

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2003

Commission File Number: 000-28063

DELTATHREE, INC.

(Exact name of registrant as specified in charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

75 Broad Street, 31st Floor

New York, New York 10004

(Address of principal executive offices)

13-4006766

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

10004

(Zip code)

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

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

None.

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

Title of Each Class

Class A Common Stock, par value \$0.001 per share

**Name of Each Exchange on Which the
Securities are Registered**

Nasdaq SmallCap Market

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

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

The aggregate market value of the Class A common stock held by non-affiliates of the Registrant based upon the closing price of the Class A common stock as reported by The Nasdaq Stock Market on June 30, 2003 was \$5,377,878. Solely for purposes of this calculation, shares beneficially owned by directors and officers of the Registrant and persons owning 5% or more of the Registrant's Class A common stock have been excluded, in that such persons may be deemed to be affiliates of the Registrant. Such exclusion should not be deemed a determination or admission by the Registrant that such individuals or entities are, in fact, affiliates of the Registrant.

The number of shares outstanding of the Registrant's capital stock as of March 26, 2004 is as follows:

Title of Each Class

Class A Common Stock, \$0.001 par value

**Number of Shares Outstanding
at March 26, 2004**

29,574,824

DOCUMENTS INCORPORATED BY REFERENCE

The following documents (or parts thereof) are incorporated by reference into the following parts of this Form 10-K: Certain information required in Part III of this Annual Report on Form 10-K is incorporated from the Registrant's Proxy Statement for the 2004 Annual Meeting of Stockholders to be held in **2004**.

DELTATHREE, INC.
2003 ANNUAL REPORT ON FORM 10-K

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DELTATHREE, INC.
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The statements in this annual report that are not descriptions of historical facts may be forward-looking statements. Those statements involve substantial risks and uncertainties. You can identify those statements by the fact that they contain words such as "anticipate," "believe," "estimate," "expect," "intend," "project" or other terms of similar meaning. Those statements reflect management's current beliefs, but are based on numerous assumptions, which we cannot control and that may not develop as we expect. Consequently, actual results may differ materially from those projected in the forward-looking statements. Among the factors that could cause actual results to differ materially are: uncertainty of financial estimates and projections, the competitive environment for Internet telephony, our limited operating history, changes of rates of all related telecommunications services, the level and rate of customer acceptance of new products and services, legislation that may affect the Internet telephony industry, rapid technological changes, and the risks, uncertainties and other matters discussed below under "Risk Factors" and elsewhere in this annual report and in our other periodic reports filed with the U.S. Securities and Exchange Commission.

PART I

ITEM 1. BUSINESS

General

We are a provider of integrated Voice over Internet Protocol (VoIP) telephony services. We were founded in 1996 to capitalize on the growth of the Internet as a communications tool by commercially offering Internet Protocol (IP) telephony services. IP 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. Our business currently includes: the provision of enhanced Web-based and other communications services to individual consumers under our iConnectHere brand name; the provision of enhanced Web-based and other communications services to international resellers, under either their own brand name, a white-label brand, and/or our iConnectHere brand name; the provision of a total "Hosted Communications Solution" that enables resellers, corporate customers and service providers to offer private label telecommunications to their customer bases, and; the transmission of voice and data traffic for communications carriers.

We have built a privately-managed, global network using IP technology and offer our customers a unique suite of IP telephony products, including: PC-to-Phone, Phone-to-Phone, and Broadband Phone. We differentiate ourselves from our competitors by providing a robust set of value-added services that enables us to effectively address the challenges that have traditionally made the provision of telecommunications services difficult. These operations management tools include: account provisioning; e-commerce based payment processing systems; billing and account management; and customer care. We are able to provide our services at a cost to users that is generally lower than that charged by traditional carriers because we minimize our network costs by using efficient packet-switched technology and we generally avoid local access charges and by-pass international settlement charges by routing international long distance calls over our privately-managed network.

Prior to 1999, our focus was to build 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 Web site. 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. Our privately-managed IP network received the Best Built Public Network Award for excellence in IP services/applications at SUPERCOMM 2000. We were also recognized as the best IP telephony provider by SmartMoney magazine and PC World Magazine during 2000. We were recognized for our innovative Broadband Phone offering during 2001, receiving both the TMC Labs Innovation Award,

and the Communications SOLUTIONS[®] magazine Product of the Year Award. In 2001, we continued to enhance our unique strengths through our pioneering work with the Session Initiation Protocol (SIP), an Internet Engineering Task Force standard that has been embraced by industry leaders such as Microsoft and the 3rd Generation Partnership Project (3GPP), which is a global cooperation between six organizational partners who are recognized as the world's major standardization bodies from the United States, Europe, China, Japan and Korea. In 2001, we also announced the launch of our state-of-the-art SIP (Session Initiation Protocol) infrastructure, and we became one of the first service providers to have built an end-to-end SIP network. During 2002, our continuing SIP efforts resulted in our launch of our SIP-based dialer, and in 2003 we continued to add new devices, new features and new calling plans to our offerings. These efforts continue to position us as one of the leading providers of VoIP services.

Recent Developments

As disclosed in a Schedule 13D filing with the SEC, in connection with its periodic review of its portfolio investments, Atarey Hasharon Chevra Lepituach Vehashkaot Benadlan (1991) Ltd. ("Atarey") has since November 25, 2003 disposed of an aggregate amount of 5,050,000 shares of our Class A common stock. All of the sales of common stock executed after December 15, 2003 were undertaken in accordance with a Rule 10b5-1 Sales Plan of Atarey and pursuant to an effective registration statement under the Securities Act of 1933, as amended (the "Securities Act"). As of the date hereof, Atarey beneficially holds 14,908,752 shares of our common stock, representing approximately 50.8% of our issued and outstanding shares of common stock.

The Increasing Significance of IP Communications

Historically, the communications services industry has transmitted voice and data over separate networks using different technologies. Traditional carriers have typically built telephone networks based on circuit switching technology, which establishes and maintains a dedicated path for each telephone call until the call is terminated. Although a circuit-switched system reliably transmits voice communications, circuit switching does not efficiently utilize transmission capacity. When a telephone call is placed, a circuit is established, and the circuit remains dedicated for transmission of the call and is therefore unavailable to transmit any other call.

Data networks have typically been built utilizing packet switching technology, such as IP, which divides signals into packets that are simultaneously routed over different channels to a final destination where they are reassembled in the original order in which they were transmitted. Packet switching provides for more efficient use of the capacity in the network because the network does not establish dedicated circuits and does not require a fixed amount of bandwidth to be reserved for each transmission. As a result, substantially greater traffic can be transmitted over a packet-switched network, such as the Internet, than a circuit-switched network.

Traditional telecommunications carriers have historically avoided the use of packet switching for transmitting voice calls due to poor sound quality attributable to delays and lost packets which prevent real-time transmission. However, recent improvements in packet switching, compression and broadband access technologies, improved hardware and the use of privately-managed networks (such as our network) have significantly improved the quality of packet-switched voice calls, allowing for real-time transmission. Service providers that use privately-managed networks are able to reduce packet loss and latency, or delay, because they are able to control the amount, timing and route of data transmitted.

As a result, packet switching technology enables service providers to converge their traditional voice and data networks and more efficiently utilize their networks by carrying voice, fax and data traffic over the same network. The improved efficiency of packet-switching technology creates network cost savings that can be passed on to the consumer in the form of lower long distance rates. In addition, international telephone calls carried over the Internet or private IP networks are less expensive than similar calls carried over circuit-switched networks primarily because they bypass the international settlement process, which represents a significant portion of international long distance tariffs.

Frost & Sullivan, a market research firm, estimates that VoIP communications services will grow to represent approximately 75% of worldwide voice services and revenues from the VoIP marketplace will surpass \$171 billion by

the end of 2007. Beyond cost savings, we believe that advanced IP communications technologies will further the potential for the Internet to become the preferred medium of communications and commerce.

Limitations of Existing IP Communications Solutions

Although the growth of IP telephony historically has been limited by poor sound quality attributable to delays and packet loss, recent technological advancements have significantly improved the quality of packet-switched telephone calls. As a result, several large long distance carriers, including AT&T and Sprint, have announced IP telephony service offerings.

In addition, many smaller service providers have begun to offer low-cost Internet telephony services from PCs to telephones and from telephones to telephones. Many of these service providers, however, offer their services only in certain geographic areas and provide limited services. In addition, many of these service providers rely solely on the public Internet for transmission, rather than a privately-managed IP network. In using only the public Internet rather than a privately-managed IP network for transmission, these service providers have less control over the network management and monitoring functions that are necessary to ensure quality of service.

Our Products and Services

Products.

We have built a privately-managed, global network using IP technology and offer our customers a unique suite of IP telephony products. Our enhanced IP communication products (which represented 92.1% and 60.2% of our revenues in 2003 and 2002, respectively) include:

PC-to-Phone. Our PC-to-Phone offering enables a user to conveniently and inexpensively place a call to a standard telephone anywhere in the world directly from a personal computer while remaining on-line. In order to use this product, a user need only download our software from our Web site and have access to the Internet. Once our software is downloaded, the user is able to place a call from the user's personal computer and, while browsing the Web, speak to a party who uses a standard telephone. Alternatively, users of Microsoft's MSN Messenger software can access our PC-to-Phone product through the "Make a phone call" function without the need to download any other software.

