

DELTATHREE INC (DDDC)

10-K

Annual report pursuant to section 13 and 15(d)

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2011, or

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

For the transition period from _____ to _____

Commission File Number: 000-28063

deltathree, Inc.

(Exact name of registrant as specified in charter)

Delaware

(State or other jurisdiction of incorporation or organization)

13-4006766

(I.R.S. employer identification no.)

26 Avenue at Port Imperial, Suite #108,
West New York, New Jersey

(Address of principal executive offices)

07093

(Zip Code)

Registrant's telephone number, including area code: (212) 500-4850

Securities registered pursuant to Section 12(b) of the Act: None.

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

Title of Each Class

Name of Each Exchange on
Which the Securities are Registered

Common Stock, par value \$0.001 per share

OTCQB

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by a check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the Common Stock held by non-affiliates of the Registrant based upon the closing bid of the Common Stock as reported by the OTCQB on June 30, 2011 (the last business day of the Registrant’s most recently completed second fiscal quarter) was \$2,974,637.25. Solely for purposes of this calculation, shares beneficially owned by directors and officers of the Registrant and persons owning 10% or more of the Registrant's Common Stock have been excluded, in that such persons may be deemed to be affiliates of the Registrant. Such exclusion should not be deemed a determination or admission by the Registrant that such individuals or entities are, in fact, affiliates of the Registrant.

As of March 20, 2012, the Registrant had outstanding 72,273,525 shares of Common Stock, par value \$0.001 per share.

Documents incorporated by reference: None

DELTATHREE, INC.
2011 ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS

	PART I
ITEM 1.	Business
ITEM 1A.	Risk Factors
ITEM 2.	Properties
ITEM 3.	Legal Proceedings
ITEM 4.	(Removed and Reserved)
	PART II
ITEM 5.	Market for Registrant's Common Equity
ITEM 6.	Selected Financial Data
ITEM 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations
ITEM 8.	Financial Statements and Supplementary Data
ITEM 9.	Changes in and Disagreements with Accountants on Accounting and Financial Reporting
ITEM 9A.	Controls and Procedures
ITEM 9B.	Other Information
	PART III
ITEM 10.	Directors, Executive Officers and Key Employees
ITEM 11.	Executive Compensation
ITEM 12.	Security Ownership of Certain Equity
ITEM 13.	Certain Relationships and Related Transactions
ITEM 14.	Principal Accounting Fees and Services
	PART IV
ITEM 15.	Exhibits, Financial Statement Schedules
	Signatures
	Index to Consolidated Financial Statements

PART I

The statements contained in this Annual Report on Form 10-K, or Annual Report, that are not descriptions of historical facts may be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are based on current expectations, estimates, forecasts and projections about us, our future performance, the industries in which we operate, our beliefs and our management's assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to assess. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Please see "Item 1A. Risk Factors" in this Annual Report for detailed information about the uncertainties and other factors that may cause actual results to materially differ from the views stated in such forward-looking statements. All forward-looking statements and risk factors included in this Annual Report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement or risk factor, whether as a result of new information, future events, changes in assumptions or otherwise.

Our fiscal year ends on December 31 of each calendar year. Each reference to a fiscal year in this Annual Report refers to the fiscal year ending December 31 of the calendar year indicated. Unless the context requires otherwise, references to "we," "us," "our," "the Company," and "deltathree" refer to deltathree, Inc. and its subsidiaries, collectively.

ITEM 1. BUSINESS

Company Overview

We are a global provider of integrated video and voice over Internet Protocol, or VoIP, telephony services, products, hosted solutions and infrastructure. We were founded in 1996 to capitalize on the growth of the Internet as a communications tool by commercially offering Internet Protocol, or IP, telephony services, or VoIP telephony. VoIP telephony is the real-time transmission of voice communications in the form of digitized "packets" of information over the Internet or a private network, similar to the way in which e-mail and other data is transmitted. While we began as primarily a low-cost alternative source of wholesale minutes for carriers around the world, we have evolved into an international provider of next generation communication services.

Today we support tens of thousands of active users around the globe through our service provider and reseller channel and our direct-to-consumer channel. We have built a privately-managed, state-of-the-art global telecommunications platform using IP technology and we offer a broad suite of private label VoIP products and services as well as a back-office platform. Our operations management tools include, among others: account provisioning; e-commerce-based payment processing systems; billing and account management; operations management; web development; network management; and customer care. Based on our customizable VoIP solutions, these customers can offer private label video and voice-over-IP services to their own customer bases under their own brand name, a "white-label" brand (in which no brand name is indicated and different customers can offer the same product), or the deltathree brand. At the same time, our direct-to-consumer channel includes our joip Mobile application (which is a new cellular phone application providing low cost mobile calls over 3G cellular networks as well as WiFi networks), iConnectHere offering (which provides VoIP products and services directly to consumers and small businesses online using the same primary platform) and our joip offering (which serves as the exclusive VoIP service provider embedded in the Globarange cordless phones of Panasonic Communications). We are able to provide our services at a cost per user that is generally lower than that charged by traditional service providers because we minimize our network costs by using efficient packet-switched technology and interconnecting to a wide variety of termination options, which allows us to benefit from pricing differences between vendors to the same termination points.

Prior to 1999, we focused on building a privately-managed, global network utilizing IP technology, and our business primarily consisted of carrying and transmitting traffic for communications carriers over our network. Beginning in 1999, we began to diversify our offerings by layering enhanced IP telephony services over our network. These enhanced services were targeted at consumers and were primarily accessible through our consumer website. During 2000, we began offering services on a co-branded or private-label basis to service providers and other businesses to assist them in diversifying their product offerings to their customer bases. In 2001, we continued to enhance our unique strengths through our pioneering work with the Session Initiation Protocol, or SIP, an Internet Engineering Task Force standard that has been embraced by industry leaders such as Microsoft and Cisco. These efforts culminated in the launch of our state-of-the-art SIP infrastructure, and in doing so we became the first major VoIP service provider to

deploy an end-to-end SIP network and services. In recent years, we have continued our pioneering efforts in SIP and these efforts have yielded significant new releases.

In 2009 we began the process of expanding the suite of our communications offerings into the global video phone services market. In the third quarter of 2009 we entered into an agreement with ACN Pacific Pty Ltd., a wholly-owned subsidiary of ACN, Inc., or ACN, pursuant to which we provide digital video and voice-over-IP services in Australia and New Zealand to ACN Pacific. In December 2010 we entered into an agreement with ACN Korea, a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP services in Korea.

In 2010 we continued to update our network by adding a video mail feature to our video phone applications and launching our joip mobile application in July 2010. Following the launch of the mobile application, in October 2010 we entered into a sales agency agreement with ACN pursuant to which ACN sells a private label version of joip Mobile under the ACN Mobile World brand in the United States and Canada. In addition, we offer the joip Mobile application on a white-label basis to other customers. Finally, we entered into affiliate agreements with different third parties pursuant to which such third parties refer potential subscribers to our joip Mobile application.

In April 2011 we entered into an introducer agreement with ACN Europe B.V., a wholly-owned subsidiary of ACN, pursuant to which ACN Europe refers potential customers in different countries in Europe to a private label version of joip Mobile sold under the ACN Mobile World brand. In November 2011 we entered into a service agreement with Momentis U.S. Corp., a multi-level marketing company, pursuant to which Momentis refers potential customers in North America to a co-branded offering of joip Mobile and other consumer VoIP products and services.

As a complement to the initiatives we have taken to attempt to organically expand our businesses, we have also evaluated opportunities for growth through strategic relationships. In February 2009 we consummated a transaction with D4 Holdings pursuant to which we sold to D4 Holdings an aggregate of 39,000,000 shares of our common stock and a warrant to purchase up to an additional 30,000,000 shares of our common stock. D4 Holdings is a private investment fund whose ownership includes owners of ACN, a direct seller of telecommunications services. As a result of the transactions with D4 Holdings, we expect to continue to seek opportunities to provide services to ACN and enter into other commercial transactions that give us access to ACN's international marketing and distribution capabilities.

From an operational standpoint, in 2011 we continued to focus our near-term strategy and market initiatives on growing our service provider and digital next generation communications offerings while still supporting our core VoIP reseller and direct-to-consumer business segments.

Going forward, we expect to:

- actively market our products and services to those entities that wish to offer white-label digital next generation communications offerings;
- pursue a targeted strategy of identifying and evaluating appropriate strategic collaborations, such as potentially engaging in commercial transactions with ACN, that we hope will continue to expand and diversify our customer base;
- market and sell our direct-to-consumer products and services through affiliates and our affiliate program; and
- support and maintain our current reseller base, as we expect our revenue from this key channel will continue to represent a significant percentage of our total revenue in the foreseeable future.

Transactions with D4 Holdings

On February 10, 2009, we entered into a Securities Purchase Agreement with D4 Holdings LLC, or D4 Holdings, pursuant to which we issued to D4 Holdings (i) 39,000,000 shares of our common stock, representing approximately 54.3% of the total number of issued and outstanding shares of common stock following the transaction, for an aggregate purchase price of \$1,170,000, paid in cash, and (ii) a warrant, exercisable for ten years, to purchase up to an additional 30,000,000 shares of our common stock at an exercise price of \$0.04 per share. The transaction closed on February 12, 2009.

Upon the closing of the transaction and pursuant to the terms of the Purchase Agreement, Noam Bardin resigned as a director and the board of directors appointed Robert Stevanovski and Anthony Cassara to serve on the board. In addition, Lior Samuelson resigned as Chairman of the Board and remained a director, and Robert Stevanovski was appointed to serve as Chairman. Following the closing of the transaction, our Board of Directors appointed three additional directors to serve on the Board. The appointments of the three new directors became effective on March 28, 2009.

In connection with the transaction, the parties also entered into an Investor Rights Agreement, pursuant to which we have agreed to file, upon the request of D4 Holdings, a registration statement covering the resale of any shares of our common stock held by D4 Holdings (including the shares of common stock underlying the warrant issued to D4 Holdings). Subject to our ability to suspend the effectiveness of the registration statement for a limited period of time under certain circumstances, we are required to maintain the effectiveness of any such registration statement until the earlier of (i) the date on which all shares of common stock covered by the registration statement have been sold thereunder or (ii) the date on which all such shares of common stock can be sold without registration pursuant to Rule 144 or another similar exemption under the Securities Act of 1933. Subject to certain limitations, D4 Holdings will also be entitled to “piggy-back” registration rights on all future registrations by and any registrations initiated by our other stockholders.

On March 1, 2010, we and our subsidiaries entered into a Loan and Security Agreement, or the “First Loan Agreement”, with D4 Holdings pursuant to which D4 Holdings agreed to provide us and our subsidiaries a line of credit in a principal amount of \$1,200,000. On August 10, 2010, we and our subsidiaries entered into the Second Loan and Security Agreement, or the “Second Loan Agreement”, with D4 Holdings, pursuant to which D4 Holdings agreed to provide us and subsidiaries an additional line of credit in a principal amount of \$1,000,000. In connection with the Second Loan Agreement, we issued D4 Holdings a warrant to purchase up to 4,000,000 shares of our common stock at an exercise price of \$0.1312 per share. We have drawn down all amounts available to be borrowed under the two lines of credit. On March 2, 2011, we and our subsidiaries entered into the Third Loan and Security Agreement, or the “Third Loan Agreement”, with D4 Holdings, pursuant to which D4 Holdings agreed to provide us and its subsidiaries an additional line of credit in a principal amount of \$1,600,000. Pursuant to the terms of the Convertible Promissory Note, or the “Convertible Note”, issued by us in connection with the Third Loan Agreement, D4 Holdings may elect to convert all or any portion of the outstanding principal amount under the Convertible Note into that number of shares of the our common stock determined by dividing such principal amount by \$0.08 (as may be adjusted under the terms of the Convertible Note). Simultaneous with our entering into the Third Loan Agreement, D4 Holdings and we entered into an amendment of the First Loan Agreement, pursuant to which (among other things) the maturity date for repayment of principal under the First Loan Agreement was extended from March 1, 2011, to March 1, 2012, and then subsequently extended by oral agreement of the parties to July 1, 2012. In connection with the Third Loan Agreement, we issued D4 Holdings a warrant to purchase up to 1,000,000 shares of our common stock at an exercise price of \$0.096 per share. We have drawn down the aggregate principal amount available under the Third Loan Agreement, the principal amount of which can be converted by D4 Holdings into an aggregate of 20,000,000 shares of our common stock. On September 12, 2011, we and our subsidiaries entered into the Fourth Loan and Security Agreement, or the “Fourth Loan Agreement”, with D4 Holdings, pursuant to which D4 Holdings agreed to provide us and our subsidiaries an additional line of credit in a principal amount of \$300,000. To date we have received advances in the aggregate amount of \$200,000 from D4 Holdings pursuant to notices of borrowing under the Fourth Loan Agreement.

Industry Background

VoIP technology translates voice into data packets, transmits the packets over data networks such as the Internet or privately managed networks (such as our network), and reconverts them into voice at the destination. Unlike traditional telephone networks, VoIP does not use dedicated circuits for each telephone call; instead, the same VoIP network can be shared by multiple users for voice, data and video simultaneously. This type of data network is more efficient than a dedicated circuit network because the data network is not restricted by the one-call, one-line limitation of a traditional telephone network and, as a result, greater traffic can be transmitted over this data network. This improved efficiency creates cost savings that can be passed on to consumers in the form of lower rates or retained by the VoIP provider. Significant cost savings are also achieved for international telephone calls carried over data networks primarily because they bypass the international settlement process, which represents a significant portion of international long distance tariffs. Additionally, VoIP allows for features that are not available on traditional telephony networks - particularly at the consumer level - including voice mail to email forwarding, find me/follow me, web-based control of call forwarding preferences, user account review/revision and a host of other features and functions.

Beyond cost savings, we believe that VoIP telephony technologies will further the potential for the Internet to become the preferred medium of communications and commerce. As a result, VoIP has experienced significant growth in recent years due to:

- improved quality and reliability of VoIP calls due to technological advances, increased network development and greater bandwidth capacity;
- new product development that allows VoIP providers to offer services not currently offered by traditional telephone companies;
- greatly improved ease of use, whereby the end-user does not perceive a difference between use of a traditional telephone and a broadband telephone;
- increasing demand for long distance communication services driven by the increased mobility of the global workforce; and
- increasing demand for lower cost telephone service around the world.

As a result of these growth trends, various service providers, enterprises and consumers are continuing to procure offerings from VoIP providers such as deltathree. Specifically, consumers in emerging markets are increasingly using VoIP-enabled services, such as IP telephones, to realize significant cost savings on long distance and international calls, while in markets where a significant number of consumers have access to broadband internet services these consumers are increasingly viewing VoIP as a viable and more affordable substitute for their traditional voice telecommunications provider. In addition, as broadband connectivity has become more

available and less expensive around the world, it is now possible for providers like us to offer video as well as voice services to businesses and residential consumers.

Our Products and Services

Products

We have built a privately-managed, global network using IP technology and offer our customers a suite of IP video and voice products. Our products include:

joip Mobile Application. Our joip Mobile application is a cellular phone application providing low cost mobile calls over 3G cellular networks as well as WiFi networks. Cellular operating systems supported by joip Mobile currently include the iPhone, Google Android, Nokia Symbian and Blackberry.

Digital Video and Voice-over-IP Services. Through the use of our network we offer a white-label solution in which our customers have the ability to customize, implement and rapidly launch digital next generation communications offerings with minimal risk and investment. For our potential partners, we offer a full spectrum of service provider back-end support services, including network management, billing, provisioning, e-commerce as well as custom web and application development.

Broadband Phone. Our Broadband Phone product is a phone replacement solution available to business and retail customers over the "last mile" through broadband connections via cable modem, DSL or fixed wireless. In addition to offering capabilities similar to those offered by traditional telephony providers and allowing users to use their existing phone, Broadband Phone enables a user to conveniently operate features and retrieve voice mail through email, web or a phone interface.

PC-to-Phone. Our PC-to-Phone offering enables a user to conveniently and inexpensively place a call to a standard telephone anywhere in the world directly from a personal computer while remaining on-line.

Services

We provide a robust set of value-added services that enables us to address the challenges that have traditionally made the provision of telecommunications services difficult. These operations management tools include the following:

- *video mail:* we provide a video mail feature for our video phone applications;
- *account provisioning:* we provide our service provider and reseller customers with a dedicated Web page through which they can order additional services or accounts, generate and activate PINs and perform other customary implementation functions;
- *payment processing systems:* we provide our customers with a fraud detection and prevention system to permit secure credit card transactions over the Web;
- *billing and account management:* we provide our customers with real-time, Web-based access to billing records to check billing and usage information or to increase prepaid accounts;
- *customer care:* we have moved and consolidated traditional first tier customer care functions onto the Web for ease and flexibility and support this with second tier customer care; and
- *network operations care:* we provide a Network Operations Center, or NOC, automated trouble ticket system, which enables our customers to submit, manage, and follow-up with technical questions and issues online.

The provision of VoIP products and services through our service provider and reseller sales channel and our direct-to-consumer channel accounted for 75.4% and 23.3% of our total revenues in 2011, respectively.

Our Distribution Channels

We market, support and distribute our products and services to tens of thousands of active users around the globe through our service provider and reseller channel and our direct-to-consumer channel.

Service Provider and Reseller Channel

We have developed high-value solutions for the large number of service providers and resellers that are focused on providing their customers with video and voice-over-IP products and services.

Our Hosted Consumer VoIP Solution leverages our VoIP experience and delivers to our service providers, resellers, and various corporate customers a customizable, private-label suite of VoIP products and services. Using our infrastructure, we enable these enterprises to offer their customers different combinations of our basic products and services, accessible through a single account.

Direct-to-Consumer Channel

Our direct-to-consumer channel includes our joip Mobile application (which is a cellular phone application providing low cost mobile calls over 3G cellular networks as well as WiFi networks), iConnectHere offering, which provides VoIP products and services directly to consumers and small businesses online, and our joip offering, which serves as the exclusive VoIP service provider embedded in the Globarange cordless phones of Panasonic.

joip Mobile. joip Mobile is our new cellular phone application providing low cost mobile calls over 3G cellular networks as well as WiFi networks. We market and sell joip Mobile directly to consumers as well as through affiliates and our affiliate program. In addition, ACN sells a private label version of joip Mobile under the ACN Mobile World brand.

Other Consumer Offerings. Our other consumer offerings, including iConnectHere and joip, demonstrate our products, services and hosting capabilities to our reseller customers and service providers. Through our other consumer offerings, an account holder can access all of our product offerings, including Broadband Phone and PC-to-Phone. Additionally, our consumer offerings permit us to collect usage information on our products and services and enables us to provide our service provider and reseller customers with key information and recommendations regarding implementation of our products and services.

Through our other consumer offerings, consumer users can:

- sign up for any of our services, including Broadband Phone, PC-to-Phone and our joip offering;
- download our software and/or order IP-based Broadband Phone devices;
- recharge their accounts, either by entering their credit card information or authorizing automatic recharging;
- send a PC-to-Phone call;
- check real-time billing and usage information;
- communicate by e-mail with a customer service representative; and
- view answers to frequently-asked questions.

Our Strategy

Our strategy is to become a leading worldwide provider of video and voice-over-IP products and services. The following are key elements of our strategy:

Capitalize on the Growth of the Video and Voice-over-IP Marketplace. We believe we are well positioned to take advantage of the expected growth of the video and voice-over-IP services markets. We plan to focus our efforts and resources on becoming a next generation service provider enabler while simultaneously maintaining our reseller business. Simultaneously we plan to allow our direct consumers to sign up for one account and choose a number of next generation communication services and products linked to that account.

Offer Flexible and Modular Deployment Alternatives. We offer our service providers and resellers a choice of deployment alternatives ranging from full outsourcing to partial outsourcing through our modular offering suite. Depending on the particular needs of each of our customers, we design our offering to fit within their business objectives, available resources and desired level of participation. We can develop and integrate specific features and functions into our package, such as various network elements, access components, fulfillment, and the specific feature/functions the provider can offer to its end-users.

Pursue Strategic Relationships. In addition to our strategy and actions to grow organically as described above, we also actively evaluate and pursue appropriate strategic relationships that we believe will continue to expand our customer base and grow our revenues. As discussed above under “ - Transactions with D4 Holdings”, in February 2009 we consummated a transaction with D4 Holdings pursuant to which we sold 39,000,000 shares of our common stock and a warrant to purchase up to an additional 30,000,000 shares of our common stock. D4 Holdings is a private investment fund whose ownership includes owners of ACN, a direct seller of telecommunications services. In October 2010 we entered into a sales agency agreement with ACN pursuant to which ACN sells a private label version of joip Mobile under the ACN Mobile World brand. In December 2010 we entered into an agreement with ACN Korea, a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP services in Korea. In April 2011 we entered into an introducer agreement with ACN Europe B.V., a wholly-owned subsidiary of ACN, pursuant to which ACN Europe refers potential customers in different countries in Europe to a private label version of joip Mobile sold under the ACN Mobile World brand. As a result of the investment in our company by D4 Holdings, we expect to continue to seek opportunities to provide

services to ACN and enter into other commercial transactions that give us access to ACN's international marketing and distribution capabilities.

Sales and Marketing

We sell and market our products and services through our service provider and reseller channel and our direct-to-consumer channel. In general, our sales and marketing activities include:

- developing, deploying and supporting local-specific product features and services, such as multiple language capabilities, different currency capabilities, and various payment methods;
- engaging in strategic relationships with customers (including licensed providers);
- entering into relationships with affiliates that sell our products and services, generally as part of our affiliate programs; and
- using various on-line advertising and search strategies to target and optimize sales efforts.

Service Provider and Reseller Channel

Service Providers. Our experience in deploying sophisticated solutions provides us with leverage as we introduce these services to other service providers.

Reseller Program. Through our reseller program, we contract with smaller service providers and resellers around the world, which in turn sell our products and services under their own brand, a white-label brand or our deltathree brand to retailers, businesses, Internet cafés and others in their local markets. Our experience in providing differentiated VoIP solutions in the emerging international telecommunications environment enables us to effectively enter new markets as they open to competition.

Direct-to-Consumer Channel

joip Mobile. Our joip Mobile application is provided by us directly to consumers as well as through our affiliate program. In addition, ACN sells a private label version of joip Mobile under the ACN Mobile World brand through its independent sales representatives. Finally, we offer the joip Mobile application on a white-label basis to other customers.

iConnectHere. iConnectHere provides VoIP products and services directly to consumers and small businesses online. Through iConnectHere, an account holder can access all of our product offerings, including Broadband Phone and PC-to-Phone.

joip. We launched our joip service and Globarange offering with Panasonic in August 2007. The Globarange phone is currently available in different international locations.

Our Infrastructure

Network

In order to deliver our products and services, we operate a privately-managed IP network. By managing our own network, we have the ability to regulate traffic volumes and to directly control the quality of service from each originating point of presence, or POP, to the termination point via a variety of termination options. Our ability to interconnect to a wide variety of termination options increases the diversity and robustness of our network, minimizes and eliminates single points of failure, and simultaneously allows us to benefit from pricing differences between vendors to the same termination points. In addition, our network allows us to avoid the significant transmission delays associated with the Internet, which may impede delivery of high quality, reliable services to our users.

In 2001, we introduced our SIP infrastructure. The SIP protocol is one of the most advanced VoIP protocols and, unlike its predecessors, which were modeled after traditional telephony protocols, SIP has the ability to scale with a distributed architecture and at a lower cost. SIP's superior attributes also include faster and more cost effective development and lower hardware requirements, which allows us to incur lower capital expenditure costs. Our SIP network currently powers all of our offerings. In recent years, we have continued our pioneering efforts in SIP and these efforts have yielded significant new releases. For example, in 2007 we released a next generation SIP-based PC-to-Phone application, certified many new devices which function as access points to our services, and added new features and new calling plans to our offerings. In 2009 we began the process of expanding the suite of our communications offerings into the global video phone services market. We are continuing to update our network capabilities by adding content enabled services to our video phone applications and providing mobile applications.

Our network is built around a high availability backbone that connects New Jersey, Atlanta, London, Frankfurt and Sydney. In each of, and between, these locations we maintain multiple interconnections or peering arrangements with Internet backbone and voice providers. These points are strategically located to allow access from our network to and from the Internet with a high level of performance. While operating as a private extension of the Internet, our backbone has a high level of security designed to isolate it from security threats found on the public Internet.

Access to our network is possible through several products and services. A call can originate from a mobile phone using our joip Mobile application, the PC-to-Phone product using our downloadable software application “soft-phones,” a Web browser, or Broadband Phone devices. These calls enter our network from the Internet through our interconnection points.

Our network can terminate calls through our and our termination providers’ POPs. Termination decisions are based on a sophisticated routing system that applies routing rules based on origination point, termination cost and other factors. These rules are consistently updated to ensure a high level of quality and economic efficiency. Each termination port is carefully managed with capacity planning tools and techniques to provide cost-effective service to customers, along with multiple termination options to ensure the highest possible levels of redundancy.

We are a party to service agreements with several telecommunications providers, including foreign telephone companies, Internet backbone providers and others. Pursuant to these agreements, we can transport video and voice data packets to our hubs and terminate calls throughout the world in a cost effective and efficient manner.

Support

Our NOC monitors and manages our network from a central location, seven days a week, 24 hours a day. The NOC monitors all aspects of our network, including the routers, databases, switches, leased lines, Internet connections, gatekeepers and gateways to ensure that they are functioning at optimal levels. In the event of a failure of any of these network components, NOC personnel are provided with a real time, systems-generated notification via an instant messaging system consisting of pagers, cellular phones, screen pop-ups and e-mail that identifies the malfunction so that proper measures can be taken to restore service in a timely fashion. Our NOC utilizes a combination of industry technologies as well as unique applications developed by us. The NOC serves all of the different parts of our operations environment, including network nodes, Web servers and specific applications.

We provide customer support on various levels to different customers. With respect to our service provider and reseller customers, we provide customer care and technical support directly to these customers and they in turn provide their own support directly to the end-users. Customers of joip Mobile, iConnectHere and joip receive technical support and customer care through e-mail support.

Our services are supported by our on-line interactive customer service and billing center, which enables an end-user to set up an account, receive an account number and a PIN, pay by credit card for services, find answers to frequently asked questions and contact customer service representatives. Once a user has established an account, the user can prepay for additional usage by credit card as well as access real-time detailed information such as call logs and transaction records. Through the on-line billing system, a user can personalize the billing information to select the data most relevant to them. This on-line interactive customer service and billing center is supported by a human customer care contact center that provides voice, e-mail and instant messaging support to the customers.

Suppliers

We outsource to third-party vendors the provisioning of certain of our local telecommunications services, including local phone numbers, access to the public switched telephone network, or PSTN, operator assistance, directory listings and assistance, E-911 emergency services and local number portability. We also outsource the development of our applications and certain of the features ancillary to our services, as well as provisioning of our consumer premises equipment, such as our analog telephone adapters, IP Phones and gateways, and certain aspects of our customer care services. We do not rely on any one specific vendor for providing these services, except for E-911 emergency services and certain specific services of customer care. While we believe our relations with our suppliers are good, we believe that we could replace our suppliers if necessary and that although our ability to provide services to our customers may be impacted in such a case we do not expect that this would have a material adverse affect on our business, financial condition and results of operation.

Proprietary Rights

We rely and expect to be able to rely on trademark and trade secret laws, confidentiality agreements and other contractual arrangements with our employees, strategic partners and others to protect our proprietary rights.

We have registered trademarks for “deltathree”, “deltathree making VoIP work for you”, “the IP Communications Network”, “iConnectHere”, “joip”, “joipy”, “joip just talk”, “Click It”, “iconnecthere.com” and other trademarks in the United States and

internationally. In connection with our acquisition of the Go2Call businesses, we acquired the “Go2Call” trademark and a variety of trademarked derivatives of “Go2Call”. These trademarks may not provide adequate protection against competitive technology and may not be held valid and enforceable if challenged. We do not own any registered copyrights.

To further safeguard our intellectual property, we have a policy that requires our employees and contractors to execute confidentiality and assignment of inventions agreements when they begin their relationships with us.

