DELTATHREE INC (DDDC)

10−Q

Quarterly report pursuant to sections 13 or 15(d)
Filed on 11/4/2010
Filed Period 9/30/2010

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

FORM 10−Q

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

For the quarterly period ended September 30, 2010

or

☐ TRANSITIONAL 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 its Charter)

Delaware	13−4006766
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
224 West 35th Street, New York, N.Y.	10001−2533
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate 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 whether the registrant is a large accelerated filer, an accelerated filer, a non−accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b−2 of the Exchange Act.

Large accelerated filer ☐	Accelerated filer ☐
Non−accelerated filer ☐	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 ☒

As of November 1, 2010, the registrant had outstanding 72,243,971 shares of common stock, par value $0.001 per share.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

DELTATHREE, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)
($ in thousands)

	As of September 30, 2010	As of December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 625	$ 1,514
Restricted cash and short−term investments	211	366
Accounts receivable, net (includes $288 and $85 as of September 30, 2010, and December 31, 2009, respectively, from a related party)	518	270
Prepaid expenses and other current assets	430	409
Inventory	29	29
Total current assets	1,813	2,588
Property and equipment, net	424	654
Deposits	77	67
Total assets	$ 2,314	$ 3,309
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of capital leases	$ 25	$ 144
Accounts payable and accrued expenses	1,562	1,912
Deferred revenues	612	657
Other current liabilities	1,573	1,868
Short−term loan from a related party	1,500	−
Total current liabilities	5,272	4,581
Long−term liabilities:		
Capital leases, net of current portion	−	3
Severance pay obligations, net	168	150
Total long−term liabilities	168	153
Total liabilities	5,440	4,734
Stockholders' equity (deficiency):		
Share capital:		
Common stock, par value $0.001 per share − authorized: 200,000,000 shares; issued and outstanding: 72,030,505 at December 31, 2009, and 72,238,121 at September 30, 2010	72	72
Additional paid−in capital	174,637	174,324
Accumulated deficit	(177,835)	(175,821)
Total stockholders' equity (deficiency)	(3,126)	(1,425)
Total liabilities and stockholders' equity (deficiency)	$ 2,314	$ 3,309

See notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenues	$ 3,528	$ 4,814	$ 9,987	$ 15,319
Costs and operating expenses:				
Cost of revenues	3,112	4,034	8,686	12,798
Research and development expenses	152	94	435	334
Selling and marketing expenses	198	227	750	914
General and administrative expenses	496	650	1,545	2,627
Accrual for contingency (see Note 3 below)	176	–	176	–
Depreciation and amortization	77	197	299	723
Total costs and operating expenses	4,211	5,202	11,891	17,396
Loss from operations	(683)	(388)	(1,904)	(2,077)
Capital gain	–	72	–	86
Other non−operating income	–	–	–	15
Interest (expense) income, net	(39)	(32)	(91)	(64)
Loss before income taxes	(722)	(348)	(1,995)	(2,040)
Income taxes	7	19	19	29
Net loss	$ (729)	$ (367)	$ (2,014)	$ (2,069)
Net loss per share – basic and diluted	$ (0.01)	$ (0.01)	$ (0.03)	$ (0.03)
Basic and diluted weighted average number of shares outstanding	72,222,622	71,962,405	72,209,442	71,962,405

See notes to unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Cash flows from operating activities:		
Net loss	$ (2,014)	$ (2,069)
Adjustments to reconcile loss for the period to net cash used in operating activities:		
Depreciation of property and equipment	299	723
Write−off of fixed asset	−	20
Stock−based compensation	314	35
Capital gain	−	(86)
Provision for losses on accounts receivable	3	186
Change in liability for severance pay, net	18	(41)
Exchange rates differences on deposits, net	(10)	(1)
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(252)	131
(Increase) in prepaid expenses and other current assets	(21)	(53)
Decrease in inventory	−	5
(Decrease) increase in accounts payable and accrued expenses	(350)	520
(Decrease) increase in deferred revenues	(45)	87
(Decrease) increase in other current liabilities	(295)	46
	(339)	1,572
Net cash (used in) operating activities	(2,353)	(497)
Cash flows from investing activities:		
Change in long−term deposit	−	50
Purchase of property and equipment	(69)	(142)
Proceeds from disposal of property and equipment	−	156
(Increase) in short−term investments	(2)	−
Net cash (used in) provided by investing activities	(71)	64
Cash flows from financing activities:		
Release of restricted cash	157	47
Proceeds from exercise of stock options	−	4
Proceeds from issuance of shares, net	−	1,070
Payment of capital leases	(122)	(109)
Short term loan from a related party	1,500	−
Net cash provided by financing activities	1,535	1,012
(Decrease) increase in cash and cash equivalents	(889)	579
Cash and cash equivalents at beginning of period	1,514	1,788
Cash and cash equivalents at end of period	$ 625	$ 2,367

	Nine Months Ended September 30,	
	2010	2009
Supplemental schedule of cash flow information:		
Cash paid for:		
Taxes	$ 20	$ 25
Supplemental schedule of financing activities:		
Cash received from:		
Proceeds from issuance of shares	−	$ 1,170
Direct costs paid for services due to issuance of shares	−	$ 100
Total proceeds	−	1,070

See notes to unaudited condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Basis of Presentation

Financial Statement Preparation

The unaudited condensed consolidated financial statements of deltathree, Inc. and its subsidiaries (collectively referred to in this Quarterly Report on Form 10−Q as the “Company”, “we”, “us”, or “our”), of which these notes are a part, have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the instructions of Form 10−Q and Article 10 of Regulation S−X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. In the opinion of our management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation of the financial information as of and for the periods presented have been included.

