

DELTATHREE INC (DDDC)

10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filed on 05/14/2012

Filed Period 03/31/2012

THOMSON REUTERS ACCELUS™



THOMSON REUTERS

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 March 31, 2012

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

(State or other jurisdiction of incorporation or organization)

13-4006766

(I.R.S. Employer Identification Number)

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

(Address of principal executive offices)

07093

(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

Non-accelerated filer

Accelerated filer

Smaller reporting

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 May 8, 2011, the registrant had outstanding 72,273,525 shares of common stock, par value \$0.001 per share.

TABLE OF CONTENTS

	Page
PART I - FINANCIAL INFORMATION	
Item 1. Financial Statements	3
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 4. Controls and Procedures	20
PART II - OTHER INFORMATION	
Item 1. Legal Proceedings	20
Item 1A. Risk Factors	20
Item 6. Exhibits	21
SIGNATURES	22
EXHIBIT INDEX	23

**PART I
FINANCIAL INFORMATION**

Item 1. Financial Statements

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

	As of	As of
	March 31,	December
	2012	31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 449	\$ 214
Restricted cash and short-term investments	80	131
Accounts receivable, net (includes \$172 and \$158 as of March 31, 2012, and December 31, 2011, respectively, from a related party)	539	415
Prepaid expenses and other current assets	367	445
Inventory	53	46
Total current assets	1,488	1,251
Property and equipment, net	301	335
Deposits	80	78
Total assets	\$ 1,869	\$ 1,664
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
Current liabilities:		
Accounts payable (includes \$868 and \$575 as of March 31, 2012, and December 31, 2011, respectively, to a related party)	1,639	1,469
Deferred revenues	686	522
Short-term loan from a related party	3,526	3,133
Other current liabilities	840	830
Total current liabilities	6,691	5,954
Long-term liabilities:		
Severance pay obligations	113	112
Total long-term liabilities	113	112
Total liabilities	6,804	6,066
Stockholders' deficiency:		
Share capital:		
Common stock, par value \$0.001 per share; authorized: 225,000,000 shares; issued and outstanding: 72,273,525 at March 31, 2012, and December 31, 2011	72	72
Additional paid-in capital	176,902	176,893
Accumulated deficit	(181,909)	(181,367)
Total stockholders' deficiency	(4,935)	(4,402)

Total liabilities and stockholders' deficiency	\$ <u>1,869</u>	\$ <u>1,664</u>
--	-----------------	-----------------

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	
	March 31,	
	2012	2011
Revenues	\$ 2,847	\$ 3,784
Costs and operating expenses:		
Cost of revenues	1,737	2,794
Research and development expenses	305	433
Selling and marketing expenses	502	538
General and administrative expenses (income)	351	(260)
Depreciation and amortization	35	60
Total costs and operating expenses	<u>2,930</u>	<u>3,565</u>
(Loss) income from operations	(83)	219
Interest expense, net	459	185
(Loss) income before income taxes	<u>(542)</u>	<u>34</u>
Income taxes	-	6
Net (loss) income	\$ (542)	\$ 28
Net loss per share – basic and diluted	\$ (0.01)	\$ 0.00
Basic and diluted weighted average number of shares outstanding	<u>72,273,525</u>	<u>72,273,525</u>

See notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended	
	March 31,	
	2012	2011
Cash flows from operating activities:		
Net (loss) income for the period	\$ (542)	\$ 28
Adjustments to reconcile loss for the period to net cash provided by (used in) operating activities:		
Accumulated interest on short-term loan	132	-
Depreciation and amortization	35	60
Amortization related to convertible notes	261	92
Tax provision	-	(158)
Stock-based compensation	9	83
Provision for losses on accounts receivable	-	100
Increase in liability for severance pay, net	1	22
Exchange rates differences on deposits, net	(2)	(4)
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(124)	159
(Increase) decrease in prepaid expenses and other current assets	(56)	60
Increase in inventory	(7)	(7)
Increase (decrease) in accounts payable	170	(366)
Increase (decrease) in deferred revenues	164	(125)
Increase (decrease) in other current liabilities	10	(759)
	<u>593</u>	<u>(843)</u>
Net cash provided by (used in) operating activities	<u>51</u>	<u>(815)</u>
Cash flows from investing activities:		
Purchase of property and equipment	(1)	(86)
Release of restricted cash	134	-
Decrease (increase) in short-term investments, net	51	(8)
Net cash provided by (used in) investing activities	<u>184</u>	<u>(94)</u>
Cash flows from financing activities:		
Payment of capital leases	-	(7)
Short-term loan from a related party	-	850
Net cash provided by financing activities	<u>-</u>	<u>843</u>
Increase (decrease) in cash and cash equivalents	235	(66)
Cash and cash equivalents at beginning of period	214	308
Cash and cash equivalents at end of period	<u>\$ 449</u>	<u>\$ 242</u>

Three Months Ended

March 31,

2012 2011

Supplemental schedule of cash flow information:

Cash paid for:

Taxes

\$ 84 \$ 6

See notes to unaudited condensed consolidated financial statements.

DELTATHREE, INC.

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, 2011, included in our Annual Report on Form 10-K filed with the SEC on March 28, 2012, and all of our other periodic filings, including Current Reports on Form 8-K, filed with the SEC after the end of our 2011 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 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 March 31, 2012, the Company had drawn down the aggregate amount of \$200,000 from D4 Holdings pursuant to notices of borrowing under the Fourth Loan Agreement.

As of March 31, 2012, the Company had negative working capital equal to approximately \$5.2 million as well as negative stockholders' equity equal to approximately \$4.9 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. As of March 31, 2012, the Company had 31 full time employees.

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.

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 March 31, 2012 and 2011, and accounts receivable as of March 31, 2012, and December 31, 2011, were as follows:

Customer	Revenues		Accounts Receivable	
	For the Three	For the Three	As of March 31,	As of December 31,
	Months Ended	Months Ended	2012	2011
	March 31, 2012	March 31, 2011		
Reseller A	24%	38%	23%	-
Reseller B	14%	21%	7%	19%
Affiliate A	12%	-	-	-
Affiliate B	11%	-	-	-
Service Provider A	8%	8%	29%	38%

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

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 "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).

No options to purchase shares of the Company's common stock were granted during the three months ended March 31, 2012.

3. Commitments and Contingencies

Lease Commitments

The Company leases 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. The aggregate rent expense, net, for the two locations for the three months ended March 31, 2012, was \$1,650.

Delta Three Israel Ltd., a wholly-owned subsidiary of the Company (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. The Subsidiary is currently in discussions with the landlord to extend the lease on the same terms, subject to a significant reduction in the size of the office space subject to the lease, for an additional three years, and expects to enter into a written agreement with the landlord to that effect in the near future. Rent expense, net for the Subsidiary for the three months ended March 31, 2012, was \$44,000.

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 assisted 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 opposed 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, and on April 19, 2012, the Company received the \$52,804. 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, or the Department of Finance, which 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. The Company has engaged outside counsel, which has begun discussions with the Department of Finance, and is contesting the assessment and simultaneously attempting to negotiate a significant reduction in the amounts to be paid. The final outcome of this assessment and our negotiations 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 Department of Finance this would have a material adverse effect on the Company's financial condition. 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.

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.

The Company paid approximately \$84,200 of state and local taxes and other fees during the three months ended March 31, 2012. To the extent the Company increases 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 the Company may have over traditional telecommunications companies.