We are able to provide our PC-to-Phone offering at rates generally lower than those charged for traditional circuit switched calls. We are able to charge lower rates because our service utilizes packet-switched technology and because it routes calls directly from the user's Internet connection onto our privately-managed IP network and to the called destination, thus avoiding access and settlement rates associated with traditional international and domestic long distance telecommunications services. PC-to-phone is currently our most popular product offering.

Phone-to-Phone. Our Phone-to-Phone offering enables a user to inexpensively place a call or send a fax from a standard telephone or a fax machine to anywhere in the world. Phone-to-Phone calls originate and terminate on the public switched telephone network (PSTN), but travel primarily over our privately-managed IP network. Similar to our PC-to-Phone product, our Phone-to-Phone product is generally less expensive than services of traditional carriers. Users can access our Phone-to-Phone product by dialing a local or toll-free access number and providing a PIN number. We currently offer toll-free access numbers in Austria, Canada, Finland, France, Germany, Hong Kong, Italy, Sweden, Switzerland, the United Kingdom and the United States. Users are charged for toll and long distance calls on a per-minute basis. We and our private-label partners receive payment for these calls by debiting pre-paid user accounts opened on-line and through the sale of pre-paid calling cards.

Broadband Phone. In early 2001, we successfully deployed the world's first commercially available Broadband Phone offering. Our Broadband Phone product is a complete phone replacement solution available to business and consumer customers over the "last mile" through broadband connections via cable modem, DSL or fixed wireless. Broadband Phone challenges the traditional PSTN and circuit switched networks with a full VoIP solution. With our high call quality, "always on" reliability and increased functionality provided by the high bandwidth access

line, we are able to offer potential partners and their customers some of the most sophisticated VoIP solutions available in the market through a highly scalable, low-cost and easily implemented product. Broadband Phone is designed to take advantage of how people communicate, building on the current customer experience by allowing them to use their existing phone. In addition to offering traditional telecommunications capabilities, Broadband Phone enables a user to conveniently retrieve e-mail, voice mail and faxes, as well as send e-mail, from a single source. For our potential partners, the turnkey solution is delivered with our full back-end infrastructure, including customer service for end users, customer service for service providers, pricing information, billing and provisioning and fraud services. Additionally, Broadband Phone is a technology-neutral solution, easily integrated (a variety of devices are available to plug directly into a PC or IP network) so as to allow broadband providers to begin delivering our voice solution rapidly.

Carrier transmission services. In addition to our enhanced IP communication products, in order to maximize the use of our available network capacity, we offer carrier transmission services over our privately-managed IP network to telecommunications carriers.

Services.

We differentiate ourselves from our competitors by providing a robust set of value-added services that enables us to effectively address the challenges that have traditionally made the provision of telecommunications services difficult. These operations management tools include the following:

- *account provisioning:* we provide our customers with a dedicated Web page through which they can order additional services or accounts, generate and activate PINs and perform other customary implementation functions;
- *payment processing systems:* we provide our customers with a fraud detection and prevention system to permit secure credit card transactions over the Web;
- *billing and account management:* we provide our customers with real-time, Web-based access to billing records to check billing and usage information or to increase prepaid accounts; and
- *customer care:* we have moved and consolidated traditional first tier customer care functions onto the Web for ease and flexibility and support this with second tier customer care via toll-free access.

iConnectHere

We began marketing our on-line consumer offering under the iConnectHere brand name in September 2000 in connection with the formal roll-out of our Hosted Communications Solution. At that time, we also decided to eliminate our free on-line service and to move away from a business model focused on consumers with a high acquisition cost. We have positioned iConnectHere as a powerful showcase and test facility for our current and future products and services. iConnectHere demonstrates our products, services and hosting capabilities to other business customers and service providers. Through iConnectHere, an account holder can access PC-to-Phone, Phone-to-Phone, Broadband Phone and the full range of our back-end infrastructure and support. Additionally, iConnectHere permits us to collect usage information on our products and services and enables us to provide our partners with key information and recommendations regarding implementation of our products and services.

Through iConnectHere, consumer users can:

- sign up for any of our services, including PC-to-Phone, Phone-to-Phone, and Broadband Phone;
- download our software;
- recharge their accounts, either by entering their credit card information or authorizing automatic recharging;

- send a PC-to-phone call;
- check real-time billing and usage information;
- communicate by e-mail with a customer service representative;
- view answers to frequently-asked questions.

iConnectHere Marketing, Advertising and Promotional Programs

We have developed and will continue to develop diversified marketing, advertising and promotional programs to stimulate demand for our iConnectHere services. Our marketing, advertising and promotional programs include:

On-line agent commission program. We have developed a Web-based agent program that allows for rapid agent enrollment and agent account maintenance. Agents may devise their own marketing programs, including Web-links, direct mail campaigns or co-branding of our services in select markets. Agents receive as commissions a percentage of revenue generated from end users who sign up for our services through the agent's Web site. We believe that providing our agents with easy, on-line access to these marketing tools helps us to maximize the number of agents selling our services while significantly reducing the resources needed to recruit agents.

Off-line agent commission program. Our off-line agent commission program allows non-Web agents to design their own marketing programs to solicit sales of our services. Off-line agents market and advertise through traditional channels such as newspaper and magazine advertisements, direct mail campaigns and telemarketing campaigns. Off-line agents receive a percentage of revenue generated from users who sign up for our services through the agent's programs. We currently have relationships with more than 30 off-line agents that have generated revenue for us.

Reseller program. We offer individuals and businesses the opportunity to become resellers of our services through our reseller program. Resellers are able to purchase bulk iConnectHere account numbers at reseller specific rates that they are then able to resell these accounts to private individuals under the iConnectHere brand, their own brand, or as "white-label" product (i.e., no brand name is indicated).

Microsoft Messenger Affiliation. Through our relationship with Microsoft, we provide PC-to-Phone service for Microsoft MSN Messenger users, to any phone number in the world. Within the Microsoft MSN Messenger program, choosing us is similar to choosing a long distance provider. With a click of the mouse, consumers can select us (under our iConnectHere brand) when utilizing the voice function bundled into the Microsoft software applications. When consumers choose us, we provide the network call delivery and termination as well as all the billing and customer relationship aspects of the service. By way of this relationship, we gain exposure to millions of current Microsoft MSN Messenger users.

Our Hosted Communications Solution

Our "Hosted Communications Solution" leverages our VoIP expertise and delivers to our resellers, corporate customers and service providers a highly customizable, private-label suite of VoIP products and services. Using our award-winning infrastructure, we enable these enterprises to offer their customers any combination of our basic products and services, accessible through a single account. We believe that our Hosted Communications Solution brings our customers the value-added services they need to leverage their strong customer bases and generate new revenues. We have dedicated significant resources to this area of our business and anticipate significant growth in the number of businesses to which we provide our Hosted Communications Solution.

With each new module that is added to our suite of VoIP products and services, customers can realize new revenue streams from their existing customer base and make their own offering even more powerful in attracting new customers. The products and services delivered under our Hosted Communications Solution are operative 24 hours a day, 7 days a week and are supported at all times by our Network Operations Center ("NOC") and our customer care center.

Future Products—Broadband focus

The market for broadband access services is projected to grow significantly over the next several years. Broadband access alone, however, is not a complete solution. As infrastructure pipes become commodities, maintaining margin and profitability on them is becoming increasingly difficult for service providers. We believe that broadband market success will be determined by the ability to layer high-margin enhanced services and applications over the infrastructure. Market leaders will need innovative, value-added solutions to maintain customers, reduce churn and grow their customer base.

We have been developing a suite of next-generation Broadband Phone products that we believe will encompass a rich sub-set of the voice-related services broadband providers will seek to deploy in the near-term. These products will build on our original Broadband Phone offering, and include a more diverse set of devices (both hardware devices as well as "soft-phones") along with additional value-added functionality and features that will appeal to a wide potential customer-base.

Our Network

In order to deliver unique VoIP services, we operate a privately-managed IP telephony network. By managing our network, we have the ability to regulate traffic volumes and to directly control the quality of service from each originating point of presence ("POP") to the termination point via a variety of termination options. In addition, our network allows us to avoid the significant transmission delays associated with the Internet, which may impede delivery of high quality, reliable services to our users. Since the protocols used by the network are highly standard protocols, our IP network has a tight connection to the public Internet, allowing us to use the Internet as a backup facility. This unique situation, where our IP network is considered a high-quality extension of the Internet, allows our customers to enjoy best-of-breed functionality: high quality, low jitter and low connection delay, on the one hand, and global reach and universal access, on the other hand.