The results for the interim periods presented are not necessarily indicative of the results that may be expected for any future period. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes for the year ended December 31, 2009, included in our Annual Report on Form 10−K filed with the SEC on March 29, 2010, our Quarterly Reports on Form 10−Q for the quarter ended March 31, 2010, filed with the SEC on May 7, 2010, and for the quarter ended June 30, 2010, filed with the SEC on August 11, 2010, and all of our other periodic filings, including Current Reports on Form 8−K, filed with the SEC after the end of our 2009 fiscal year and through the date of this Report.

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 has entered into two 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 $2,200,000. The initial Loan and Security Agreement was entered into on March 1, 2010, and the Company has drawn the maximum principal amount of $1,200,000. 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. On September 14 and October 28, 2010, the Company received $300,000 and $400,000, respectively, from D4 Holdings pursuant to a notice of borrowing 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.

As of September 30, 2010, the Company had negative working capital equal to approximately $3.5 million as well as negative stockholders’ equity equal to approximately $3.1 million. The Company believes that it will continue to experience losses and increased negative working capital and negative stockholders’ equity in the near future and may 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 Second Loan Agreement) in the near term. The Company may experience difficulties accessing the equity and debt markets and raising such 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. As a result of the foregoing factors, there is substantial doubt about the Company’s ability to continue as a going concern.

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.

Concentration of Credit and Business Risks

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash and cash equivalents and trade accounts receivable. The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history, age of the balance and the customer’s current credit worthiness, as determined by a review of the customer’s current credit information. The Company monitors collections and payments from its customers and maintains an allowance for doubtful accounts based upon historical experience and any specific customer collection issues that have been identified. A considerable amount of judgment is required in assessing the ultimate realization of these receivables. Customer receivables are generally unsecured.

Sales to material customers representing ten percent or more of total revenues for each of the three months ended September 30, 2010 and 2009, and accounts receivable as of September 30, 2010, and December 31, 2009, were as follows:

	Revenues		Accounts Receivable	
Customer	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	As of September 30, 2010	As of December 31, 2009
Reseller A	48%	21%		
Reseller B	15%	8%		15%
Reseller C		29%		
Service provider A			34%	31%
Service provider B			22%	

Earnings per Common Share

Basic earnings per common share is computed by dividing net income by the weighted−average number of shares of common stock outstanding during the reporting period. Diluted earnings per common share is computed by dividing net income by the combination of dilutive common share equivalents, comprised of shares issuable under the Company’s stock option and stock incentive compensation plans, and the weighted−average number of shares of common stock outstanding during the reporting period. Dilutive common share equivalents include the dilutive effect of in−the−money shares, which is calculated based on the average share price for each period using the treasury stock method. Under the treasury stock method, the exercise price of a share, the amount of compensation cost, if any, for future service that the Company has not yet recognized, and the amount of estimated tax benefits that would be recorded in additional paid−in capital, if any, when the share is exercised are assumed to be used to repurchase shares in the current period.

2. Stock−Based Compensation

A. Options

Stock−based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as expense over the employee’s requisite service period in accordance with the provisions of FASB Statement No. 123R, “Compensation – Stock Compensation” [ASC 718−10].

The Company has no awards with market or performance conditions.

The risk−free interest rate assumption is based upon observed interest rates appropriate for the terms of the Company’s employee stock options. The Company does not target a specific dividend yield for its dividends payments but is required to assume a dividend yield as an input to the Black–Scholes model. The dividend yield assumption is based on the Company’s history and expectation of future dividends payout and may be subject to substantial change in the future. The expected life of employee stock options represent the period the stock options are expected to remain outstanding. The Black−Scholes model assumes that an employee’s exercise behavior is a function of the option’s remaining contractual life and the extent to which the option is in−the−money (i.e., the average market price of the underlying stock during the period is above the strike price of the stock option).

Options to purchase an aggregate of 250,000 shares of the Company’s common stock were granted during the three months ended September 30, 2010.

B. Restricted shares of the Company’s common stock

The Company grants restricted shares to retain, reward and motivate selected employees and directors whom we believe are critical to the future success of the Company. We record compensation expense associated with non−vested restricted shares that have been granted in accordance with [ASC 718−10]. In accordance with [ASC 718−10], we calculate compensation expense on the date of grant by multiplying the number of shares granted by the fair value of our common stock on the date of grant and recognize this expense, adjusted for forfeitures, ratably over the applicable vesting period.

There were no restricted shares of the Company’s common stock granted during the three months ended September 30, 2010.

3. Commitments and Contingencies

Lease Commitments

We lease our principal executive offices at 224 West 35th Street, New York, N.Y. The term of the lease is until August 31, 2011, with an option for us to extend the lease through August 31, 2012. Rent expense, net, for the three months ended September 30, 2010, was approximately $7,000.

Delta Three Israel Ltd., a wholly−owned subsidiary of the Company, or the Subsidiary, leases a 734 square meter office that houses the Company’s research and development facilities in Jerusalem, Israel. Rent expense, net for the Subsidiary was approximately $48,000 for the three months ended September 30, 2010.