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

4. Warrants and Convertible Note

As discussed above under "Basis of Presentation", the Company issued to D4 Holdings a warrant in connection with the Second Loan Agreement and a warrant and the Convertible Note in connection with the Third Loan Agreement. The Company evaluated the warrants in accordance with "Contracts in Entity's Own Equity" [ASC 815-40] and determined that the warrants should be classified as equity and should not be considered derivatives. The Company accounted for the Convertible Note in accordance with "Debt with Conversion and Other Options" [ASC 470-20], which requires the Company to recognize separately, at issuance, the

embedded beneficial conversion feature of the Convertible Note as additional paid-in capital. The amount to be recognized is calculated as the difference between the effective conversion price of the convertible instrument and the fair value of the underlying shares on the issuance date. As a result, the Convertible Note was initially recorded as having no value as the beneficial conversion feature exceeded the carrying value of the Convertible Note.

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, 2011.

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 increase revenues and generate additional cash;
- our ability to obtain additional capital in the near term to finance operations;
- our ability to meet our obligations under outstanding indebtedness, and the impact of any remedies our secured lender may seek thereunder;
- our ability to successfully pursue strategic alternatives in the event we are unable to increase revenues and generate additional cash;
- our ability to retain key personnel and employees needed to support our services and ongoing operations and our ability to continue to effectively maintain our ongoing operations, especially following the reduction in force that we recently effected;
- 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;
- the outcome of our discussions with the New York City Department of Finance regarding the outstanding commercial rent tax, interest and penalties it claims we owe;
- the impact of continuing unrest in the Middle East on our customers doing business in that region, as well as the ability of certain of our major customers operating in that region to resume or continue operations;
- 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, 2011, as filed with the SEC on March 28, 2012. 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 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.

On April 3, 2012, we entered into an amendment to our sales agency agreement with ACN and our introducer agreement with ACN Europe. Pursuant to the terms of the amendment, beginning April 1, 2012, we are required to pay all then-current commissions on a

timely basis as required under the agreements and a late fee in the amount of one percent per month of any past-due, unpaid commissions (which, as of March 31, 2012, was equal to approximately \$868,000). Beginning July 15, 2012, we are required to pay down any unpaid past due amounts in an amount equal to at least \$15,000 per month through June 15, 2013, and at least \$25,000 per month thereafter until such time as the unpaid balance is paid in full, and are required to pay in full any unpaid, past due amounts upon 30 days' notice. In addition, in the event of certain insolvency-related events defined in the agreements, all unpaid amounts will become immediately due and payable effective immediately prior to such event.

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.

As of March 31, 2012, we had negative working capital equal to approximately \$5.2 million as well as negative stockholders' equity equal to approximately \$4.9 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 flows, 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 flows, 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 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. As of March 31, 2012, we had 31 full time employees.

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 it, 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 its 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.

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 and continuing 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: For a discussion of the impact of market risks, financial risks and other risks and uncertainties that we face, see “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2012, as filed with the SEC on March 28, 2012.

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 62% and 86% of our total revenues for the three months ended March 31, 2012 and 2011, respectively, and the provision of VoIP telephony through our direct-to-consumer division accounted for approximately 36% and 13% of our total revenues for the three months ended March 31, 2012 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 customers to our direct-to-consumer divisions. In addition, we expense all sales commissions paid to third parties that sell our products and services pursuant to the terms of our agreements with such third parties.

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 March 31, 2012. 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 March 31, 2012, we had net operating losses, or NOLs, generated in the U.S. of approximately \$21 million and Delta Three Israel Ltd., our wholly-owned subsidiary, had NOLs of approximately \$5 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 began to expire in 2011 and will continue to expire at various dates until 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 March 31, 2012, Compared to Three Months Ended March 31, 2011

Revenues

Revenues decreased by approximately \$1.0 million, or 26%, to approximately \$2.8 million for the three months ended March 31, 2012, from approximately \$3.8 million for the three months ended March 31, 2011. During this period the number of minutes carried by our network decreased by approximately 27% from approximately 100 million minutes during the three months ended March 31, 2011, to approximately 73 million minutes for the corresponding period in 2012. This was caused, in large part, by the temporary cessation of services to our then-largest reseller beginning in February 2011. In September 2011, this reseller resumed operations and conducting business with our company, and became a material customer of the company again beginning the fourth quarter of 2011 and the largest customer of the company again beginning the first quarter of 2012, but at levels materially lower than historic levels.