During 2001, in conjunction with our relationship with Microsoft and over 12 months of work, we rolled out our state of the art SIP (Session Initiation Protocol) infrastructure. Our SIP network currently powers the majority of our offerings, including our Microsoft relationship. The SIP protocol is one of the most advanced VoIP protocols and unlike its predecessors, which were modeled after traditional telephony protocols, SIP has the ability to scale with a distributed architecture and at a lower cost. SIP's superior attributes also include faster and more cost effective development and lower hardware requirements, which allows us to incur lower capital expenditure costs. During 2004, we intend to continue to expand our offerings on this network. At the same time, we continue to build our SIP expertise through relationships with other SIP leaders such as Cisco and Microsoft.

Backbone

Our network is built around a redundant, high availability backbone that connects Los Angeles, New York and London. In each of these locations there are multiple interconnections or peering arrangements with Internet backbone providers. These points are strategically located to allow access from our network to and from the Internet with the best performance. The backbone is based on Cisco routing equipment utilizing Hot Standby Routing Protocol. In order to achieve maximum redundancy, our network has several connections to the public Internet. While operating as a private extension of the Internet, the backbone has a high level of security designed to isolate it from security threats found on the public Internet.

Origination Access

Access to our network is possible through several points. Users may access services through PSTN connections (toll free and local access). Carrier transmission access is aggregated through our switch in New York or through any one of our POPs directly. Call origination is possible from the PC-to-Phone product, using our downloadable software client or using a Web browser, Microsoft Messenger or Broadband Phone. These calls enter our network from the Internet through our interconnect points with the Internet. We carefully manage each originating port and utilize innovative capacity planning tools and techniques to provide the best and most cost effective service to customers.

Termination

Our network can terminate calls through any of our POPs and termination providers' POPs. Termination decisions are based on a sophisticated Least Cost Routing system which applies routing rules based on origination point, time of day, termination cost and other factors. These rules are constantly updated to ensure maximum economic and quality efficiency. Our network has termination facilities that enable us to interconnect with multiple carriers. This allows us to refile traffic to our own switch, giving us the ability to route calls to virtually anywhere in the world. Each termination port is carefully managed with innovative capacity planning tools and techniques to provide the best and most cost effective service to customers, along with multiple termination options to ensure the highest possible levels of redundancy.

Network Services

Our network supports several application building services on the network level, including:

Programmable Interactive Voice Response (PIVR). Our network is capable of playing a configurable voice prompt to enable it to provide applications such as pre-paid calling cards. PIVR services are highly programmable and can be customized to fulfill a variety of customer needs. The configuration of the PIVR is controlled from a central location, enabling efficient management and faster maintenance in the event of malfunctions.

Real Time AAA. We are able to authenticate, authorize and account (AAA) for inbound services through the network's real time radius protocol. Whether services are pre-paid or post-paid, the network will disconnect the call when the user's account balance runs out. These protocols interface with the billing system to rate the calls correctly and allow access to permitted services only. Authentication may be customized to utilize numbers, textual strings, credit card numbers and more.

Reporting Tools. All network services are accounted for in real time, generating Call Detail Records. These records are aggregated in real time to both the billing systems, for rating, and to the data warehouse, which provides access to the information by the marketing, financial, capacity planning and operational groups through a client or Web interface using advanced OLAP cubes.

The Network Operations Center (NOC). Our NOC monitors and manages our network from a central location, seven days a week, 24 hours a day. The NOC monitors all aspects of our network, including the routers, databases, switches, leased lines, Internet connections, gatekeepers and gateways, to ensure that they are functioning at optimal

levels. In the event of a failure of any of these network components, NOC personnel are provided with a real time, systems generated notification via an instant messaging system consisting of pagers, cellular phones, screen pop-ups and e-mail, which identifies the malfunction so that proper measures can be taken to restore service in a timely fashion. Our NOC utilizes a combination of proprietary and leading industry technologies, including Hewlett-Packard Open View software and Ericsson IPT management console, as well as unique applications developed by us. The NOC serves all of the different parts of our operations environment, including network nodes, Web servers and specific applications.

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

Proprietary Rights

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

We have registered trademarks for "deltathree™" and "iConnectHere.com™" in the United States. However, these trademarks may not provide adequate protection against competitive technology and may not be held valid and enforceable if challenged. We do not own any registered copyrights.

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

Regulatory Environment

Regulation of IP Telephony

The use of the Internet and private IP networks to provide telephone service is a relatively recent market development. While the provision of voice communication services over the Internet and private IP networks is currently permitted under United States law, some foreign countries have laws or regulations that may prohibit voice communications over the Internet or using private IP networks. Increased regulation of the Internet may slow its growth, particularly if many countries impose restrictive regulations. Increased regulation of the Internet and/or IP telephony providers or the prohibition of Internet and IP telephony in one or more countries, more aggressive enforcement of existing regulations in such countries or our failure or the failure of our network partners to comply with applicable regulations could materially adversely affect our business, financial condition, operating results and future prospects.

United States. Based on information users provide to us when they signed up to use our services, we estimate that approximately 35% of our IP communications services are provided to carriers or users in the United States. We believe that, under United States law, based on specific regulatory classifications and recent regulatory decisions, the IP communications services that we provide constitute information services (as opposed to regulated telecommunications services). As such, our services are not currently regulated by the Federal Communications Commission (FCC) or state agencies charged with regulating telecommunications carriers. Nevertheless, aspects of our operations may be subject to state or federal regulation, including regulation governing universal service funding, payment of access charges, disclosure of confidential communications and tax issues. We cannot assure you that our services will not be regulated in the future. Several efforts have been made or are currently being considered in the United States to enact federal legislation that would either regulate or exempt from regulation communications services provided over the Internet.

In addition, the FCC is currently considering reforms to universal service funding and may consider whether to impose various types of charges, other common carrier regulations and/or additional operational burdens upon some providers of Internet and IP telephony. The FCC has stated that the development of new technologies, such as IP telephony, may increase the strain on universal service funding. In that regard, the FCC is currently reviewing whether to extend universal service obligations to non-traditional providers such as facilities-based providers of broadband Internet services.

Several other carriers have asked the FCC to make definitive rulings regarding the classification of their IP telephony services. In response to one of those requests, the FCC determined that a particular free, peer-to-peer IP application is an interstate information service. The FCC's ruling applies only to that particular application and does not affect the regulatory classification of the services we offer. In addition, the FCC has initiated a generic proceeding to investigate the legal and regulatory framework for all IP-enabled services, including IP telephony services. Thus, the regulatory classification issue is now before the FCC. Any ruling by the FCC on the regulatory considerations affecting Internet and IP telephony services will affect our operations and revenues.

If the FCC were to determine that certain services are subject to FCC regulations as telecommunications services, the FCC might require providers of Internet and IP telephony services to be subject to traditional common carrier regulation, make universal service contributions and/or pay access charges. It is also possible that the FCC may adopt a regulatory framework other than traditional common carrier regulation, which would apply to Internet and IP telephony providers.

State regulatory authorities may also retain jurisdiction to regulate the provision of, and impose charges on, intrastate Internet and IP telephony services. Several state regulatory authorities have initiated proceedings to examine the regulation of such. Many of the states that have looked at the regulation of IP telephony services have deferred consideration of the issue pending the outcome of the FCC's proceedings. Although, at least one state has ordered that access charges apply to the termination of IP telephony calls provided by a particular carrier and another state has ordered an IP telephony provider to submit to state regulation. The latter decision later was overturned in federal district court and is currently on appeal. In addition, several state commissions have participated in the FCC's proceedings and have advocated imposing traditional common carrier regulation on Internet and IP telephony providers. Rulings by the state commissions on the regulatory considerations affecting Internet and IP telephony services could affect our operations and revenues.

International. The regulatory treatment of Internet and IP telephony outside of the United States varies widely from country to country. A number of countries that currently prohibit competition in the provision of voice telephony may also prohibit Internet and IP telephony. Other countries permit, but regulate Internet and IP telephony. Some countries will evaluate proposed Internet and IP telephony service on a case-by-case basis and determine whether it should be regulated as a voice service or as another telecommunications service. Finally, in many countries Internet and IP telephony has not yet been addressed by legislation or regulatory action.

In 2003 the European Commission adopted directives for a new framework for electronic communications regulation that, in part, attempt to harmonize the regulations that apply to services regardless of the technology used by the provider. Under the New Regulatory Framework, there is no distinction in regulation made based upon technology between switched or packet-based networks. As a result, some types of IP telephony services may be regulated like traditional telephony services while others may remain free from regulation. We cannot predict what future actions the European Commission and courts reviewing the New Regulatory Framework may take regarding IP telephony and related matters, or what impact, if any, such actions may have on our business.

Based on the Commission's current position, we believe that most providers of IP telephony should be subjected to no more than a general authorization or declaration requirement by the European Union Member States. The Member States of the European Union are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden and the United Kingdom. However, since the Commission's findings on IP telephony are not binding on the Member States, we cannot assure you that the services

provided over our network will not be deemed “voice telephony” subject to heightened regulation by one or more EU Member States. For example, the United Kingdom has opened a proceeding to review the regulation of Internet-based voice services.