Legal Proceedings

On December 5, 2008, a complaint for patent infringement was filed in the United States District Court for the Eastern District of Texas (Tyler Division) by Centre One naming the Company, Verizon Communications Inc., Vonage Holdings Corp. and Vonage America Inc. as defendants. The complaint alleges, inter alia, that the Company and Verizon are offering for sale “a VoIP service, including, but not limited to, a service under the name Verizon VoiceWing” that infringes United States Patent No. 7,068,668, or Patent ’668, entitled “Method and Apparatus for Interfacing a Public Switched Telephone Network and an Internet Protocol Network for Multi−Media Communication.”

On April 7, 2009, the court held a status conference and assigned May 6, 2010, and December 6, 2010, as the dates for the pretrial hearing, or the Markman hearing, to interpret the construction of Centre One’s claims and the commencement of the trial, respectively.

On June 9, 2009, Centre One served a Disclosure of Asserted Claims and Infringement Contentions, in which it accused certain of the Company’s VoIP services, in addition to Verizon VoiceWing, of infringing Patent ’668. Centre One identified the Company’s Hosted Consumer VoIP Solutions, Consumer Group Global Internet Phone Service, and Reseller Programs as allegedly infringing.

On June 22, 2009, the United States Patent and Trademark Office, or the “PTO”, granted a request by Verizon to reexamine Patent ’668, and issued a non−final office action rejecting all but two of the 37 claims of Patent ’668 as not patentable.

On July 14, 2009, Verizon, and on August 13, 2009, the Company and Vonage, filed Invalidity Contentions seeking to invalidate under 35 U.S.C. §102 and/or §103 all of the claims of Patent ’668 asserted over prior patents and publications of third parties not disclosed to the PTO at the time that Patent ’668 was granted.

On August 24, 2009, Centre One amended at the PTO 12 of the 21 claims it had asserted in the litigation. On September 18, 2009, Centre One moved to amend its Infringement Contentions to withdraw the claims it had amended at the PTO and to assert two additional claims of infringement. The Company and the other defendants agreed to the withdrawn claims but opposed Centre One’s attempt to assert new claims.

On October 1, 2009, Vonage separately filed a request for reexamination of Patent ’668, stating additional grounds for invalidity beyond those presented by Verizon in its request for reexamination of the patent. The PTO granted Vonage’s request on December 16, 2009, and subsequently consolidated the proceeding with the Verizon reexamination proceeding.

On February 17, 2010, Centre One’s counsel filed a motion to withdraw as counsel and requested that the court stay all deadlines and discovery in the litigation until Centre One obtained new counsel. The court granted the motion on February 19, and stayed all deadlines in the litigation for 60 days. Following the expiration of the 60−day period on April 20, 2010, without Centre One obtaining new counsel, on April 21 the Company filed a motion to dismiss the litigation for failure of Centre One to prosecute. On April 22, the Chief Executive Officer of Centre One wrote a letter to the court asking for an additional 90 days for Centre One to obtain new counsel. Also on April 22, the court granted Centre One an additional 60 days to obtain new counsel. Following the expiration of the 60−day stay on June 21, 2010, without Centre One obtaining new counsel, on June 22 the Company and Verizon each filed a motion to dismiss the litigation for failure of Centre One to prosecute. Also on June 22, the Chief Executive Officer of Centre One wrote a letter to the court asking for an additional seven days for Centre One to obtain new counsel. On June 23 the court granted Centre One until June 28 to obtain new counsel.

On June 28, 2010, new counsel made an appearance on behalf of Centre One. On July 22, 2010, the court held a scheduling conference and denied all of the pending motions, including the Company’s and Verizon’s respective motions to dismiss for failure to prosecute and Centre One’s motion to supplement its Infringement Contentions. Additionally, the court set a date of June 9, 2011, for the Markman hearing and December 12, 2011, for commencement of the trial. Also at the conference Vonage and Centre One announced that they had reached an agreement in principle to settle the litigation, and on July 26, 2010, Vonage and Centre One filed a Stipulation of Dismissal dismissing Vonage from the lawsuit.

The Company’s examination of the allegations set forth in the Complaint lead the Company to firmly believe that it does not infringe any valid claim of Patent ’668. The Company is continuing its examination into the allegations set forth in the complaint and the validity of Patent ’668, and cannot predict with any degree of certainty the results of the Company’s examination and/or the outcome of the suit or determine the extent of any potential liability or damages.

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. In the event the Company’s petition is denied it has the right to present an offer of compromise. The Company also has the right to seek judicial action at any time for the return of the seized funds. 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. Any recovery of the seized amounts would be recognized as a reversal of the loss recognized.

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.

Regulatory Taxes, Fees and Surcharges

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 $7,000 of state and local taxes and other fees during the three months ended September 30, 2010. We have also determined that we need to collect sales and excise taxes in each of the states and different local jurisdictions and began collecting such taxes in the second quarter of 2010, and have finalized with the relevant state tax authorities and paid any prior amounts that were due. 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 local jurisdictions and that such jurisdictions (as well as the states and local jurisdictions where we have begun collecting and remitting sales and excise taxes) may take the position that we should have collected such taxes, fees and surcharges in the past. 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 our business, financial condition and results of operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Management’s Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10−K for the year ended December 31, 2009.