Revenues generated by our reseller division decreased by approximately \$1.3 million, or 46%, to approximately \$1.5 million for the three months ended March 31, 2012, from approximately \$2.8 million for the three months ended March 31, 2011. Our two largest resellers accounted for approximately \$1.1 million, or approximately 75%, of the revenue generated from our reseller division for the three months ended March 31, 2012, which represented approximately 38% of our total revenue for such period. By comparison, for the three months ended March 31, 2011, our two largest resellers accounted for approximately \$2.2 million, or approximately 80%, of the revenue generated from our reseller division, or approximately 59% of our total revenue during such period.

Revenues generated by our service provider division decreased by approximately \$176,000, or 37%, from approximately \$472,000 for the three months ended March 31, 2011, to approximately \$296,000 for the three months ended March 31, 2012. This decrease was mostly due to our receipt of one time set-up fees during the three months ended March 31, 2011, arising from the service agreement we signed with ACN Korea.

Sales to direct consumers increased by approximately \$514,000, or 106%, to approximately \$1.0 million for the three months ended March 31, 2012, from approximately \$486,000 for the three months ended March 31, 2011. Revenues generated through our iConnectHere offering declined by approximately \$75,000 from approximately \$252,000 for the three months ended March 31, 2011, to approximately \$177,000 for the three months ended March 31, 2012. This was offset by the revenues generated by our joip Mobile offering, which increased from \$209,000 for the three months ended March 31, 2011, to approximately \$844,000 for the three months ended March 31, 2012, primarily as a result of the sales agency agreement we entered into with ACN, the introducer agreement we entered into with ACN Europe and the sales agreement we entered into with Momentis.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by approximately \$1.1 million, or 39%, from approximately \$2.8 million for the three months ended March 31, 2011, to approximately \$1.7 million for the three months ended March 31, 2012. Our network rent cost decreased slightly by approximately \$41,000 from approximately \$293,000 for the three months ended March 31, 2011 to approximately \$252,000 for the three months ended March 31, 2012. Our termination cost decreased by approximately \$987,000, or 42%, from approximately \$2.3 million for the three months ended March 31, 2011, to approximately \$1.3 million for the three months ended March 31, 2012. The main reason for the decrease in cost of revenues was the reduction in our termination cost, which was caused by a decrease in the amount of traffic being terminated over our network, as well as cost savings in our network expenses.

Research and development expenses. Research and development expenses decreased by approximately \$128,000, or 30%, from approximately \$433,000 for the three months ended March 31, 2011, to approximately \$305,000 for the three months ended

March 31, 2012. The main reason for the decrease was the reduction in the number of employees in our research and development department. As a percentage of revenues, research and development expenses for the three months ended March 31, 2012 and 2011 were approximately 11%.

Selling and marketing expenses. Selling and marketing expenses decreased by approximately \$36,000, or 7%, to approximately \$502,000 for the three months ended March 31, 2012, from approximately \$538,000 for the three months ended March 31, 2011. The main reason for the decrease was the reduction in the number of employees in our selling and marketing department, offset by an increase in commissions accrued to be paid to ACN, ACN Europe and Momentis. As a percentage of revenues, selling and marketing expenses increased to approximately 18% for the three months ended March 31, 2012, from approximately 14% for the three months ended March 31, 2011.