Regulation

Regulatory Environment Overview

The use of the Internet and private IP networks to provide VoIP service is a relatively recent market development. Although the provision of such services is currently not as regulated as traditional telephony services within the United States, the Federal Communications Commission, or FCC, has applied some regulation to certain types of VoIP services and is reviewing whether to apply additional regulations to VoIP services. In addition, several foreign governments have adopted or proposed regulations that could restrict or prohibit the provision of VoIP services. Regulation of Internet telephony providers and services may materially and adversely affect our business, financial condition, operating results and future prospects, particularly if increased numbers of governments impose regulations restricting the use and sale of IP telephony services. In addition, to the extent we become required to contribute to regulatory funds and collect and remit regulatory fees, taxes and surcharges this will increase our costs, which may result in either our increasing the retail price of our service offerings or reducing our profitability.

Federal Regulation

Regulatory Classification of VoIP Services

Although there are several regulatory proceedings currently pending before federal authorities, providers of interconnected VoIP services are lightly regulated compared to providers of traditional telecommunications services. On February 12, 2004, the FCC initiated a generic rulemaking proceeding concerning the provision of voice and other services using IP technology, including assessing whether VoIP services should be classified as information services or telecommunications services. The rulemaking is ongoing and we cannot predict the outcome of this proceeding. In November 2004, the FCC determined that certain interconnected VoIP services (meaning VoIP services that can be used to send and receive calls to or from the PSTN), including some services that are similar to ours, should be considered interstate services subject to federal rather than state jurisdiction. Although this ruling was appealed by several states, on March 21, 2007, the United States Court of Appeals for the Eighth Circuit affirmed the FCC's determination.

The FCC's generic rulemaking proceeding could result in the FCC determining, for instance, that certain types of Internet telephony should be regulated like basic telecommunications services. Thus, Internet telephony would no longer be exempt from more onerous telecommunications-related regulatory obligations, could potentially become subject to state telecommunications regulations, and could become subject to other economic regulations typically imposed on traditional telecommunications carriers.

VoIP E-911 Matters

On June 3, 2005, the FCC released an order and notice of proposed rulemaking concerning VoIP emergency 911 services. The order set forth two primary requirements for providers of interconnected VoIP services. The order applies to our iConnectHere and joip customers, or our "retail customers". We do not believe that we are responsible for compliance with this order when we sell our service wholesale to companies who then offer the service to retail end-users. We cannot predict whether we would be subject to any third-party litigation in connection with such customers who resell our services or whether the rules will be interpreted as applicable to those who wholesale interconnected VoIP services.

The order set forth two primary requirements for providers of interconnected VoIP services. First, the order requires providers of interconnected VoIP services like us to notify our retail customers of the differences between the emergency services available through our offerings and those available through traditional telephony providers. We also had to receive affirmative acknowledgment from some of our retail customers that they understand the nature of the emergency services available through our service. On September 27, 2005, the FCC's Enforcement Bureau released an order stating that the Enforcement Bureau will not pursue enforcement actions against interconnected VoIP providers that have received affirmative acknowledgement from at least 90% of their subscribers. We received affirmative acknowledgment from more than 95% of our relevant customers that they understand the nature of the emergency services available through our service, and thus we believe we are substantially in compliance with the first aspect of the FCC's June 3 order.

Second, the order required providers of interconnected VoIP services like us to offer enhanced emergency dialing capabilities, or E-911, to all of our retail customers by November 28, 2005. Under the terms of the order, we are required to use the dedicated wireline E-911 network to transmit customers' 911 calls, callback number and customer-provided location information to the emergency authority serving the customer's specified location. On November 7, 2005, the FCC's Enforcement Bureau issued a

Public Notice with respect to that requirement. The Public Notice indicated that providers who have not fully complied with the enhanced emergency dialing capabilities requirement are not required to discontinue the provision of services to existing customers, but that the FCC expects that such providers will discontinue marketing their services and accepting new customers in areas in which the providers cannot offer enhanced emergency dialing capabilities where such capabilities are otherwise available.

Almost all of our retail customers currently receive E-911 service in conformity with the FCC's order. Like many interconnected VoIP providers, we rely on third parties to route emergency calls originated by our customers. In certain instances and for some of our customers, the third party provider may route 911 calls to an unofficial emergency call center. Such unofficial call centers may not be able to receive appropriate call back information. To the extent that they are so able or callers provide their location information the emergency dispatchers in such call centers may not then be able to route such calls to the appropriate public safety answering point. The FCC could find that calls routed in this manner violates its rules, potentially subjecting us to enforcement actions including, but not limited to, fines, cease and desist orders, or other penalties. Moreover, and as is the case with customers for other interconnected VoIP providers some customers who were receiving service prior to the FCC's deadline for compliance with the E-911 regulations may not receive such service. The FCC permitted service providers to continue to provide service to those existing customers rather than disconnect those customers. Pursuant to the FCC's requirement, after the implementation of the FCC E-911 requirements, we provide services to our new retail customers only where we can provide the FCC required E-911 service. We may be required to stop serving those customers to whom we cannot provide the required enhanced emergency dialing capabilities that were being serviced prior to the issuance of the FCC's rules at any time.

The FCC is considering modifying its VoIP E-911 rules. In June 2007, the FCC released a Notice of Proposed Rulemaking to consider whether it should impose additional obligations on interconnected VoIP providers. Specifically, the FCC considered mandating that interconnected VoIP providers implement a solution that will allow for automatically determining the location of their customers for purposes of E-911 rather than require customers to manually update their existing location information (as is the case under the current regulations). Moreover, the Notice included a tentative conclusion that interconnected VoIP providers that allow their service to be used in more than one location, like us, be required to meet the same customer location accuracy standards applicable to providers of mobile telecommunications services. In September 2010, the FCC released a Notice of Inquiry again requesting comment on, among other issues, whether interconnected VoIP providers should be required to provide automatic location information about their customers rather than requiring customers to self-report their location. Additionally, the Notice of Inquiry sought comment on whether the FCC's rules concerning the delivery of emergency services should be extended to non-interconnected VoIP services as well as to mobile VoIP applications used on smartphones, computers and other devices. At this time we cannot predict the outcome of these proceedings or their potential impact on our business.

See “ - State and Local Regulation” below for a discussion of fees we may collect in the future in connection with providing E-911.

Communications Assistance for Law Enforcement Act

The Communications Assistance for Law Enforcement Act, or CALEA, requires certain communications service providers to assist law enforcement agencies in conducting lawfully authorized electronic surveillance. On September 23, 2005, the FCC released an order concluding that CALEA applies to interconnected VoIP providers. In May 2006 the FCC released an order finding that broadband Internet access service providers and interconnected VoIP providers are required to implement the same type of CALEA requirements that have been applied to wireline telecommunications carriers. These include obligations to (1) ensure that communications equipment, facilities, and services meet interception assistance capability requirements and (2) develop system security policies and procedures to define employee supervision and record retention requirements. As a result of the steps we have taken, we believe that we comply with CALEA.

Universal Service Fund

The FCC decided in June 2006 that interconnected VoIP service providers should be required to contribute to the universal service fund, or USF. The amount of universal service contribution for interconnected VoIP service providers is based on a percentage of revenues earned from end-user interstate services. The FCC developed three alternatives under which an interconnected VoIP service provider may elect to calculate its universal service contribution: (1) a safe harbor that assumes 64.9% of the provider's end-user revenues are interstate; (2) a traffic study to determine an allocation for interstate end-user revenues; or (3) actual interstate and international end-user revenues. If an interconnected VoIP service provider calculates its universal service contributions based on its actual percentage of interstate calls, the FCC suggested that its preemption of state regulation of such services may no longer apply, in which case the interconnected VoIP service provider could be subject to regulation by each state in which it operates as well as federal regulation. In addition, the FCC is considering a number of proposals that could alter the way that the USF is assessed. For instance, the FCC is considering an assessment based on the use of telephone numbers. The U.S. Congress may also provide the FCC with additional authority to reform USF or mandate a particular methodology. At this time we cannot predict what impact, if any, USF reform may have on our business.

Numerous states may attempt to impose state universal service contribution requirements on interconnected VoIP providers such as deltathree. At this time, various states – including Kansas, Nebraska and New Mexico – claim that they have the right to require interconnected VoIP providers to contribute to their respective USF funds. On March 3, 2008, the U.S. District Court for Nebraska issued a preliminary injunction and found that Nebraska's state Public Service Commission does not have jurisdiction to require Universal Service contributions from VoIP providers. On May 1, 2009, a panel of the U.S. Circuit Court of Appeals for the Eighth Circuit affirmed the U.S. District court ruling. In response, the Nebraska and New Mexico state commissions filed a petition with the FCC seeking the authority to impose state USF contribution obligations on interconnected VoIP providers, like us, and the FCC granted the petition. As a result of this ruling, a number of other states have either stated that offerings such as ours may be subject to their respective state USF or are considering imposing such obligations on us. We would likely pass through to our customers in those states any such state USF fees, potentially making our services less competitive with offerings available from traditional providers of telecommunications services, which may cause us to lose customers in those states. In addition, in the past some states have attempted to impose retroactive application of any state USF obligations. Retroactive applicability of any state USF fees would effectively bar us from collecting such fees from our customers, reducing our future profits.

Customer Proprietary Network Information

On April 2, 2007, the FCC issued an order that tightened existing rules on protection and use of Customer Proprietary Network Information, or CPNI, and extended coverage of the CPNI rules to interconnected VoIP service providers. Among other things, the Order imposes greater obligations on us and other companies like us to protect CPNI, acquire customer consent prior to engaging in certain kinds of marketing efforts based on CPNI, train our employees concerning protecting (and the use of) CPNI and to file formal certifications with the FCC regarding procedures for protecting this information. As a result of the steps we have taken, we believe that we comply with this Order.

Access for People with Disabilities

On June 15, 2007, and effective October 5, 2007, interconnected VoIP providers, like us, became required to, among other things, make certain that their equipment and service is accessible to and usable by individuals with disabilities, if readily achievable. In addition, interconnected VoIP providers like us became obligated to contribute to the Telecommunications Relay Services, or TRS, fund and to offer 711 abbreviated dialing for access to relay services. Following March 31, 2009, interconnected VoIP providers are required to route such 711 calls to the appropriate TRS relay center serving the state in which the caller is located or the relay center corresponding to the caller's last registered address. As a result of the steps we have taken, we believe that we comply with the applicable requirements.

Regulatory Fees

On August 6, 2007 and effective November 2007, the FCC adopted an Order concerning the collection of regulatory fees for Fiscal Year 2007 requiring the collection of such fees from interconnected VoIP providers like us. Like other interconnected VoIP providers, we now pay regulatory fees based on interstate and international revenues.

Local Number Portability

On November 8, 2007, the FCC released an Order relating to local number portability imposing local number portability, or LNP, and related obligations on interconnected VoIP Providers like us. The Order requires interconnected VoIP providers to contribute to shared numbering administration costs. Additionally, the Order mandates that we process certain kinds of telephone number porting requests within certain timeframes. As a result of the steps we have taken, we believe that we comply with this Order. Subsequently, on May 13, 2009, the FCC released another order concerning LNP that further reduces the porting timeframe for certain types of telephone number porting requests that interconnected VoIP providers, like us, have to process. Since we are not a licensed telecommunications carrier, we must rely on third parties to comply with these porting obligations. If these third parties fail to comply with these obligations we could be subject to fines, forfeitures and other penalties by the FCC or state public utilities commissions or we could face legal liability in state or federal court from customers or carriers. The FCC also released a Further Notice of Proposed Rulemaking to refresh the record on how to further improve the porting process, and how to potentially expand the new one business day porting timeframe to other kinds of ports. We cannot predict the outcome of this proceeding or its potential impact on us at this time.

Intercarrier Compensation

The FCC is actively considering reform of the intercarrier compensation system, which is a set of FCC rules and regulations by which telecommunications carriers compensate each other for the use of their respective networks. These rules and regulations affect the prices we pay to our suppliers for access to the facilities and services that they provide to us, such as termination of calls by our customers onto the public switched telephone network. At this time we cannot predict what impact, if any, new intercarrier compensation regulations would have on our business.

Discontinuance Requirements

In May 2009, the FCC extended discontinuance rules that apply to non-dominant common carriers to interconnected VoIP providers, like us. The FCC's rules require non-dominant domestic carriers to provide notice to customers at least 30 days prior to discontinuing service to a telephone exchange, toll stations serving a community in whole or in part, and other similar activities that affect a community or part of a community. Carriers must inform certain state authorities of the discontinuation, and obtain prior FCC approval before undertaking the service disruption. The FCC's rules allow for streamlined treatment for FCC discontinuance approvals and interconnected VoIP providers will be able to take advantage of the same streamlined procedures afforded to non-dominant

carriers. It is not yet clear how these rules apply to interconnected VoIP providers. But in the event we discontinue one of our service offerings in its entirety or if we were to exit the market in whole we would likely have to comply with these new rules. We do not expect these new obligations to have a material impact on our business.

Katrina Reporting Requirements

In June 2007, the FCC adopted various recommendations from its Independent Panel Reviewing the Impact of Hurricane Katrina on Communications Networks Panel, including a requirement that certain interconnected VoIP providers submit reports regarding the reliability and resiliency of their 9-1-1 systems. At this time, we are not subject to these reporting requirements but may become subject in the future.

Open Internet, or “Net Neutrality”, Obligations

We rely upon providers of broadband Internet access services to offer our services to our customers. The FCC recently adopted “open Internet” rules that would, among other things, prohibit fixed providers of broadband Internet access services from blocking, impairing or downgrading such access. Wireless providers of broadband Internet access services would be prohibited from blocking VoIP applications like ours. The open Internet rules are not yet effective and, as a result of both legislative efforts to overturn the rules as well as potential appeals of the passage of the rules, it is unclear whether (and when) the rules will become effective. While we are not aware of any provider of broadband Internet access attempting to interfere with our Internet access, the lack of enforceable rules could potentially negatively impact our service offerings and impede our ability to offer new services that require significant Internet bandwidth.

State and Local Regulation

Some state and local regulatory authorities believe they retain jurisdiction to regulate the provision of, and impose taxes, fees and surcharges on, intrastate Internet and VoIP telephony services, and have attempted to impose such taxes, fees and surcharges, such as a fee for providing E-911 service. Rulings by the state commissions on the regulatory considerations affecting Internet and IP telephony services could affect our operations and revenues, and we cannot predict whether state commissions will be permitted to regulate the services we offer in the future.

We paid approximately \$150,000 of state and local taxes and other fees during 2011. To the extent we increase the cost of services to our customers to recoup some of the costs of compliance this will have the effect of decreasing any price advantage we may have over traditional telecommunications companies.

In addition, it is possible that we will be required to collect and remit taxes, fees and surcharges in other states and local jurisdictions and which such authorities may take the position that we should have collected. If so, they may seek to collect those past taxes, fees and surcharges from us and impose fines, penalties or interest charges on us. Our payment of these past taxes, fees and surcharges, as well as penalties and interest charges, could have a material adverse effect on us.

International Regulation

The regulatory treatment of Internet and Internet-based voice services, including IP telephony or VoIP, outside of the United States varies widely from country to country. A number of countries may prohibit Internet and IP telephony, while other countries expressly permit but regulate Internet and IP telephony. Some countries evaluate proposed Internet and IP telephony service on a case-by-case basis to determine whether any regulation is necessary or whether it should be regulated as a voice service or as another telecommunications or data service. Finally, in many countries neither Internet nor IP telephony have been addressed by legislation or regulatory action as of the date of this filing. Although we strive to comply with applicable international IP telephony regulations, we cannot be certain that we are in compliance with all of the relevant regulations at any given point in time.

In 2002, the European Commission adopted a set of directives for a new framework (Regulatory Framework) for electronic communications regulation that, in part, attempts to harmonize the regulations that apply to services regardless of the technology used by the provider. The Regulatory Framework was further amended in November 2009. Under the Regulatory Framework, there is no distinction in regulation made based upon technology between switched or packet-based networks. As a result, some types of IP telephony and VoIP services may be regulated like traditional telephony services while others may be subject to less stringent regulation. The European Commission has published a staff working paper aimed at clarifying the conditions applicable to providers of IP-based services. The working paper identifies various issues that may arise in relation to IP-based services including the regulatory classification of Internet telephony and VoIP under the Regulatory Framework. The European Regulators Group (consisting of regulators from European Union Member States and the European Commission) has adopted a Common Statement for VoIP regulation. The European Commission currently is reviewing how IP telephony services fit into the Regulatory Framework and analyzing other issues associated with IP telephony, such as access to numbering resources and provision of emergency services.

Although the European Commission has recommended that a “light touch” to regulation be taken, we cannot predict what future actions the European Commission, Member States, and courts reviewing the Regulatory Framework may take regarding IP telephony and related matters, or what impact, if any, such actions may have on our business.

Based on the European Commission's current position, we believe that most providers of IP telephony would be subjected to no more than minimal regulation such as a general authorization or declaration requirements that may be imposed by the European Union Member States. Several Member States have issued statements or regulations concerning IP telephony and VoIP while others have issued consultations requesting industry comments on the applicability of the Regulatory Framework to various IP telephony and VoIP services in their respective countries. However, since the Commission's findings on IP telephony are not binding on the Member States, we cannot assure you that the services provided over our network will not be deemed "voice telephony" subject to heightened regulation by one or more EU Member States. Although Member States are required to adhere to the Regulatory Framework, Member States may not take a uniform approach in regulating a particular Internet-enabled service including IP telephony. We cannot predict the manner in which Member States will regulate our particular services.

As we make our services available in foreign countries, and as we facilitate sales by our network partners to end-users located in foreign countries, such countries may claim that we are required to qualify to do business in the particular foreign country. Such countries may also claim that we are subject to regulation, including requirements to obtain authorization for the provision of voice telephony or other telecommunications services, or for the operation of telecommunications networks. It is also possible that such countries may claim that we are prohibited in all cases from providing our services or conducting our business in those countries. Failure to qualify as a foreign corporation in certain jurisdictions, or to comply with foreign laws and regulations, may adversely affect our business. In addition, we cannot predict how a regulatory or policy change of a particular country might affect the provision of our services.

Our network partners may also currently be, or in the future may become, subject to requirements to qualify to do business in a particular foreign country, comply with regulations (including requirements to obtain authorizations for the provision of voice telephony or other telecommunications services or for the operation of telecommunications networks) or cease providing services or conducting their business as conducted in that country. We cannot be certain that our network partners either are currently in compliance with any such requirements, will be able to comply with any such requirements, and/or will continue in compliance with any such requirements.

Other Regulation Affecting the Internet

The European Union has also enacted several directives relating to the Internet, including regulations that address online commerce and data protection. International governments are adopting and implementing privacy and data protection regulations that establish certain requirements with respect to, among other things, the confidentiality, processing and retention of personal subscriber information. The potential effect, if any, of these data protection rules on the development of our business remains uncertain.

Competition

We compete primarily in the market for enhanced video and VoIP telephony services, products, hosted solutions and infrastructure, and specifically in the VoIP service provider and reseller markets. This VoIP market is highly competitive and there are numerous competing providers. We believe that the primary competitive factors determining our success in the VoIP telephony market are: quality of service and network capacity; the ability to meet and anticipate customer needs through multiple service offerings and feature sets; customer services; and price.

Future competition could come from a variety of companies in the video and voice-over-IP industry. This industry includes major companies who have greater resources and larger subscriber bases than we have, and have been in operation for many years. In addition, many companies provide, or are planning to provide, some of the services we offer.

Revenues and Assets by Geographic Area

For the year ended December 31, 2011, approximately \$8.7 million, or 82.9%, of our revenue was derived from international customers, and \$1.8 million, or 17.1%, was derived from customers in the United States. Most of our long-lived assets are located in the United States. For more detailed information concerning our geographic segments, see Note 14 to our financial statements included elsewhere in this Annual Report.

Employees

As of December 31, 2011, we had 32 employees, of which 31 were located in Israel (six of whom were part-time employees) and one was located in the United States. We consider our relationship with our employees to be good. None of our employees is covered by collective bargaining agreements.

Customers

In 2011, two customers accounted for approximately 43.4% of our gross revenues. Any significant decline in our sales to any of our material customers could have a material adverse effect on our business, operating results and financial condition. At the end of February 2011 our largest customer temporarily suspended its operations and conducting business with our company due to the recent unrest in the Middle East and ongoing instability and operating difficulties caused by such unrest. In September 2011, this reseller resumed operations and conducting business with our company, and has become a material customer of the company again beginning the fourth quarter of 2011.

Available Information

Our Internet address is www.deltathree.com. Through a link at the Investor Relations section of our website we make available, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such materials have been electronically filed with, or furnished to, the SEC.

ITEM 1A. RISK FACTORS

Our business, financial condition and results of operations and the trading price of our common stock could be materially adversely affected by any of the following risks as well as the other risks highlighted elsewhere in this Annual Report, particularly the discussions about regulation, competition and intellectual property. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations.

Risks Related to our Company

We have a history of losses and we are uncertain as to our future profitability.

Except for the year ended December 31, 2006, in which we reported net income of approximately \$500,000 but a net loss from operations of \$52,000, we have a history of significant, recurring losses since our inception, and we may continue to incur significant losses for the foreseeable future. We reported net losses of approximately \$3.2 million in 2009, \$2.5 million in 2010 and \$3.1 million in 2011. As of December 31, 2011, our accumulated deficit was approximately \$181 million. Our revenues may not grow or even continue at their current level. Going forward, we will need to increase our revenues and/or lower our current cost structure to reach profitability. If our revenues do not increase and/or if we are unable to reduce our expenses, we may not be able to reach profitability again. We cannot assure you that we will be able to reach profitability on a quarterly or annual basis in the future. These factors raise substantial doubt about our ability to continue as a going concern.

We may not be able to expand our revenue.

Our business strategy is to expand our revenue sources and our distribution channels in order to include the provision of video and VoIP telephony services to different customer groups. We can neither assure you that we will be able to accomplish this nor that this strategy will be profitable. Currently, our revenues are primarily generated by sales of our video and VoIP telephony products and services through our service provider and reseller sales channel and our direct-to-consumer channel. VoIP telephony from these channels generated 99.1%, 98.5% and 98.7% of our total revenues in 2009, 2010 and 2011, respectively.

We expect that our revenues for the foreseeable future will be dependent on, among other factors:

- sales of our video and voice-over-IP products and services;
- the public's acceptance and use of video and voice-over-IP services;
- expansion of our service offerings;
- the effect of competition, regulatory environment, international long distance rates and access and transmission costs on our prices; and
- continued improvement of our global network quality.

Our business strategy assumes, among other things, that the voice-over-IP market generally and such market as it applies to mobile devices specifically will expand significantly. If this market does not expand significantly we may not be able to expand our revenues and successfully carry out our business strategy.

The global financial crisis may have an impact on our business and financial condition in ways that we currently cannot predict.

The continued financial crisis and related turmoil in the global financial system may have an impact on our business and our financial condition, as well as increase the risk of uncollectible accounts receivable from our customers. For example, our ability to obtain additional financing may be severely restricted at a time when we would like, or need, to do so, which could have an impact on our flexibility to react to changing economic and business conditions.

We are substantially dependent upon a few material customers, and any significant decline in our sales to those customers could have a material adverse effect on our business.

In 2011, two customers accounted for approximately 43.4% of our annual gross revenues. Any significant decline in our sales to any of our material customers could have a material adverse effect on our business, operating results and financial condition.

A continuing decline in telecommunications prices may cause us to lower our prices to remain competitive, which could prevent our future profitability.

International and domestic telecommunications prices have decreased significantly over the last few years in most of the markets in which we operate, and as a result our margins have decreased materially. We anticipate that prices will continue to be reduced in all of the markets in which we do business or expect to do business. Users who select our services (or our resellers' or service provider customers' services) to take advantage of the current pricing differential between traditional telecommunications prices and our (or our customers') prices may switch to traditional telecommunications carriers as such pricing differentials diminish or disappear, and we will be unable to use such pricing differentials to attract new customers in the future. Such competition or continued price decreases may require us to lower our prices to remain competitive, may result in reduced revenue, a loss or decrease of customers and may prevent our future profitability.

We believe it is probable that we will need additional capital to continue our operations.

We have sustained significant operating losses in recent periods, which have led to a significant reduction in our cash reserves. As of December 31, 2011, we had negative working capital of approximately \$4.8 million and negative stockholders' equity of approximately \$4.4 million. We believe it is probable that we will continue to experience losses and increased negative working capital and negative stockholders' equity in the near future, and that we will not be able to return to positive cash flow before we require additional capital (in addition to any further amounts we may borrow from D4 Holdings under the Fourth Loan Agreement) in the near term. Each loan advance under the Fourth Loan Agreement requires the satisfaction of certain conditions, including a condition that there shall not have occurred, in D4 Holdings' sole discretion, any material adverse change in our business, operations or condition (financial or otherwise) or a material impairment in the prospect of repayment of any portion of our obligations under the loan agreements. In the event that any such events occur, we may be unable to access credit under the Fourth Loan Agreement.

We believe that, unless we are able to increase our revenues, we will not have sufficient funds to continue our current operations over the foreseeable future if we do not receive additional financing. We may experience difficulties accessing the equity and debt markets and raising such capital, and there can be no assurance that we will be able to raise such additional capital on favorable terms or at all. In addition, as a result of D4 Holdings' controlling interest in our company, D4 Holdings will be able to exercise a controlling influence over future issuances of capital stock or other securities by us and a third party may be deterred from investing in us.

Intense competition could reduce our market share and decrease our revenue.

The market for video and voice-over-IP services is extremely competitive. Our competitors include companies in the video and voice-over-IP industry. Many of our existing competitors and potential competitors have broader portfolios of services, greater financial, management and operational resources, greater brand-name recognition, larger subscriber bases and more experience than we have. In addition, our Internet competitors use the Internet instead of a private network to transmit traffic, and the operating and capital costs of these providers may be less than ours.

If we are unable to provide competitive service offerings, we may lose existing customers and be unable to attract additional customers. In addition, many of our competitors enjoy economies of scale that result in a lower cost structure for transmission and related costs, which cause significant pricing pressures within the industry. To remain competitive, we must continue to invest significant resources in research and development, sales and marketing, and customer support. We may not have sufficient resources to make these investments or to make the technical advances necessary to be competitive, which, in turn, will cause our business to suffer.

Fluctuations in our quarterly financial results may make it difficult for investors to predict our future performance.

Our quarterly operating results may fluctuate significantly in the future as a result of a variety of factors, many of which are outside our control. The factors generally within our control include:

- the rate at which we are able to attract users to purchase our video and voice-over-IP products and services;
- the amount and timing of expenses to enhance marketing and promotion efforts and to expand our infrastructure;
and
- the timing of announcements or introductions of new or enhanced services by us.

The factors outside our control include:

- the timing of announcements or introductions of new or enhanced services by our competitors;
- regulations in various countries that prohibit us from providing our services cost-effectively or at all;
- technical difficulties or network interruptions in the Internet or our privately-managed network; and
- general economic and competitive conditions specific to our industry.

We believe that quarter-to-quarter comparisons of our historical operating results may not be a good indication of our future performance, nor would our operating results for any particular quarter be indicative of our future operating results.

We face a risk of failure of computer and communications systems used in our business.

Our business depends on the efficient and uninterrupted operation of our computer and communications systems as well as those that connect to our network. We maintain communications systems in facilities in New Jersey, Atlanta, London, Frankfurt and Sydney. Although we have designed our network to reduce the possibility of disruptions or other outages, our systems and those that connect to our network are subject to damage or interruption from natural disasters, power loss, communications failure, hardware or software malfunction, network failures, physical or electronic break-ins, sabotage, computer viruses, intentional acts of terrorism or vandalism and other events that may be or may not be beyond our control. Any system interruptions that cause our services to be unavailable, including significant or lengthy telephone network failures or difficulties for users in communicating through our network or portal, could damage our reputation and result in a loss of users.

Our computer systems and operations may be vulnerable to security breaches.

We believe that the safety of our network and the secure transmission of confidential information over the Internet are essential to our operations and maintaining user confidence in our services. Although we have developed systems and processes that are designed to protect our network, the consumer information stored on our network, unauthorized use of our network and other security breaches, our computer infrastructure is potentially vulnerable to physical or electronic computer viruses, abuse of use, break-ins and similar disruptive problems and security breaches that could cause loss (both economic and otherwise), interruptions, delays or loss of services to our users. We rely on licensed encryption and authentication technology to effect secure transmission of confidential information, including credit card numbers. It is possible that advances in computer capabilities or new technologies could result in a compromise or breach of the technology we use to protect user transaction data. A party that is able to circumvent our security systems could misappropriate proprietary information, cause interruptions in our operations or utilize our network without authorization. Security breaches also could damage our reputation and expose us to a risk of loss, litigation and possible liability. While we have experienced isolated instances of unauthorized use of our network, and have responded to such events by taking steps to increase our network security, we cannot guarantee you that our security measures will prevent security breaches.