Forward−Looking Statements

This Quarterly Report on Form 10−Q contains 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 “may,” “expect,” “anticipate,” “forecast,” “intend,” “plan,” “believe,” “seek,” “estimate,” 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. These risks and uncertainties include, but are not limited to, the following:

- our ability to obtain additional capital in the near term to finance operations;
- our ability to reduce our costs and expenses and expand our revenues;
- our ability to retain key personnel and employees needed to support our services and ongoing operations;
- our dependence on a small number of key customers for a significant percentage of our revenue;
- decreasing rates of all related telecommunications services;

- the public’s acceptance of Voice over Internet Protocol, or VoIP, telephony, and the level and rate of customer acceptance of our new products and services;
- the competitive environment of VoIP telephony and our ability to compete effectively;
- fluctuations in our quarterly financial results;
- our ability to maintain and operate our computer and communications systems without interruptions or security breaches;
- our ability to operate in international markets;
- our ability to provide quality and reliable service, which is in part dependent upon the proper functioning of equipment owned and operated by third parties;
- the uncertainty of future governmental regulation;
- our ability to successfully seek the return of all or substantially all of the funds seized by the DHS;
- our ability to protect our intellectual property against infringement by others, and the costs and diversion of resources relating to any claims that we infringe the intellectual property rights of third parties;
- our ability to comply with governmental regulations applicable to our business;
- the need for ongoing product and service development in an environment of rapid technological change; and
- other risks referenced from time to time in our filings with the SEC.

For a more complete list and description of such risks and uncertainties, as well as other risks, please refer to the section entitled "Risk Factors" in our Annual Report on Form 10−K for the year ended December 31, 2009, as filed with the SEC on March 29, 2010, and our Form 10−Q for the quarter ended June 30, 2010, as filed with the SEC on August 11, 2010. Except as required under the federal securities laws and the rules and regulations promulgated thereunder, we do not have any intention or obligation to update publicly any forward−looking statements or risk factors after the filing of this report, whether as a result of new information, future events, changes in assumptions or otherwise.

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 iConnectHere offering (which provides VoIP products and services directly to consumers and small businesses online using the same primary platform), our joip mobile phone application (which provides low cost mobile calls over leading cellular operating systems) 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. During the fourth quarter of 2009 we entered into an agreement with Ojo Service, LLC, a wholly−owned subsidiary of WorldGate Communications, Inc., a publicly−held provider of video phone equipment, pursuant to which we provide Ojo Service 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, discussed below. In 2010 we are continuing to update our network by adding content enabler services to our video phone applications. Following the successful integration of these services, we believe that our full suite of service offerings will constitute a complete next generation communication service package that will provide our customers the ability to customize, implement and rapidly launch digital next generation communications offerings.

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.

Following a comprehensive review of the our strategy in the second quarter of 2009, we decided to focus our near−term strategy and market initiatives on growing our service provider business while still supporting our core VoIP reseller and direct−to−consumer business segments. While our revenues for the third quarter of 2010 decreased by approximately $134,000 compared to the second quarter of 2010, our net loss decreased from approximately 813,000 to approximately $729,000. As of September 30, 2010, we had negative working capital equal to approximately $3.5 million and negative stockholders' equity equal to approximately $3.1 million.

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:

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 and by other political developments and laws and regulations, such as: telecommunications regulations; war, 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" in our Annual Report on Form 10−K for the year ended December 31, 2009, as filed with the SEC on March 29, 2010, and Part II. Item 1A. "Risk Factors" in our Form 10−Q for the quarter ended June 30, 2010, as filed with the SEC on August 11, 2010, for a discussion of some of the 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 resellers and service provider divisions accounted for approximately 91% and 90% of our total revenues for the three months ended September 30, 2010 and 2009, respectively, and the provision of VoIP telephony through our direct to consumer division accounted for approximately 8% and 10% of our total revenues for the three months ended September 30, 2010 and 2009, 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 customers 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.

We have not recorded any income tax benefit for net losses and credits incurred for any period from inception to September 30, 2010. 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, 2009, we had net operating losses, or NOLs, generated in the U.S. of approximately $159 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.

Results of Operations − Three Months Ended September 30, 2010, Compared to Three Months Ended September 30, 2009

Revenues

Revenues decreased by approximately $1.3 million, or 27%, to approximately $3.5 million for the three months ended September 30, 2010, from approximately $4.8 million for the three months ended September 30, 2009. During this period, the number of minutes carried by our network decreased by 22%, a decline of approximately 21,000,000 minutes to approximately 77,000,000 minutes for the third quarter of 2010 compared to 98,000,000 minutes for the third quarter of 2009.

Revenues from our reseller and service provider divisions decreased by approximately $1.1 million, or 26%, to approximately $3.2 million for the three months ended September 30, 2010, from approximately $4.3 million for the three months ended September 30, 2009. This occurred primarily as a result of the suspension during the fourth quarter of 2009 of the operations of our then−largest reseller, which had generated revenues of approximately $1.4 million during the three months ended September 30, 2009.

Within the reseller division itself, revenues decreased by approximately $1.0 million, or 28%, to approximately $2.8 million for the three months ended September 30, 2010, from approximately $3.8 million for the three months ended September 30, 2009. As mentioned above, this was primarily due to the suspension during the fourth quarter of 2009 of the operations of our then−largest reseller. We made a decision in the first quarter of 2009 to focus on servicing fewer, larger resellers rather than more, smaller resellers. Consequently, our two largest resellers accounted for approximately $2.4 million, or approximately 63%, of the revenue generated from our reseller division in the third quarter of 2009. This represented approximately 50% of our total revenue for the third quarter of 2009. By comparison, in the third quarter of 2010 our two largest resellers accounted for approximately $2.2 million, or approximately 80%, of the revenue generated from our reseller division, which equaled approximately 63% of our total revenue for the second quarter of 2010.