General and administrative (income) expenses. General and administrative (income) expenses sharply increased by approximately \$611,000 to approximately \$351,000 for the three months ended March 31, 2012, from an income of approximately (\$260,000) for the three months ended March 31, 2011. During the three months ended March 31, 2011, we reversed an accrual of \$706,000 for expenses expected to arise from our litigation with Centre One and also reversed an accrual for tax liability we had recorded in 2008 for \$158,000. This was offset by \$100,000 we recorded as a provision for losses on accounts receivable in connection with outstanding amounts owed to us by our then-largest reseller. Excluding these one-time items, our general and administrative expenses would have decreased in the three months ended March 31, 2012, by approximately \$153,000 from the three months ended March 31, 2011, primarily due to a reduction in salaries arising from our reorganization as well as a reduction in payments to be made to our vendors and other third parties.

Depreciation and amortization. Depreciation and amortization decreased by approximately \$25,000, or 42%, from approximately \$60,000 for the three months ended March 31, 2011, to approximately \$35,000 for the three months ended March 31, 2012. This was caused by a decline in the value of our fixed assets during this period.

(Loss) Income from Operations

For the three months ended March 31, 2012, we recorded a loss from operations of approximately \$83,000 compared to an income from operations of approximately \$219,000 for the three months ended March 31, 2011, due to the factors set forth above.

Interest Expense, Net

We recorded interest expense of approximately \$459,000 for the three months ended March 31, 2012, compared to approximately \$185,000 for the three months ended March 31, 2011. This increase was due primarily to interest accrued to be paid under our loan agreements with D4 Holdings of approximately \$132,000, and the expense equal to \$261,000 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 addition, we accrued \$50,000 for interest on unpaid commissions to ACN and ACN Europe.

Income Taxes, Net

We did not record net income tax expenses for the three months ended March 31, 2012, compared to approximately \$6,000 for the three months ended March 31, 2011.

Net (Loss) Income

For the three months ended March 31, 2012, we recorded a net loss of approximately \$542,000 compared to a net income of approximately \$28,000 for the three months ended March 31, 2011, 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 losses from operations. For the three months ended March 31, 2012, we recorded a net loss from operations of approximately \$83,000 compared to a net income of approximately \$219,000 for the three months ended March 31, 2011. To date, we have an accumulated deficit of approximately \$182 million.

As of March 31, 2012, we had cash and cash equivalents of approximately \$449,000 and restricted cash and short-term investments of approximately \$80,000, or a total of cash, cash equivalents and restricted cash of \$529,000, an increase of approximately \$184,000 from December 31, 2011. The increase in cash, restricted cash, and short and long term investments was

primarily caused by the net cash provided by operating activities during the three months ended March 31, 2012, of approximately \$51,000 and net cash provided by financing activity during the three months ended March 31, 2012, of approximately \$134,000.

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 positive cash flow from operating activities of approximately \$51,000 and negative cash flow from operating activities of \$815,000 during the three months ended March 31, 2012 and 2011, respectively. The increase in our cash generated from operating activities was primarily due to an increase in our net loss of \$542,000, offset by accumulated interest on short-term loans of \$132,000, amortization of \$261,000 related to convertible notes an increase in deferred revenues of \$164,000, and an increase in accounts receivables of \$124,000.

Net cash used in or provided by investing activities is generally driven by our capital expenditures and changes in our short and long-term investments. For the three months ended March 31, 2012, we expensed \$1,000 for purchases of new equipment, compared to \$86,000 for the three months ended March 31, 2011. In addition, during the three months ended March 31, 2012, we had a decrease of approximately \$51,000 in short-term investments. During the three months ended March 31, 2012, we received \$134,000 of our restricted cash that was being held back by a third party service provider.

Net cash used in or provided by financing activities is generally driven by drawing down amounts available under lines of credit available to us, issuing shares of our capital stock and receiving cash that we had previously pledged or otherwise deposited as security for our lenders and creditors. For the three months ended March 31, 2011, we drew down a total of \$850,000 pursuant to our loan agreements with D4 Holdings.