Operating internationally exposes us to additional and unpredictable risks.

We operate in many international markets, including the Middle East. There are certain risks inherent in doing business on an international basis, including:

- political and economic instability, including the risk of social unrest, war, civil war and armed conflict in the countries in which we operate;
- uncertainty regarding the ability of our resellers to resell our service in compliance with all laws, rules and regulations in such markets and actions by foreign governments or foreign telecommunications companies to limit access to our services;
- fluctuations in exchange rates;
- potentially adverse tax consequences;
- potentially weaker protection of intellectual property rights; and
- uncertain market acceptance and difficulties in marketing efforts due to language and cultural differences.

We need to retain key personnel to support our products and ongoing operations.

The marketing and operations of our products and services will continue to place a significant strain on our limited personnel, management, and other resources; this is particularly true following the significant decline in the number of our employees that occurred as a result of the reduction in force we effected during 2011. Our future success depends upon the continued services of our

executive officers and other key employees whom we rely upon to run our operations. Except for Mr. Effi Baruch, our Chief Executive Officer, President and Senior Vice President of Technology and Operations, none of our officers or key employees is subject to an employment agreement for any specific term. The loss of the services of any of these officers or key employees could impact our ability to run our operations and delay the development and introduction of, and negatively impact our ability to sell, our products, either of which could adversely affect our financial results. We currently do not maintain key person life insurance policies on any of our employees.

Our ability to provide our service and to comply with certain regulatory obligations is dependent in part upon third-party providers, facilities and equipment, the failure of which could cause delays or interruptions of our service, expose us to legal liability, damage our reputation, cause us to lose customers and limit our growth.

Our success depends on our ability to provide quality and reliable service, which is in part dependent upon the proper functioning of facilities and equipment owned and operated by third parties and is, therefore, beyond our control. Unlike traditional wireline telephone service or wireless service, our service requires our customers to have an operative broadband Internet connection and an electrical power supply, which are provided by the customer's Internet service provider and electric utility company, respectively, and not by us. The quality of some broadband Internet connections may be too poor for customers to use our services properly. In addition, if there is any interruption to a customer's broadband Internet service or electrical power supply, that customer will be unable to make or receive calls, including emergency calls, using our service. We also outsource several of our network functions to third-party providers. For example, we outsource the maintenance of our regional data connection points, which are the facilities at which our network interconnects with the public switched telephone network. If our third-party service providers fail to maintain these facilities properly, or fail to respond quickly to problems, our customers may experience service interruptions. We also outsource the development of several of our applications and features, and in some cases enter into license and support agreements with the applicable providers. If those providers seek to terminate our license and support agreements, we would need to find replacement providers, and our customers may experience service interruptions. In addition, our E-911 service is currently dependent upon a third-party provider. Interruptions in service from this vendor could cause failures in our customers' access to E-911 services. Finally, our service offerings that integrate with the public switched telephone network are wholly reliant on third party network service providers to originate and terminate substantially all of our calls to users of traditional telephone services. Interruptions in our service caused by third-party facilities or service providers have in the past caused and may in the future cause us to lose customers, or cause us to offer substantial customer credits, which could adversely affect our revenue and profitability. If interruptions adversely affect the perceived reliability of our service, we may have difficulty attracting new customers and our brand, reputation and growth will be negatively impacted.

Our emergency and E-911 calling services may expose us to significant liability.

Our emergency calling service and E-911 calling service are different from the corresponding services offered by traditional wireline telephone companies. These differences may lead to failures that would not occur for users of traditional telephony services. For example, providers of interconnected VoIP services, like us, must use components of both the wireline and wireless infrastructure in unique ways that can result in failure. Also, emergency services provided over the Internet can be adversely impacted by power outages and network congestion that do not necessarily have the same adverse impact on users of traditional telephone services. Emergency call centers may not be equipped with appropriate hardware or software to accurately process and respond to emergency calls received by consumers of interconnected VoIP services. Finally, users of nomadic interconnected VoIP services must manually update their location information, and failure to do so can result in dispatching of assistance to the wrong location. For these reasons, some of our customers do not receive emergency services in full compliance with the FCC rules. Any of these failures could result in enforcement action by the FCC, significant monetary penalties and restrictions on our ability to offer non-compliant services.

Third parties might infringe upon our proprietary technology.

We cannot assure you that the steps we have taken to protect our intellectual property rights will prevent misappropriation of our proprietary technology. To protect our rights to our intellectual property, we rely on a combination of trademarks and trade secret protection, confidentiality agreements and other contractual arrangements with our employees, affiliates, strategic partners and others. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our intellectual property rights. Effective trademark and trade secret protection may not be available in every country in which we offer or intend to offer our services. Failure to adequately protect our intellectual property could materially harm our brand, devalue our proprietary content and affect our ability to compete effectively. Further, defending our intellectual property rights could result in significant financial expenses and managerial resources.

Third parties may claim that our services infringe upon their intellectual property rights.

Third parties have asserted and may assert claims that we have violated a patent or infringed a copyright, trademark or other proprietary right belonging to them and subject us to expensive and disruptive litigation. In addition, we incorporate licensed third-party technology in some of our products and services. In these license agreements, the licensors have agreed to indemnify us with respect to any claim by a third party that the licensed software infringes any patent or other proprietary right so long as we have not made changes to the licensed software. We cannot assure you that these provisions will be adequate to protect us from infringement

claims. Any infringement claims and lawsuits, even if not meritorious, could be expensive and time consuming to defend; divert management's attention and resources; require us to redesign our products, if feasible; require us to pay royalties or enter into licensing agreements in order to obtain the right to use necessary technologies; and/or may materially disrupt the conduct of our business.

Risks Related to our Industry

Government regulation and legal uncertainties relating to IP telephony could harm our business.

Historically, voice communications services have been provided by regulated telecommunications common carriers. We offer voice communications to the public for international and domestic calls using IP telephony, and we do not operate as a licensed telecommunications common carrier in many jurisdictions based on specific regulatory classifications and recent regulatory decisions. However, the growth of IP telephony has led to close examination of its regulatory treatment in many jurisdictions, making the legal status of our services uncertain and subject to change as a result of future regulatory action, judicial decisions or legislation in any of the jurisdictions in which we operate. Established regulated telecommunications carriers have sought and may continue to seek regulatory actions to restrict the ability of companies such as ours to provide services or to increase the cost of providing such services.

Application of new regulatory restrictions or requirements to us could increase our costs of doing business and prevent us from delivering our services through our current arrangements. In such event, we would consider a variety of alternative arrangements for providing our services, including obtaining appropriate regulatory authorizations for our local network partners or ourselves, changing our service arrangements for a particular country or limiting our service offerings. Such regulations could limit our service offerings, raise our costs and restrict our pricing flexibility, and potentially limit our ability to compete effectively. Furthermore, regulations and laws that affect the growth of the Internet could hinder our ability to provide our services over the Internet.

Our international operations are also subject to regulatory risks, including the risk that regulations in some jurisdictions will prohibit us from providing our services (or our resellers from reselling our services) cost-effectively or at all, which could limit our growth. Currently, there are several countries where regulations prohibit us and our resellers from offering service. We cannot assure you that these conditions will not have a material effect on our revenues and growth in the future. In addition, because customers can use our services almost anywhere that a broadband Internet connection is available, including countries where providing VoIP services is illegal, the governments of those countries may attempt to assert jurisdiction over us, which could expose us to significant liability and regulation.

We may not be able to keep pace with rapid technological changes in the communications industry.

Our industry is subject to rapid technological change, and we cannot predict the effect of technological changes on our business. We expect that new services and technologies will emerge in the market in which we compete. These new services and technologies may be superior to the services and technologies that we use and/or may render our services and technologies obsolete.

To be successful, we must adapt to our rapidly changing market by continually improving and expanding the scope of services we offer and by developing new services and technologies to meet customer needs. Our success will depend, in part, on our ability to license leading technologies and respond to technological advances and emerging industry standards on a cost-effective and timely basis. We will need to spend significant amounts of capital to enhance and expand our services to keep pace with changing technologies.

The success of our business is affected by customers' unimpeded access to broadband service. Providers of broadband services may be able to block our services, which could adversely affect our revenue and growth.

A portion of our customers must have broadband access to the Internet in order to use our service. Some providers of broadband access have taken measures that affect their customers' ability to use our service, such as downgrading the quality of the data packets we transmit over their lines, giving those packets low priority, giving other packets higher priority than ours, blocking our packets entirely or attempting to charge their customers more for also using our services. It is not clear whether suppliers of broadband access services have a legal obligation to allow their customers to access and use our service without interference. As a result of recent decisions by the U.S. Supreme Court and the FCC, providers of broadband services are subject to relatively light regulation by the FCC. Consequently, federal and state regulators might not prohibit broadband providers from limiting their customers' access to VoIP or otherwise discriminating against VoIP providers. Interference with our service or higher charges for using our service could cause us to lose existing customers, impair our ability to attract new customers, and harm our revenue and growth.

The FCC's "open Internet" rules, which would partially address issues relating to blocking, impairing or downgrading our service by either fixed or wireless providers of broadband Internet access services, are not yet effective and, as a result of both legislative efforts to overturn the rules as well as potential appeals of the passage of the rules, it is unclear whether (and when) the

rules will become effective. While we are not aware of any provider of broadband Internet access attempting to interfere with our Internet access, the lack of enforceable rules could potentially negatively impact our service offerings and impede our ability to offer new services that require significant Internet bandwidth.

We are not currently accepting customers in areas where we cannot provide E-911 service in conformity with the FCC's rules. This has adversely impacted the ability of iConnectHere to accept new customers and may also have an adverse effect on our sales to customers who resell our service.

Various U.S. state and local fees, taxes and surcharges may increase our costs and our customers' cost of using our services.

Some state and local regulatory authorities claim that they retain jurisdiction to regulate the provision of, and impose taxes, fees and surcharges on, intrastate Internet and VoIP telephony services, and have attempted to impose such taxes, fees and surcharges, such as a fee for providing E-911 service. A recent FCC ruling allows states to require providers of interconnected VoIP services, like us, to contribute to state USF programs. While the decision did not address retroactive liability, there is a possibility that certain states will seek to impose retroactive application of any state USF obligations. We would likely pass through to our customers in those states any such state USF fees, potentially making our services less competitive with offerings available from traditional providers of telecommunications services, which may cause us to lose customers in those states. In addition, it is possible that we will be required to collect and remit taxes, fees and surcharges in other states and local jurisdictions, and which such authorities may take the position that we should have collected. If so, they may seek to collect those past taxes, fees and surcharges from us and impose fines, penalties or interest charges on us. Our payment of these past taxes, fees and surcharges, as well as penalties and interest charges, could have a material adverse effect on us.

We paid approximately \$150,000 of state and local taxes and other fees during 2011. To the extent we increase the cost of services to our customers to recoup some of the costs of compliance this will have the effect of decreasing any price advantage we may have over traditional telecommunications companies.

There may be risks associated with our ability to comply with funding requirements of the USF and similar state or federal funds as well as other FCC-mandated funding requirements or that our customers will cancel service due to the impact of these or other price increases to their service.

We began contributing to the USF during the fourth fiscal quarter of 2006 and began charging our customers a USF surcharge fee. In addition, we are required to collect and remit other FCC-related fees, such as the TRS fund and contributions towards local number portability, and the FCC and state public utilities commissions are considering subjecting interconnected VoIP providers like us to additional fees and surcharges. The impact of this price increase on our customers or our inability to recoup the costs or liabilities in remitting such fees as well as any future fees could have a material adverse effect on our financial position, results of operations and cash flows, or could cause some customers to cancel our service due to the loss of any price advantage we may have over traditional telecommunications companies.

Future legislation or regulation of our service offerings may increase our costs, which may result in either our increasing the retail price of our service offerings or reducing our profitability.

The FCC has several ongoing proceedings that could negatively impact us. Specifically, the FCC may reform the system of payments between companies that connect telephone companies and the methodology for contributing to the federal USF program. Such reforms may increase the charges we pay to other companies for handling our calls. The FCC may adopt more stringent E-911 obligations. This could result in us having to deploy new technologies or engage a third party to provide services in compliance with the new regulations, increasing our costs. The FCC may determine that some or all of our offerings are properly classified as "telecommunications" services subjecting our offerings to state and federal regulations, thereby increasing our compliance costs. The U.S. Congress, state legislatures, state regulatory commissions and foreign regulatory commissions could attempt to impose additional obligations on us at any time or reform existing law concerning the contribution methodology for regulatory fees and surcharges in a manner that negatively impacts us. We cannot predict the outcome of pending FCC proceedings or what actions such other governmental and regulatory bodies may take that may affect us.

Risks Related to our Relationship with D4 Holdings

D4 Holdings controls a majority of our common stock and has the ability to exercise control over all matters submitted to a stockholder vote.

D4 Holdings currently owns approximately 54.0% of the issued and outstanding shares of our common stock, holds warrants to purchase an aggregate of 35,000,000 shares of our common stock and can convert the principal outstanding under the Convertible Note into 20,000,000 shares of our common stock. Assuming the exercise of all warrants held by D4 Holdings and the conversion of

outstanding principal under the Convertible Note, D4 Holdings beneficially owns 73.9% of our common stock. As long as D4 Holdings continues to beneficially own more than 50% of the voting power of our company, D4 Holdings will be able to exercise a controlling influence over decisions affecting us, including:

- composition of our board of directors and, through it, our direction and policies, including the appointment and removal of our officers;
- potential mergers, acquisitions, sales of assets and other significant corporate transactions;
- future issuances of capital stock or other securities by us;
- incurrence of debt by us;
- amendments, waivers and modifications to any agreements between us and D4 Holdings;
- payment of dividends on our capital stock; and
- approval of our business plans and general business development.

In addition, this concentration of ownership may discourage, delay or prevent a change in control of our company, which could deprive our stockholders of an opportunity to receive a premium for their common stock as part of a sale of our company or result in strategic decisions that could negatively impact the value and liquidity of our outstanding stock. D4 Holdings also has sufficient voting power to amend our organizational documents. Furthermore, conflicts of interest could arise in the future between us and D4 Holdings concerning, among other things, potential competitive business activities or business opportunities. D4 Holdings is not restricted from competitive activities or investments. We cannot provide assurance that the interests of D4 Holdings will coincide with the interests of other holders of our common stock. Also, four of our six directors are affiliated with D4 Holdings. As a result, the ability of any of our other stockholders to influence the management of our company is limited, which could have an adverse effect on the market price of our stock.

The ownership of D4 Holdings includes owners of ACN, and we may engage in commercial transactions with ACN and its affiliated entities in the future.

D4 Holdings is a private investment fund whose ownership includes owners of ACN. Four of the members of our board of directors currently serve as officers and/or directors of ACN. Because ACN is a direct seller of telecommunications services, we may seek to engage in commercial transactions to provide services to ACN in the future. During the third quarter of 2009 we entered into an agreement with ACN Pacific Pty Ltd., a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP telecommunications services in Australia and New Zealand to ACN Pacific. In October 2010 we entered into a sales agency agreement with ACN pursuant to which ACN sells a private label version of joip Mobile under the ACN Mobile World brand. In December 2010 we entered into an agreement with ACN Korea, a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP services in Korea. In April 2011 we entered into an introducer agreement with ACN Europe B.V., a wholly-owned subsidiary of ACN, pursuant to which ACN Europe refers potential customers in different countries in Europe to a private label version of joip Mobile sold under the ACN Mobile World brand. Although we expect that the terms of any such transactions will be established based upon negotiations between employees of ACN and us and, when appropriate, subject to the approval of the independent directors on our board or a committee of disinterested directors, there can be no assurance the terms of any such transactions will be as favorable to us as might otherwise be obtained in arm's length negotiations.

As a result of D4 Holding's controlling interest in deltathree a third party may be deterred from attempting to acquire our company.

D4 Holding's controlling interest in deltathree could delay, deter or prevent a third party from attempting to acquire control of us. This may have the effect of discouraging a third party from making a tender offer or otherwise attempting to obtain control of us, even though such a change in ownership would be economically beneficial to us and our stockholders.

Our stockholders may suffer dilution in the future in the event that D4 Holdings exercises any of the warrants or its right to convert outstanding principal amounts under the Convertible Note into shares of our common stock.

D4 Holdings currently holds warrants to purchase an aggregate of 35,000,000 shares of our common stock at exercise prices ranging from \$0.04 per share to \$0.1312 per share and can convert the principal outstanding under the Convertible Note into 20,000,000 shares of our common stock. In the event that D4 Holdings exercises any or all of the warrants or converts principal amounts outstanding under the Convertible Note into shares of our common stock, in full or in part, our existing stockholders may experience significant and immediate dilution.

Risks Related to our Common Stock

Volatility of our stock price could adversely affect our stockholders.

From the time that trading commenced in our common stock in November 1999, the market price of our common stock has been highly volatile and may continue to be volatile and could be subject to wide fluctuations in response to factors such as:

- the market price for the stock of our major competitors;
- variations in our actual or anticipated quarterly operating results or those of our competitors;
- announcements by us or our competitors of technological innovations;
- introduction of new products or services by us or our competitors;
- announcements by us or our competitors of significant acquisitions;

- our entry into strategic partnerships or joint ventures; and
- purchases and sales of our common stock by D4 Holdings.

All of these factors are, in whole or part, beyond our control and may materially adversely affect the market price of our common stock regardless of our performance.

Investors may not be able to resell their shares of our common stock following periods of volatility because of the market's adverse reaction to such volatility. In addition, the market price for shares of telecommunications, Internet-related and technology companies has dramatically decreased. We cannot assure you that our common stock will trade at the same levels of other telecommunications or Internet stocks.

Our common stock is quoted on the OTCQB, which may increase the volatility of our stock and make it harder to sell shares of our stock.

Our common stock is quoted on the OTCQB, which tends to be a highly illiquid market. There is a greater chance of market volatility for securities that trade on the OTCQB (as opposed to a national exchange or quotation system), as a result of which stockholders may experience wide fluctuations and a depressed price in the market price of our securities. Thus, stockholders may be required to either sell our securities at a market price which is lower than their purchase price or to hold our securities for a longer period of time than they planned. Because our common stock falls under the definition of "penny stock," trading in our common stock may be limited because broker-dealers are required to provide their customers with disclosure documents prior to allowing them to participate in transactions involving our common stock. These rules impose additional sales practice requirements on broker-dealers that sell low-priced securities to persons other than established customers and institutional accredited investors; and require the delivery of a disclosure schedule explaining the nature and risks of the penny stock market. As a result, the ability or willingness of broker-dealers to sell or make a market in our common stock might decline, and stockholders could find it more difficult to sell their stock.

Risks Related to our Israel Operations

We may be negatively impacted by changes in political, military and/or economic conditions.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. A peace agreement between Israel and Egypt was signed in 1979 and a peace agreement between Israel and Jordan was signed in 1994. However, as of the date hereof Israel has not entered into any peace agreement with Syria or Lebanon.

Despite peace-related developments, certain countries, companies and organizations continue to participate in a boycott of Israeli firms. We do not believe that the boycott has had a material adverse effect on us, but there can be no assurance that restrictive laws, policies or practices directed towards Israel or Israeli-based businesses will not have an adverse impact on our business or financial condition in the future.

Our costs of operations have at times been affected by changes in the cost of our operations in Israel resulting from changes in the value of the Israeli shekel relative to the U.S. dollar. Recently, the weakening of the dollar relative to the shekel has significantly increased the costs of our Israeli operations, stated in U. S. dollars.

Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early- to mid-1980s, low foreign exchange reserves, fluctuations in world commodity prices and military conflicts. The Israeli Government has, for these and other reasons, intervened in the economy by utilizing, among other means, fiscal and monetary policies, import duties, foreign currency restrictions and control of wages, prices and exchange rates. The Israeli Government has periodically changed its policies in all these areas. Although we derive most of our revenues outside of Israel, a substantial portion of our expenses are incurred in Israel and are affected by economic conditions in the country.

All of these factors are, in whole or part, beyond our control and may materially adversely affect on our business, financial condition and operating results, or market price of our common stock regardless of our performance.

We may be negatively impacted by employees being called for army service.

Generally, all male adult citizens and permanent residents of Israel under the age of 41 are, unless exempt, obligated to perform up to 36 days of military reserve duty annually. Additionally, all such residents are subject to being called to active duty at any time under emergency circumstances. Furthermore, some of our officers and employees are currently obligated to perform annual reserve duty. While we have operated effectively under these requirements since we began operations, no assessment can be made as to the full impact of such requirements on our workforce or business if conditions should change, and no prediction can be made as to the effect on us of any expansion of such obligations.

ITEM 2. PROPERTIES

Until November 2011, we leased our executive offices at 224 West 35th Street, New York, N.Y. Since such time we have been renting our executive offices at 26 Avenue at Port Imperial, West New York, New Jersey, and storage and equipment space at 117 Central Avenue, Hackensack, New Jersey. We lease each of these facilities on a month-to-month basis. Rent expense, net, for 2011 was \$22,550.

Delta Three Israel Ltd., a wholly-owned subsidiary of the Company, leases an office that houses the Company's research and development facilities in Jerusalem, Israel. The term of the lease expires June 30, 2012, and we are currently seeking suitable new office space. Rent expense, net for our subsidiary for 2011 was \$163,200.

ITEM 3. LEGAL PROCEEDINGS

On August 31, 2010, the U.S. Department of Homeland Security, or the DHS, seized approximately \$176,000 held in our bank accounts in connection with its investigation into the activities of certain of our resellers. In subsequent conversations with the Assistant United States Attorney for the Eastern District of New York, or the U.S. Attorney, which is assisting the DHS in the investigation, we were informed that the government suspects that these resellers were engaged in money laundering activities. In addition, the U.S. Attorney stated that we had failed to file certain reports of cash payments under applicable law. We are opposing this seizure, and on October 12, 2010, we filed a petition with the DHS for the return of the money. On February 4, 2011, our petition was denied, and on February 22, 2011, we presented an offer of compromise. On November 1, 2011, we were notified by the DHS that our offer of compromise had been denied. On March 27, 2012, we signed a Stipulation of Settlement with the U.S. Customs and Border Protection, or the CBP, pursuant to which, amongst other things, we agreed to a forfeiture of the seized funds and the CBP agreed to return \$52,804 to us following completion of the forfeiture proceedings. In accordance with FASB Statement 5, "Loss Contingencies" [ASC 450-20], we accounted for the seizure as a loss contingency that is probable of occurrence and recognized a loss in the entire amount seized, and recognized the recovery of the amount to be returned to us as a reversal of the loss recognized.

On July 5, 2011, we received a notice from the New York City Department of Finance that claimed that we had not paid commercial rent tax required under the New York City Administrative Code from June 1998 through May 2008 for the two offices that we had leased during that time. The notice stated that we are obligated to pay the outstanding tax amounts, as well as significant interest and penalties that were assessed on the unpaid amounts as well as for the failure to file the applicable tax returns. On August 15, 2011, we filed a response contesting the assessment and/or attempting to negotiate a reduction in the amounts to be paid. The final outcome of this assessment and our negotiations with the New York City Department of Finance cannot be determined at this time. In the event that we are required to pay all or most of the amounts claimed by the New York City Department of Finance this would have a material adverse effect on our financial condition and liquidity. During 2011 we recorded \$300,000 as a provision for commercial rent tax.

We are not a party to any other material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which we are a party or of which any of our property is subject.

ITEM 4. (REMOVED AND RESERVED)

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is currently quoted and traded on the OTCQB under the symbol "DDDC". The quoting and trading of our common stock was transferred from The Nasdaq Capital Market to the OTC Bulletin Board on March 28, 2008. Beginning approximately April 2010, the market makers in our common stock began quoting and trading our common stock on the OTCQB in addition to the OTC Bulletin Board. In February 2011, all quoting and trading of our common stock on the OTC Bulletin Board ceased when the last of the market makers quoting and trading our common stock on the OTC Bulletin Board began doing so on the OTCQB.

The following table sets forth the high and low bid prices of our common stock for the periods indicated:

	<u>High</u>	<u>Low</u>
Year ended December 31, 2010		
First quarter	0.37	0.1
Second quarter	0.26	0.1
Third quarter	0.25	0.1
Fourth quarter	0.30	0.1
Year ended December 31, 2011		
First quarter	0.19	0.0
Second quarter	0.13	0.0
Third Quarter	0.09	0.0
Fourth Quarter	0.07	0.0
Year ending December 31, 2012		
First Quarter (through March 20, 2012)	0.05	0.0

Holder

As of March 20, 2012, we had 135 holders of record of the 72,273,525 outstanding shares of our common stock. This does not reflect persons or entities that hold their stock in nominee or "street" name through various brokerage firms.

Dividend Policy

We have never declared or paid any cash dividends on our capital stock, and do not anticipate paying any cash dividends on our capital stock in the foreseeable future. We currently intend to retain future earnings, if any, to finance our operations and to expand our business. Any future determination to pay cash dividends will be at the discretion of our board of directors and will be dependent upon our financial condition, operating results, capital requirements and other factors that our board of directors considers appropriate.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

ITEM 6. SELECTED FINANCIAL DATA

You should read the selected consolidated financial data together with our consolidated financial statements and related notes and the section of this Annual Report entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations." The selected financial data for each of the years in the three-year period ended December 31, 2011, and as of December 31, 2010 and 2011 is derived from our audited financial statements that have been included in this Annual Report. The selected financial data as of December 31, 2007, 2008 and 2009 and for the years ended December 31, 2007 and 2008 is derived from consolidated financial statements that have not been included in this Annual Report.

	<u>2007</u>	<u>2008</u>
Statement of Operations Data:		
Revenues	\$ 29,477	\$ 29,477
Costs and operating expenses:		
Cost of revenues	(21,107)	(21,107)
Research and development expenses	(4,669)	(4,669)
Selling and marketing expenses	(5,068)	(5,068)
General and administrative expenses	(2,952)	(2,952)
Depreciation and amortization	(2,644)	(2,644)
Write-off of goodwill	-	-
Write-off of intangible assets	(2,680)	(2,680)
Restructuring expenses	-	-
Deferred revenue restatement	-	-
Accrual for contingency	-	-
Accrual for commercial rent tax	-	-
Total costs and operating expenses	(39,120)	(39,120)
Loss from operations	(9,643)	(9,643)
Capital gain	-	-
Other non-operating income	13	13
Interest income, (expense) net	442	442
Income taxes	(126)	(126)
Net income (loss)	\$ (9,314)	\$ (9,314)
Net income (loss) per share – basic and diluted	\$ (0.29)	\$ (0.29)
Weighted average shares outstanding – basic and diluted	32,427	32,427

	<u>2007</u>	<u>2008</u>
Balance Sheet Data:		
Cash and cash equivalents	\$ 1,649	\$ 1,780
Short-term investments	5,883	3,125
Working capital (deficit)	4,522	(720)
Long-term investments	1,085	1,085
Total assets	17,299	4,850
Total stockholders' equity	12,024	5,425

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and the related notes thereto included elsewhere in this Annual Report. This discussion contains certain forward-looking statements that involve substantial risks and uncertainties. When used in this report, words such as "anticipate," "believe," "estimate," "expect," "target," "goal," "project," "intend," "plan," "believe," "seek," variations of such words and similar expressions as they relate to our management or us are intended to identify such forward-looking statements. Our actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in "Risk Factors" and other risks referenced from time to time in our filings with the SEC. Historical operating results are not necessarily indicative of the trends in operating results for any future period.

Overview

We are a global provider of integrated video and voice over Internet Protocol, or VoIP, telephony services, products, hosted solutions and infrastructure. We were founded in 1996 to capitalize on the growth of the Internet as a communications tool by commercially offering Internet Protocol, or IP, telephony services, or VoIP telephony. VoIP telephony is the real-time transmission of voice communications in the form of digitized "packets" of information over the Internet or a private network, similar to the way in which e-mail and other data is transmitted. While we began as primarily a low-cost alternative source of wholesale minutes for carriers around the world, we have evolved into an international provider of next generation communication services.