Revenues generated by our service provider division decreased slightly by approximately $39,000, or 8%, to approximately $431,000 for the three months ended September 30, 2010, from $470,000 for the three months ended September 30, 2009. Approximately 80% of the revenues from our service provider division for the three months ended September 30, 2010, were generated from agreements with two related parties, including $97,000 for one−time development fees. For the three months ended September 30, 2009, we recorded one−time development fees of $260,000 from an agreement with a related party.

Sales to direct consumers decreased by approximately $170,000, or 37%, to approximately $291,000 for the three months ended September 30, 2010, from approximately $461,000 for the three months ended September 30, 2009. The decrease in direct consumer revenues was primarily due to a shift in our focus and resources away from this division, which has resulted in a decrease in the number of our direct consumers.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by approximately $0.9 million, or 23%, to approximately $3.1 million, at a gross margin of approximately 11%, for the three months ended September 30, 2010, from approximately $4.0 million, at a gross margin of approximately 17%, for the three months ended September 30, 2009. The decrease in cost of revenues was primarily due to the loss of our then−largest reseller in the fourth quarter of 2009, as during the third quarter of 2009 we incurred $0.8 million of direct costs associated with this reseller. Pricing pressures causing a reduction in our margins for our other resellers and direct consumers increased our termination and network costs for such period by approximately $100,000.

Research and development expenses. Research and development expenses increased by approximately $58,000, or 61%, to approximately $152,000 for the three months ended September 30, 2010, from approximately $94,000 for the three months ended September 30, 2009, mainly due to an increase of salaries and related expenses. As a percentage of revenues, research and development expenses increased to approximately 4% for the three months ended September 30, 2010, from approximately 2% for the three months ended September 30, 2009.

Selling and marketing expenses. Selling and marketing expenses decreased by approximately $29,000, or 13%, to approximately $198,000 for the three months ended September 30, 2010, from approximately $227,000 for the three months ended September 30, 2009. As a percentage of revenues, sales and marketing expenses were approximately 6% for the three months ended September 30, 2010, and approximately 5% for the three months ended September 30, 2009. This decline in the amount of sales and marketing expenses was primarily caused by a decrease in sales commissions, salaries and related expenses.

General and administrative expenses. General and administrative expenses decreased by approximately $154,000, or 24%, to approximately $496,000 for the three months ended September 30, 2010, from approximately $650,000 for the three months ended September 30, 2009. The decrease was due to our having recorded during the three months ended September 30, 2009, a provision for $100,000 for legal and professional fees and litigation and other related expenses and a loss of $50,000 for a write−off of a deposit not refunded. As a percentage of revenues, general and administration expenses decreased to approximately 14% for the three months ended September 30, 2010, from approximately 15% for the three months ended September 30, 2009.

Accrual for contingency. As discussed below under Part II. Item 1. "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. Any recovery of the seized amounts would be recognized as a reversal of the loss recognized.

Depreciation and amortization. Depreciation and amortization decreased by approximately $120,000, or 61%, to approximately $77,000 for the three months ended September 30, 2010, from approximately $197,000 for the three months ended September 30, 2009. Due to the level of investment we made in capital expenditures in previous years, we do not currently expect to make significant capital expenditures to support our network infrastructure in the near term. As a result, we have reduced our investments in fixed assets, which resulted in the decrease in depreciation and amortization.

Loss from Operations

As a result of the above, loss from operations was approximately $683,000 and $388,000 for the three months ended September 30, 2010, and September 30, 2009, respectively.

Interest Expense, Net

Interest expense, net increased to approximately $39,000 for the three months ended September 30, 2010, from approximately $32,000 for the three months ended September 30, 2009. The primary cause of the increase was interest payments we made pursuant to our loan agreements with D4 Holdings.

Income Taxes, Net

We accrued net income taxes of approximately $7,000 for the three months ended September 30, 2010, and $19,000 for the three months ended September 30, 2009.

Net Loss

For the three months ended September 30, 2010, we had a net loss of approximately $729,000 compared to a net loss of approximately $367,000 for the three months ended September 30, 2009. The change in the net loss was due to the factors set forth above.

Results of Operations − Nine Months Ended September 30, 2010, Compared to Nine Months Ended September 30, 2009

Revenues

Revenues decreased by approximately $5.3 million, or 35%, to approximately $10.0 million for the nine months ended September 30, 2010, from approximately $15.3 million for the nine months ended September 30, 2009. During this period, the number of minutes carried by our network decreased by 26%, a decline of approximately 82,000,000 minutes to 230,000,000 minutes for the nine months ended September 30, 2010, from 312,000,000 for the corresponding period in 2009.

Revenues from our reseller and service provider divisions decreased by approximately $4.7 million, or 35%, to approximately $8.9 million for the nine months ended September 30, 2010, from approximately $13.6 million for the nine months ended September 30, 2009. This occurred primarily as a result of the suspension during the fourth quarter of 2009 of the operations of our then−largest reseller, which had generated revenues of approximately $4.5 million during the nine months ended September 30, 2009.