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 \$1,200,000. 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 our 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 first 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 our subsidiaries an additional line of credit in a principal amount of \$1,600,000. Pursuant to the terms of the Convertible Note we issued to D4 Holdings 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 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 March 31, 2012, we have drawn down 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 three months ended March 31, 2012. For the three months ended March 31, 2012 and 2011, we paid \$0 and approximately \$7,000, respectively, for capital leases.

As discussed above under Note 3 of the Notes to the Condensed Consolidated Financial Statements contained in this report, the 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. We opposed 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 that our offer 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, and on April 19, 2012, we received the \$52,804. 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.

On April 3, 2012, we entered into an amendment to our sales agency agreement with ACN and our introducer agreement with ACN Europe. Pursuant to the terms of the amendment, beginning April 1, 2012, we are required to pay all then-current commissions on a timely basis as required under the agreements and a late fee in the amount of one percent per month of any past-due, unpaid commissions (which, as of March 31, 2012, was equal to approximately \$818,000). Beginning July 15, 2012, we are required to pay down any unpaid past due amounts in an amount equal to at least \$15,000 per month through June 15, 2013, and at least \$25,000 per month thereafter until such time as the unpaid balance is paid in full, and are required to pay in full any unpaid, past due amounts upon 30 days' notice. In addition, in the event of certain insolvency-related events defined in the agreements, all unpaid amounts will become immediately due and payable effective immediately prior to such event.

As of March 31, 2012, we had negative working capital equal to approximately \$5.2 million as well as negative stockholders' equity equal to approximately \$4.9 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 our 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 37, reduced the salaries of all remaining employees by five percent, and decreased our non-material expenses as well as payments to be made to vendors and other third parties. As of March 31, 2012, we had 31 full time employees.

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 its securities, financial reorganization, liquidation and/or ceasing operations. In the event that we 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 company pursuing any particular transaction or, if we pursue any such transaction, that it will be completed.

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 4. 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 March 31, 2012, 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, 2011, as filed with the SEC on March 28, 2012.

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 1A. Risk Factors

There have been no material changes to our risk factors as described in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, as filed with the SEC on March 28, 2012, except to the extent additional factual information disclosed in this Quarterly Report on Form 10-Q relates to such risk factors and except as described below.

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 or loss of which could cause delays, interruptions or cessations 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. In addition, 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. Finally, we depend upon the service provided to us by our credit card payment processor, which processes credit card payments provided by the customers in our direct-to-consumer division and some of our reseller customers. We have recently been informed that this payment processor may cease providing service to us in the near future. If that were to occur we would need to find a new payment processor, and although we are in the final stages of discussions with other payment processors this may be difficult given our financial condition. If we were required to find a replacement processor and were unable to do so, we would not be able to process credit card payments provided by the customers in our direct-to-consumer division and some of our reseller clients. This would have a material adverse effect on our business, operating results and financial condition.

Item 6. Exhibits.

See Exhibit Index on page 23 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: May 14, 2012

By: /s/ Effi Baruch

Name: Effi Baruch

Title: Chief Executive Officer, President and Senior Vice

President of Operations and Technology

(Principal Executive Officer)

Date: May 14, 2012

By: /s/ Yochai Ozeri

Name: Yochai Ozeri

Title: Director of Finance and Treasurer

(Principal Financial Officer)

EXHIBIT INDEX

Exhibit	Description
10.1	Letter Amendment, dated as of April 1, 2012, between deltathree, Inc., Delta Three Israel, Ltd. and 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 April 4, 2012).
31.1	Certification of the Principal Executive Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Principal Financial Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Principal Executive Officer, furnished 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 Principal Financial Officer, furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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: May 14, 2012

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, Yochai Ozeri, 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: May 14, 2012

By: /s/ Yochai Ozeri

Yochai Ozeri

Director of Finance 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 March 31, 2012 (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: May 14, 2012

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 March 31, 2012 (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: May 14, 2012

By: /s/ Yochai Ozeri

Yochai Ozeri, Director of Finance 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.