As we make our services available in foreign countries, and as we facilitate sales by our network partners to end users located in foreign countries, such countries may claim that we are required to qualify to do business in the particular foreign country. Such countries may also claim that we are subject to regulation, including requirements to obtain authorization for the provision of voice telephony or other telecommunications services, or for the operation of telecommunications networks. It is also possible that such countries may claim that we are prohibited in all cases from providing our services or conducting our business as conducted in those countries.

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

Other Regulation Affecting the Internet

United States. Congress has recently adopted legislation that affects certain aspects of the Internet, including on-line content, user privacy, national security and taxation. For example, the extension of the Internet Tax Freedom Act prohibited certain taxes on Internet uses through November 1, 2003. Congress currently is considering whether to extend the Internet tax prohibition and debating the effect of the Internet Tax Freedom Act on IP telephony services. Congress did not temporarily extend the prohibition pending its decision. As a result, some taxes may be able to be imposed on Internet uses until Congress takes further action. We cannot predict whether substantial new taxes will be imposed on our services. In addition, Congress, the FCC and other federal entities are considering other legislative and regulatory proposals that would further affect the Internet, including with regard to broadband networks used to support high-speed Internet access services. Congress is, for example, currently considering legislation on a wide range of issues including Internet spamming, database privacy, gambling, pornography and child protection, Internet fraud and privacy. Various states have adopted and are considering Internet-related legislation.

International. The European Union has also enacted several directives relating to the Internet. The European Union has, for example, adopted a directive on data protection that imposes restrictions on the processing of personal data. Under the directive, personal data may not be collected, processed, used for other purposes or transferred outside the European Union unless certain specified conditions are met. In addition, persons whose personal data is processed within the European Union are guaranteed a number of rights. The directive may affect companies that collect or transmit information over the Internet from individuals in the European Union Member States. In particular, companies with establishments in the European Union may not be permitted to transfer personal data to countries that do not maintain adequate levels of data protection.

In addition, the European Union has adopted a separate, complementary privacy directive that pertains to the telecommunications sector. This directive establishes certain requirements with respect to, among other things, the confidentiality, processing and retention of subscriber traffic and billing data, security of services and networks, subscriber rights to non-itemized bills, and the presentation and restriction of calling and connected line identification. In addition, a number of European countries outside the European Union have adopted, or are in the process of adopting, rules similar to those set forth in the European Union directives. Although we do not engage in the collection of data for purposes other than routing calls and billing for our services, the data protection directives are quite broad and the European Union privacy standards are stringent. Accordingly, the potential effect of these data protection rules on the development of our business is uncertain.

Competition

We compete primarily in the market for enhanced IP communications services. This market is highly competitive and has numerous service providers.

The market for enhanced Internet and IP communications services is new and rapidly evolving. We believe that the primary competitive factors determining our success in the Internet and IP communications market are:

- quality of service;
- the ability to meet and anticipate customer needs through multiple service offerings and feature sets;
- responsive customer care services;
- price.

Future competition could come from a variety of companies both in the Internet and telecommunications industries. These industries include major companies who have greater resources and larger subscriber bases than we have, and have been in operation for many years. We also compete in the growing market of discount telecommunications services including calling cards, prepaid cards, call-back services, dial-around or 10-10 calling and collect calling services. In addition, some Internet service providers have begun to aggressively enhance their real time interactive communications, focusing initially on instant messaging, although we expect them to begin to provide PC-to-Phone services, and Broadband phone services.

IP Telephony Providers. Many companies provide, or are planning to provide, certain portions of the complete communications solution we offer, including, iBasis, Inc., ITXC Corp., Net2Phone, and Vonage.

Traditional Telecommunications Carriers, and Broadband Services Providers. Several traditional telecommunications companies, including industry leaders such as AT&T, Sprint, Deutsche Telekom, WorldCom and Qwest Communications International, and established broadband services providers, such as Time Warner, Comcast, and Cablevision have announced their intention to offer enhanced Internet and IP communications services in both the United States and internationally. All of these competitors are significantly larger than we are and have:

- substantially greater financial, technical and marketing resources;
- larger networks;
- a broader portfolio of services;
- stronger name recognition and customer loyalty;
- well-established relationships with many of our target customers;
- an existing user base to which they can cross-sell their services.

These and other competitors may be able to bundle services and products that are not offered by us together with enhanced Internet and IP communications services, which could place us at a significant competitive disadvantage. Many of our competitors enjoy economies of scale that can result in lower cost structure for transmission and related costs, which could cause significant pricing pressures within the industry.

Employees

As of December 31, 2003, we employed 82 full-time and 21 part-time employees, of which 86 were located in Israel, and 17 were located in New York. We consider our relationship with our employees to be good. None of our employees is covered by collective bargaining agreements.

Generally, all male adult citizens and permanent residents of Israel under the age of 51 are, unless exempt, obligated to perform up to 31 days of military reserve duty annually. Additionally, all such residents are subject to being called to active duty at any time under emergency circumstances. Some of our officers and employees are currently obligated to perform annual reserve duty. While we have operated effectively under these requirements since we began operations, no assessment can be made as to the full impact of such requirements on our workforce or business if conditions should change, and no prediction can be made as to the effect on us of any expansion of such obligations.

ITEM 2. PROPERTIES

We maintain our executive offices at 75 Broad Street, New York, New York under a lease with an annual rent of approximately \$650,000, increasing annually to \$815,000 during the final year of the lease. The lease term extends until July 2010, with an option to extend the lease for an additional five years. In October 2003 we entered into a sub-lease agreement with a third party to sub-lease approximately 30% of the overall the New York office space. The annual sub-lease income is approximately \$148,000 for the first year, increasing annually to \$168,000 during the final year of the lease and extends until July 2010.

We lease a 1,440 square meter office, which houses our research and development facilities, at the Jerusalem Technology Park, Jerusalem, Israel at an annual cost of \$ 292,000. The lease term that expired in February 2003 contained an option to extend the lease for an additional five years. In June 2002 we signed an extension agreement for additional three years, commencing February 2003, at an annual cost of \$201,600, for 1,056 square meters, with the remaining 384 square meters to be returned to the building owner.

ITEM 3. LEGAL PROCEEDINGS

We, as well as certain of our former officers and directors, have been named as defendants in a number of purported securities class actions in Federal District Court for the Southern District of New York, arising out of our initial public offering in November 1999 (the "IPO"). Various underwriters of the IPO also are named as defendants in the actions. The complaints allege, among other things, that the registration statement and prospectus filed with the Securities and Exchange Commission for purposes of the IPO were false and misleading because they failed to disclose that the underwriters allegedly (i) solicited and received commissions from certain investors in exchange for allocating to them shares of our stock in connection with the IPO and (ii) entered into agreements with their customers to allocate such stock to those customers in exchange for the customers agreeing to purchase additional shares in the aftermarket at predetermined prices. On August 8, 2001, the court ordered that these actions, along with hundreds of IPO allocation cases against other issuers, be transferred to Judge Scheindlin for coordinated pre-trial proceedings. In July 2002, omnibus motions to dismiss the complaints based on common legal issues were filed on behalf of all issuers and underwriters. On February 19, 2003, the Court issued an opinion granting in part and denying in part those motions to dismiss. The complaint against the Company was not dismissed as a matter of law. These cases remain at a preliminary stage and no discovery proceedings have taken place. We believe that the claims asserted against us in these cases are without merit and intend to defend ourselves vigorously against them. A proposed settlement agreement between the plaintiffs and issuer defendants is in the process of being negotiated and approved.

We are not a party to any other material litigation and are not aware of any other pending or threatened litigation that could have a material adverse effect on us or our business taken as a whole.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We held our Annual Meeting of Stockholders (the "Meeting") on December 8, 2003. The following matters were submitted to our stockholders for their vote, and the results of the votes taken at the Meeting were as follows:

- (1) Eight Directors were elected for a term of one year:
 - (a) Noam Bardin: 27,780,683 votes for; 21,616 votes against;

- (b) Ilan Biran 27,780,683 votes for; 21,616 votes against;
- (c) Ehud Erez: 27,746,843 votes for; 55,456 votes against;
- (d) Amir Gera: 27,780,683 votes for; 21,616 votes against;
- (e) Joshua Maor: 27,780,683 votes for; 21,616 votes against;
- (f) Lior Samuelson: 27,780,683 votes for; 21,616 votes against; and
- (g) Shimmy Zimels: 27,780,683 votes for; 21,616 votes against;

(2) The appointment of Brightman Almagor & Co., a member firm of Deloitte & Touche Tohmatsu, as our independent auditors for the fiscal year ending December 31, 2003 was ratified by the following vote: 27,779,3195 votes for; 4,960 votes against; and 18,020 abstentions.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information

Our common stock is currently listed on the Nasdaq SmallCap Market under the symbol "DDDC". The listing of our common stock was transferred from the Nasdaq National Market to the Nasdaq SmallCap Market effective on September 17, 2002. Our common stock had traded on the Nasdaq National Market under the symbol "DDDC" since November 22, 1999. We currently meet all criteria for continued inclusion in the Nasdaq SmallCap Market.