Within the reseller division itself, revenues decreased by approximately $4.1 million, or 35%, to approximately $7.9 million for the nine months ended September 30, 2010, from approximately $12.0 million for the nine months ended September 30, 2009. As mentioned above, this was primarily due to the suspension during the fourth quarter of 2009 of the operations of our then−largest reseller. We made a decision in the first quarter of 2009 to focus on servicing fewer, larger resellers rather than more, smaller resellers. Consequently, our two largest resellers accounted for approximately $7.6 million, or 63%, of the revenue generated from our reseller division in the first three quarters of 2009. This represented approximately 49% of our total revenue for the period. By comparison, for the nine months ended September 30, 2010, our two largest resellers accounted for approximately $5.9 million, or 75%, of the revenue generated from our reseller division, which equaled approximately 59% of our total revenue for the period.

Revenues generated by our service provider division decreased by approximately $0.5 million, or 33%, to approximately $1.1 million for the nine months ended September 30, 2010, from approximately $1.6 million for the nine months ended September 30, 2009. This decrease was primarily due to the termination during 2009 of our agreements with two of our service provider clients (including our then−largest service provider client), which cumulatively accounted for revenue of approximately $811,000 in the first three quarters of 2009. As a result of the termination of these agreements, we did not generate any revenues from those clients in the nine months ended September 30, 2010. This decrease was partially offset by $670,000 of revenues generated in the nine months ended September 30, 2010, from our agreement with a related party that we entered into in the third quarter of 2009.

Sales to direct consumers decreased by approximately $590,000, or 38%, to approximately $966,000 for the nine months ended September 30, 2010, from approximately $1.6 million for the nine months ended September 30, 2009. The decrease in direct consumer revenues was primarily due to a shift in our focus and resources away from this division, which has resulted in a decrease in the number of our direct consumers.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by approximately $4.1 million, or 32%, to approximately $8.7 million, at a gross margin of approximately 13%, for the nine months ended September 30, 2010, from approximately $12.8 million, at a gross margin of approximately 16%, for the nine months ended September 30, 2009. The decrease in cost of revenues for the nine months ended September 30, 2010, was primarily due to the loss of our then−largest reseller in the fourth quarter of 2009, as during the nine months ended September 30, 2009, we incurred approximately $3.4 million of direct costs and $0.2 million of equipment costs associated with this reseller. Pricing pressures causing a reduction in our margins for our other resellers and direct consumers increased our termination and network costs for such period by approximately $0.5 million.

Research and development expenses. Research and development expenses increased by approximately $101,000, or 30%, to approximately $435,000 for the nine months ended September 30, 2010, from approximately $334,000 for the nine months ended September 30, 2010, mainly due to an increase of salaries and related expenses. As a percentage of revenues, research and development expenses increased to approximately 4% for the nine months ended September 30, 2010, from approximately 2% for the nine months ended September 30, 2009.

Selling and marketing expenses. Selling and marketing expenses decreased by approximately $164,000, or 18%, to approximately $750,000 for the nine months ended September 30, 2010, from approximately $914,000 for the nine months ended September 30, 2009. As a percentage of revenues, sales and marketing expenses were approximately 8% for the nine months ended September 30, 2010, and approximately 6% for the nine months ended September 30, 2009. This decline in the amount of sales and marketing expenses was primarily caused by a decrease in sales commissions, salaries and related expenses.

General and administrative expenses. General and administrative expenses decreased by approximately $1.1 million, or 41%, to approximately $1.5 million for the nine months ended September 30, 2010, from approximately $2.6 million for the nine months ended September 30, 2009. The decrease was due to our having recorded during the nine months ended September 30, 2009, a provision for $500,000 for legal and professional fees and litigation and other related expenses, a provision for $200,000 for doubtful debt expense and loss of $50,000 for a write−off of a deposit not refunded. As a percentage of revenues, general and administration expenses decreased to approximately 15% for the nine months ended September 30, 2010, from approximately 17% for the nine months ended September 30, 2009.

Accrual for contingency. As discussed below under Part II. Item 1. “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. Any recovery of the seized amounts would be recognized as a reversal of the loss recognized.

Depreciation and amortization. Depreciation and amortization decreased by approximately $424,000, or 59%, to approximately $299,000 for the nine months ended September 30, 2010, from approximately $723,000 for the nine months ended September 30, 2009. Due to the level of investment we made in capital expenditures in previous years, we do not currently expect to make significant capital expenditures to support our network infrastructure in the near term. As a result, we have reduced our investments in fixed assets, which resulted in the decrease in depreciation and amortization.

Loss from Operations

As a result of the above, loss from operations was approximately $1.9 million and $2.0 million for the nine months ended September 30, 2010, and September 30, 2009, respectively.

Interest Expense, Net

Interest expense, net increased to approximately $91,000 for the nine months ended September 30, 2010, from approximately $64,000 for the nine months ended September 30, 2009. The primary cause of the increase was interest payments we made pursuant to the First Loan Agreement with D4 Holdings.

Income Taxes, Net

We accrued net income taxes of approximately $19,000 for the nine months ended September 30, 2010, and $29,000 for the nine months ended September 30, 2009.

Net Loss

For the nine months ended September 30, 2010, we had a net loss of approximately $2.0 million, compared to a net loss of approximately $2.1 million for the nine months ended September 30, 2009. The change in the net loss was due to the factors set forth above.

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 our recent losses from operations. For the nine months ended September 30, 2010, our net loss from operations was approximately $1.9 million. To date, we have an accumulated deficit of approximately $178 million.

As of September 30, 2010, we had cash and cash equivalents of approximately $625,000 and restricted cash and short−term investments of approximately $211,000, or a total of cash, cash equivalents and restricted cash of approximately $836,000, a decrease of approximately $1.0 million from December 31, 2009. 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 nine months ended September 30, 2010, of approximately $2.4 million.