Today we support tens of thousands of active users around the globe through our service provider and reseller channel and our direct-to-consumer channel. We have built a privately-managed, state-of-the-art global telecommunications platform using IP technology and we offer a broad suite of private label VoIP products and services as well as a back-office platform. Our operations management tools include, among others: account provisioning; e-commerce-based payment processing systems; billing and account management; operations management; web development; network management; and customer care. Based on our customizable VoIP solutions, these customers can offer private label video and voice-over-IP services to their own customer bases under their own brand name, a "white-label" brand (in which no brand name is indicated and different customers can offer the same product), or the deltathree brand. At the same time, our direct-to-consumer channel includes our joip Mobile application (which is a new cellular phone application providing low cost mobile calls over 3G cellular networks as well as WiFi networks), iConnectHere offering (which provides VoIP products and services directly to consumers and small businesses online using the same primary platform) and our joip offering (which serves as the exclusive VoIP service provider embedded in the Globarange cordless phones of Panasonic Communications). We are able to provide our services at a cost per user that is generally lower than that charged by traditional service providers because we minimize our network costs by using efficient packet-switched technology and interconnecting to a wide variety of termination options, which allows us to benefit from pricing differences between vendors to the same termination points.

Prior to 1999, we focused on building a privately-managed, global network utilizing IP technology, and our business primarily consisted of carrying and transmitting traffic for communications carriers over our network. Beginning in 1999, we began to diversify our offerings by layering enhanced IP telephony services over our network. These enhanced services were targeted at consumers and were primarily accessible through our consumer website. During 2000, we began offering services on a co-branded or private-label basis to service providers and other businesses to assist them in diversifying their product offerings to their customer bases. In 2001, we continued to enhance our unique strengths through our pioneering work with the Session Initiation Protocol, or SIP, an Internet Engineering Task Force standard that has been embraced by industry leaders such as Microsoft and Cisco. These efforts culminated in the launch of our state-of-the-art SIP infrastructure, and in doing so we became the first major VoIP service provider to deploy an end-to-end SIP network and services. In recent years, we have continued our pioneering efforts in SIP and these efforts have yielded significant new releases.

In 2009 we began the process of expanding the suite of our communications offerings into the global video phone services market. In the third quarter of 2009 we entered into an agreement with ACN Pacific Pty Ltd., a wholly-owned subsidiary of ACN, Inc., or ACN, pursuant to which we provide digital video and voice-over-IP services in Australia and New Zealand to ACN Pacific. In December 2010 we entered into an agreement with ACN Korea, a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP services in Korea.

In 2010 we continued to update our network by adding a video mail feature to our video phone applications and launching our joip mobile application in July 2010. Following the launch of the mobile application, in October 2010 we entered into a sales

agency agreement with ACN pursuant to which ACN sells a private label version of joip Mobile under the ACN Mobile World brand in the United States and Canada. In addition, we offer the joip Mobile application on a white-label basis to other customers. Finally, we entered into affiliate agreements with different third parties pursuant to which such third parties refer potential subscribers to our joip Mobile application.

In April 2011 we entered into an introducer agreement with ACN Europe B.V., a wholly-owned subsidiary of ACN, pursuant to which ACN Europe refers potential customers in different countries in Europe to a private label version of joip Mobile sold under the ACN Mobile World brand. In November 2011 we entered into a service agreement with Momentis U.S. Corp., a multi-level marketing company, pursuant to which Momentis refers potential customers in North America to a co-branded offering of joip Mobile and other consumer VoIP products and services.

As a complement to the initiatives we have taken to attempt to organically expand our businesses, we have also evaluated opportunities for growth through strategic relationships. In February 2009 we consummated a transaction with D4 Holdings pursuant to which we sold to D4 Holdings an aggregate of 39,000,000 shares of our common stock and a warrant to purchase up to an additional 30,000,000 shares of our common stock. D4 Holdings is a private investment fund whose ownership includes owners of ACN, a direct seller of telecommunications services. As a result of the transactions with D4 Holdings, we expect to continue to seek opportunities to provide services to ACN and enter into other commercial transactions that give us access to ACN's international marketing and distribution capabilities.

From an operational standpoint, in 2011 we continued to focus our near-term strategy and market initiatives on growing our service provider and digital next generation communications offerings while still supporting our core VoIP reseller and direct-to-consumer business segments. We

Going forward, we expect to:

- actively market our products and services to those entities that wish to offer white-label digital next generation communications offerings;
- pursue a targeted strategy of identifying and evaluating appropriate strategic collaborations, such as potentially engaging in commercial transactions with ACN, that we hope will continue to expand and diversify our customer base;
- market and sell our direct-to-consumer products and services through affiliates and our affiliate program; and
- support and maintain our current reseller base, as we expect our revenue from this key channel will continue to represent a significant percentage of our total revenue in the foreseeable future.

Trends in Our Industry and Business

A number of factors in our industry and business have a significant effect on our results of operations and are important to an understanding of our financial statements. These trends include:

Overall Economic Factors: Our operations and earnings are affected by local, regional and global events or conditions that affect supply and demand for telecommunications products and services. These events or conditions are generally not predictable and include, among other things, general economic growth rates and the occurrence of economic recessions; changes in demographics, including population growth rates; and consumer preferences. Our strategy and execution focus is predicated on an assumption that these factors will continue to promote strong desire for the utilization of telephony products and services and that the cost and feature advantages of VoIP alternatives will not be negatively impacted by unforeseen changes in these factors.

Industry: The telecommunications industry is highly competitive. In recent years we have seen new sources of supply for our underlying infrastructure that have reduced our overall costs of operation, including both advances in telecommunications technology and advances in technology relating to telecommunications usage, and have enjoyed the benefits of competition among these suppliers for a relatively limited amount of viable customers. A key component of our competitive position, particularly given the number and range of competing communications products, is our ability to manage operating expenses successfully, which requires continuous management focus on reducing unit costs and improving efficiency.

Consumer Demand: There is significant competition within the traditional telecommunications marketplaces (landline and wireless) and also with other emerging next generation telecommunications providers, including IP telecommunications providers, in supplying the overall telecommunications needs of businesses and individual consumers.

A key component of our competitive position, particularly given the commodity-based nature of many of our products, is our ability to sell to a growing demand base for alternative communications products, in both the developed and developing global marketplace. Within the developed global marketplace, our ability to sell broadband video and voice-over-IP products and services is directly linked to the significant growth rate of broadband adoption, and we expect this trend to continue. We benefit from this trend

because our service requires a broadband Internet connection and our potential addressable market increases as broadband adoption increases. Within the developing areas of the world, our ability to sell alternative telephony products and services is linked to both the increasing baseline economic trends within these countries as well as the growing desire for individuals and businesses to communicate and do business outside of their own countries. We expect these trends to continue, and benefit from them because both the ability to afford long distance calls and the desire to make them increase as a result.

Political Factors: Our operations and earnings have been, and may in the future be, affected from time to time in varying degree by political instability, social unrest (including the recent social unrest in the Middle East) and by other political developments and laws and regulations, such as: telecommunications regulations; war, civil war, armed conflict, terrorism and other international conflicts; restrictions on production, imports and exports; price controls; tax increases and retroactive tax claims; expropriation of property; and cancellation of contract rights. Both the likelihood of such occurrences and their overall effect upon us vary greatly from country to country and are not predictable. At the same time, VoIP is becoming legal in more countries as governments seek to increase competition, and this helps us as service providers and resellers seek to meet their customers' telecommunications needs with newly available solutions. Both the likelihood of VoIP legalization and its overall effect upon us vary greatly from country to country and are not predictable.

Regulatory Factors: Our business has developed in an environment largely free from regulation. However, the United States and other countries have begun to examine how VoIP services should be regulated and to begin instituting such regulation, and a number of initiatives could have an impact on our business. These initiatives include the assertion of state regulatory and taxing authorities over us, FCC rulemaking regarding emergency calling services, the imposition of law-enforcement obligations like the Communications Assistance for Law Enforcement Act, referred to as "CALEA", marketing restrictions and data protection rules for Customer Proprietary Network Information, referred to as "CPNI", access to relay services for people with disabilities, local number portability, proposed reforms for the inter-carrier compensation system, and an ongoing generic rulemaking considering the classification of interconnected VoIP services under federal law. Complying with regulatory developments will impact our business by increasing our operating expenses, including legal fees, requiring us to make significant capital expenditures or increasing the taxes and regulatory fees we pay. We may impose additional fees on our customers in response to these increased expenses. This would have the effect of increasing our revenues per customer, but not our profitability, and increasing the cost of our services to our customers, which would have the effect of decreasing any price advantage we may have over traditional telecommunications companies.

Project Factors: In addition to the factors cited above, the advancement, cost and results of particular projects depend on the outcome of: negotiations with potential partners, governments, suppliers, customers or others; changes in operating conditions or costs; and the occurrence of unforeseen technical difficulties or enhancements. The likelihood of these items occurring and its overall positive or negative effect upon us vary greatly from project to project and are not predictable.

Risk Factors: See "Item 1A. Risk Factors" for a discussion of the impact of market risks, financial risks and other risks and uncertainties that we face.

Revenues

Our revenues are derived mainly from resellers, service providers, and direct consumers of our video and voice-over-IP products and services. All revenues are recognized at the time the services are performed. The provision of video and voice-over-IP products and services through our service provider and reseller channel accounted for approximately 89.7% and 75.4% of our total revenues in 2010 and 2011, respectively, while the provision of VoIP telephony through our direct-to-consumer channel accounted for approximately 8.8% and 23.3% of our total revenues in 2010 and 2011, respectively.

Costs and Operating Expenses

Costs and operating expenses consist of the following: cost of revenues; research and development expenses; selling and marketing expenses; general and administrative expenses; and depreciation and amortization.

Cost of revenues consist primarily of network, access, termination and transmission costs paid to carriers that we incur when providing services and fixed costs associated with leased transmission lines. The term of our contracts for leased transmission lines is generally one year or less, and either party can terminate with prior notice.

Research and development expenses consist primarily of costs associated with establishing our network and the initial testing of our services and compensation expenses of software developers involved in new product development and software maintenance. Since our inception, we have expensed all research and development costs in each of the periods in which they were incurred.

Selling and marketing expenses consist primarily of expenses associated with our direct sales force incurred to attract potential service provider, reseller, and corporate customers and advertising and promotional expenses incurred to attract potential consumer users to our direct-to-consumer divisions.

General and administrative expenses consist primarily of compensation and benefits for management, finance and administrative personnel, insurance premiums, occupancy costs, legal and accounting fees and other professional fees. Additionally, we incur expenses associated with our being a public company, including the costs of directors' and officers' insurance.

Depreciation and amortization consists of the depreciation calculated on our fixed assets for the fiscal year ended December 31, 2011.

We have not recorded any income tax benefit for net losses and credits incurred for any period from inception to December 31, 2011. The utilization of these losses and credits depends on our ability to generate taxable income in the future. Because of the uncertainty of our generating taxable income going forward, we have recorded a full valuation allowance with respect to these deferred assets.

Net Operating Losses

As of December 31, 2011, we had net operating losses, or NOLs, generated in the U.S. of approximately \$21.2 million. Our issuance of common stock to D4 Holdings in February 2009 constituted an “ownership change” as defined in Section 382 of the Internal Revenue Code. As a result, under Section 382 our ability to utilize NOLs generated in the U.S. prior to February 2009 (equal to approximately \$156 million) to offset any income we may generate in the future will be limited to approximately \$600,000 per year from February 2009. The NOLs will expire at various dates between 2011 and 2029 if not utilized. Our ability to utilize our remaining NOLs could be additionally reduced if we experience any further “ownership change,” as defined under Section 382.

Critical Accounting Policies

The SEC defines critical accounting policies as those that are, in management's view, most important to the portrayal of a company's financial condition and results of operations and most demanding on their calls on judgment, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. We believe our most critical accounting policies relate to:

Use of estimates: Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported and disclosed in the consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

On an ongoing basis, we evaluate our estimates, including those related to allowances for doubtful accounts receivable, the amortization of deferred revenue associated with customer accounts, the useful lives of property and equipment and the value of common stock, common stock options, and restricted stock for the purpose of determining stock-based compensation. We base our estimates on historical experience, available market information, appropriate valuation methodologies, including the Black Scholes option model and on various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Revenue recognition and deferred revenue: We record revenue from VoIP telephony services based on minutes (or fractions thereof) of customer usage. We record revenue from related services based on completion of the specific activities associated with the services. We record payments received in advance for prepaid services and services to be supplied under contractual agreements as deferred revenue until such related services are provided. We estimate the allowance for doubtful accounts by reviewing the status of significant past due receivables and analyzing historical bad debt trends and we then reduce accounts receivables by such allowance for doubtful accounts to expected net realizable value.

Long-lived assets: We assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant decrease in the market price of a long-lived asset;
- significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition;
- significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator;
- accumulation of costs significantly in excess of the amount originally expected for the acquisition of the long-lived asset;
- current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset; and
- current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

We determine the recoverability of long-lived assets based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Such estimation process is highly subjective and involves significant management judgment. Determination of impairment loss from long-lived assets to be disposed of is reported at the lower of carrying amount or fair value less costs to sell.

Results of Operations

The following table sets forth the statement of operations data presented as a percentage of revenues for the periods indicated:

	Year Ended December 31,		
	2009	2010	2011
Revenues:			
Total revenues	100.0%	100.0%	100.0%
Costs and operating expenses:			
Cost of revenues	84.9	79.0	69.2
Research and development expenses	2.4	10.4	14.2
Selling and marketing expenses	6.3	6.7	18.8
General and administrative expenses	18.5	16.4	11.5
Accrual for contingency	-	1.2	(0.1)
Accrual for commercial rent tax	-	-	2.8
Depreciation and amortization	4.7	2.4	1.7
Total costs and operating expenses	116.8	116.1	117.8
Loss from operations	(16.8)	(16.2)	(17.8)
Capital gain	0.5	-	-
Other non-operating income	-	-	-
Interest expense, net	(0.3)	(1.1)	(11.7)
Income taxes	(0.2)	(0.2)	(0.0)
Net income (loss)	(16.8)	(17.5)	(29.5)
	%	%	%

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Revenues

Revenues overall for 2011 decreased by approximately \$3.7 million, or 26%, to approximately \$10.5 million from approximately \$14.2 million in 2010. Revenues declined even though during this period the number of minutes carried by our network increased by approximately 15% from approximately 312 million minutes in 2010 to approximately 358 million minutes in 2011. This was due to a change in the relative mix of the destinations of the calls placed over our network, with a higher percentage of calls being made during 2011 to destinations for which we charge significantly lower rates than during 2011. This was caused, in large part, by the temporary cessation of services to our then-largest reseller beginning in February 2011, for which we terminated a large number of calls to higher-rate destinations. In September 2011, this reseller resumed operations and conducting business with our company, and has become a material customer of the company again beginning the fourth quarter of 2011.

Revenues generated by our reseller division decreased by approximately \$4.7 million, or 42%, to \$6.6 million for 2011 from \$11.3 million in 2010. This was primarily due to our then-largest reseller temporarily suspending its operations and conducting business with our company beginning in February 2011 due to the recent unrest in the Middle East and ongoing instability and operating difficulties caused by such unrest. In 2010, this customer generated revenues of approximately \$6.9 million, which accounted for approximately 48% of our annual gross revenues and in 2011 this customer generated revenues of approximately \$1.6 million, which accounted for approximately 15% of our annual gross revenues. At the time this reseller suspended its operations it owed us approximately \$196,000 for services we had rendered, and we recorded a provision of the entire outstanding amount for losses on accounts receivable. In September 2011, this reseller paid us \$50,000 towards the outstanding amount, and we reduced the provision for losses on accounts receivable for the three months ended September 30, 2011, by such amount. In the fourth quarter of 2011 this reseller paid us an additional \$146,000 towards the outstanding amount and we reversed the provision entirely.

This decrease in revenues was partially offset by an increase of approximately \$1.0 million in revenues generated by our largest reseller during 2011. Our two largest resellers accounted for approximately \$4.6 million, or approximately 70%, of the revenue

generated from our reseller division in 2011, which represented approximately 43% of our total revenue for 2011. By comparison, in 2010 our two largest resellers accounted for approximately \$8.7 million, or approximately 78%, of the revenue generated from our reseller division, or approximately 61% of our total revenue for 2010.

Revenues generated by our service provider division remained constant at approximately \$1.4 million for each of 2011 and 2010. Although revenues decreased due to the expiration of our service agreements with Market America in 2010, the termination of our agreement with Ojo Service, LLC in July 2011 and a decline in revenues generated from our agreement with Velocity Services, Inc, this was offset by increased revenues generated by our service agreements with ACN Pacific and ACN Korea.

Sales to direct consumers sharply increased by approximately \$1.2 million, or 92%, to approximately \$2.5 million in 2011 from approximately \$1.3 million in 2010. Revenues generated through our iConnectHere offering declined by approximately \$337,000 from approximately \$1.2 million for 2010 to approximately \$900,000 for 2011. This was offset by the revenues generated by our joip Mobile offering, which increased from 0 for 2010 to approximately \$1.4 million for 2011, primarily as a result of the sales agency agreement we entered into with ACN and the introducer agreement we entered into with ACN Europe. In addition, during the fourth quarter of 2011 we entered into a sales agreement with Momentis pursuant to which Momentis refers potential customers in North America to a co-branded offering of joip Mobile and other consumer VoIP products and services.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by approximately \$3.9 million, or 34.8%, from \$11.2 million in 2010 to \$7.3 million in 2011. Our network rent cost remained constant at approximately \$1.2 million in 2010 and 2011, while our termination costs decreased by 39.8% from \$9.3 million in 2010 to \$5.6 million in 2011. The main cause of the decrease in cost of revenues was the suspension of the operations of our then-largest reseller in the first quarter of 2011.

Research and development expenses. Research and development expenses remained constant at approximately \$1.5 million for each of 2010 and 2011.

Selling and marketing expenses. Selling and marketing expenses increased by approximately \$1.0 million, or 100%, to \$2.0 million in 2011 from \$1.0 million in 2010. The main reason for the increase was commissions accrued to be paid to ACN in connection with the ACN Mobile World offering.

General and administrative expenses. General and administrative expenses decreased by approximately \$1.1 million, or 47.8%, to \$1.2 million in 2011 from \$2.3 million in 2010. This was due primarily to a reversal of an accrual of \$706,000 for expected legal expenses and the reversal of an accrual for tax liability of \$158,000. Excluding these onetime expenses, our general and administrative expenses decreased by approximately \$245,000 during 2011, primarily due to a reduction in expenses for professional services.

Accrual for contingency. As discussed above under Item 3 - "Legal Proceedings", on August 31, 2010, the DHS seized approximately \$176,000 held in our bank accounts in connection with its investigation into the activities of certain of our resellers. In accordance with FASB Statement 5, "Loss Contingencies" [ASC 450-20], we accounted for the seizure as a loss contingency that is probable of occurrence and recognized a loss in the entire amount seized, and recognized the return of \$52,804 to us as a reversal of the loss recognized.

Accrual for commercial rent tax. During 2011 we recorded \$300,000 as a provision for commercial rent tax. As discussed above under Item 3 - "Legal Proceedings", on July 5, 2011, we received a notice from the New York City Department of Finance, or the Department, which claimed that we had not paid commercial rent tax, required under the New York City Administrative Code from June 1998 through May 2008 for the two offices that we had leased during that time. The notice stated that we are obligated to pay the outstanding tax amounts, as well as significant interest and penalties that were assessed on the unpaid amounts as well as for the failure to file the applicable tax returns.

Depreciation and amortization. Depreciation and amortization decreased by \$165,000, or 47.8%, from \$345,000 in 2010 to \$180,000 in 2011 due to a decline in the value of our fixed assets during this period.

Loss from Operations

Loss from operations decreased by approximately \$449,000, or 19.5%, from \$2.3 million in 2010 to \$1.9 million in 2011, due to the factors set forth above.

Interest Expense, Net

We recorded interest expense of approximately \$1.2 million in 2011 compared to \$162,000 in 2010. This was due primarily to interest accrued to be paid to D4 Holdings under our loan agreements with D4 Holdings in an amount equal to \$281,000, and the expense recorded for the warrant we issued to D4 Holdings in connection with the Second Loan Agreement and the warrant and Convertible Note we issued to D4 Holdings in connection with the Third Loan Agreement in an aggregate amount equal to \$768,000.

Income Taxes, Net

We recorded net income taxes of \$11,000 in 2011 compared to \$29,000 in 2010.

Net Loss

Net loss increased by approximately \$615,000, or 24.6%, from approximately \$2.5 million in 2010 to \$3.1 million in 2011, due to the foregoing factors.

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Revenues

Revenues for 2010 overall decreased by approximately \$4.8 million, or 25%, to approximately \$14.2 million from approximately \$19.0 million in 2009. Both our service provider and reseller channel and our direct-to-consumer channel were affected. Revenues from our service provider and reseller sales channels decreased approximately \$4.1 million, or 24%, from approximately \$16.8 million in 2009 to approximately \$12.7 million in 2010. Revenues from our direct-to-consumer channel decreased approximately \$0.7 million, or 36%, from approximately \$2.0 million in 2009 to approximately \$1.3 million in 2010.

Revenues generated by our reseller division decreased by approximately \$3.8 million, or 25%, to \$11.2 million for 2010 from \$15.0 million for 2009. This was largely due to the suspension of the operations of our then-largest reseller in the fourth quarter of 2009. In 2009, this customer generated revenues of approximately \$4.9 million, which accounted for approximately 25.8% of our annual gross revenues. The loss of revenue attributable to this customer had a material adverse effect on our financial condition and results of operations. Within the reseller business itself, our two largest resellers accounted for approximately \$8.7 million, or approximately 78%, of the revenue generated from our reseller division in 2010, which represented approximately 61% of our total revenue for 2010. By comparison, in 2009 our two largest resellers accounted for approximately \$9.2 million, or approximately 61%, of the revenue generated from our reseller division, which equaled approximately 48% of our total revenue for 2009. At the end of February 2011 our then-largest reseller temporarily suspended its operations and conducting business with our company due to the recent unrest in the Middle East and ongoing instability and operating difficulties. In September 2011, this reseller resumed operations and conducting business with our company, and has become a material customer of the company again beginning the fourth quarter of 2011.

Revenues generated by our service provider division decreased by approximately \$0.3 million, or 20%, to \$1.4 million for 2010 from \$1.8 million for 2009, largely due to the expiration of our service agreements with Verizon Communications and RCN Corporation in 2009 and with Market America in 2010 and a decline in revenues generated from our agreement with Velocity Services, Inc. This has been partially offset by revenues generated from our agreements signed in the second half of 2009 with ACN Pacific, pursuant to which we provide digital video and voice-over-IP services in Australia and New Zealand, and Ojo Service, pursuant to which we provide digital video and voice-over-IP services in the United States. WorldGate is majority-owned by WGI Investor LLC, which shares common majority ownership and a common manager with D4 Holdings. Additionally, in 2010 we signed a service agreement with ACN Korea pursuant to which we provide digital video and voice-over-IP services in Korea.

Sales to direct consumers decreased by approximately \$0.7 million, or 36%, to approximately \$1.3 million in 2010 from approximately \$2.0 million in 2009. The decrease in direct-to-consumer revenues was primarily due to a continued lack of investment on our part in our consumer division and an increasingly competitive VoIP market causing the rates we charge our customers to decline a decline in the rates we can charge our customers due to a competitive market for our VoIP services. In October 2010 we entered into a sales agency agreement with ACN pursuant to which ACN sells to our direct consumers a private label version of joip Mobile under the ACN Mobile World brand.

The number of minutes on our network utilized by our customers decreased by approximately 20% from approximately 390 million minutes in 2009 to approximately 312 million in 2010.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by \$4.9 million, or 30.4%, from \$16.1 million in 2009 to \$11.2 million in 2010. Our network rent cost decreased by 14.3% from \$1.4 million in 2009 to \$1.2 million in 2010 and our termination cost decreased by 27.9% from \$12.9 million in 2009 to \$9.3 million in 2010. The main reason for the decrease in cost of revenues was a

decrease in the amount of traffic being terminated over our network. In addition, due to a reallocation of our human resources and efforts towards more research and development work and a resulting adjustment of our cost allocation, cost of revenue decreased in 2010 by \$0.8 million. Also, during 2009 we incurred \$0.3 million in expenses for shipping devices to certain customers, and we did not incur any such expenses in 2010.

Research and development expenses. Research and development expenses increased by \$1.0 million, or 200%, from \$0.5 million in 2009 to \$1.5 million in 2010. The primary reason for the increase was the reallocation of our human resources and efforts towards more research and development work and resulting adjustment of our cost allocation discussed above, which caused an increase of \$0.9 million to our research and development expenses.

Selling and marketing expenses. Selling and marketing expenses decreased by \$0.2 million, or 16.6%, to \$1.0 million in 2010 from \$1.2 million in 2009. The main reason for the decrease was the termination of the employment of our Senior Vice President of Sales and Marketing in the beginning of 2010. During the second half of 2010 and the first quarter of 2011 we hired three new salespeople.

General and administrative expenses. General and administrative expenses decreased by \$1.2 million, or 34.3%, to \$2.3 million in 2010 from \$3.5 million in 2009, due primarily to \$1.0 million we recorded as litigation expenses during 2009 as well as a credit of \$0.4 million we recorded in 2009 for revaluation of a tax estimation that we had recorded in 2008. In addition, we recorded \$0.3 million as doubtful debts during 2009. Excluding the litigation expenses and the revaluation of the tax liability, our general and administrative expenses decreased by approximately \$0.2 million during 2010, mostly due to our incurring reduced expenses for professional services.

Accrual for contingency. As discussed above under Item 3 - "Legal Proceedings", on August 31, 2010, the DHS seized approximately \$176,000 held in our bank accounts in connection with its investigation into the activities of certain of our resellers. In accordance with FASB Statement 5, "Loss Contingencies" [ASC 450-20], we accounted for the seizure as a loss contingency that is probable of occurrence and recognized a loss in the entire amount seized, and recognized the recovery of the \$52,804 to be returned to us as a reversal of the loss recognized.

Depreciation and amortization. Depreciation and amortization decreased by \$0.6 million, or 50%, from \$0.9 million in 2009 to \$0.3 million in 2010 due to a significant decline in the value of our fixed assets during this period.

Loss from Operations

Loss from operations decreased by \$0.9 million, or 28%, from \$3.2 million in 2009 to \$2.3 million in 2010, due primarily to the decrease in costs and operating expenses (including selling and marketing expenses) and one-time general and administrative expenses recorded during 2009.

Interest Expense, Net

We recorded interest expense of \$162,000 in 2010 compared to \$72,000 in 2009, mostly due to interest paid to D4 Holdings under our loan agreements.

Income Taxes, Net

We paid net income taxes of \$29,000 in 2010 compared to \$34,000 in 2009.

Net Loss

Net loss decreased by \$0.7 million, or 22%, from \$3.2 million in 2009 to \$2.5 million in 2010, due to the foregoing factors.

Liquidity and Capital Resources

Since our inception in June 1996, we have incurred significant operating and net losses due in large part to the start-up and development of our operations and losses from operations. For the year ended December 31, 2011, our net loss from operations decreased by approximately \$449,000, or 19.5%, from approximately \$2.3 million in 2010 to \$1.9 million in 2011. To date, we have an accumulated deficit of approximately \$181 million.

As of December 31, 2011, we had cash and cash equivalents of approximately \$214,000 and restricted cash and short-term investments of approximately \$131,000, or a total of cash, cash equivalents and restricted cash of \$345,000, a decrease of approximately \$130,000 from December 31, 2010. The decrease in cash, restricted cash, and short and long term investments was primarily caused by the net cash used in operating activities during the year ended December 31, 2011, of approximately \$2.1 million. Our average monthly cash burn during 2011 was approximately \$175,000, and during the three months ended December 31, 2011, was approximately \$30,000.

Cash used in or provided by operating activities is net income adjusted for certain non-cash items and changes in assets and liabilities. We had negative cash flow from operating activities of approximately \$2.1 million during 2011 compared with negative

cash flow from operating activities of approximately \$3.1 million during 2010. The decrease in our cash generated from operating activities was primarily driven by an increase in our net loss of \$556,000, accrual for commercial rent tax of \$300,000, amortization related to convertible notes of \$768,000, and accumulated interest on a short-term loan of \$281,000, offset by a decrease in other current liabilities of \$549,000.