The following table sets forth the per share range of high and low closing sales prices of our common stock for the periods indicated:

	<u>High</u>	<u>Low</u>
Year ended December 31, 2001		
First quarter	\$3.50	\$1.03
Second quarter	1.61	0.60
Third quarter	0.98	0.26
Fourth quarter	0.93	0.52
Year ended December 31, 2002		
First quarter	1.25	0.75
Second quarter	1.08	0.60
Third quarter	0.63	0.34
Fourth quarter	0.90	0.37
Year ended December 31, 2003		
First quarter	0.68	0.48
Second quarter	0.80	0.53
Third quarter	1.95	0.62
Fourth quarter	4.26	1.53
Year ended December 31, 2003		
First quarter (through March 26 th , 2004)	3.43	2.17

On March 26, 2004, the last reported sale price for our common stock on the Nasdaq SmallCap Market was \$2.26 per share. The market price for our stock is highly volatile and fluctuates in response to a wide variety of factors.

Holdings

As of March 26, 2004, we had approximately 128 holders of record of our common stock. This does not reflect persons or entities who hold their stock in nominee or "street" name through various brokerage firms.

Dividend Policy

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

Equity Compensation Plan Information

The following table provides certain aggregate information with respect to all of our equity compensation plans in effect as of December 31, 2003:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in first column)
Equity Compensation Plans Approved by Security Holders (1)	2,753,130	\$2.55	1,515,846
Equity Compensation Plans not Approved by Security Holders	N/A	N/A	N/A
Total	2,753,130	\$2.55	1,515,846

(1) These plans consist of our 1999 Stock Incentive Plan, 1999 Directors' Plan, and 1999 Employee Stock Purchase Plan.

Recent Sales of Unregistered Securities

None.

Use of Proceeds

On November 22, 1999, we offered 6,000,000 shares of our common stock in an initial public offering. These shares were registered with the Securities and Exchange Commission on a registration statement on Form S-1 (file no. 333-86503), which became effective on November 22, 1999. We received net proceeds of approximately \$96,255,000 from the sale of 6,900,000 shares at the initial public offering price of \$15.00 per share after deducting underwriting commissions and discounts and expenses of approximately \$6,300,000. The managing underwriters for our initial public offering were Lehman Brothers Inc., Merrill Lynch & Co., U.S. Bancorp Piper Jaffray, Lazard Frères & Co. LLC and Fidelity Capital Markets.

Through December 31, 2003, we used approximately \$36 million of the net proceeds for sales, marketing and promotional activities, \$21 million for capital expenditures and \$16 million for general corporate purposes. Pending use of the remaining net proceeds, we have invested the remaining net proceeds in interest-bearing, investment-grade instruments, certificates of deposit, or direct or guaranteed obligations of the United States.

ITEM 6. SELECTED FINANCIAL DATA

We derived the selected consolidated financial data presented below from our consolidated financial statements and related notes included in this annual report. You should read the selected consolidated financial data together with our consolidated financial statements and related notes and the section of this annual report entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations." Brightman Almagor & Co., a member firm of Deloitte Touche, independent certified public accountants, audited our historical financial statements since inception and as of and for the years ended December 31, 1999, 2000, 2001, 2002 and 2003. Their report appears elsewhere in this annual report.

	<u>Year Ended December 31,</u>				
	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
	(In thousands, except share data)				
Statement of Operations Data:					
Revenues:					
Affiliates.....	\$7,431	\$13,977	\$1,669	\$-	\$-
Non-affiliates	3,621	16,399	13,991	12,929	13,162
Total revenues.....	11,052	30,376	15,660	12,929	13,162
Costs and operating expenses:					
Cost of revenues.....	(9,723)	(24,932)	(13,486)	(8,934)	(8,393)
Research and development expenses.....	(1,233)	(6,625)	(5,648)	(3,435)	(2,326)
Selling and marketing expenses.....	(7,403)	(20,548)	(7,800)	(3,910)	(3,325)
General and administrative expenses (exclusive of non-cash compensation expense).....	(2,754)	(6,694)	(6,982)	(2,158)	(2,062)
Non-cash compensation expense.....	(19,116)	(6,331)	(825)	(270)	-
Depreciation and amortization	(3,721)	(7,919)	(8,996)	(6,606)	(5,584)
Write-down of fixed assets	-	-	(1,003)	-	-
Expenses due to cancellation of supplier agreement.....	-	-	(3,628)	-	-
Impairment of goodwill	-	(8,905)	(4,151)	-	-
Total costs and operating expenses	(43,950)	(81,954)	(52,519)	(25,313)	(21,690)
Loss from operations	(32,898)	(51,578)	(36,859)	(12,384)	(8,528)
Interest income (expense), net	(873)	3,632	1,677	448	245
Income taxes	-	(311)	(552)	(141)	(57)
Net loss	\$(33,771)	\$(48,257)	\$(35,734)	\$(12,077)	\$(8,340)
Net loss per share – basic and diluted	\$(1.65)	\$(1.67)	\$(1.23)	\$(0.42)	\$(0.29)
Weighted average shares outstanding – basic and diluted	20,418	28,833	29,035	28,888	28,989
	<u>December 31,</u>				
	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
	(In thousands)				
Balance Sheet Data:					
Cash and cash equivalents	\$89,957	\$20,857	\$13,583	\$5,681	\$1,682
Short-term investments.....	11,276	30,542	14,192	15,552	16,442
Working capital	82,942	43,538	23,374	17,675	14,820
Total assets	126,832	86,169	45,869	32,197	23,643
Total stockholder's equity	102,580	72,479	38,921	27,114	19,141

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

The following discussion of our financial condition and results of operations should be read together with our consolidated financial statements and the related notes thereto included in another part of this annual report. This discussion contains certain forward-looking statements that involve substantial risks and uncertainties. When used in this report the words "anticipate," "believe," "estimate," "expect" and similar expressions as they relate to our management or us are intended to identify such forward-looking statements. Our actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. Historical operating results are not necessarily indicative of the trends in operating results for any future period.

Overview

We are a provider of integrated Voice over Internet Protocol (VoIP) telephony services and we were founded in 1996 to capitalize on the growth of the Internet as a communications tool by commercially offering Internet Protocol (IP) telephony services. IP 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. . Our business currently includes: the provision of enhanced Web-based and other communications services to individual consumers under our iConnectHere brand name; the provision of enhanced Web-based and other communications services to international resellers, under either their own brand name, a white-label brand, and/or our iConnectHere brand name; the provision of a total "Hosted Communications Solution" that enables resellers, corporate customers and service providers to offer private label telecommunications to their customer bases, and; the transmission of voice and data traffic for communications carriers.

Prior to 1999, our focus was to build 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 Web site. 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. Our privately-managed IP network received the Best Built Public Network Award for excellence in IP services/applications at SUPERCOMM 2000. We were also recognized as the best IP telephony provider by SmartMoney magazine and PC World Magazine during 2000. We were recognized for our innovative Broadband Phone offering during 2001, receiving both the TMC Labs Innovation Award, and the Communications SOLUTIONS[®] magazine Product of the Year Award. In 2001, we continued to enhance our unique strengths through our pioneering work with the Session Initiation Protocol (SIP), an Internet Engineering Task Force standard that has been embraced by industry leaders such as Microsoft and the 3rd Generation Partnership Project (3GPP), which is a global cooperation between six organizational partners who are recognized as the world's major standardization bodies from the United States, Europe, China, Japan and Korea. In 2001, we also announced the launch of our state-of-the-art SIP (Session Initiation Protocol) infrastructure, and we became one of the first service providers to have built an end-to-end SIP network. During 2002, our continuing SIP efforts resulted in our launch of our SIP-based dialer, and in 2003 we continued to add new devices, new features and new calling plans to our offerings. These efforts continue to position us as one of the leading providers of VoIP services.

Factors Affecting Future Results

Industry and 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; the development of new supply sources; supply disruptions; technological advances, including advances in telecommunications technology and advances in technology relating to telecommunications usage; changes in demographics, including population growth rates and consumer preferences; and the competitiveness of alternative telecommunications sources or product substitutes. Currently, the economy in general and the telecommunications industry in particular are suffering. A number of the leading telecommunications companies have seen their market capitalizations decrease dramatically and some have filed for bankruptcy protection. As a result, raising capital has

become extremely difficult, there is extreme pressure on the pricing of telecommunications services and potential customers and partners have sharply cut back on expenditures, all of which impact us.

Competitive Factors: The telecommunications industry is highly competitive. There is competition within the traditional telecommunications marketplaces (landline and wireless) and also with other emergent “next generation” telecommunications providers, including IP telecommunications providers in supplying the overall telecommunications needs of businesses and individual consumers. We compete with other telecommunications firms in the sale and purchase of various products and services in many national and international markets and employ all methods of competition which are lawful and appropriate for such purposes. A key component of our competitive position, particularly given the commodity-based nature of many of our products, is our ability to manage operating expenses successfully, which requires continuous management focus on reducing unit costs and improving efficiency.