Cash used in operating activities is net income adjusted for certain non−cash items and changes in assets and liabilities. During the nine months ended September 30, 2010, we generated negative cash flow from operating activities of approximately $2.4 million compared with negative cash flow from operating activities of approximately $0.5 during the nine months ended September 30, 2010. The increase in cash used in operating activities was primarily driven by a decrease of approximately $424,000 and $185,000 for depreciation of fixed assets and a provision for losses on account receivables, respectively, as well as a decrease of approximately $900,00 and $300,000 for accounts payables and other current liabilities, respectively..

Net cash provided by investing activities is generally driven by our capital expenditures and changes in our short and long term investments. During the nine months ended September 30, 2010, we expensed $69,000 for purchasing new equipment compared to $142,000 for the nine months ended September 30, 2009.   In addition, during the nine months ended September 30, 2009, we also received $156,000 from selling fixed assets and other 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. 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 March 2, 2010, May 3, 2010, June 24, 2010, and August 3, 2010, we received $500,000, $250,000, $250,000 and $200,000, respectively, from D4 Holdings pursuant to notices of borrowing under the First Loan Agreement. 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. On each of September 14 and October 28, 2010, we received $300,000 and $400,000, respectively, from D4 Holdings pursuant to a notice of borrowing under the Second Loan Agreement. 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. There were no options exercised by our employees or directors during the nine months ended September 30, 2010.

As discussed below under Part II. Item 1. “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. In the event our petition is denied we have the right to present an offer of compromise. We also have the right to seek judicial action at any time for the return of the seized funds. Our inability to access these funds has had a material impact on our cash position and liquidity. In the event that we are unsuccessful in effecting the return of all or substantially all of the seized funds, this would have a material adverse impact on our business, liquidity and financial condition.

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 has led to a significant reduction in our cash reserves. As of September 30, 2010, we had negative working capital equal to approximately $3.5 million as well as negative stockholders’ equity equal to approximately $3.1 million. We believe 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 Second Loan Agreement) in the near term. 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. If additional funds are raised through the issuance of equity securities, our existing stockholders will experience significant further dilution. As a result of the foregoing factors, there is substantial doubt about our ability to continue as a going concern.

Off−Balance Sheet Arrangements

None.

Contingencies

For a discussion of contingencies, see Note 3 of the Notes to the Condensed Consolidated Financial Statements of this report, which is incorporated herein by reference.

Item 4T. 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)) as of the end of the period covered by this Quarterly Report on Form 10−Q, has concluded that, based on such evaluation, our disclosure controls and procedures as of September 30, 2010, 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) Changes in Internal Controls.

There were no changes in our internal control over financial reporting during our most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1.   Legal Proceedings.

There have been no material changes to our Legal Proceedings as described in Item 3 of our Annual Report on Form 10−K for the year ended December 31, 2010, as filed with the SEC on March 29, 2010, and Item 1 to our Quarterly Report on Form 10−Q for the quarter ended March 31, 2010, filed with the SEC on May 7, 2010, and for the quarter ended June 30, 2010, filed with the SEC on August 11, 2010, except as described below.

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 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 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. In the event our petition is denied we have the right to present an offer of compromise. We also have the right to seek judicial action at any time for the return of the seized funds. No assurance can be given that we will be successful in recovering all or a substantial portion of the seized funds. In the event we are unable to recover all or a substantial portion of the funds, it could have a material adverse effect on our business, results of operations and financial condition.

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 the subject.

Item 6.   Exhibits.

See Exhibit Index on page 21 for a description of the documents that are filed as Exhibits to this Quarterly Report on Form 10−Q or incorporated by reference herein.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Quarterly Report on Form 10−Q to be signed on its behalf by the undersigned thereunto duly authorized.

DELTATHREE, INC.

Date: November 4, 2010

By: /s/ Effi Baruch
Name: Effi Baruch
Title: Chief Executive Officer, President and Senior Vice President of Operations and Technology
(Principal Executive Officer)

Date: November 4, 2010

By: /s/ Arie Rand
Name: Arie Rand
Title: Chief Financial Officer and Treasurer
(Principal Financial Officer)

EXHIBIT INDEX

Exhibit Number	Description
4.1	Promissory Note, dated August 10, 2010, by deltathree, Inc., Delta Three Israel, Ltd. and DME Solutions, Inc. in favor of D4 Holdings, LLC in a principal amount of $1,000,000 (incorporated by reference from our Current Report on Form 8−K filed on August 11, 2010).
10.1	Second Loan and Security Agreement, dated as of August 10, 2010, by and among deltathree, Inc., Delta Three Israel, Ltd., DME Solutions, Inc. and D4 Holdings, LLC (incorporated by reference from our Current Report on Form 8−K filed on August 11, 2010).
10.2	Warrant, dated August 10, 2010, between deltathree, Inc., and D4 Holdings, LLC (incorporated by reference from our Current Report on Form 8−K filed on August 11, 2010).
10.3	First Amendment to Loan and Security Agreement, dated as of August 10, 2010, by and among deltathree, Inc., Delta Three Israel, Ltd., DME Solutions, Inc. and D4 Holdings, LLC (incorporated by reference from our Current Report on Form 8−K filed on August 11, 2010).
10.4	Offer of Employment Letter between deltathree, Inc. and Ari Rand, dated September 19, 2010 (incorporated by reference from our Current Report on Form 8−K filed on September 22, 2010).
10.5	Sales Agency Agreement, dated as of September 27, 2010, by and among deltathree, Inc., Delta Three Israel, Ltd., DME Solutions, Inc. and LKN Communications, Inc., doing business as ACN, Inc. (incorporated by reference from our Current Report on Form 8−K filed on October 4, 2010).
10.6*	Amendment No. 1 to Offer of Employment Letter between Delta Three Israel, Ltd. and Arie Rand, dated October 17, 2010.
10.7*	Amendment No. 3 to Executive Employment Agreement among deltathree, Inc., Delta Three Israel, Ltd. and Effi Baruch, dated as of October 27, 2010.
31.1*	Certification of the Chief Executive Officer, as adopted pursuant to Section 302 of the Sarbanes−Oxley Act of 2002.
31.2*	Certification of the Chief Financial Officer, as adopted pursuant to Section 302 of the Sarbanes−Oxley Act of 2002.
32.1*	Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002.
32.2*	Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002.