Net cash used in investing activities is generally driven by our capital expenditures and changes in our short and long-term investments. In 2011 and 2010 we expensed approximately \$117,000 and \$89,000, respectively, for the purchase of new equipment.

Financing cash flows have historically consisted primarily of payments of capital leases and proceeds from the exercise of options we have granted to our employees and directors. As discussed above under “Item 1. Business - Transactions with D4 Holdings”, in February 2009 we consummated a transaction with D4 Holdings pursuant to which we sold to D4 Holdings an aggregate of 39,000,000 shares of our common stock and a warrant to purchase up to an additional 30,000,000 shares of our common stock for an aggregate purchase price of \$1.2 million. In addition, on March 1, 2010, we and our subsidiaries entered into the First Loan Agreement with D4 Holdings pursuant to which D4 Holdings agreed to provide us and our subsidiaries a line of credit in a principal amount of \$1,200,000. On August 10, 2010, we and our subsidiaries entered into the Second Loan Agreement with D4 Holdings, pursuant to which D4 Holdings agreed to provide us and subsidiaries an additional line of credit in a principal amount of \$1,000,000. In connection with the Second Loan Agreement, we issued D4 Holdings a warrant to purchase up to 4,000,000 shares of our common stock at an exercise price of \$0.1312 per share. We have drawn down all amounts available to be borrowed under the two lines of credit. On March 2, 2011, we and our subsidiaries entered into the Third Loan Agreement with D4 Holdings, pursuant to which D4 Holdings agreed to provide us and its subsidiaries an additional line of credit in a principal amount of \$1,600,000. Pursuant to the terms of the Convertible Note issued by us in connection with the Third Loan Agreement, D4 Holdings may elect to convert all or any portion of the outstanding principal amount under the Convertible Note into that number of shares of the our common stock determined by dividing such principal amount by \$0.08 (as may be adjusted under the terms of the Convertible Note). Simultaneous with our entering into the Third Loan Agreement, D4 Holdings and we entered into an amendment of the First Loan Agreement, pursuant to which (among other things) the maturity date for repayment of principal under the First Loan Agreement was extended from March 1, 2011, to March 1, 2012, and then subsequently extended by oral agreement of the parties to July 1, 2012. In connection with the Third Loan Agreement, we issued D4 Holdings a warrant to purchase up to 1,000,000 shares of our common stock at an exercise price of \$0.096 per share. We have drawn down the aggregate principal amount available under the Third Loan Agreement, the principal amount of which can be converted by D4 Holdings into an aggregate of 20,000,000 shares of our common stock. On September 12, 2011, we and our subsidiaries entered into the Fourth Loan Agreement with D4 Holdings, pursuant to which D4 Holdings agreed to provide us and our subsidiaries an additional line of credit in a principal amount of \$300,000. As of December 31, 2011, we had received advances in the aggregate amount of \$200,000 from D4 Holdings pursuant to notices of borrowing under the Fourth Loan Agreement.

There were no options exercised by our employees or directors during the year ended December 31, 2011. During 2011 and 2010 we paid approximately \$7,000 and \$140,000 for capital leases, respectively.

As discussed above under “Item 3. – Legal Proceedings”, on August 31, 2010, the DHS seized approximately \$176,000 held in our bank accounts in connection with its investigation into the activities of certain of our resellers. We are opposing this seizure, and on October 12, 2010, we filed a petition with the DHS for the return of the money. On February 4, 2011, our petition was denied, and on February 22, 2011, we presented an offer of compromise. On November 1, 2011, we were notified by the DHS that our offer of compromise had been denied. On March 27, 2012, we signed a Stipulation of Settlement with the CBP pursuant to which, amongst other things, we agreed to a forfeiture of the seized funds and the CBP agreed to return \$52,804 to us following completion of the forfeiture proceedings. Our inability to access these funds has had a material impact on our cash position and liquidity. The loss of the seized funds that will not be returned to us may have a material adverse impact on our business, liquidity and financial condition.

On July 5, 2011, we received a notice from the New York City Department of Finance that claimed that we had not paid commercial rent tax required under the New York City Administrative Code from June 1998 through May 2008 for the two offices that we had leased during that time. The notice stated that we are obligated to pay the outstanding tax amounts, as well as significant interest and penalties that were assessed on the unpaid amounts as well as for the failure to file the applicable tax returns. On August 15, 2011, we filed a response contesting the assessment and/or attempting to negotiate a reduction in the amounts to be paid. The final outcome of this assessment and our negotiations with the New York City Department of Finance cannot be determined at this time. In the event that we are required to pay all or most of the amounts claimed by the New York City Department of Finance this would have a material adverse effect on our financial condition and liquidity. During 2011 we recorded \$300,000 as a provision for commercial rent tax.

We experience fluctuations in our cash cycle, as we generally make payments to our termination suppliers more frequently (often on a weekly basis) than we receive payments from our customers (often on a monthly basis). In the event one of our customers did not pay us, we would experience a direct loss of the amounts we had already paid to our termination suppliers. We maintain our free cash in accounts with major banks located in the United States, and generally do not invest such cash in short or long-term investments. As a way to try to offset our declining cash position we generally seek to extend payment terms to our suppliers other than our termination providers.

We have historically obtained our funding from our utilization of the remaining proceeds from our initial public offering, offset by positive or negative cash flow from our operations, and most recently from the sale of shares of our common stock to D4 Holdings in February 2009 and borrowings under our loan agreements with D4 Holdings. These proceeds are maintained as cash, restricted cash, and short and long term investments. We have sustained significant operating losses in recent periods, which have led to a significant reduction in our cash reserves.

As of December 31, 2011, we had negative working capital equal to approximately \$4.8 million as well as negative stockholders' equity equal to approximately \$4.4 million. We believe it is probable that we will continue to experience losses and increased negative working capital and negative stockholders' equity in the near future and will not be able to return to positive cash flow before we require additional cash (in addition to any further amounts we may borrow from D4 Holdings under the Fourth Loan Agreement) in the near term. We may experience difficulties accessing the equity and debt markets and raising additional capital, and there can be no assurance that we will be able to raise such additional capital on favorable terms or at all. If additional funds are raised through the issuance of equity securities, our existing stockholders will experience significant further dilution. Because of our significant losses to date and our limited tangible assets, we do not fit traditional credit lending criteria, which could make it difficult for us to obtain loans or to access the capital markets. If we issue additional equity or convertible debt securities to raise funds, the ownership percentage of our existing stockholders would be reduced and they may experience significant dilution. New investors may demand rights, preferences or privileges senior to those of existing holders of our common stock.

Due to the limited availability of additional loan advances under the Fourth Loan Agreement, we believe that, unless we are able to increase revenues and generate additional cash, our current cash and cash equivalents will not satisfy our current projected cash requirements beyond the foreseeable future. As a result, there is substantial doubt about our ability to continue as a going concern.

In addition, unless we are able to increase revenues and generate additional cash, based on currently projected cash flows we believe that we may be unable to pay future scheduled interest and/or principal payments under the various loan agreements with D4 Holdings as these obligations become due. In the event that were to occur, if D4 Holdings is not willing to waive compliance or otherwise modify our obligations such that we are able to avoid defaulting on such obligations, D4 Holdings could accelerate the maturity of our debts due to it. Further, because D4 Holdings has a lien on all of our assets to secure our obligations under the loan agreements, D4 Holdings could take actions under the loan agreements and seek to take possession of or sell our assets to satisfy our obligations thereunder. Any of these actions would likely have an immediate material adverse effect on our business, financial condition or results of operations.

Due to our ongoing losses and reduction in cash, we initiated restructuring activities beginning in the second quarter of 2011 in an effort to cut operating costs significantly and better align our operations with our current business model. In accordance with the restructuring, we instituted a reduction in force and decreased the number of full time employees from approximately 53 to 32, reduced the salaries of all remaining employees by five percent, and decreased non-material expenses as well as payments to be made to vendors and other third parties.

In view of our current cash resources, nondiscretionary expenses, debt and near term debt service obligations, we may begin to explore all strategic alternatives available to us, including, but not limited to, a sale or merger of our company, a sale of our assets, recapitalization, partnership, debt or equity financing, voluntary deregistration of our securities, financial reorganization, liquidation and/or ceasing operations. In the event that we require but are unable to secure additional funding, we may determine that it is in our best interests to voluntarily seek relief under Chapter 11 of the U.S. Bankruptcy Code. Seeking relief under the U.S. Bankruptcy Code, even if we are able to emerge quickly from Chapter 11 protection, could have a material adverse effect on the relationships between us and our existing and potential customers, employees, and others. Further, if we were unable to implement a successful plan of reorganization, we might be forced to liquidate under Chapter 7 of the U.S. Bankruptcy Code. There can be no assurance that exploration of strategic alternatives will result in our pursuing any particular transaction or, if we pursue any such transaction, that it will be completed.

Contractual Obligations and Commercial Commitments

The following table sets forth our future contractual obligations and commercial commitments in total, for each of the next five years and thereafter:

Contractual obligations	Payments due by period	
	Total	Less than 1 year
Real estate leases	884	174
Auto leases	210	131
Capital leases	-	-
Total	1,094	305

Off-Balance Sheet Arrangements

None.

Certain Factors That May Affect Future Results of Operations

The SEC encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions. This Annual Report contains such "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, as amended.

Words such as "may," "anticipate," "estimate," "expects," "projects," "intends," "plans," "believes" and words and terms of similar substance used in connection with any discussion of future operating or financial performance, identify forward-looking statements. All forward-looking statements are management's present expectations of future events and are subject to a number of risks and uncertainties that could cause actual results to differ materially and adversely from those described in the forward-looking statements. These risks include, but are not limited to, those set forth under the heading "Risk Factors" contained in Item 1A of this Annual Report.

In light of these assumptions, risks and uncertainties, the results and events discussed in the forward-looking statements contained in this Annual Report or in any document incorporated by reference might not occur. Stockholders are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report. We are not under any obligation, and we expressly disclaim any obligation, to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. All subsequent forward-looking statements attributable to deltathree or to any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Company's Consolidated Financial Statements required by this Item are set forth in Item 15 beginning on page 48 of this Annual Report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) *Evaluation of Disclosure Controls and Procedures.* Each of our principal executive officer and principal financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) as of the end of the period covered by this Annual Report, has concluded that, based on such evaluation, our disclosure controls and procedures were adequate and effective to ensure that material information required to be disclosed by us in the reports that we file and submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) *Management's Report on Internal Control over Financial Reporting.* Management is responsible for establishing and maintaining adequate internal control over financial reporting of the Company. We maintain internal control over financial reporting designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Therefore, internal control over financial reporting determined to be effective provides only reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, management has evaluated internal control over financial reporting by the Company using the framework for effective internal control established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011.

Based on this assessment, management concluded that internal controls over financial reporting were effective as of December 31, 2011. In connection with this assessment, no material weaknesses in the Company's internal control over financial reporting were identified by management. This Annual Report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting, as management's report is not subject to attestation by our registered public accounting firm pursuant to the rules of the SEC that permit us to provide only management's report in this Annual Report.

(c) *Changes in Internal Controls.* There were no changes in our internal control over financial reporting that occurred during the fourth quarter of 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Directors

Our Amended and Restated Certificate of Incorporation provides that a director shall hold office until the annual meeting for the year in which his or her term expires except in the case of elections to fill vacancies or newly created directorships. Each director is elected for a one-year term. Set forth below are the name, age and the positions and offices held by each of our current directors, his or her principal occupation, business experience and public company board experience during at least the past five years, and the experience, qualifications, attributes or skills that qualify such person to serve on our Board of Directors.

Robert Stevanovski, 48. Mr. Stevanovski has served as a director and Chairman of the Board since February 2009. He is one of the co-founders of ACN and has served as Chairman of ACN since its founding in 1993. Mr. Stevanovski has served as a director of WorldGate since April 2009. He is the brother of David Stevanovski, also a member of the Board. Mr. Robert Stevanovski's areas of relevant experience, qualifications, attributes or skills include sales and marketing expertise generally, extensive knowledge of the telecommunications and multi-level marketing industries, outside board experience with WorldGate and extensive business and management experience as co-founder and Chairman of ACN.

Anthony J. Cassara, 57. Mr. Cassara has served as a director since February 2009. Mr. Cassara founded and has served as President of Cassara Management Group, Inc., a privately held business counseling practice focused on the telecommunications industry, since October 2000. Prior to founding Cassara Management Group, Mr. Cassara was President of the Carrier Services division at Frontier Corporation and later at Global Crossing Ltd. from October 1999 to December 2000. Mr. Cassara served as a member of the board of directors of MPower Holding Corporation from May 2002 to August 2006; Teleglobe International Holdings Ltd. from February 2004 to February 2006; Eschelon Telecom Inc. from November 2002 to December 2004; and has served as a director of WorldGate since April 2009. Mr. Cassara's areas of relevant experience, qualifications, attributes or skills include telecommunications and information services; senior leadership roles in global telecommunications companies; public company board experience, corporate finance, and financial reporting.

David Stevanovski, 45. Mr. Stevanovski has served as a director since March 2009. He has served in a number of positions at ACN, and currently serves as Vice President. Mr. Stevanovski has served as a director of WorldGate since April 2009. Mr. Stevanovski is the brother of Robert Stevanovski. Mr. David Stevanovski's areas of relevant experience, qualifications, attributes or skills include sales and marketing expertise generally, extensive knowledge of the telecommunications and multi-level marketing industries, outside board experience with WorldGate, and extensive business and management experience at ACN.

Colleen R. Jones, 50. Ms. Jones has served as a director since February 2011. She has served as ACN's chief legal officer since 2003, and is presently its Executive Vice President, Global Counsel and Secretary. She has served as general counsel to D4 Holding since its formation in 2009. Ms. Jones has served as a director of WorldGate since February 2011. Ms. Jones has practiced law for over 25 years, serving as chief legal officer in corporations and as a partner at large international law firms. Her areas of relevant experience, qualifications, attributes or skills include legal expertise in general corporate and commercial domestic and international transactional work for both publicly- and privately-held companies, extensive knowledge of the telecommunications and technology sectors, management experience at ACN, and public company corporate governance.

Lior Samuelson, 63. Mr. Samuelson served as Chairman of the Board from January 2008 until February 2009, and has served as a director of deltathree since August 2001. Mr. Samuelson has served as the Chairman of the Board of Commtouch Software Ltd., a provider of internet security technology, since January 1, 2011, and as a director at Commtouch since August 2, 2010. Since August 1999, Mr. Samuelson has served as a Co-Founder and Principal of Mercator Capital, and served as a director of Mercator Partners Acquisition Corp. from January 2005 to December 2007. His experience includes advising clients in the technology, communications and consumer sectors on mergers, acquisitions and private placements. From March 1997 to August 1999, Mr. Samuelson was the President and Chief Executive Officer of PricewaterhouseCoopers Securities. Prior to that, he was the President and Chief Executive Officer of The Barents Group, a merchant bank specializing in advising and investing in companies in emerging markets. Mr. Samuelson was also the Co-Chairman of Peloton Holdings, a private equity management company. Before that, he was a managing partner with KPMG and a senior consultant at Booz, Allen & Hamilton. Mr. Samuelson's areas of relevant experience, qualifications, attributes or skills include extensive experience in finance and investment banking, public company board experience, financial reporting, and his long history of service to deltathree and knowledge of its operations.

J. Lyle Patrick, 59. Mr. Patrick has served as a director since March 2009. Mr. Patrick is currently a financial consultant and has served as chief financial officer of a number of telecommunications companies, including, most recently, First Communications, Inc., a provider of high-capacity metro and long-haul fiber network services as well as voice and data services across the Midwest and Mid-Atlantic United States, from March 2009 to December 2011, US LEC, a competitive telecommunications company, from June 2005 to March 2007, and MetroPCS, a wireless communications provider, from May 2004 to March 2005. Mr. Patrick is a Certified Public Accountant. Mr. Patrick's areas of relevant experience, qualifications, attributes or skills include extensive accounting for public companies, with particular experience in the telecommunications industry, and financial reporting.

Executive Officers and Key Employees

Set forth below is a brief description of the present and past business experience of each of the persons who currently serve as our executive officers or key employees.

Efraim Baruch, 36, Chief Executive Officer, President and Senior Vice President of Operations and Technology. In October 2010, Mr. Baruch became our Chief Executive Officer and President, having been named our interim Chief Executive Officer and President in December 2008. In January 2007, Mr. Baruch became our Senior Vice President of Operations and Technology. Mr. Baruch has been with deltathree since 1998. Mr. Baruch began working in deltathree as an engineer in the Network Operations Center, and soon after specialized in the management of data networks and security in our Wide Area Network department.

Yochai Ozeri, 35, Director of Finance and Treasurer. Prior to assuming the positions of Director of Finance and Treasurer in January 2012, Mr. Ozeri served as our Assistant Controller from July 2007 to March 2008, as Finance Manager from April 2008 to July 2009 and as Controller from August 2009 until the present. Prior to joining our company, Mr. Ozeri served as a senior auditor at Kost, Forer, Gabbay & Kasierer, a member firm of Ernst & Young International, in its technology practice group. Mr. Ozeri is a Certified Public Accountant.

Board of Directors and Committees of the Board

Our Amended and Restated Certificate of Incorporation provides that the number of members of our Board of Directors shall be not less than three and not more than thirteen. There are currently seven directors on the Board. At each annual meeting of stockholders, directors are elected to hold office for a term of one year and until their respective successors are elected and qualified.

The Board had four regular meetings during 2011. Each incumbent member of the Board participated in at least 75% of the aggregate of all Board and committee (for such committees on which the director served) meetings held during the period for which he was a director or member of such committee. None of our directors attended our 2011 Annual Stockholder Meeting. The Board has established an Audit Committee and a Compensation Committee. The functions of the committees and their current members are set forth below.

Director Nominations. Due to a decrease in the number of members of the Board after our 2006 Annual Stockholders Meeting, our Board members determined that it is efficient and important for each member to actively participate in all matters that were previously the responsibility of the Nominating and Governance Committee and dissolved the Nominating and Governance Committee as of September 11, 2006. As such, each of our Board members is expected to take part in, among other matters, the following nominating and governance-related matters:

- identifying and recommending qualified candidates for director, and recommending the director nominees for our annual meetings of stockholders;
- conducting an annual review of the Board's performance;
- recommending the director nominees for each of the Board committees; and
- developing and recommending our company's corporate governance guidelines.

Furthermore, our Board adopted a nominating and governance policy that was based on the former Nominating and Governance Committee Charter. This policy outlines our Board's goals, responsibilities, and procedures related to nominating and governance matters. In this regard, our Board may consider candidates recommended by stockholders as well as from other sources such as other directors or officers, third party search firms or other appropriate sources.

For all potential candidates, the Board considers a number of factors, such as the extent to which the candidate's knowledge and experience would fill a need in the Board and help complement the other directors, a candidate's personal integrity and sound judgment, independence, knowledge of the industry in which we operate, possible conflicts of interest, and concern for the long-term interests of our stockholders. In addition, although the Company does not have a formal policy regarding the consideration of diversity in identifying and evaluating potential director candidates, the Board will consider diversity in the context of the Board as a whole and takes into account the personal characteristics (gender, ethnicity and age), skills and experience, qualifications and background of current and prospective directors diversity as one factor in identifying and evaluating potential director candidates. In general, persons recommended by stockholders will be considered on the same basis as candidates from other sources. If a stockholder wishes to nominate a candidate to be considered for election as a director at our 2011 Annual Meeting of Stockholders using the procedures set forth in the Company's Amended and Restated By-laws, it must follow the procedures described under "Nomination of Directors" in our Amended and Restated By-laws. If a stockholder wishes simply to propose a candidate for consideration as a nominee by our Board, it should submit any pertinent information regarding the candidate to the Chairman of the Board by mail care of our Secretary at 26 Avenue at Port Imperial, Suite #108, West New York, New Jersey 07093.

Compensation Committee. The Compensation Committee is responsible for:

- evaluating our compensation policies;
- determining executive compensation, and establishing executive compensation policies and guidelines; and
- administering our stock option and compensation plans.

As part of these responsibilities, the Compensation Committee determines the compensation of our Chief Executive Officer, and conducts its decision making process with respect to this issue without the presence of the Chief Executive Officer. The Compensation Committee had one formal meeting and additional informal meetings and discussions during 2011. The Compensation Committee has a charter, a copy of which is available to our stockholders at the Corporate Governance section of our website located at www.deltathree.com. The Compensation Committee is composed of Lior Samuelson and J. Lyle Patrick.

Audit Committee. The Audit Committee is responsible for:

- recommending to the Board the appointment of the firm selected to serve as our independent auditors and monitoring the performance of such firm;
- reviewing and approving the scope of the annual audit and evaluating with the independent auditors our annual audit and annual financial statements;
- reviewing with management the status of internal accounting controls;
- evaluating issues having a potential financial impact on us which may be brought to the Audit Committee's attention by management, the independent auditors or the Board;
- evaluating our public financial reporting documents; and
- reviewing the non-audit services to be performed by the independent auditors, if any, and considering the effect of such performance on the auditor's independence.

The Audit Committee had six meetings during 2011. The Audit Committee has a charter, a copy of which is available to our stockholders at the Corporate Governance section of our website located at www.deltathree.com. The Audit Committee is composed of J. Lyle Patrick (Chairman) and Lior Samuelson. The Board of Directors has determined that Mr. Patrick meets the requirements of the applicable Securities and Exchange Commission rules for membership on the Audit Committee, including Rule 10A-3(b) under the Exchange Act and is "independent" as defined in Rule 5605(a)(2) of the Nasdaq Marketplace Rules. The Board has also determined that Mr. Patrick qualifies as an "audit committee financial expert" as defined in Item 407 of Regulation S-K.

As discussed below under "Director Independence", we are not currently subject to the Nasdaq continued listing requirements or the requirements of any other national securities exchange, including the independence requirements for audit committees. The Board of Directors has not reached an affirmative conclusion that Mr. Samuelson is "independent" as such term is described in the Nasdaq Marketplace Rules. However, the Board of Directors determined that his membership on the Audit Committee and Compensation Committee is in the best interest of the Company and its stockholders in light of his extensive experience in financial and related matters in our industry and the fact that each of the Audit Committee and Compensation Committee would otherwise be composed of only one member. In connection with his re-appointments to the Audit Committee and Compensation Committee on June 7, 2011, the Board waived the independence requirements set forth in the Audit Committee Charter and Compensation Committee Charter with respect to Mr. Samuelson.

Board Leadership Structure

The Board has no policy regarding the need to separate or combine the offices of Chairman of the Board and Chief Executive Officer and remains free to make this determination from time to time in a manner that the Board deems most appropriate for our company. Currently, we have separated the positions of CEO and Chairman of the Board in recognition of the differences between the two roles. The CEO is responsible for the day to day leadership and performance of the Company, while the Chairman of the Board (in collaboration with other members of the Board) sets the strategic direction of the Company, provides guidance to the management, sets the agenda for the Board meetings (in collaboration with the other members of the Board) and presides over meetings of the Board. We believe that separating these positions allows the Chairman of the Board to lead the board in its fundamental role of providing direction and guidance to management, while allowing our Chief Executive Officer to focus on our day-to-day operations. In addition, we believe that the current separation provides a more effective monitoring and objective evaluation of the performance of the CEO.

Risk Management

The Board is actively involved in the oversight and management of risks that could affect our company. This oversight and management is conducted primarily through committees of the Board, as disclosed in the descriptions of each of the committees above and in the charters of each of the committees, but the full Board has retained responsibility for general oversight of risks. The Board regularly receives reports from members of senior management on areas of material risk to the company, including operational, financial, regulatory and legal. The Audit Committee oversees management of financial risks (including liquidity and credit) and approves all transactions with related persons. The Compensation Committee is responsible for overseeing the management of risks relating to the Company's executive compensation plans and arrangements. The Board satisfies its oversight responsibility through full reports by each committee chair regarding the committee's considerations and actions, as well as through regular reports directly from officers responsible for oversight of particular risks within the Company.

Legal Proceedings

None.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires that the Company's directors, executive officers and persons who own more than 10% of the outstanding common stock of the Company file initial reports of ownership and reports of changes in ownership in such common stock with the SEC. Officers, directors and stockholders who own more than 10% of the outstanding common stock are required by the SEC to furnish the Company with copies of all Section 16(a) reports they file.

To our knowledge, based solely upon our review of the copies of such reports furnished to us, we believe that all of our directors, officers and holders of more than 10% of any class of our equity securities have complied with the applicable Section 16(a) reporting requirements.

Code of Conduct and Ethics

On March 25, 2004, we adopted a Corporate Code of Conduct and Ethics applicable to all employees and directors of deltathree, including our principal executive officer, principal financial and accounting officer and controller. There were no changes made to the Corporate Code of Conduct and Ethics during 2011. The text of the Corporate Code of Conduct and Ethics is posted on the Corporate Governance section of our website at www.deltathree.com and will be made available to stockholders without charge, upon request, in writing to the Secretary at 26 Avenue at Port Imperial, Suite #108, West New York, New Jersey 07093. We intend to post on our website any amendments to, or waivers from, our Code of Conduct and Ethics that apply to our principal executive officer, principal financial and accounting officer and controller. We have all of our new employees certify that they have read and understand our Corporate Code of Conduct and Ethics, and, periodically, we also ask our existing employees to certify that they have reviewed our Corporate Code of Conduct and Ethics.

ITEM 11. EXECUTIVE COMPENSATION

Summary Compensation Table

The following table shows the total compensation accrued during the fiscal years ended December 31, 2010 and 2011 to (1) all individuals who served as our Chief Executive Officer during any part of 2011 and (2) our next two most highly compensated executive officers whose total compensation exceeded \$100,000 during the fiscal year ended December 31, 2011. These executive officers are referred to in this Annual Report as our “named executive officers”.

Name and Principal Position	Year	Salary (\$)
Effi Baruch, <i>Chief Executive Officer, President and Senior Vice President of Operations and Technology (principal executive officer)</i>	2011	180,736
	2010	186,000
Arie Rand, <i>Former Chief Financial Officer and Treasurer (2)</i>	2011	131,424
	2010	33,126
Peter Friedman, <i>Former General Counsel and Secretary (3)</i>	2011	114,996
	2010	112,487

- (1) Represents the aggregate grant date fair value calculated in accordance with ASC 718-10 in connection with the issuance of the applicable restricted stock or restricted unit award or option award. For a detailed discussion of the assumptions made in the valuation of stock awards, please see the Notes to the Consolidated Financial Statements included in this Annual Report.
- (2) Mr. Rand resigned from the company effective January 13, 2012.
- (3) Mr. Friedman resigned from the company effective February 14, 2012.

Employment Agreement with Mr. Effi Baruch

We currently have an employment agreement with Mr. Baruch, our Chief Executive Officer, President and Senior Vice President of Operations and Technology. The agreement became effective on December 9, 2008, and was amended as of March 17, 2009, October 20, 2009, October 27, 2010, and August 17, 2011. Mr. Baruch receives a base salary of \$180,735.60 per year, which is adjusted as of January 15 each year (beginning 2011) by the percentage change in the Cost of Price Index during the preceding year. Mr. Baruch is entitled to receive an annual bonus under our then-applicable bonus plan equal to up to three (3) months' salary based on performance criteria that will be agreed upon by him and the Board of Directors. In the event of termination of the agreement, the terminating party is required to provide the other party 90 days' written notice unless the Company terminates the agreement for cause, in which case the Company is required to provide such written notice required by applicable law. In the event the Company terminates the agreement without cause, Mr. Baruch shall be entitled to receive a lump sum payment equal to his then-current monthly base salary multiplied by three, subject to Mr. Baruch executing a general release of all claims to the maximum extent permitted by law. However, if Mr. Baruch is offered and accepts employment in any other position with our company or any subsidiary or affiliate, we will not be required to make any such severance payment.

Outstanding Equity Awards at Fiscal Year-End

The following table shows certain information with respect to stock options and unvested stock awards outstanding as of December 31, 2011, for each of the named executive officers.