Political Factors: Our operations and earnings have been, and may in the future be, affected from time to time in varying degree by political instability and by other political developments and laws and regulations, such as forced divestiture of assets; restrictions on production, imports and exports; war or other international conflicts; civil unrest and local security concerns that threaten the safe operation of company facilities; price controls; tax increases and retroactive tax claims; expropriation of property; cancellation of contract rights; and telecommunications regulations. Both the likelihood of such occurrences and their overall effect upon us vary greatly from country to country and are not predictable.

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.

Risk Factors: See “—Risk Factors” below for discussion of the impact of market risks, financial risks and other uncertainties.

Revenues

Prior to June 28, 2001, our majority shareholder was RSL COM, a large telecommunications provider, who was also our largest customer. As such, for financial reporting purposes for fiscal year 2001 and prior years, revenues were derived from affiliates and non-affiliates. Revenues from affiliates consist of revenues received from RSL COM for the carrier transmission and calling card services we provided to RSL COM, prior to Atarey’s acquisition of RSL COM’s holdings of our stock. The majority of the services we provided to RSL COM were resold by RSL COM to other communications companies, and the remainder were used directly by RSL COM’s customers. Carrier transmission services to RSL COM accounted for 0% of our total revenues in both 2003 and 2002.

Revenues from non-affiliates consist of revenues from end-users of our enhanced IP communications services, including PC-to-Phone, Broadband Phone and Phone-to-Phone, which are generated by our both our consumer offering, iConnectHere, and our Hosted Communications Solution, and revenues from carriers other than RSL COM for carrier transmission services. All revenues are recognized as the services are performed. The provision of enhanced IP communications services (primarily PC-to-Phone) through iConnectHere accounted for 47.1% and 43.3% of our total revenues in 2003 and 2002, respectively, while the provision of enhanced IP communications services through our reseller and service provider sales efforts (including sales of our Hosted Communications Solution) accounted for 45% and 16.9% of our total revenues in 2003 and 2002, respectively. Carrier transmission services to non-affiliates accounted for 3.9% and 10.9% of our total revenues in 2003 and 2002, respectively.

Costs and Operating Expenses

Costs and operating expenses consist of cost of revenues, research and development expenses, selling and marketing expenses, general and administrative expense, depreciation and amortization of goodwill, non-cash stock compensation, write-down of fixed assets, expenses due to cancellation of agreement with a supplier and impairment of goodwill related expenses.

- Cost of revenues consist primarily of 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. In the future, these expenses may fluctuate as a percentage of revenue depending on the project undertaken during the reporting period. 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 advertising and promotional expenses incurred to attract potential consumer users of iConnectHere and expenses associated with our direct sales force incurred to attract potential reseller, corporate, and service provider customers (including sales of our Hosted Communications Solution). We anticipate that as we add new paid users we will be able to spread these costs over a larger revenue base and accordingly improve our operating margins.
- General and administrative expenses consist primarily of compensation and benefits for management, finance and administrative personnel, occupancy costs and legal and accounting fees, as well as the expenses associated with being a public company, including the costs of directors' and officers' insurance.

We have not recorded any income tax benefit for net losses and credits incurred for any period from inception to December 31, 2003. 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, we have recorded a full valuation allowance with respect to these deferred assets.

We recognized \$825,000 in non-cash compensation expense in 2001, \$270,000 in 2002, and \$0 in 2003.

Critical Accounting Policies

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

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

Long-lived Assets: Property and equipment are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the depreciable assets, which range from two to five years. Improvements are capitalized, while repair and maintenance costs are charged to operations as incurred. Our long-lived assets are reviewed for impairment on a quarterly basis and whenever events or changes in circumstances occur indicating that the net carrying amount may not be recoverable. We review for impairment by comparing the carrying value of the long-lived asset to the estimated undiscounted future cash flows expected to result from the use of the long-lived assets (and their eventual disposition). If the sum of the expected undiscounted future cash flows is less than the

carrying amount of assets, we would recognize an impairment loss. The impairment loss, if determined to be necessary, would be measured as the amount by which the carrying amount of the long-lived asset exceeds the fair value of the long-lived asset based on estimated future discounted cash flows.

Results of Operations

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

	<u>Year Ended December 31,</u>		
	<u>2001</u>	<u>2002</u>	<u>2003</u>
Revenues:			
Affiliates	10.7%	0.0%	0.0%
Non-affiliates	<u>89.3</u>	<u>100.0</u>	<u>100.0</u>
Total revenues	100.0	100.0	100.0
Costs and operating expenses:			
Cost of revenues	86.1	69.1	63.8
Research and development expenses	36.1	26.6	17.7
Selling and marketing expenses	49.8	30.2	25.3
General and administrative expenses (exclusive of non-cash compensation expense)	44.6	16.7	15.7
Non-cash compensation expense	5.3	2.1	0.0
Depreciation and amortization	57.4	51.1	42.4
Write down of fixed assets	6.4	0.0	0.0
Expenses due to cancellation of supplier agreement	23.2	0.0	0.0
Impairment of goodwill	<u>26.5</u>	<u>0.0</u>	<u>0.0</u>
Total costs and operating expenses	<u>335.4</u>	<u>195.8</u>	<u>164.9</u>
Loss from operations	(235.4)	(95.8)	(64.9)
Interest income, net	10.7	3.5	1.9
Income taxes	<u>(3.5)</u>	<u>(1.1)</u>	<u>(0.4)</u>
	<u>(228.2)%</u>	<u>(93.4)%</u>	<u>(63.4)%</u>

Comparison of 2003 and 2002

Revenues

Affiliates. There were no revenues from affiliates in 2003 or in 2002. This was due to the sale of all of our Class B Common Stock, representing majority ownership of us, on June 29, 2001 by RSL Communications, Ltd. (“RSL COM”) and our disconnection from the RSL COM network. Since June 29, 2001, there have been no further revenues from affiliates, and we do not anticipate receiving revenues from affiliates in the future.

Non-affiliates. Revenues from non-affiliates increased approximately \$0.3 million or 2.3% to approximately \$13.2 million in 2003 from approximately \$12.9 million in 2002. Revenues from enhanced IP communications services (including our Hosted Communications Solution) increased by approximately \$1.1 million or 9.6% to approximately \$12.6 million in 2003 from approximately \$11.5 million in 2002, due to a greater number of iConnecthere, reseller, corporate and service provider customers, yielding a greater number of calls being placed by an increasing user base.

Revenues from carrier transmission services for telecommunications carriers decreased by approximately \$0.9 million or 64.3% to approximately \$0.5 million in 2003 from approximately \$1.4 million in 2002, due primarily to decreased demand from a smaller customer base. One “Master Reseller” accounted for approximately 19% of our sales in aggregate in 2003.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by \$0.5 million or 5.6% to \$8.4 million in 2003 from \$8.9 million in 2002, due to both a decrease in the amount of carrier traffic being terminated and lower pricing from suppliers.

Research and development expenses. Research and development expenses decreased by \$1.1 million or 32.4% to \$2.3 million in 2003 from \$3.4 million in 2002, due to lower personnel costs associated with the development of new services and enhancements to our existing services.

Selling and marketing expenses. Selling and marketing expenses decreased by \$0.6 million or 15.4% to \$3.3 million in 2003 from \$3.9 million in 2002, due to a decrease in branding and promotional activities.

General and administrative expenses. General and administrative expenses decreased by \$0.1 million or 4.5% to \$2.1 million in 2003 from \$2.2 million in 2002, primarily due to decreased personnel and occupancy costs, somewhat offset by increased professional fees.

Non-cash compensation expenses. There were no non-cash compensation expenses in 2003 compared to approximately \$270,000 in 2002, due to the completed amortization of costs incurred during 1998 and 1999 related to the grants of options and warrants below the then fair market value during those periods.

Depreciation and amortization. Depreciation and amortization decreased by \$1.0 million or 15.2% to \$5.6 million in 2003 from \$6.6 million in 2002, due to a lower relative level of capital expenditures in 2003, and certain assets have been fully depreciated in 2002.

Loss from Operations

Loss from operations decreased by \$3.9 million or 31.5% to \$8.5 million in 2003 from \$12.4 million in 2002, due primarily to the decrease in costs and operating expenses, including selling and marketing expenses. We expect to continue to incur losses for the foreseeable future.

Interest Income, Net

Interest income decreased by \$0.2 million or 50.0% to \$0.2 million in 2003 from \$0.4 million in 2002, due primarily to lower interest rates earned on a reduced balance of remaining proceeds from our initial public offering.

Income Taxes, Net

We paid net income taxes of \$0.1 million in 2003 compared to \$0.1 million in 2002.

Net Loss

Net loss decreased \$3.8 million or 31.4% to \$8.3 million in 2003 from \$12.1 million in 2002, due to the foregoing factors.

