in order to measure the impairment loss. Under the second step, goodwill is reduced to its implied fair value through an adjustment to the goodwill balance, resulting in an impairment charge. The Company has elected to perform its analysis of goodwill during the fourth quarter of each year. We determine fair value using widely accepted valuation techniques, inc