Name	Grant Date (1)	Number of Securities Underlying Unexercised Options (#) Exercisable
Effi Baruch	3/30/2008	25,000
	5/6/2009	6,667
	9/15/2009	25,000
	10/19/2010	8,250
	9/26/2011	8,250
Arie Rand	10/3/2010	75,000
	9/26/2011	75,000
Peter Friedman	3/30/2008	10,000
	5/6/2009	33,333
	9/15/2009	75,000
	10/19/2010	25,000
	9/26/2011	25,000

- (1) For a better understanding of this table, we have included an additional column showing the grant date of the stock options. Subject to the terms and conditions contained in any award agreement between the Company and the holder of any such award, in the event of a change of control of the Company the outstanding stock options granted under our 2009 Stock Incentive Plan or our Amended and Restated 2004 Stock Incentive Plan, as applicable, will not accelerate and become immediately vested and exercisable unless otherwise determined by the Compensation Committee.
- (2) Options to purchase 33,333 shares vested and became exercisable on each of May 6, 2010 and 2011, and options to purchase 33,333 shares vest and become exercisable on May 6, 2012.
- (3) Options to purchase 125,000 shares vested and became exercisable on each of September 15, 2010 and 2011, and options to purchase 125,000 shares vest and become exercisable on each of September 15, 2012 and 2013.
- (4) Options to purchase 81,250 shares vested and became exercisable on October 19, 2011, and options to purchase 81,250 shares vest and become exercisable on each of October 19, 2012, 2013 and 2014.
- (5) Options to purchase 125,000 shares vest and become exercisable on each of September 15, 2012, 2013, 2014 and 2015.
- (6) Options to purchase 75,000 shares vested and became exercisable on October 3, 2011.
- (7) Mr. Rand resigned from the Company effective January 13, 2012. All options to purchase shares of common stock previously granted to Mr. Rand that had not yet vested as of that date expired on that date, and all options that had vested as of that date will expire on April 11, 2012.
- (8) Mr. Friedman resigned from the Company effective February 14, 2012. All options to purchase shares of common stock previously granted to Mr. Friedman that had not yet vested as of that date expired on that date, and all options that had vested as of that date will expire on May 14, 2012.
- (9) Options to purchase 16,667 shares vested and become exercisable on each of May 6, 2010 and 2011.
- (10) Options to purchase 37,500 shares vested and became exercisable on September 15, 2010 and 2011.
- (11) Options to purchase 25,000 shares vested and became exercisable on October 19, 2011.

Director Compensation

The following table shows the total compensation earned for services performed for us by each member of our Board of Directors during the fiscal year ended December 31, 2011.

Name	Fees Earned or Paid in Cash (\$)	Stock Awards \$(1)
Robert Stevanovski	-(2)	
Anthony Cassara	20,000(3)	15,29
David Stevanovski	-(2)	
Gregory Provenzano(4)	-(2)	
Lior Samuelson	30,000(5)	15,29
J. Lyle Patrick	45,000(6)	15,29
Brian Fitzpatrick(7)	35,000(8)	
Colleen Jones(9)	16,964(10)	4,05

- (1) Represents the aggregate grant date fair value, calculated in accordance with ASC 718-10, of options to purchase 100,000 shares of the Common Stock granted to each of Lior Samuelson, Anthony Cassara, J. Lyle Patrick and Colleen Jones in 2011. All such options granted to Brian Fitzpatrick were cancelled upon his resignation from the Board of Directors effective November 14, 2011. The grants were made pursuant to the 2009 Stock Incentive Plan. Each of Robert Stevanovski and David Stevanovski elected to waive their right to receive such grant. For a detailed discussion of the assumptions made in the valuation of stock awards, please see the Notes to the Consolidated Financial Statements included in this Annual Report.
- (2) Each of Robert Stevanovski, David Stevanovski and Gregory Provenzano elected to waive their right to receive compensation for their services to the Company. Mr. Provenzano resigned as a director of the Company, effective February 23, 2011. This election is revocable by each of Messrs. R. Stevanovski and D. Stevanovski at any time.
- (3) Represents \$20,000 paid to Mr. Cassara for his services as a director.
- (4) Mr. Provenzano resigned from the Board of Directors effective February 23, 2011.
- (5) Represents \$20,000 paid to Mr. Samuelson for his services as a director, \$5,000 for his services as a member of the Audit Committee and \$5,000 for his services as a member of the Compensation Committee.
- (6) Represents \$20,000 paid to Mr. Patrick for his services as a director, \$20,000 for his services as Chairman of the Audit Committee and \$5,000 for his services as a member of the Compensation Committee.
- (7) Mr. Fitzpatrick resigned from the Board of Directors effective November 14, 2011.
- (8) Represents \$17,500 paid to Mr. Fitzpatrick for his services as a director, 13,125 for his services as Chairman of the Compensation Committee and \$4,375 for his services as a member of the Audit Committee through November 14, 2011.
- (9) Ms. Jones was elected to the Board of Directors effective February 23, 2011.
- (10) Represents \$16,964 paid to Ms. Jones for her services as a director beginning February 23, 2011.

Director Compensation Policy

In May 2009, the Board of Directors approved the following annual cash compensation for our directors effective as of April 1, 2009:

- each director receives cash compensation of \$20,000;
- the Chairman of the Audit Committee receives additional cash compensation of \$20,000;
- the Chairman of the Compensation Committee receives additional cash compensation of \$15,000; and
- each non-Chairman committee member receives additional cash compensation of \$5,000.

We reimburse each member of our Board of Directors for reasonable travel and other expenses in connection with attending meetings of the Board of Directors.

Each of our directors has the right to elect to convert the total cash compensation that such director is eligible to receive into shares of our common stock at the then-applicable market price. Directors have the right to make this election only during such times as the employees and directors of the Company are not in a black-out period in trading in securities of the Company and such director is not in possession of material, non-public information about the Company. Any such shares so acquired by a director are restricted and vest only after a period of one year from the date of grant, following which the director is able to sell such shares in accordance with Rule 144 under the Securities Act of 1933.

In September 2011, the Board of Directors approved a grant of options to purchase 100,000 shares of our Common Stock under the 2009 Plan to each of the members of the Board.

At this time each of Robert Stevanovski and David Stevanovski has elected to waive their right to receive compensation for their services to the Company. This election is revocable by each of Messrs. R. Stevanovski and D. Stevanovski at any time.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

As of March 20, 2012, there were 72,273,525 shares of our common stock issued and outstanding. Each share of common stock entitles the holder thereof to one vote with respect to each item to be voted on by holders of the shares of common stock. We have no other securities, voting or nonvoting, outstanding.

The following table sets forth information with respect to the beneficial ownership of shares of our common stock as of March 20, 2012, by:

- each person whom we know beneficially owns more than 5% of the common stock;
- each of our directors individually;
- each of our named executive officers individually; and
- all of our current directors and executive officers as a group.

Unless otherwise indicated, to our knowledge, all persons listed below have sole voting and investment power with respect to their shares of common stock. Each person listed below disclaims beneficial ownership of their shares, except to the extent of their pecuniary interests therein. Shares of common stock that an individual or group has the right to acquire within 60 days of March 20, 2012, pursuant to the exercise of options or the vesting of restricted stock or restricted units are deemed to be outstanding for the purpose of computing the percentage ownership of such person or group, but are not deemed outstanding for the purpose of calculating the percentage owned by any other person listed.

	<u>Number</u> <u>Shares of Common Stock</u>
Principal Stockholders:	
D4 Holdings, LLC (2)	94,000,000
Abraham Ziv-Tal (3) 4 Hanurit Street Rishpon, Israel 49615	9,954,100
Executive Officers and Directors:	
Effi Baruch (4)	521,667
Arie Rand (5)	75,000
Peter Friedman (6)	185,833
Robert Stevanovski (2)	94,000,000
Anthony Cassara (7) (8)	94,075,000
Lior Samuelson (9)	567,000
David Stevanovski (7)	94,000,000
J. Lyle Patrick (8)	75,000
Colleen Jones (10)	25,000
All directors and executive officers as a group (7 persons) (11)	95,083,667

* Less than 1%.

- (1) Percentage of beneficial ownership is based on 72,273,525 shares of common stock outstanding as of March 20, 2012.
- (2) Ownership is based on a Schedule 13D/A filed March 8, 2011, by D4 Holdings, Manna Holdings, LLC (“Manna Holdings”), Praescient, LLC (“Praescient”) and Robert Stevanovski and includes (a) 39,000,000 shares of common stock, (b) 35,000,000 shares of common stock issuable under warrants held by D4 Holdings and (c) 20,000,000 shares of common stock issuable upon conversion of outstanding principal under the Convertible Note held by D4 Holdings. For a description of the Convertible Note, see Part I, Item 1. “Business – Transactions with D4 Holdings.” Robert Stevanovski is the manager of Praescient, which serves as the sole manager of D4 Holdings and as the managing member of Manna Holdings. Manna Holdings is the sole member of D4 Holdings. As such, Mr. Stevanovski, Praescient and Manna Holdings may be deemed to beneficially own the securities reported in the table. Each of Mr. Stevanovski, Praescient and Manna Holdings disclaims beneficial ownership of such securities, and the information reported herein shall not be deemed an admission that such reporting person is the beneficial owner of the securities for any purpose, except to the extent of such person’s pecuniary interest therein.
- (3) Ownership is based on a Form 4 filed April 1, 2011.
- (4) Includes (a) options to purchase 466,667 shares of common stock and (b) 55,000 shares of common stock.
- (5) Includes options to purchase 75,000 shares of common stock.
- (6) Includes (a) options to purchase 170,833 shares of common stock and (b) 15,000 shares of common stock.
- (7) Includes the following securities: (a) 39,000,000 shares of common stock, (b) warrants to purchase 35,000,000 shares of common stock and (c) 20,000,000 shares of common stock issuable upon conversion of outstanding principal under the Convertible Note. Each of Anthony Cassara and David Stevanovski beneficially owns a membership interest in Manna Holdings, which is the sole member of D4 Holdings. As such, each of Messrs. Cassara and Stevanovski may be deemed to beneficially own the securities reported herein and owned directly by D4 Holdings. Each of Messrs. Cassara and Stevanovski disclaims beneficial ownership of such securities, and the information reported herein shall not be deemed an admission that such reporting person is the beneficial owner of the securities for any purpose, except to the extent of his pecuniary interest therein.
- (8) Includes options to purchase 75,000 shares of common stock.
- (9) Includes (a) options to purchase 415,000 shares of common stock and (b) 152,000 shares of common stock.
- (10) Includes options to purchase 25,000 shares of common stock.
- (11) Includes (a) 39,207,000 shares of common stock, (b) options to purchase 1,056,667 shares of common stock, (c) warrants to purchase 35,000,000 shares of common stock and (d) 20,000,000 shares of common stock issuable

upon conversion of outstanding principal under the Convertible Note held directly (or deemed to be beneficially owned) by all of our current directors and executive officers as a group.

Equity Compensation Plan Information

The following table provides certain aggregate information with respect to shares of our common stock that may be issued under our equity compensation plans in effect as of December 31, 2011.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	W pri
Equity compensation plans approved by security holders (1)	8,869,500	\$
Equity compensation plans not approved by security holders	N/A	
Total	8,869,500	\$

- (1) These plans consist of our Amended and Restated 2004 Stock Incentive Plan and Amended and Restated 2006 Non-Employee Director Stock Plan, which were terminated except with respect to outstanding options previously granted thereunder, and our 2009 Stock Incentive Plan.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Certain Relationships and Related Transactions

As described above under “Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters”, D4 Holdings beneficially owns an aggregate of approximately 73.9% of our common stock (which includes 39,000,000 shares of common stock, warrants to purchase 35,000,000 shares of our common stock, and 20,000,000 shares of common stock issuable upon conversion of outstanding principal under the Convertible Note. The ultimate ownership of D4 Holdings includes owners of ACN, Inc. Each of Robert Stevanovski, Anthony Cassara and David Stevanovski, members of the Company’s Board of Directors, is a principal of D4 Holdings. As a result, each of these individuals and D4 Holdings may be deemed to have a direct or indirect interest in the transactions contemplated by the Purchase Agreement and the Investor Rights Agreement, and the Loan Agreements, described above under “Item 1. Business - Transactions with D4 Holdings”.

During the third quarter of 2009 we entered into an agreement with ACN Pacific Pty Ltd., a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP telecommunications services in Australia and New Zealand to ACN Pacific. In October 2010 we entered into a sales agency agreement with ACN pursuant to which ACN sells a private label version of joip Mobile under the ACN Mobile World brand. In December 2010 we entered into an agreement with ACN Korea, a wholly-owned subsidiary of ACN, pursuant to which we provide digital video and voice-over-IP services in Korea. In April 2011 we entered into an introducer agreement with ACN Europe B.V., a wholly-owned subsidiary of ACN, pursuant to which ACN Europe refers potential customers in different countries in Europe to a private label version of joip Mobile sold under the ACN Mobile World brand. We recognized revenues of approximately \$950,000, \$130,000 and \$22,000 in 2010 from our agreements with ACN Pacific, Ojo Service and ACN Korea, respectively, and \$977,000, \$14,000, \$233,000, \$1,118,000 and \$272,000 in 2011 from our agreements with ACN Pacific, Ojo Service, ACN Korea, ACN and ACN Europe, respectively. Each of Robert Stevanovski, Anthony Cassara and David Stevanovski has an ownership interest in, and a director, officer and/or advisory position with, ACN. As a result of their relationship with ACN, each of these individuals may be deemed to have a direct or indirect interest in the transactions contemplated by our agreements with ACN and ACN Korea.

All transactions between us and our officers, directors, principal stockholders and affiliates must be reviewed and approved in advance by the Audit Committee. To the extent that any member of the Audit Committee has an interest in any such transaction, the member will recuse himself from considering and voting on the matter.

Director Independence

Our common stock is currently quoted on the OTCQB and is not listed on the Nasdaq Stock Market or any other national securities exchange. Accordingly, we are not currently subject to the Nasdaq continued listing requirements or the requirements of any other national securities exchange. Nevertheless, in determining whether a director or nominee for director should be considered “independent” the board utilizes the definition of independence set forth in Rule 5605(a)(2) of the Nasdaq Marketplace Rules. The board has determined that J. Lyle Patrick qualifies as “independent” under this rule.

Our company also would qualify as a “controlled company” under Rule 5615(c)(2) of the Nasdaq Marketplace Rules because D4 Holdings holds more than 50% of the voting power of our company. Accordingly, we would have the option to be exempt from the requirements under Rule 5605 to have:

- a majority of independent directors;
- a compensation committee composed solely of independent directors;
- compensation of our executive officers determined by a majority of independent directors or a compensation committee composed solely of independent directors;
- a nominating committee composed solely of independent directors; and
- director nominees selected, or recommended for the Board's selection, either by a majority of the independent directors or a nominating committee composed solely of independent directors.

Because we are not currently subject to the Nasdaq continued listing requirements we have not determined to what extent we would rely on the “controlled company” exemption from any of the foregoing requirements if we were subject to these requirements.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The following table presents fees for professional audit services rendered by Brightman Almagor Zohar & Co. for the audit of the Company's annual financial statements for the years ended December 31, 2010 and 2011, and fees billed for other services rendered by Brightman Almagor Zohar & Co. during those periods.

	2011	2010
Audit fees	\$ 71,000	\$ 71,000
Audit-related fees	-	-
Tax fees	-	2,500
All other fees	-	-
Total	<u>\$ 71,000</u>	<u>\$ 73,500</u>

In the above table, in accordance with the SEC’s definitions and rules, “audit fees” are fees we paid Brightman Almagor Zohar & Co. for professional services for the audit of our annual financial statements and review of financial statements included in our quarterly reports filed with the SEC, as well as for work generally only the independent auditor can reasonably be expected to provide, such as statutory audits and consultation regarding financial accounting and/or reporting standards; “audit-related fees” are fees billed by Brightman Almagor Zohar & Co. for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements; “tax fees” are fees for tax compliance, tax advice and tax planning; and “all other fees” are fees billed by Brightman Almagor Zohar & Co. for any services not included in the first three categories.

Policy on Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Auditors

Consistent with SEC policies regarding auditor independence, the Audit Committee has responsibility for appointing, setting compensation and overseeing the work of the independent auditor. In recognition of this responsibility, the Audit Committee has established a policy to pre-approve all audit and permissible non-audit services provided by the independent auditor.

Prior to engagement of the independent auditor for the next year's audit, management will submit an aggregate of services expected to be rendered during that year for each of four categories of services to the Audit Committee for approval.

1. **Audit** services include audit work performed in the preparation of financial statements, as well as work that generally only the independent auditor can reasonably be expected to provide, including comfort letters, statutory audits, and attest services and consultation regarding financial accounting and/or reporting standards.

2. **Audit-related** services are for assurance and related services that are traditionally performed by the independent auditor, including due diligence related to mergers and acquisitions, employee benefit plan audits, and special procedures required to meet certain regulatory requirements.

3. **Tax** services include all services performed by the independent auditor's tax personnel except those services specifically related to the audit of the financial statements, and includes fees in the areas of tax compliance, tax planning, and tax advice.

4. **Other** services are those associated with services not captured in the other categories. The Company generally does not request such services from the independent auditor.

Prior to engagement, the Audit Committee pre-approves these services by category of service. The fees are budgeted and the Audit Committee requires the independent auditor and management to report actual fees versus the budget periodically throughout the year by category of service. During the year, circumstances may arise when it may become necessary to engage the independent auditor for additional services not contemplated in the original pre-approval. In those instances, the Audit Committee requires specific pre-approval before engaging the independent auditor.

The Audit Committee may delegate pre-approval authority to one or more of its members. The member to whom such authority is delegated must report, for informational purposes only, any pre-approval decisions to the Audit Committee at its next scheduled meeting.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements.

The Consolidated Financial Statements filed as part of this Annual Report are identified in the Index to Consolidated Financial Statements on page F-1 hereto.

(a)(2) Financial Statement Schedules.

Financial Statement Schedules have been omitted because the information required to be set forth therein is not applicable or is shown on the financial statements or notes thereto.

(a)(3) Exhibits.

We hereby file, as exhibits to this Annual Report, those exhibits listed on the Exhibit Index immediately following the signature page hereto.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, on March 28, 2012.

DELTATHREE, INC.

By: /s/ Effi Baruch

Effi Baruch
Chief Executive Officer, President and Senior Vice
President of Operations and Technology
(Principal Executive Officer)

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Effi Baruch his true and lawful attorney-in-fact, acting alone, with full power of substitution, for and in the name, place and stead of the undersigned, in any and all capacities to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, and hereby grants to such attorney-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done, as fully to all intents and purposes as the undersigned might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent or his substitutes, may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	
<u>/s/ Effi Baruch</u> Effi Baruch	Chief Executive Officer, President and Senior Vice President of Operations and Technology (Principal Executive Officer)
<u>/s/ Yochai Ozeri</u> Yochai Ozeri	Director and Treasurer (Principal Financial Officer and Principal Accounting Officer)
<u>/s/ Robert Stevanovski</u> Robert Stevanovski	Chairman of the Board of Directors
<u>/s/ Anthony Cassara</u> Anthony Cassara	Director
<u>/s/ David Stevanovski</u> David Stevanovski	Director
<u>/s/ Colleen Jones</u> Colleen Jones	Director
<u>/s/ Lior Samuelson</u> Lior Samuelson	Director
<u>/s/ J. Lyle Patrick</u> J. Lyle Patrick	Director

EXHIBIT INDEX

The following documents are filed as exhibits to this Annual Report on Form 10-K or incorporated by reference to exhibits previously filed with the Securities and Exchange Commission.

Exhibit Number	Description
3.1	Form of the Company's Annual Report on Schedule 14A filed
3.2	Form of the Company's Annual Report on Schedule 14A filed Form S-1 (Registration No. 333-122222)
3.3	Certificate of Amendment to the Articles of Incorporation, incorporated by reference from our Quarterly Report on Form 10-Q filed on September 12, 2011
4.1	Specimen Certificate of Conversion, incorporated by reference from our Quarterly Report on Form 10-Q filed on September 12, 2011 (Registration No. 333-122222)
4.2	Convertible Promissory Note, dated September 12, 2011, of D4 Holdings, LLC in favor of D4 Holdings, LLC, incorporated by reference from our Quarterly Report on Form 10-Q filed on September 12, 2011 (Registration No. 333-122222)
4.3	Promissory Note, dated September 12, 2011, of D4 Holdings, LLC in favor of D4 Holdings, LLC, incorporated by reference from our Quarterly Report on Form 10-Q filed on September 12, 2011 (Registration No. 333-122222)
10.1	2004 Non-Employee Director Compensation Policy, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2009 (Registration No. 333-122222)
10.2	First Amendment to the deltatree, Inc. 2009 Stock Incentive Plan, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222)
10.3	Form of Option Agreement, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222)
10.4	deltathree, Inc. Amended and Restated Certificate of Incorporation, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222)
10.5	deltathree, Inc. Amended and Restated Definitive Proxy Statement, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222)
10.6	Form of Option Agreement, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222)
10.7	Form of Restricted Unit Agreement, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222)
10.8	deltathree, Inc. 2009 Stock Incentive Plan, incorporated by reference from our Annual Report on Form 10-K filed on March 3, 2010 (Registration No. 333-122222) (14A filed on June 22, 2009)
10.9	Form of deltatree, Inc. 2009 Stock Incentive Plan, incorporated by reference from our Quarterly Report on Form 10-Q filed on September 12, 2011 (Registration No. 333-122222)

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10.20

10.21*

21.1*

23.1*

31.1*

31.2*

32.1*

32.2*

101.INS*

101.SCH*

101.CAL*

101.DEF*

101.LAB*

101.PRE*

* Filed herewith.

+ Indicates management contract or compensatory plan, contract or arrangement.

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that the Company specifically incorporates such information by reference.

Index to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets as of December 31, 2011 and 2010	F-3
Consolidated Statements of Operations for the years ended December 31, 2011, 2010 and 2009	F-4
Statements of Stockholders' Deficiency for the years ended December 31, 2011, 2010 and 2009	F-5
Consolidated Statements of Cash Flows for the years ended December 31, 2011, 2010 and 2009	F-6
Notes to Consolidated Financial Statements	F-7



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
To the Shareholders of
DELTATHREE, INC.

We have audited the accompanying consolidated balance sheets of deltathree, Inc. ("the Company") and its subsidiary as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders' deficiency and cash flows for each of the three years in the period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements, present fairly, in all material respects, the financial position of the Company and its subsidiary as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company's recurring losses from operations and deficiency in stockholders' equity raise substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also discussed in Note 1 to the financial statements. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Brightman Almagor Zohar & Co.

Brightman Almagor Zohar & Co.

Certified Public Accountants

A member firm of Deloitte Touche Tohmatsu Limited

Tel Aviv, Israel
March 28, 2012

TEL AVIV - MAIN OFFICE	RAMAT GAN	JERUSALEM	HAIFA	BEER SHEVA	EILAT
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DELTATHREE , INC.
CONSOLIDATED BALANCE SHEETS
(\$ in thousands)

	<u>December 31,</u>	
	<u>2011</u>	<u>2010</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 214	\$ 308
Restricted cash and short-term investments (Note 3)	131	167
Accounts receivable, net (Note 4)	415	812
Prepaid expenses and other current assets (Note 5)	445	406
Inventory	46	25
Total current assets	<u>1,251</u>	<u>1,718</u>
Property and equipment, net (Note 6)	<u>335</u>	<u>398</u>
Deposits	<u>78</u>	<u>80</u>
Total assets	<u>\$ 1,664</u>	<u>\$ 2,196</u>
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
Current liabilities:		
Current portion of capital leases	\$ -	\$ 7
Accounts payable	1,469	1,554
Deferred revenues	522	659
Short-term loan from a related party (Note 2(w))	3,133	1,900
Other current liabilities (Note 7)	830	1,484
Total current liabilities	<u>5,954</u>	<u>5,604</u>
Long-term liabilities:		
Severance pay obligations (Note 8)	112	152
Total current liabilities	<u>112</u>	<u>152</u>
Total liabilities	<u>6,066</u>	<u>5,756</u>
Commitments and contingencies (Note 9)		
Stockholders' deficiency (Note 10):		
Share capital:		
Common stock, par value \$0.001 per share; authorized 225,000,000 shares; issued and outstanding: 72,273,525 at December 31, 2011, and 72,243,971 at December 31, 2010.	72	72
Additional paid-in capital	176,893	174,684
Accumulated deficit	(181,367)	(178,316)
Total stockholders' deficiency	<u>(4,402)</u>	<u>(3,560)</u>
Total liabilities and stockholders' deficiency	<u>\$ 1,664</u>	<u>\$ 2,196</u>

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

DELTATHREE , INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(\$ in thousands, except share and per share data)

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Revenues:	\$ 10,535	\$ 14,200	\$ 19,002
Costs and operating expenses:			
Cost of revenues (exclusive of \$123, \$242 and \$536 depreciation included in a separate line below, respectively)	7,288	11,220	16,127
Research and development expenses (Note 11)	1,492	1,483	464
Selling and marketing expenses	1,970	958	1,201
General and administrative expenses	1,213	2,322	3,514
Accrual for (recovery of) contingency	(53)	176	-
Accrual for commercial rent tax	300	-	-
Depreciation and amortization	180	345	890
Total costs and operating expenses	<u>12,390</u>	<u>16,504</u>	<u>22,196</u>
Loss from operations	(1,855)	(2,304)	(3,194)
Capital gain	-	-	86
Other non-operating income	-	-	15
Interest expense, net (Note 12)	(1,185)	(162)	(72)
Loss before income taxes	(3,040)	(2,466)	(3,165)
Income taxes (Note 13)	11	29	34
Net loss	<u>\$ (3,051)</u>	<u>\$ (2,495)</u>	<u>\$ (3,199)</u>
Net loss per share-basic and diluted	<u>\$ (0.04)</u>	<u>\$ (0.03)</u>	<u>\$ (0.05)</u>
Basic and diluted weighted average number of shares outstanding	<u>72,273,525</u>	<u>72,231,942</u>	<u>67,877,743</u>

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

DELTATHREE, INC.
STATEMENTS OF STOCKHOLDERS' DEFICIENCY
(\$ in thousands, except share data)

	<u>Common Stock</u>		Additional	Accumulated	Total
	Number of	Amount			
	Outstanding		Paid-in	Deficit	Stockholders'
	<u>Shares</u>		<u>Capital</u>		<u>Deficiency</u>
Balance at January 1, 2009	32,870,105	33	173,137	(172,622)	548
Issuance of shares to D4 Holdings	39,000,000	39	1,031		1,070
Vesting of restricted shares	5,600	-*			
Exercise of options	154,800	-*	14		14
Stock-based compensation			142		142
Loss for the year				(3,199)	(3,199)
Balance at December 31, 2009	<u>72,030,505</u>	<u>72</u>	<u>174,324</u>	<u>(175,821)</u>	<u>(1,425)</u>
Retirement of restricted shares	(33,508)	-*			-
Vesting of restricted shares	246,974	-*			-
Exercise of options	-	-			-
Stock-based compensation			360		360
Loss for the year				(2,495)	(2,495)
Balance at December 31, 2010	<u>72,243,971</u>	<u>72</u>	<u>174,684</u>	<u>(178,316)</u>	<u>(3,560)</u>
Vesting of restricted shares	29,554	-*			
Issuance of debt containing beneficial conversion feature			1,916		1,916
Stock-based compensation			293		293
Loss for the year				(3,051)	(3,051)
Balance at December 31, 2011	<u><u>72,273,525</u></u>	<u><u>72</u></u>	<u><u>176,893</u></u>	<u><u>(181,367)</u></u>	<u><u>(4,402)</u></u>

* Less than \$1.