Comparison of 2002 and 2001

Revenues

Affiliates. There were no revenues from affiliates in 2002, compared to \$1.7 million in 2001. The decrease in revenues from affiliates was due to the sale of all of our Class B Common Stock, representing majority ownership of us, on June 29, 2001 by RSL Communications, Ltd. ("RSL COM") and our disconnection from the RSL COM network. After June 29, 2001, there were no further revenues from affiliates, and we do not anticipate receiving revenues from affiliates in the future.

Non-affiliates. Revenues from non-affiliates decreased approximately \$1.1 million or 7.9% to approximately \$12.9 million in 2002 from approximately \$14.0 million in 2001. Revenues from enhanced IP communications services (including sales of our Hosted Communications Solution) decreased by approximately \$0.7 million or 5.7% to approximately \$11.5 million in 2002 from approximately \$12.2 million in 2001, due to a lesser number of new Hosted Communications Solution partners, yielding lower up-front integration fees, and partially offset by a greater number of PC-to-Phone and Phone-to-Phone calls being placed by an increasing user base.

Revenues from carrier transmission services, for telecommunications carriers other than RSL COM, decreased by approximately \$0.4 million or 22.2% to approximately \$1.4 million in 2002 from approximately \$1.8 million in 2001, due primarily to decreased demand from a smaller customer base. No customer (other than RSL COM in 2001) accounted for greater than 10% of our revenues during these periods.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by \$4.6 million or 34.1% to \$8.9 million in 2002 from \$13.5 million in 2001, due primarily to a decrease in the amount of traffic being terminated.

Research and development expenses. Research and development expenses decreased by \$2.2 million or 39.3% to \$3.4 million in 2002 from \$5.6 million in 2001, due to lower personnel costs associated with the development of new services and enhancements to our existing services.

Selling and marketing expenses. Selling and marketing expenses decreased by \$3.9 million or 50.0% to \$3.9 million in 2002 from \$7.8 million in 2001, due to a significant decrease in branding and promotional activities.

General and administrative expenses. General and administrative expenses decreased by \$4.8 million or 68.6% to \$2.2 million in 2002 from \$7.0 million in 2001, primarily due to decreased personnel and occupancy costs.

Non-cash compensation expenses. Non-cash compensation expenses decreased by \$0.5 million or 62.5% to

\$0.3 million in 2002 from \$0.8 million in 2001, due to our impairment of goodwill during 2001. Consequently, there were no goodwill related expenses during 2002.

Depreciation and amortization. Depreciation and amortization increased by \$2.4 million or 26.7% to \$6.6 million in 2002 from \$9.0 million in 2001, due to our on-going purchase, and subsequent depreciation of fixed assets.

Loss from Operations

Loss from operations decreased by \$24.5 million or 66.4% to \$12.4 million in 2002 from \$36.9 million in 2001, due primarily to the decrease in costs and operating expenses, including non-cash compensation expenses and selling and marketing expenses. We expect to continue to incur losses for the foreseeable future.

Interest Income, Net

Interest income decreased by \$1.3 million or 76.5% to \$0.4 million in 2002 from \$1.7 million in 2001, due primarily to lower interest rates earned on a reduced balance of remaining proceeds from our initial public offering.

Income Taxes, Net

We paid net income taxes of \$0.1 million in 2002 compared to \$0.6 million in 2001.

Net Loss

Net loss decreased \$23.6 million or 66.1% to \$12.1 million in 2002 from \$35.7 million in 2001, due to the foregoing factors.

Liquidity and Capital Resources

Since our inception in June 1996, we have incurred significant operating and net losses due in large part to the start-up and development of our operations. As of December 31, 2003, we had an accumulated deficit of approximately \$147.9 million. We anticipate that we will continue to incur operating and net losses for the foreseeable future.

As of December 31, 2003, we had cash and cash equivalents of approximately \$1.7 million, marketable securities and other short-term investments of approximately \$16.4 million and working capital of approximately \$14.8 million. We generated negative cash flow from operating activities of approximately \$3.2 million during 2003 compared with negative cash flow from operating activities of \$6.2 million during 2002. Accounts receivable were approximately \$0.4 million and \$0.7 million at December 31, 2003 and December 31, 2002, respectively. Net cash used in investing activities decreased from \$338,000 during 2002 to \$325,000 in 2003.

Our capital expenditures decreased from approximately \$403,000 in the year ended December 31, 2002 compared to approximately \$368,000 in the year ended December 31, 2003, as we better utilized our existing domestic and international network infrastructure.

Short-term, we obtain our funding from our utilization of the remaining proceeds from our initial public offering offset by positive or negative cash flow from our operations. These proceeds are maintained as cash and cash equivalents with an original maturity of three months or less. Based on current trends in our operations, these funds will be sufficient to meet our working capital requirements, including operating losses, and capital expenditure requirements for at least the next fiscal year, assuming that our business plan is implemented successfully, and that:

- our recent revenue trends, which reflected an increase in our higher-margin (primarily PC-to-Phone) products and services continues to increase;
- our expense trends remain at or near the rates of our fourth quarter 2003 rates, which were significantly reduced compared to the previous the year through reductions in personnel,

curtailment of discretionary expenditures, and reduced network rent and termination rates from our carriers; and

- our net cash-burn rate, which was significantly reduced compared to the previous year due to the foregoing factors to approximately \$0.4 million in the fourth quarter of 2003, continues to improve throughout 2004 and beyond.

To the extent that these trends do not remain steady, or if in the longer-term we are not able to successfully implement our business strategy we may be required to raise additional funds for our ongoing operations. Additional financing may not be available when needed or, if available, such financing may not be on terms favorable to us, especially in light of current economic conditions and the unfavorable market for telecommunications companies in particular. If additional funds are raised through the issuance of equity securities, our existing stockholders may experience significant dilution. In addition, while the indentures governing outstanding indebtedness of RSL COM were cancelled and no longer restrict our ability to incur indebtedness, we cannot assure you that any third party will be willing or able to provide additional capital on favorable terms or at all.

Contractual Obligations and Commercial Commitments

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

Contractual obligations	Payments due by period (in thousands)				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Real Estate Leases	5,812	921	1,832	1,679	1,380
Auto Leases	145	82	63	-	-
Other Operating Leases	163	138	25	-	-
Capital Lease Obligations	-	-	-	-	-
Purchase Obligations	51	51	-	-	-
Other Commercial Commitments	-	-	-	-	-
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP	-	-	-	-	-
Total	6,171	1,192	1,920	1,679	1,380

Risk Factors

In addition to the other information included in this annual report, you should consider the following risk factors. This annual report contains forward-looking statements covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve risks and uncertainties that may affect our business and prospects. Our results may differ significantly from the results discussed in the forward-looking statements as a result of certain factors that are listed below or discussed elsewhere in this annual report and our other filings with the Securities and Exchange Commission.

Risks Related to Our Company

We Have a History of Losses and Negative Cash Flow and We Anticipate They Will Continue

We have incurred significant losses since inception, and we expect to continue to incur significant losses for the foreseeable future. We reported net losses of approximately \$8.3 million in 2003, approximately \$12.1 million in 2002, and approximately \$35.7 million in 2001. As of December 31, 2003, our accumulated deficit was approximately \$147.9 million. We generated negative cash flow of approximately \$4.0 million during 2003 and \$7.9 million during 2002. As a percentage of revenues, our net loss was 63.4% in 2003, 93.4% in 2002 and 228.2% in 2001. Our revenues may not grow or even continue at their current level. As a result, while we believe we have sufficient funds to meet our working capital requirements for at least the next fiscal year (see – Liquidity and Capital Resources), we will need to increase our revenues significantly to become profitable. In order to increase our revenues, we need to attract and maintain customers to increase the fees we collect for our services. If our revenues do not increase as much as we expect or if our expenses increase at a greater pace than revenues, we may never be profitable or, if we become profitable, we may not be able to sustain or increase profitability on a quarterly or annual basis.

We Will Need Additional Capital to Finance Our Operations in the Future

We intend to continue to enhance and expand our network in order to maintain our competitive position and meet the increasing demands for service quality, capacity and competitive pricing. Also, the introduction of new products and/or service will require significant marketing and promotional expenses that we often incur before we begin to receive the related revenue. While we believe we have sufficient funds to meet our working capital requirements for at least the next fiscal year (see – Liquidity and Capital Resources), if our cash flow from operations is not sufficient to meet our capital expenditure and working capital requirements, we will need to raise additional capital to continue our operations. Especially in light of current economic conditions and the unfavorable market for telecommunications companies in particular, we may not be able to raise additional capital, and if we are able to raise additional capital through the issuance of additional equity, our current investors could experience dilution. If we are unable to obtain additional capital, we may be required to reduce the scope of our business or our anticipated growth, which would reduce our revenues.

We Have a Limited Operating History Upon Which You Can Evaluate Us

We have only a limited operating history upon which you can evaluate our business and prospects. We commenced operations in June 1996. You should consider our prospects in light of the risks, expenses and difficulties we may encounter as an early stage company in the new and rapidly evolving market for IP communications services. These risks include our ability:

- to increase acceptance of our enhanced IP communications services (including our Hosted Communications Solution), thereby increasing the number of users of our IP telephony services;
- to compete effectively;
- to develop new products and keep pace with developing technology.