* Filed herewith.

AMENDMENT #1 TO OFFER OF EMPLOYMENT LETTER

This Amendment #1 (“Amendment #1”) to the Offer of Employment Letter by and between Delta Three Israel, Ltd. (the “Company”) and Arie Rand (“Executive”), dated as of September 19, 2010 (the “Offer of Employment Letter”), is dated October 17, 2010.

Recitals:

WHEREAS, the Company and Executive entered into the Offer of Employment Letter and now wish to enter into this Amendment #1 to amend the Offer of Employment Letter 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 clause “10,000 USD (with payment in NIS according to the official exchange rate of the Bank of Israel on the day of payroll processing).” found on page 2 of the Offer of Employment Letter is hereby deleted in its entirety and replaced with the following:

“10,000 USD (with payment in NIS at an exchange rate of 4 NIS for 1 USD).”

2. Except as expressly provided in this Amendment #1, 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 remain in full force and effect.

IN WITNESS WHEREOF, the parties hereto have executed this Amendment #1 as of the date first set forth above.

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

By: /s/ Arie Rand
Arie Rand

AMENDMENT NO. 3 TO EXECUTIVE EMPLOYMENT AGREEMENT

This Amendment No. 3 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") and that certain Amendment No. 2, dated as of October 20, 2009 ("Amendment No. 2", and together with the Executive Employment Agreement and Amendment No. 1, the "Agreement"), is dated as of October 27, 2010.

Recitals:

WHEREAS, the Company and Executive entered into the Executive Employment Agreement, as amended by Amendment No. 1 and Amendment No. 2, and now wish to enter into this Amendment No. 3 to Executive Employment Agreement ("Amendment No. 3") 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 2(a) of the Agreement is hereby deleted in its entirety and replaced with the following:

"Executive shall be employed as Chief Executive Officer and President of Inc. and Ltd. and shall perform such duties and services, consistent with such position and its current duties and services for Inc. and Ltd., and as may be assigned to him from time to time by the Board of Directors."

2. The foregoing amendment to the Agreement shall be effective commencing on the date hereof.

3. Except as expressly provided in this Amendment No. 3, 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. 3 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

Exhibit 31.1

CERTIFICATION BY PRINCIPAL EXECUTIVE OFFICER

I, Effi Baruch, certify that:

1. I have reviewed this Quarterly Report on Form 10−Q of deltathree, Inc. (the “registrant”);

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: November 4, 2010

By: /s/ Effi Baruch
Effi Baruch
Chief Executive Officer, President and Senior Vice President of
Operations and Technology

Exhibit 31.2

CERTIFICATION BY PRINCIPAL FINANCIAL OFFICER

I, Arie Rand, certify that:

1. I have reviewed this Quarterly Report on Form 10−Q of deltathree, Inc. (the “registrant”);

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)) 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: November 4, 2010

By: /s/ Arie Rand
Arie Rand
Chief Financial Officer and Treasurer

Exhibit 32.1

CERTIFICATION

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to
Section 906 of the Sarbanes−Oxley Act of 2002

Pursuant to Section 906 of the Sarbanes−Oxley Act of 2002, 18 U.S.C. Section 1350, the undersigned officer of deltathree, Inc. (the "registrant") does hereby certify, to such officer's knowledge, that:

(1) the Quarterly Report on Form 10−Q for the quarter ended September 30, 2010 (the "Form 10−Q") of the registrant fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Form 10−Q fairly presents, in all material respects, the financial condition and results of operations of the registrant.

Date: November 4, 2010	By:	/s/ Effi Baruch
		Effi Baruch, Chief Executive Officer, President and Senior Vice President of Operations and Technology

The foregoing certification will not be deemed "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

Exhibit 32.2

CERTIFICATION

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to
Section 906 of the Sarbanes−Oxley Act of 2002

Pursuant to Section 906 of the Sarbanes−Oxley Act of 2002, 18 U.S.C. Section 1350, the undersigned officer of deltathree, Inc. (the “registrant”) does hereby certify, to such officer’s knowledge, that:

(1) the Quarterly Report on Form 10−Q for the quarter ended September 30, 2010 (the “Form 10−Q”) of the registrant fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Form 10−Q fairly presents, in all material respects, the financial condition and results of operations of the registrant.

Date: November 4, 2010

By: /s/ Arie Rand
Arie Rand, Chief Financial Officer and Treasurer

The foregoing certification will not be deemed “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.