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

DELTATHREE , INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(\$ in thousands)

	Year ended	
	2011	2010
Cash flows from operating activities:		
Net loss	\$ (3,051)	\$ 2,106
Adjustments to reconcile net loss to net cash (used in) operating activities:		
Accumulated interest on short-term loan	281	-
Depreciation and amortization	180	-
Amortization related to convertible notes	768	-
Write-off of office equipment	-	-
Write-off of long-term deposits	-	-
Tax provision	(158)	-
Stock-based compensation	293	-
Capital gain, net	-	-
Liability for severance pay, net	(40)	-
Provision for losses on accounts receivable	-	-
Exchange rates differences on deposits, net	2	-
Accrual for commercial rent tax	300	-
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable	397	-
(Increase) decrease in prepaid expenses other current assets	(39)	-
(Increase) decrease in inventory	(21)	-
(Decrease) increase in accounts payable	(85)	-
(Decrease) increase in deferred revenues	(137)	-
(Decrease) increase in other current liabilities	(796)	-
	<u>945</u>	<u>2,106</u>
Net cash (used in) operating activities	<u>(2,106)</u>	<u>2,106</u>
Cash flows from investing activities:		
Purchase of property and equipment	(117)	-
Proceeds from sale of property and equipment	-	-
Decrease (increase) in short-term investments	6	-
Net cash (used in) investing activities	<u>(111)</u>	<u>2,106</u>
Cash flows from financing activities:		
Payment of capital leases	(7)	-
Proceeds from exercise of options	-	-
Proceeds from issuance of shares, net	-	-
Short-term loan from a related party	2,100	-
Release of restricted cash	30	-
Net cash provided by financing activities	<u>2,123</u>	<u>2,106</u>
(Decrease) in cash and cash equivalents	(94)	-
Cash and cash equivalents at beginning of year	308	-
Cash and cash equivalents at end of year	<u>214</u>	<u>2,106</u>
Supplemental disclosures of cash flow information:		
Cash paid for:		
Taxes	46	-
Supplemental schedule of investing and financing activities:		
Cash received from:		

Proceeds from issuance of shares	-
Direct costs paid for services due to issuance of shares	-
Total proceeds	-

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

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - The Company

deltathree, Inc. (the "Company") is a global provider of integrated Voice over Internet Protocol, or VoIP, digital video and voice-over-IP services, products, hosted solutions and infrastructure. The Company was founded in 1996 to capitalize on the growth of the Internet as a communications tool by commercially offering Internet Protocol, or IP, telephony services, or VoIP telephony. While the Company began as primarily a low-cost alternative source of wholesale minutes for carriers around the world, it has evolved into an international provider of next generation communication services.

Going Concern

The Company has sustained significant operating losses in recent periods, which has resulted in a significant reduction in its cash reserves. The Company and its subsidiaries have entered into four loan agreements with D4 Holdings, LLC, its majority stockholder, pursuant to which D4 Holdings has agreed to provide the Company with loans in the aggregate principal amount of \$4,100,000. The initial Loan and Security Agreement was entered into on March 1, 2010, and the Company has drawn the maximum principal amount available under the initial Loan and Security Agreement. On August 10, 2010, the Company and its subsidiaries entered into the Second Loan and Security Agreement, or the "Second Loan Agreement", with D4 Holdings with a maximum principal amount of \$1,000,000, and the Company has drawn the maximum principal amount available under the Second Loan Agreement. In connection with the Second Loan Agreement, the Company issued D4 Holdings a warrant to purchase up to 4,000,000 shares of the Company's common stock at an exercise price of \$0.1312 per share. On March 2, 2011, the Company and its subsidiaries entered into the Third Loan and Security Agreement, or the "Third Loan Agreement", with D4 Holdings, pursuant to which D4 Holdings agreed to provide the Company and its subsidiaries an additional line of credit in a principal amount of \$1,600,000. Pursuant to the terms of the Convertible Promissory Note, or the "Convertible Note", issued by the Company in connection with the Third Loan Agreement, D4 Holdings may elect to convert all or any portion of the outstanding principal amount under the Convertible Note into that number of shares of the Company's common stock determined by dividing such principal amount by \$0.08 (as may be adjusted under the terms of the Convertible Note). Simultaneous with the Company's entering into the Third Loan Agreement, D4 Holdings and the Company entered into an amendment of the First Loan Agreement, pursuant to which (among other things) the maturity date for repayment of principal under the First Loan Agreement was extended from March 1, 2011, to March 1, 2012, and then subsequently extended by oral agreement of the parties to July 1, 2012. In connection with the Third Loan Agreement, the Company issued D4 Holdings a warrant to purchase up to 1,000,000 shares of the Company's common stock at an exercise price of \$0.096 per share. The Company has drawn the aggregate principal amount available under the Third Loan Agreement, the principal amount of which can be converted by D4 Holdings into an aggregate of 20,000,000 shares of the Company's common stock. On September 12, 2011, the Company and its subsidiaries entered into the Fourth Loan and Security Agreement, or the "Fourth Loan Agreement", with D4 Holdings, pursuant to which D4 Holdings agreed to provide the Company and its subsidiaries an additional line of credit in a principal amount of \$300,000. As of December 31, 2011, the Company had received advances in the aggregate amount of \$200,000 from D4 Holdings pursuant to notices of borrowing under the Fourth Loan Agreement.

As of December 31, 2011, the Company had negative working capital equal to approximately \$4.8 million as well as negative stockholders' equity equal to approximately \$4.4 million. The Company believes it is probable that it will continue to experience losses and increased negative working capital and negative stockholders' equity in the near future and will not be able to return to positive cash flow before it requires additional cash (in addition to any further amounts it may borrow from D4 Holdings under the Fourth Loan Agreement) in the near term. The Company may experience difficulties accessing the equity and debt markets and raising additional capital, and there can be no assurance that the Company will be able to raise such additional capital on favorable terms or at all. If additional funds are raised through the issuance of equity securities, the Company's existing stockholders will experience significant further dilution. Because of the Company's significant losses to date and the Company's limited tangible assets, the Company does not fit traditional credit lending criteria, which could make it difficult for the Company to obtain loans or to access the capital markets. If the Company issues additional equity or convertible debt securities to raise funds, the ownership percentage of the Company's existing stockholders would be reduced and they may experience significant dilution. New investors may demand rights, preferences or privileges senior to those of existing holders of the Company's common stock.

Due to the limited availability of additional loan advances under the Fourth Loan Agreement, the Company believes that, unless it is able to increase revenues and generate additional cash flows, its current cash and cash equivalents will not satisfy its current projected cash requirements beyond the foreseeable future. As a result, there is substantial doubt about the Company's ability to continue as a going concern.

In addition, unless the Company is able to increase revenues and generate additional cash flows, based on currently projected cash flows the Company believes that it may be unable to pay future scheduled interest and/or principal payments under the various loan agreements with D4 Holdings as these obligations become due. In the event that were to occur, if D4 Holdings is not willing to waive compliance or otherwise modify the Company's obligations such that the Company is able to avoid defaulting on such obligations, D4 Holdings could accelerate the maturity of the Company's debts due to it. Further, because D4 Holdings has a lien on all of the Company's assets to secure the Company's obligations under the loan agreements, D4 Holdings could take actions under the loan agreements and seek to take possession of or sell the Company's assets to satisfy the Company's obligations thereunder. Any of these actions would likely have an immediate material adverse effect on the Company's business, financial condition or results of operations.

Due to the Company's ongoing losses and reduction in cash, the Company initiated restructuring activities beginning in the second quarter of 2011 in an effort to cut operating costs significantly and better align the Company's operations with its current business model. In accordance with the restructuring, the Company instituted a reduction in force and decreased the number of full time employees from approximately 53 to 37, reduced the salaries of all remaining employees by five percent, and decreased non-material expenses as well as payments to be made to vendors and other third parties.

In view of the Company's current cash resources, nondiscretionary expenses, debt and near term debt service obligations, the Company may begin to explore all strategic alternatives available to it, including, but not limited to, a sale or merger of the Company, a sale of its assets, recapitalization, partnership, debt or equity financing, voluntary deregistration of its securities, financial reorganization, liquidation and/or ceasing operations. In the event that the Company requires but is unable to secure additional funding, the Company may determine that it is in its best interests to voluntarily seek relief under Chapter 11 of the U.S. Bankruptcy Code. Seeking relief under the U.S. Bankruptcy Code, even if the Company is able to emerge quickly from Chapter 11 protection, could have a material adverse effect on the relationships between the Company and its existing and potential customers, employees, and others. Further, if the Company was unable to implement a successful plan of reorganization, the Company might be forced to liquidate under Chapter 7 of the U.S. Bankruptcy Code. There can be no assurance that exploration of strategic alternatives will result in the Company pursuing any particular transaction or, if the Company pursues any such transaction, that it will be completed.

Note 2 - Summary of significant accounting policies

a. Basis of presentation

The financial statements have been prepared in conformity with U.S. generally accepted accounting principles.

b. Principles of consolidation

The consolidated financial statements include the accounts of the Company and Delta Three Israel Ltd., the Company's Israeli subsidiary (the "Subsidiary"). All significant inter-company accounts and transactions have been eliminated.

c. Financial statements in U.S. dollars

The reporting currency of the Company is the U.S. dollar ("dollar"). The dollar is the functional currency of the Company and its subsidiary. Transactions and balances originally denominated in dollars are presented at their original amounts. Non-dollar transactions and balances are re-measured into dollars in accordance with the principles set forth in "Foreign Currency Matters" [ASC 830]. All exchange gains and losses from translation of monetary balance sheet items resulting from transactions in non-dollar currencies are recorded in the statement of operations as they arise.

d. Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported and disclosed in the consolidated financial statement and the accompanying notes. Actual results could differ from those estimates.

e. Cash and cash equivalents

Cash held in U.S. banks are subject to U.S. Federal Depository Insurance Corporation (“FDIC”) limits of \$250,000 and cash held in foreign accounts are unprotected. Due to the Company’s cash needs, management has generally held and continues to hold the majority of its cash in U.S. banks that are insured under the FDIC.

f. Restricted cash

Restricted cash represents amounts held in cash, money market funds and certificates of deposit to support stand-by-letters of credit used as security for third party vendors, as well as amounts deposited as guarantees for the Company’s office in Jerusalem and for currency hedging transactions in which the Company engages.

g. Marketable securities

The Company accounts for its investments in marketable securities using “Accounting for Certain Investments in Debt and Equity Securities” [ASC 320-10]. Management determines the appropriate classification of its investments in marketable securities at the time of purchase and reevaluates such determinations at each balance sheet date. Securities for which the Company does not have the intent or ability to hold to maturity are classified as available-for-sale. Available-for-sale securities are stated at fair value, with the unrealized gains and losses reported as a separate component of shareholders' equity under accumulated other comprehensive gain or loss. The Company has not recorded any unrealized gains or losses to date. The Company does not currently have any of its assets invested in marketable securities, but rather all amounts are held in cash.

h. Inventory

Inventory consists of the cost of customer equipment and is at the lower of cost (principally on a standard cost basis that approximates the “first-in-first-out”, or FIFO, standard) or market.

i. Property and equipment

Property and equipment are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the depreciable assets, which range from two to five years. Leasehold improvements are amortized based on the straight-line method over the shorter of the term of the lease, or the estimated useful life of the improvements.

j. Long-lived assets

The Company applies the provisions of “Accounting for the Impairment or Disposal of Long-Lived Assets” [ASC 360-10]. This statement requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment 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 undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. At December 31, 2011, there were no intangible assets listed on the Company's balance sheet.

k. Write-off of goodwill and intangible assets

The Company evaluates its long-lived tangible assets for impairment in accordance with “Accounting for the Impairment or Disposal of Long-Lived Assets,” [ASC 360-10] whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. No amortizations or write-offs were recorded during 2010 or 2011.

l. Revenue recognition

The Company recognizes revenues from VoIP telephony services based on minutes (or fractions thereof) of customer usage. The Company records payments received in advance for prepaid services and services to be supplied under contractual agreements as deferred revenue until such related services are provided.

m. Cost of revenues

Cost of revenues consists primarily of direct costs that the Company pays to third parties in order to provide telephony services. These costs include access, transmission and interconnection charges that the Company pays to other access providers to terminate domestic and international phone calls on the public switched telephone network. In addition, these costs include the cost to lease phone numbers and to co-locate in other telephone companies' facilities, as well as to purchase equipment. These costs also include taxes that the Company pays on telecommunications services from its suppliers.

n. Research and development expenses

Research and development expenses are expensed as incurred and consist primarily of payroll and facilities charges associated with the research and development of our current and future products.

o. Income taxes

The Company provides for income taxes using the liability approach defined by “Accounting for Income Taxes” [ASC 740-10]. Deferred tax assets and liabilities are recognized for the expected tax consequences between the tax bases of the assets and liabilities and their reported amounts. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized and are reversed at such time that realization is believed to be more likely than not.

p. Stock-based compensation

The following assumptions were used for the fiscal year 2011: dividend yield of 0.00% for all periods; risk-free interest rate of 2.4%; an expected life of 3-4 years for all periods; and a volatility rate of 80%.

q. Restricted shares and restricted units

The Company has granted restricted shares and restricted units to purchase shares of the Company’s common stock to retain, reward and motivate those employees who are deemed critical to the future success of the Company. The stock incentive plan under which the Company grants restricted share and restricted units was approved by the Board of Directors. The Company values restricted shares and restricted units to purchase shares of its common stock at the aggregate grant date fair value in accordance with ASC 718-10.

r. Net income (loss) per share

Basic and diluted net income (loss) per share have been computed in accordance with “Earnings Per Share” [ASC 260-10] using the weighted average number of shares of common stock outstanding. Diluted earnings per share give effect to all potential dilutive issuances of shares of common stock that were outstanding during the period.

s. Concentration of credit and business risk

The Company is subject to concentrations of credit risk, which consist principally of cash and cash equivalents, short-term investments and trade accounts receivable.

The Company maintains its cash balances at various financial institutions. The Company performs periodic evaluations of the relative credit standing of these institutions.

The majority of the Company's non-carrier customers prepay for their services. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of customers, historical trends and other information.

Sales to material customers representing ten percent or more of total revenues for each of the three months ended December 31, 2011 and 2010, and accounts receivable as of December 31, 2011, and December 31, 2010, were as follows:

Customer	Revenues		Accounts Receivable	
	For the Year	For the Year	As of December 31,	As of December
	Ended	Ended	2011	2010
	December 31, 2011	December 31, 2010		
Reseller A	15.6%	48.3%	-	4
Reseller B	27.8%	13.1%	19.3%	
Service provider A	10.0%	6.7%	34.2%	2

t. Fair value of financial instruments

The financial instruments of the Company consist mainly of cash and cash equivalents, short-term investments, current accounts receivable, accounts payable and long-term liabilities. In view of their nature, the fair value of the financial instruments included in working capital of the Company is usually identical or close to their carrying amounts.

u. Derivatives

The Company applies the provisions of “Accounting for Derivative Instruments and Hedging Activities,” [ASC 815-10], as amended. The standard requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through the statement of operations. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings, or recognized in other comprehensive income (loss) until the hedged item is recognized in earnings. The ineffective portion of a derivative’s change in fair value will be immediately recognized in earnings. The Company use of derivatives is immaterial.

v. Reclassification

Certain prior years' amounts have been reclassified in conformity with the current year's financial statements presentation. For more information, please see Selected Quarterly Financial Information (Unaudited) in Note 14 below.

w. Short-term loan from a related party

The Second Loan Agreement and the Third Loan Agreement as described in Note 1 above are accounted for in accordance with "Debt with Conversion and Other Options" [ASC 470-20-25].

The Second Loan Agreement was accounted as a debt instrument with stock warrants. Under ASC 470-20-25, issuers of certain debt instruments with stock purchase warrants are required to separately account for the liability components and the equity components, based on the relative fair value of the debt instrument without the warrants and of the warrants themselves at time of issuance. The Company separated it accordingly.

The Third Loan Agreement was accounted as a convertible debt instrument with stock warrants and a beneficial conversion features. Under ASC 470-20-25, as a first step the Company separated the debt instruments and the warrants based on their relative fair value for the liability components and for the equity components. In addition, as a second step the Company concluded that the liability component includes beneficial conversion features. Under ASC 470-20-25, issuers of certain debt instruments with beneficial conversion features need to allocate to an equity component an amount based on the amount the feature is in-the-money at the commitment date. The Company separated it accordingly.

The following is a summary of the short term loans and the equity components:

	<u>December 31,</u>	
	<u>2011</u>	<u>2010</u>
	(\$ in thousands)	
Face value of the short-term loans	\$ 4,000	\$ 1,900
Unamortized discount	(1,148)	
Accumulated interest	281	
Net carrying amount of debt component	<u>3,133</u>	<u>1,900</u>

The interest expenses relating to both the contractual interest coupon and amortization of the discount on the liability component are as follows:

	<u>December 31,</u>	
	<u>2011</u>	<u>2010</u>
	(\$ in thousands)	
Contractual interest coupon	413	
Amortization of the discount on the liability components	768	
Total interest expense on short-term loans	<u>1,181</u>	

Note 3 - Restricted cash and short-term investments

The following is a summary of our restricted cash and available-for-sale securities as of December 31, 2011 and 2010:

	December 31,	
	2011	2010
	(\$ in thousands)	
Restricted cash (money market funds)*	\$ 131	\$ 13
Bank deposits	-	3
Total restricted cash and short-term investments	<u>131</u>	<u>16</u>

* Restricted cash represents amounts held in certificates of deposit and money market funds to support stand-by letters of credit used as security for third party vendors as well as amounts deposited as guarantees for the Subsidiary's office in Jerusalem and for currency hedging transactions in which the Company engages.

Note 4 - Accounts receivable, net

Accounts receivable are stated net of an allowance for doubtful accounts of approximately \$508,000 at each of December 31, 2011 and 2010, respectively. Accounts receivable, net includes \$158,000 and \$235,000 as of December 31, 2011 and December 31, 2010, respectively for related parties.

Note 5 - Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	December 31,	
	2011	2010
	(\$ in thousands)	
Government of Israel (VAT refund and other)	\$ 14	\$ -
Deposits with suppliers	227	16
Prepaid expenses	153	21
Other	51	2
Total prepaid expenses and other current assets	<u>\$ 445</u>	<u>\$ 40</u>

Note 6 - Property and equipment, net

	December 31,	
	2011	2010
	(\$ in thousands)	
Telecommunications equipment	\$ 17,205	\$ 17,12
Furniture, fixtures and other	630	62
Leasehold improvements	797	79
Capital leases	422	42
Computers, hardware and software	9,245	9,21
	<u>28,299</u>	<u>28,18</u>
Less - accumulated depreciation	(27,964)	(27,78)
Total property and equipment, net	<u>\$ 335</u>	<u>\$ 39</u>

Note 7 - Other current liabilities

Other current liabilities consist of the following:

December 31,

	<u>2011</u>	<u>2010</u>
	(\$ in thousands)	
Accrued expenses	\$ 582	\$ 1,18
Employees and related expenses	228	27
Other	20	2
Total other current liabilities	<u>\$ 830</u>	<u>\$ 1,48</u>

Note 8 - Severance pay obligations

The Subsidiary is subject to certain Israeli laws and labor agreements that determine the obligations of the Subsidiary to make severance payments to employees who have been terminated and who are leaving the employment of the Subsidiary under certain other circumstances. The amount of severance pay benefits requirement to be paid is determined based upon the employee's length of service and the employee's salary at the time of termination. This obligation is partially funded through regular deposits made by the Subsidiary into accounts maintained by unaffiliated third party insurance company funds for managers' insurance policies. Amounts deposited are controlled by the fund trustees and insurance companies and are not under the control and management of the Subsidiary.

Expenses (income) relating to employee termination benefits were \$196,567, \$200,570 and \$211,663 for the years ended December 31, 2011, 2010 and 2009, respectively.

The aggregate value of the insurance policies as of December 31, 2011 and 2010 was \$605,933 and \$712,511, respectively.

Note 9 - Commitments and contingencies

a. Lease commitments

Until November 2011, the Company leased its executive offices at 224 West 35th Street, New York, N.Y. Since such time the Company has been leasing its executive offices at 26 Avenue at Port Imperial, West New York, New Jersey, and storage and equipment space at 117 Central Avenue, Hackensack, New Jersey. The Company leases each of these facilities on a month-to-month basis. Rent expense, net, for 2011 was \$22,550.

The Subsidiary leases an office that houses the Company's research and development facilities in Jerusalem, Israel. The term of the lease expires June 30, 2012, and the Subsidiary is currently seeking suitable new office space. Rent expense, net for the Subsidiary for 2011 was \$163,200.

b. Legal proceedings

On August 31, 2010, the U.S. Department of Homeland Security, or the DHS, seized approximately \$176,000 held in the Company's bank accounts in connection with its investigation into the activities of certain of the Company's resellers. In subsequent conversations with the Assistant United States Attorney for the Eastern District of New York, or the U.S. Attorney, which is assisting the DHS in the investigation, the Company was informed that the government suspects that these resellers were engaged in money laundering activities. In addition, the U.S. Attorney stated that the Company failed to file certain reports of cash payments under applicable law. The Company is opposing this seizure, and on October 12, 2010, it filed a petition with the DHS for the return of the money. On February 4, 2011, the Company's petition was denied, and on February 22, 2011, the Company presented an offer of compromise. On November 1, 2011, the Company was notified by the DHS that its offer of compromise had been denied. On March 27, 2012, the Company signed a Stipulation of Settlement with the U.S. Customs and Border Protection, or the CBP, pursuant to which, amongst other things, the Company agreed to a forfeiture of the seized funds and the CBP agreed to return and remit \$52,804 to the Company following completion of the forfeiture proceedings. In accordance with FASB Statement 5, "Loss Contingencies" [ASC 450-20], the Company accounted for the seizure as a loss contingency that is probable of occurrence and recognized a loss in the entire amount seized, and recognized the recovery of the amount to be returned to the Company as a reversal of the loss recognized.

On July 5, 2011, the Company received a notice from the New York City Department of Finance that claimed that the Company had not paid commercial rent tax required under the New York City Administrative Code from June 1998 through May 2008 for the two offices that the Company had leased during that time. The notice stated that the Company is obligated to pay the outstanding tax amounts, as well as significant interest and penalties that were assessed on the unpaid amounts as well as for the failure to file the applicable tax returns. On August 15, 2011, the Company filed a response contesting the assessment and/or attempting to negotiate a reduction in the amounts to be paid. The final outcome of this assessment and the Company's negotiations with the New York City Department of Finance cannot be determined at this time. In the event that the Company is required to pay all or most of the amounts claimed by the New York City Department of Finance this would have a material adverse effect on the Company's financial condition and liquidity. During 2011 the Company recorded \$300,000 as a provision for commercial rent tax.

In addition, from time to time the Company is a party to legal proceedings, much of which is ordinary routine litigation incidental to the business, and is regularly required to expend time and resources in connection with such proceedings. Accordingly, the Company, in consultation with its legal advisors, accrues amounts that management believes it is probable the Company will be required to expend in connection with all legal proceedings to which it is a party.

c. Regulation

Although there are several regulatory proceedings currently pending before federal authorities, providers of interconnected VoIP services are lightly regulated compared to providers of traditional telecommunications services. On February 12, 2004, the FCC initiated a generic rulemaking proceeding concerning the provision of voice and other services using IP technology, including assessing whether VoIP services should be classified as information services or telecommunications services. The rulemaking is ongoing and we cannot predict the outcome of this proceeding. In November 2004, the FCC determined that certain interconnected VoIP services (meaning VoIP services that can be used to send and receive calls to or from the PSTN), including some services that are similar to ours, should be considered interstate services subject to federal rather than state jurisdiction. Although this ruling was appealed by several states, on March 21, 2007, the United States Court of Appeals for the Eighth Circuit affirmed the FCC's determination.

The FCC's generic rulemaking proceeding could result in the FCC determining, for instance, that certain types of Internet telephony should be regulated like basic telecommunications services. Thus, Internet telephony would no longer be exempt from more onerous telecommunications-related regulatory obligations, could potentially become subject to state telecommunications regulations, and could become subject to other economic regulations typically imposed on traditional telecommunications carriers.

On June 3, 2005, the FCC released an order and notice of proposed rulemaking concerning VoIP emergency 911 services. The order set forth two primary requirements for providers of interconnected VoIP services. The order applies to our iConnectHere and joip customers, or our "retail customers". We do not believe that we are responsible for compliance with this order when we sell our service wholesale to companies who then offer the service to retail end-users. We cannot predict whether we would be subject to any third-party litigation in connection with such customers who resell our services or whether the rules will be interpreted as applicable to those who wholesale interconnected VoIP services.

The order set forth two primary requirements for providers of interconnected VoIP services. First, the order requires providers of interconnected VoIP services like us to notify our retail customers of the differences between the emergency services available through our offerings and those available through traditional telephony providers. We also had to receive affirmative acknowledgment from some of our retail customers that they understand the nature of the emergency services available through our service. On September 27, 2005, the FCC's Enforcement Bureau released an order stating that the Enforcement Bureau will not pursue enforcement actions against interconnected VoIP providers that have received affirmative acknowledgement from at least 90% of their subscribers. We received affirmative acknowledgment from more than 95% of our relevant customers that they understand the nature of the emergency services available through our service, and thus we believe we are substantially in compliance with the first aspect of the FCC's June 3 order.

Second, the order required providers of interconnected VoIP services like us to offer enhanced emergency dialing capabilities, or E-911, to all of our retail customers by November 28, 2005. Under the terms of the order, we are required to use the dedicated wireline E-911 network to transmit customers' 911 calls, callback number and customer-provided location information to the emergency authority serving the customer's specified location. On November 7, 2005, the FCC's Enforcement Bureau issued a Public Notice with respect to that requirement. The Public Notice indicated that providers who have not fully complied with the enhanced emergency dialing capabilities requirement are not required to discontinue the provision of services to existing customers, but that the FCC expects that such providers will discontinue marketing their services and accepting new customers in areas in which the providers cannot offer enhanced emergency dialing capabilities where such capabilities are otherwise available.

Almost all of our retail customers currently receive E-911 service in conformity with the FCC's order. Like many interconnected VoIP providers, we rely on third parties to route emergency calls originated by our customers. In certain instances and for some of our customers, the third party provider may route 911 calls to an unofficial emergency call center. Such unofficial call centers may not be able to receive appropriate call back information. To the extent that they are so able or callers provide their location information the emergency dispatchers in such call centers may not then be able to route such calls to the appropriate public safety answering point. The FCC could find that calls routed in this manner violates its rules, potentially subjecting us to enforcement actions including, but not limited to, fines, cease and desist orders, or other penalties. Moreover, and as is the case with customers for other interconnected VoIP providers some customers who were receiving service prior to the FCC's deadline for compliance with the E-911 regulations may not receive such service. The FCC permitted service providers to continue to provide service to those existing customers rather than disconnect those customers. Pursuant to the FCC's requirement, after the implementation of the FCC E-911 requirements, we provide services to our new retail customers only where we can provide the FCC required E-911 service. We may be required to stop serving those customers to whom we cannot provide the required enhanced emergency dialing capabilities that were being serviced prior to the issuance of the FCC's rules at any time.

The FCC is considering modifying its VoIP E-911 rules. In June, 2007, the FCC released a Notice of Proposed Rulemaking to consider whether it should impose additional obligations on interconnected VoIP providers. Specifically, the FCC considered mandating that interconnected VoIP providers implement a solution that will allow for automatically determining the location of their customers for purposes of E-911 rather than require customers to manually update their existing location information (as is the case under the current regulations). Moreover, the Notice included a tentative conclusion that interconnected VoIP providers that allow their service to be used in more than one location, like us, be required to meet the same customer location accuracy standards applicable to providers of mobile telecommunications services. In September 2010, the FCC released a Notice of Inquiry again requesting comment on, among other issues, whether interconnected VoIP providers should be required to provide automatic location information about their customers rather than requiring customers to self-report their location. Additionally, the Notice of Inquiry sought comment on whether the FCC's rules concerning the delivery of emergency services should be extended to non-interconnected

VoIP services as well as to mobile VoIP applications used on smartphones, computers and other devices. At this time we cannot predict the outcome of these proceedings or their potential impact on our business.

The Communications Assistance for Law Enforcement Act, or CALEA, requires certain communications service providers to assist law enforcement agencies in conducting lawfully authorized electronic surveillance. On September 23, 2005, the FCC released an order concluding that CALEA applies to interconnected VoIP providers. In May 2006 the FCC released an order finding that broadband Internet access service providers and interconnected VoIP providers are required to implement the same type of CALEA requirements that have been applied to wireline telecommunications carriers. These include obligations to (1) ensure that communications equipment, facilities, and services meet interception assistance capability requirements and (2) develop system security policies and procedures to define employee supervision and record retention requirements. As a result of the steps the Company has taken, we believe that we comply with CALEA.

The FCC decided in June 2006 that interconnected VoIP service providers should be required to contribute to the universal service fund, or USF. The amount of universal service contribution for interconnected VoIP service providers is based on a percentage of revenues earned from end-user interstate services. The FCC developed three alternatives under which an interconnected VoIP service provider may elect to calculate its universal service contribution: (1) a safe harbor that assumes 64.9% of the provider's end-user revenues are interstate; (2) a traffic study to determine an allocation for interstate end-user revenues; or (3) actual interstate and international end-user revenues. If an interconnected VoIP service provider calculates its universal service contributions based on its actual percentage of interstate calls, the FCC suggested that its preemption of state regulation of such services may no longer apply, in which case the interconnected VoIP service provider could be subject to regulation by each state in which it operates as well as federal regulation. In addition, the FCC is considering a number of proposals that could alter the way that the USF is assessed. For instance, the FCC is considering an assessment based on the use of telephone numbers. The U.S. Congress may also provide the FCC with additional authority to reform USF or mandate a particular methodology. At this time we cannot predict time what impact, if any, USF reform, may have on our business.

Numerous states may attempt to impose state universal service contribution requirements on interconnected VoIP providers such as deltatthree. At this time, various states – including Kansas, Nebraska and New Mexico – claim that they have the right to require interconnected VoIP providers to contribute to their respective USF funds. On March 3, 2008, the U.S. District Court for Nebraska issued a preliminary injunction and found that Nebraska's state Public Service Commission does not have jurisdiction to require Universal Service contributions from VoIP providers. On May 1, 2009, a panel of the U.S. Circuit Court of Appeals for the Eighth Circuit affirmed the U.S. District court ruling. In response, the Nebraska and New Mexico state commissions filed a petition with the FCC seeking the authority to impose state USF contribution obligations on interconnected VoIP providers, like us, and the FCC granted the petition. As a result of this ruling, a number of other states have either stated that offerings such as ours may be subject to their respective state USF or are considering imposing such obligations on us. We would likely pass through to our customers in those states any such state USF fees, potentially making our services less competitive with offerings available from traditional providers of telecommunications services, which may cause us to lose customers in those states. In addition, in the past some states have attempted to impose retroactive application of any state USF obligations. Retroactive applicability of any state USF fees would effectively bar us from collecting such fees from our customers, s reducing our future profits.

On April 2, 2007, the FCC issued an order that tightened existing rules on protection and use of Customer Proprietary Network Information, or CPNI, and extended coverage of the CPNI rules to interconnected VoIP service providers. Among other things, the Order imposes greater obligations on us and other companies like us to protect CPNI, acquire customer consent prior to engaging in certain kinds of marketing efforts based on CPNI, train our employees concerning protecting (and the use of) CPNI and to file formal certifications with the FCC regarding procedures for protecting this information. As a result of the steps we have taken, we believe that we comply with this Order.

On June 15, 2007, and effective October 5, 2007, interconnected VoIP providers, like us, became required to, among other things, make certain that their equipment and service is accessible to and usable by individuals with disabilities, if readily achievable. In addition, interconnected VoIP providers like us became obligated to contribute to the Telecommunications Relay Services, or TRS, fund and to offer 711 abbreviated dialing for access to relay services. Following March 31, 2009, interconnected VoIP providers are required to route such 711 calls to the appropriate TRS relay center serving the state in which the caller is located or the relay center corresponding to the caller's last registered address. As a result of the steps we have taken, we believe that we comply with the applicable requirements.

On August 6, 2007 and effective November 2007, the FCC adopted an Order concerning the collection of regulatory fees for Fiscal Year 2007 requiring the collection of such fees from interconnected VoIP providers like us. Like other interconnected VoIP providers, we now pay regulatory fees based on interstate and international revenues.

On November 8, 2007, the FCC released an Order relating to local number portability imposing local number portability, or LNP, and related obligations on interconnected VoIP Providers like us. The Order requires interconnected VoIP providers to contribute to shared numbering administration costs. Additionally, the Order mandates that we process certain kinds of telephone number porting requests within certain timeframes. As a result of the steps we have taken, we believe that we comply with this Order. Subsequently, on May 13, 2009, the FCC released another order concerning LNP that further reduces the porting timeframe for certain types of telephone number porting requests that interconnected VoIP providers, like us, have to process. Since we are not a licensed telecommunications carrier, we must rely on third parties to comply with these porting obligations. If these third parties fail to comply with these obligations we could be subject to fines, forfeitures and other penalties by the FCC or state public utilities commissions or we could face legal liability in state or federal court from customers or carriers. The FCC also released a Further Notice of Proposed Rulemaking to refresh the record on how to further improve the porting process, and how to potentially expand the new one business day porting timeframe to other kinds of ports. We cannot predict the outcome of this proceeding or its potential impact on us at this time.

The FCC is actively considering reform of the intercarrier compensation system, which is a set of FCC rules and regulations by which telecommunications carriers compensate each other for the use of their respective networks. These rules and regulations affect the prices we pay to our suppliers for access to the facilities and services that they provide to us, such as termination of calls by our customers onto the public switched telephone network. At this time we cannot predict what impact, if any, new intercarrier compensation regulations would have on our business.

In May 2009, the FCC extended to interconnected VoIP providers like us the discontinuance rules that previously applied only to non-dominant common carriers. The FCC's rules require non-dominant domestic carriers to provide notice to customers at least 30 days prior to discontinuing service to a telephone exchange, toll stations serving a community in whole or in part, and other similar activities that affect a community or part of a community. Carriers must inform certain state authorities of the discontinuation, and obtain prior FCC approval before undertaking the service disruption. The FCC's rules allow for streamlined treatment for FCC discontinuance approvals and interconnected VoIP providers will be able to take advantage of the same streamlined procedures afforded to non-dominant carriers. It is not yet clear how these rules apply to interconnected VoIP providers. But in the event we discontinue one of our service offerings in its entirety or if we were to exit the market in whole we would likely have to comply with these new rules. We do not expect these new obligations to have a material impact on our business.

In June 2007, the FCC adopted various recommendations from its Independent Panel Reviewing the Impact of Hurricane Katrina on Communications Networks Panel, including a requirement that certain interconnected VoIP providers submit reports regarding the reliability and resiliency of their 9-1-1 systems. At this time, we are not subject to these reporting requirements but may become subject in the future.

We rely upon providers of broadband Internet access services to offer our services to our customers. The FCC recently adopted "open Internet" rules that would, among other things, prohibit fixed providers of broadband Internet access services from blocking, impairing or downgrading such access. Wireless providers of broadband Internet access services would be prohibited from blocking VoIP applications like ours. The open Internet rules are not yet effective and, as a result of both legislative efforts to overturn the rules as well as potential appeals of the passage of the rules, it is unclear whether (and when) the rules will become effective. While we are not aware of any provider of broadband Internet access attempting to interfere with our Internet access, the lack of enforceable rules could potentially negatively impact our service offerings and impede our ability to offer new services that require significant Internet bandwidth.

In addition, some state and local regulatory authorities believe they retain jurisdiction to regulate the provision of, and impose taxes, fees and surcharges on, intrastate Internet and VoIP telephony services, and have attempted to impose such taxes, fees and surcharges, such as a fee for providing E-911 service. Rulings by the state commissions on the regulatory considerations affecting Internet and IP telephony services could affect our operations and revenues, and we cannot predict whether state commissions will be permitted to regulate the services we offer in the future.

The Company paid approximately \$150,000 of state and local taxes and other fees during 2011. To the extent we increase the cost of services to its customers to recoup some of the costs of compliance, this will have the effect of decreasing any price advantage we may have over traditional telecommunications companies.

In addition, it is possible that we will be required to collect and remit taxes, fees and surcharges in other states and local jurisdictions where we have not done so, and which such authorities may take the position that we should have collected. If so, they may seek to collect those past taxes, fees and surcharges from us and impose fines, penalties or interest charges on us. Our payment of these past taxes, fees and surcharges, as well as penalties and interest charges, could have a material adverse effect on us.

Note 10 - Stockholders' equity

a. Share capital

The Company's common stock is currently listed on the OTCQB under the symbol "DDDC". The quoting and trading of the Company's common stock was transferred from The Nasdaq Capital Market to the OTC Bulletin Board on March 28, 2008. Beginning approximately April 2010, the market makers in the Company's common stock began quoting and trading the Company's common stock on the OTCQB in addition to the OTC Bulletin Board. In February 2011, all quoting and trading of the Company's common stock on the OTC Bulletin Board ceased when the last of the market makers quoting and trading the Company's common stock on the OTC Bulletin Board began doing so on the OTCQB.

b. Change in Control

On February 10, 2009, the Company entered into the Purchase Agreement with D4 Holdings pursuant to which the Company issued to D4 Holdings the Shares, representing approximately 54.3% of the total number of issued and outstanding shares of Common Stock following the transaction, for an aggregate purchase price of \$1,170,000, payable in cash, and the Warrant, exercisable for ten years, to purchase up to an additional 30,000,000 shares of Common Stock at an exercise price of \$0.04 per share. The transaction closed on February 12, 2009.

In connection with the closing of the transaction and pursuant to the terms of the Purchase Agreement, Noam Bardin resigned as a director and the board of directors appointed Robert Stevanovski and Anthony Cassara to serve on the board. In addition, Lior Samuelson resigned as Chairman of the Board and remained a director, and Robert Stevanovski was appointed to serve as Chairman. Under the terms of the Purchase Agreement, D4 Holdings had the right to nominate for appointment by the board one director in addition to Messrs. Stevanovski and Cassara, and it nominated David Stevanovski. In addition, on March 4, 2009, the Board of Directors of the Company increased the size of the board from five to seven members and filled the two vacancies remaining on the board by appointing Gregory Provenzano and J. Lyle Patrick as directors. The appointments of the three new directors to serve on the board became effective on March 28, 2009.

As a result of the transaction between the Company and D4 Holdings, D4 Holdings obtained a controlling interest in the Company.

c. Stock Options

At our Annual Meeting on August 6, 2009, upon the recommendation of our Board of Directors our stockholders approved the adoption of our 2009 Stock Incentive Plan (the "2009 Plan"). Upon the adoption of the 2009 Plan, our 2004 Stock Incentive Plan and 2006 Non-Employee Director Stock Plan were terminated except with respect to outstanding awards previously granted under those plans and no additional awards will be made under those plans. Under the 2009 Plan, the Compensation Committee is authorized to grant awards, either in the form of incentive or non-incentive stock options or restricted stock.

As of December 31, 2011, options to purchase 2,642,006 shares of Common Stock granted under the Company's stock incentive plans were exercisable with exercise prices ranging between \$0.14 and \$2.90 per share.

A summary of the status of the Company's stock incentive plans as of December 31, 2009, 2010 and 2011 and changes during the years then-ended, is presented below:

	<u>December 31, 2009</u>		<u>December 31, 2010</u>		<u>December 31, 2011</u>	
	<u>Number of</u>	<u>Weighted</u>	<u>Number of</u>	<u>Weighted</u>	<u>Number of</u>	<u>Weighted</u>
	<u>Options</u>	<u>average</u>	<u>Options</u>	<u>average</u>	<u>Options</u>	<u>average</u>
		<u>Exercise price</u>		<u>Exercise price</u>		<u>Exercise price</u>
Options outstanding at beginning of year	2,353,541	\$ 0.85	5,893,000	\$ 0.70	7,530,333	\$ 0.32
Granted during the year	4,660,000	0.34	2,995,000	0.25	4,680,000	0.04
Exercised during the year	92,500	0.15	-	-	-	-
Forfeited during the year	1,028,041	1.39	1,357,667	0.34	3,340,833	1.33
Outstanding at end of year	<u>5,893,000</u>	<u>\$ 0.70</u>	<u>7,530,333</u>	<u>\$ 0.32</u>	<u>8,869,500</u>	<u>\$ 0.21</u>
Weighted average fair value of options granted during the year	\$ 0.34		\$ 0.25		\$ 0.04	

Additional information regarding options outstanding as of December 31, 2011, is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Outstanding	Weighted average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Exercisable Options	Weighted Average Exercise Price
\$ 0.03	3,600,000	9.8	0.03	-	-
\$ 0.09	50,000	9.6	0.09	-	-
\$ 0.11 – 0.14	505,000	7.0	0.14	270,006	0.14
\$ 0.15	540,000	6.3	0.15	540,000	0.15
\$ 0.16	50,000	9.8	0.16	-	-
\$ 0.18 – 0.22	600,000	8.8	0.20	225,000	0.20

\$	0.27	1,360,000	8.8	0.27	340,000	0.27
\$	0.32 – 0.386	350,000	3.8	0.376	312,500	0.376
\$	0.41	1,720,000		0.41	860,000	0.41
\$	2.85 – 3.20	94,500	1.3	2.90	94,500	2.90
		<u>8,869,500</u>		<u>0.21</u>	<u>2,642,006</u>	<u>0.38</u>

c. Restricted shares of the Company's Common Stock

During the year ended December 31, 2011, the Company did not grant restricted shares of the Company's common stock or restricted units to purchase shares of the Company's common stock.

Note 11 - Research and development expenses

Research and development expenses consist of the following:

	Year ended December 31, 2011	
	(\$ in thousands)	
	2011	2010
Salaries and related expenses	\$ 1,177	\$ 1,144
Consulting and advisory fees	66	44
Travel	5	4
Other	244	288
Total research and development expenses	\$ 1,492	\$ 1,480

Note 12 - Interest expense, net

Interest expense consists of the following:

	Year ended December 31, 2011	
	(\$ in thousands)	
	2011	2010
Discount of convertible notes	\$ 768	\$ 1,144
Interest paid and accrued on related party's loan	413	124
Bank charges	39	44
Foreign exchange differences	(35)	(144)
Total interest expense	\$ 1,185	\$ 1,168

Note 13 - Income taxes

a. Provision for income taxes

No provision for income taxes was required for the years ended December 31, 2011, 2010 and 2009 due to net losses in these periods.

b. Net operating losses

As of December 31, 2011, the Company had net operating losses generated in the U.S. and Israel of approximately \$21.2 million and \$4.7 million, respectively.

The Company's issuance of common stock to D4 Holdings in February 2009 constituted an "ownership change" as defined in Section 382 of the Internal Revenue Code. As a result, under Section 382 the Company's ability to utilize NOLs generated in the U.S. prior to February 2009 (equal to approximately \$156 million) to offset any income it may generate in the future will be limited to approximately \$600,000 per year from February 2009. The NOLs began expiring in 2011 and will expire at various dates until 2029 if not utilized. The Company's ability to utilize its remaining NOLs could be additionally reduced if it experiences any further "ownership change," as defined under Section 382.

The Company's net operating losses generated in Israel may be carried forward indefinitely. The Subsidiary received final tax assessments through the tax year ended December 31, 2008.

c. In accordance with ASC 740-10, the components of deferred income taxes are as follows:

	December 31,	
	2011	2010
	(\$ in thousands)	
Net operating losses carryforwards	\$ 8,590	\$ 7,500*
Less valuation allowance	(8,590)	(7,500)*
Net deferred tax assets	\$ -	\$ -

* amended

A valuation allowance of \$8.59 million and \$7.5 million is provided as of December 31, 2011 and 2010, respectively, as the realization of the deferred tax assets are not assured.

	Year ended December 31,		
	2011	2010	2009
	(US\$ in thousands)		
Domestic	\$ (3,360)	\$ (2,746)	\$ (3,337)
Foreign	250	251	138
Total	\$ (3,110)	\$ (2,495)	\$ (3,199)

Note 14 - Segment reporting, geographical information and major customers

The Company operates in one business segment, VoIP Telephony services, and makes business decisions and allocates resources accordingly.

The following table summarizes the Company's revenues and long-lived assets by country. Revenue is attributed to geographic region based on the location of the customers. Long-lived assets are attributed to geographic region based on the country in which the assets are located.

	Year ended Dec	
	2011	2010
	(\$ in thousands)	
Revenues:		
United States	\$ 1,834	\$ 1,834
Europe	140	140
South America	1,448	1,448
Far East	1,772	1,772
Middle East	5,127	5,127
Other	214	214
Total revenues	<u>\$ 10,535</u>	<u>\$ 10,535</u>

Revenues from major customers exceeding 10% of revenues:

Master Reseller - A	15.6%
Master Reseller - B	27.8%
Service Provider Customer - A	10.0%

	December 31,	
	2011	2010
	(\$ in thousands)	
Long-lived assets:		
United States	274	300
Israel	23	3
Australia	38	5
Total long-lived assets	<u>335</u>	<u>308</u>

Selected Quarterly Financial Information (Unaudited)

	Three Months Ended,			
	March 31	June 30	September 30	December 31
	(\$ in thousands, except per share data)			
2011				
Total revenues	\$ 3,784	\$ 2,206	\$ 2,215	\$ 2,330
Costs and operating expenses:				
Cost of revenues	2,794	1,561	1,524	1,409
Research and development expenses	433	459	366	234
Selling and marketing expenses	538	584	424	424
General and administrative (income) expenses	(260)	628	407	438
(Recovery of) contingency	-	-	-	(53)
Accrual for commercial rent tax	-	300	-	-
Depreciation and amortization	60	45	36	39
Total costs and operating expenses	<u>3,565</u>	<u>3,577</u>	<u>2,757</u>	<u>2,491</u>
Income (loss) from operations	219	(1,371)	(542)	(161)
Interest expense, net	(185)	(247)	(329)	(424)
Income (loss) before income taxes	34	(1,618)	(871)	(585)
Income taxes	6	2	1	2
Net income (loss)	<u>\$ 28</u>	<u>\$ (1,620)</u>	<u>\$ (872)</u>	<u>\$ (587)</u>
Net income (loss) per share - basic and diluted	<u>\$ 0.00</u>	<u>\$ (0.02)</u>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>
Basic and diluted weighted average number of shares outstanding	<u>72,273,525</u>	<u>72,273,525</u>	<u>72,273,525</u>	<u>72,273,525</u>

	Three Months Ended,			
	March 31	June 30	September 30	December 31
	(\$ in thousands, except per share data)			
2010				
Total revenues	\$ 3,065	\$ 3,394	\$ 3,528	\$ 4,213
Costs and operating expenses:				
Cost of revenues (*)	2,247	2,793	2,806	3,374
Research and development expenses (*)	362	404	350	367
Selling and marketing expenses (*)	248	227	206	278
General and administrative expenses (*)	554	623	596	548
Accrual for contingency	-	-	176	-
Depreciation and amortization	118	104	77	46
Total costs and operating expenses	<u>3,529</u>	<u>4,151</u>	<u>4,211</u>	<u>4,613</u>
Loss from operations	(464)	(757)	(683)	(400)
Interest expense, net	-	(52)	(39)	(71)
Loss before income taxes	(464)	(809)	(722)	(471)
Income taxes	8	4	7	10
Net loss	<u>\$ (472)</u>	<u>\$ (813)</u>	<u>\$ (729)</u>	<u>\$ (481)</u>
Net loss per share - basic and diluted	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>
Basic and diluted weighted average number of shares outstanding	<u>72,172,124</u>	<u>72,233,580</u>	<u>72,222,622</u>	<u>72,242,021</u>

(*) Reclassified, except for numbers for three months ended December 31, 2010.

AMENDMENT NO. 4 TO EXECUTIVE EMPLOYMENT AGREEMENT

This Amendment No. 4 to Executive Employment Agreement by and between deltathree, Inc., a Delaware corporation (“Inc.”) and Delta Three Israel, Ltd., an Israeli corporation (“Ltd.”, and together with Inc., the “Company”), on the one hand, and Effi Baruch, an individual (“Executive”) on the other hand, dated as of December 9, 2008 (the “Executive Employment Agreement”), as amended by that certain Amendment No. 1, dated as of March 17, 2009 (“Amendment No. 1”), that certain Amendment No. 2, dated as of October 20, 2009 (“Amendment No. 2”), and that certain Amendment No. 3, dated as of October 27, 2010 (“Amendment No. 3”, and together with the Executive Employment Agreement, Amendment No. 1 and Amendment No. 2, the “Agreement”), is dated as of August 17, 2011.

Recitals:

WHEREAS, the Company and Executive entered into the Executive Employment Agreement, as amended by Amendment No. 1, Amendment No. 2 and Amendment No. 3, and now wish to enter into this Amendment No. 3 to Executive Employment Agreement (“Amendment No. 4”) to further amend the Agreement as set forth below;

NOW, THEREFORE, in consideration of the foregoing and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto, intending to be legally bound, hereby agree as follows:

1. The first sentence of Section 3(a) of the Agreement is hereby deleted in its entirety and replaced with the following:

“During the Employment Period, the Company shall pay Executive a base salary at the annual rate of U.S.\$180,735.60 (\$15,061.30 per month, or the pro rata portion thereof), payable in accordance with the Company’s customary payroll practices (the “Base Salary”).”

2. The foregoing amendment to the Agreement shall be effective commencing as of August 1, 2011.

3. Except as expressly provided in this Amendment No. 4, all of the terms and conditions of the Agreement remain unchanged, and the terms and conditions of the Agreement as amended hereby remain in full force and effect.

IN WITNESS WHEREOF, the parties hereto have executed this Amendment No. 4 as of the date first set forth above.

DELTATHREE, INC.

By: /s/ Robert Stevanovski
Name: Robert Stevanovski
Title: Chairman of the Board

DELTA THREE ISRAEL, LTD.

By: deltathree, Inc., its sole director

By: /s/ Robert Stevanovski
Name: Robert Stevanovski
Title: Chairman of the Board

/s/ Effi Baruch
Effi Baruch

AMENDMENT NO. 2 TO OFFER OF EMPLOYMENT LETTER

This Amendment No. 2 ("Amendment No. 2") to Offer of Employment Letter by and between Delta Three Israel, Ltd. (the "Company") and Yochai Ozeri ("Employee"), dated as of July 19, 2007 (the "Offer of Employment Letter"), as amended by Amendment No. 1 to Offer of Employment Letter, dated as of October 17, 2010 ("Amendment No. 1"), and together with the Offer of Employment Letter, the "Agreement", is dated as of November 29, 2011.

Recitals:

WHEREAS, the Company and Employee entered into the Offer of Employment Letter, as amended by Amendment No. 1, and now wish to enter into this Amendment No. 2 to Offer of Employment Letter ("Amendment No. 2") to further amend the Agreement as set forth below;

NOW, THEREFORE, in consideration of the foregoing recital and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto, intending to be legally bound, hereby agree as follows:

1. The second paragraph on page 1 of the Offer of Employment Letter is hereby deleted and replaced in its entirety with the following:

"Effective as of January 13, 2012, you will be employed in the positions of Director of Finance and Treasurer of Delta Three Israel and deltathree, Inc. ("deltathree", and together with Delta Three Israel, the "Company"), reporting to the Chief Executive Officer and President of the Company and available to respond to questions and inquiries of the Board of Directors of deltathree.

The duties and responsibilities of Director of Finance and Treasurer of the Company include, but are not limited to, the following:

- Supervising the other members of the Finance Department;
- Maintaining the Company's books and records in accordance with U.S. and Israeli GAAP (as applicable);
- Preparing monthly, quarterly and annual financial reports and assisting in the preparation of the Forms 10-Q and Forms 10-K filed by the Company with the SEC, and signing the Forms 10-Q and Forms 10-K and accompanying certifications as the principal financial officer and principal accounting officer of the Company;
- Managing the Company's monthly cash flow and arranging for payment of invoices;
- Monitoring and supervising the Company's compliance with the Sarbanes-Oxley Act;
- Assuming responsibility for all credit and banking relationships and activities;
- Arranging for insurance for the Company; and
- Consulting and advising the Company's officers and directors on a range of issues related to finance (including financial controls, accounting, financial analysis and capital management), strategy, risk management, compliance/regulatory issues, acquisitions, and outside investment.

You are expected to carry out and fulfill these duties and responsibilities in addition to your current duties and responsibilities.”

2. Item #1 on pages 1 and 2 of Amendment No. 1 is hereby deleted in its entirety and replaced with the following:

“Effective as of December 1, 2011, you will be eligible to receive monthly compensation according to the table below. Payments will be made every month, starting on or before the ninth of the month following the commencement of your employment. You acknowledge that your monthly compensation stated below includes remuneration for all allowances and benefits required by law, by extension of the law, or any collective bargaining agreements (with the sole exception of travel allowances and meal allowances, also described below), as follows:

Type of Payment	Sum
Base Salary	27,000 NIS
Travel Allowance	Equal to intercity bus fare (“chofshi-chodshi”) (up to a maximum currently set at 510
Meals	Up to a maximum currently set at 14 NIS per meal, plus income tax, as appropriate for portion subsidized by the Company.
Dmei Havra’a	One-twelfth (1/12) of the annual payment due included in the gross monthly salary of above, as this amount may be adjusted from time to time.

You are eligible to continue to lease a car through the Company according to the rates, policies and procedures of the Company. Please note that if you wish to continue to lease a car (i) your Base Salary will be reduced by the amount of your monthly car lease price, (ii) you will pay tax and Bituach Leumi on the reduced Base Salary and (iii) all salary-related benefits (such as Manager's Insurance, severance pay and Keren Hishtalmut) will be calculated based upon the reduced Base Salary. You will pay the tax applicable to the lease of your car as required by the law, which will be automatically deducted from your monthly paycheck. For example, if your Base Salary (as indicated in the table above) is 27,000 NIS and the car lease cost is 2,300 NIS per month, your reduced monthly Base Salary will be 24,700 NIS. Please note that if you continue to lease a car through the Company, you will not be eligible to receive the Travel Allowance described in the table above.

You are expected to work a five-day week, Sunday through Thursday inclusive, from 9:00-18:00. In calculating the Base Salary, it is understood that you will be involved in duties which require your special personal care and loyalty, and therefore the provisions of the Work Hours and Rest Law, 1951, or any law that may be enacted in its place, will not apply to you. You will not be entitled to remuneration according to the Work Hours and Rest Law and acknowledge that your Base Salary has already been increased to include within it all payments which are paid to an employee who is paid in accordance with the directives of the Work Hours and Rest Law. You are expected to work those days and hours necessary for the proper performance of your duties.”

3. Except as expressly provided in this Amendment #2, all of the terms and conditions of the Offer of Employment Letter remain unchanged, and the terms and conditions of the Offer of Employment Letter as amended hereby remain in full force and effect.

IN WITNESS WHEREOF, the parties hereto have executed this Amendment No. 2 as of the date first set forth above.

DELTA THREE ISRAEL, LTD.

By: /s/ Effi Baruch
Name: Effi Baruch
Title: Chief Executive Officer and President

/s/ Yochai Ozeri
Yochai Ozeri

Exhibit 21.1

SUBSIDIARIES

Name of Subsidiary	Jurisdiction
Delta Three Israel, Ltd.	Israel

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements Nos. 333-109495 and 333-143292 on Form S-3 and Nos. 333-34156, 333-122242 ,333-137379, 333-153670 and 333-161312 on Form S-8 of our report, dated March 28, 2012, relating to the financial statements of deltathree, Inc. (which report expresses an unqualified opinion and includes an explanatory paragraph regarding the Company's ability to continue as going concern) appearing in this Annual Report on Form 10-K of deltathree, Inc. for the year ended December 31, 2011.

/s/ Brightman Almagor Zohar & Co. _____

Brightman Almagor Zohar & Co.

Certified Public Accountants,

A member firm of Deloitte Touche Tohmatsu Limited

Tel Aviv, Israel

March 28, 2012

Exhibit 31.1

CERTIFICATION UNDER SECTION 302

I, Effi Baruch, certify that:

1. I have reviewed this annual report on Form 10-K of deltathree, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 28, 2012

/s/ Effi Baruch

Effi Baruch, Principal Executive Officer

Exhibit 31.2

CERTIFICATION UNDER SECTION 302

I, Yochai Ozeri, certify that:

1. I have reviewed this annual report on Form 10-K of deltathree, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 28, 2012

/s/ Yochai Ozeri

Yochai Ozeri, Principal Financial Officer

Exhibit 32.1

CERTIFICATION UNDER SECTION 906

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), the undersigned officer of deltathree, Inc., a Delaware corporation (the "Company"), does hereby certify, to such officer's knowledge, that:

The Annual Report for the year ended December 31, 2011 (the "Form 10-K") of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 28, 2012

/s/ Effi Baruch

Effi Baruch, Chief Executive Officer, President and Senior Vice
President of Operations and Technology (Principal Executive
Officer)

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

Exhibit 32.2

CERTIFICATION UNDER SECTION 906

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), the undersigned officer of deltathree, Inc., a Delaware corporation (the "Company"), does hereby certify, to such officer's knowledge, that:

The Annual Report for the year ended December 31, 2011 (the "Form 10-K") of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 28, 2012

/s/ Yochai Ozeri

Yochai Ozeri, Director of Finance and Treasurer (Principal
Financial Officer)

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.