In addition, because we expect an increasing percentage of our revenues to be derived from our enhanced IP communications services (including our Hosted Communications Solution), our past operating results may not be indicative of our future results.

We May Not be Able to Expand Our Revenue and Achieve Profitability

Our business strategy is to expand our revenue sources to include the provision of enhanced IP communications services to several different customer groups. We can neither assure you that we will be able to accomplish this nor that this strategy will be profitable. Currently, our revenues are primarily generated by sales of enhanced IP communications services through our direct consumer offering, iConnectHere, and our service provider and reseller sales channel (including sales of our Hosted Communications Solution). Enhanced IP communications services from these channels generated 92.1%, 60.2%, and 54.8% of our total revenues in 2003, 2002 and 2001, respectively. The provision of enhanced IP communications services has not been profitable to date and may not be profitable in the future.

In the future, we intend to generate increased revenues from enhanced IP communications services, from multiple sources, many of which are unproven, including the commercial sale of our Hosted Communications Solution. We expect that our revenues for the foreseeable future will be dependent on, among other factors:

- sales of enhanced IP communications services, including sales of our Hosted Communications Solution;
- acceptance and use of IP telephony;
- expansion of service offerings;
- traffic levels on our network;
- the effect of competition, regulatory environment, international long distance rates and access and transmission costs on our prices;
- continued improvement of our global network quality.

We may not be able to sustain our current revenues or successfully generate additional revenues from the sale of enhanced IP communications services, including Hosted Communications Solutions or carrier transmission services.

We Cannot Assure You That a Market for Our Services Will Develop

We are uncertain whether a market will develop for our enhanced IP communications services, including our Hosted Communications Solutions. Our market is new and rapidly evolving. Our ability to sell our services may be inhibited by, among other factors, the reluctance of some end users to switch from traditional communications carriers to IP communications carriers and by concerns with the quality of IP telephony and the adequacy of security in the exchange of information over the Internet. End users in markets serviced by recently deregulated telecommunications providers are not familiar with obtaining services from competitors of these providers and may be reluctant to use new providers, such as us. Our ability to increase revenues depends on the migration of traditional telephone network traffic to our IP network. We will need to devote substantial resources to educate customers and end users about the benefits of IP communications solutions in general and our services in particular. If enterprises and their customers do not accept our enhanced IP communications services as a means of sending and receiving communications, we will not be able to increase our number of paid users or successfully generate revenues in the future.

Our Future Success Depends on the Growth in the Use of the Internet as a Means of Communications

If the market for IP communications, in general, and our services in particular, does not grow at the rate we anticipate or at all, we will not be able to increase our number of users or generate revenues we anticipate. To be successful, IP communications requires validation as an effective, quality means of communication and as a viable alternative to traditional telephone service. Demand and market acceptance for recently introduced services are subject to a high level of uncertainty. The Internet may not prove to be a viable alternative to traditional telephone service for reasons including:

- inconsistent quality or speed of service;
- traffic congestion on the Internet;
- potentially inadequate development of the necessary infrastructure;
- lack of acceptable security technologies;
- lack of timely development and commercialization of performance improvements;
- unavailability of cost-effective, high-speed access to the Internet.

If Internet usage grows, the Internet infrastructure may not be able to support the demands placed on it by such growth, or its performance or reliability may decline. In addition, Web sites may from time to time experience interruptions in their service as a result of outages and other delays occurring throughout the Internet network infrastructure. If these outages or delays frequently occur in the future, Internet usage, as well as usage of our communications portal and our services, could be adversely affected.

Potential Fluctuations in Our Quarterly Financial Results Make it Difficult for Investors to Predict Our Future Performance

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

- the rate at which we are able to attract users to purchase our enhanced IP communications services, including our Hosted Communications Solutions;
- the amount and timing of expenses to enhance marketing and promotion efforts and to expand our infrastructure;
- the timing of announcements or introductions of new or enhanced services by us.

The factors outside our control include:

- the timing of announcements or introductions of new or enhanced services by our competitors;
- technical difficulties or network interruptions in the Internet or our privately-managed network;
- general economic and competitive conditions specific to our industry.

The foregoing factors also may create other risks affecting our long-term success, as discussed in the other risk factors.

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

Our Network May Not Be Able to Accommodate Our Capacity Needs

We expect the volume of traffic we carry over our network to increase significantly as we expand our operations and service offerings. Our network may not be able to accommodate this additional volume. In order to ensure that we are able to handle additional traffic, we may have to enter into long-term agreements for leased capacity. To the extent that we overestimate our capacity needs, we may be obligated to pay for more transmission capacity than we actually use, resulting in costs without corresponding revenues. Conversely, if we underestimate our capacity needs, we may be required to obtain additional transmission capacity from more expensive sources. If we are unable to maintain sufficient capacity to meet the needs of our users, our reputation could be damaged and we could lose users.

We Face a Risk of Failure of Computer and Communications Systems Used in Our Business

Our business depends on the efficient and uninterrupted operation of our computer and communications systems as well as those that connect to our network. We maintain communications systems in four facilities in New York, Los Angeles, London and Jerusalem. Our systems and those that connect to our network are subject to disruption from natural disasters or other sources of power loss, communications failure, hardware or software malfunction, network failures and other events both within and beyond our control. Any system interruptions that cause our services to be unavailable, including significant or lengthy telephone network failures or difficulties for users in communicating through our network or portal, could damage our reputation and result in a loss of users.

Our Computer Systems and Operations May Be Vulnerable to Security Breaches

Our computer infrastructure is potentially vulnerable to physical or electronic computer viruses, break-ins and similar disruptive problems and security breaches that could cause interruptions, delays or loss of services to our users. We believe that the secure transmission of confidential information over the Internet, such as credit card numbers, is essential in maintaining user confidence in our services. We rely on licensed encryption and authentication technology to effect secure transmission of confidential information, including credit card numbers. It is possible that advances in computer capabilities, new technologies or other developments could result in a compromise or breach of the technology

we use to protect user transaction data. A party that is able to circumvent our security systems could misappropriate proprietary information or cause interruptions in our operations. Security breaches also could damage our reputation and expose us to a risk of loss or litigation and possible liability. Although we have experienced no security breaches to date of which we are aware, we cannot guarantee you that our security measures will prevent security breaches.

Third Parties Might Infringe Upon Our Proprietary Technology

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

Our Services May Infringe on the Intellectual Property Rights of Others

Third parties may assert claims that we have violated a patent or infringed a copyright, trademark or other proprietary right belonging to them. We incorporate licensed third-party technology in some of our services. In these license agreements, the licensors have agreed to indemnify us with respect to any claim by a third party that the licensed software infringes any patent or other proprietary right so long as we have not made changes to the licensed software. We cannot assure you that these provisions will be adequate to protect us from infringement claims. Any infringement claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

Operating Internationally Exposes Us to Additional and Unpredictable Risks

We intend to continue to enter additional markets in Eastern Europe, Latin America, Africa and Asia and to expand our existing operations outside the United States. International operations are subject to inherent risks, including:

- potentially weaker protection of intellectual property rights;
- political instability;
- unexpected changes in regulations and tariffs;
- fluctuations in exchange rates;
- varying tax consequences;
- uncertain market acceptance and difficulties in marketing efforts due to language and cultural differences.

We Have Experienced Losses as a Result of Fraud

We have experienced losses due to fraud. While in 2003, we experienced losses from fraud of less than 1% of our revenues, callers have obtained our services without rendering payment by unlawfully using our access numbers and personal identification numbers. While we have implemented anti-fraud measures in order to control losses relating to these practices, and these measures have proven to be effective today, these measures may not in the future be sufficient to effectively limit all of our exposure in the future from fraud and future losses could rise significantly above current levels.

Intense Competition Could Reduce Our Market Share and Harm Our Financial Performance

Competition in the market for enhanced IP communications services is becoming increasingly intense and is expected to increase significantly in the future. The market for enhanced Internet and IP communications is new and rapidly evolving. We expect that competition from companies both in the Internet and telecommunications industries

will increase in the future. Our competitors include both start-up IP telephony service providers and established traditional communications providers. Many of our existing competitors and potential competitors have broader portfolios of services, greater financial, management and operational resources, greater brand-name recognition, larger subscriber bases and more experience than we have. In addition, many of our IP telephony competitors use the Internet instead of a private network to transmit traffic. Operating and capital costs of these providers may be less than ours, potentially giving them a competitive advantage over us in terms of pricing.

We also compete in the growing market of discount telecommunications services including calling cards, prepaid cards, call-back services, dial-around or 10-10 calling and collect calling services. In addition, some Internet service providers have begun to aggressively enhance their real time interactive communications, focusing initially on instant messaging, although we expect them to begin to provide PC-to-phone and/or broadband phone services.

If we are unable to provide competitive service offerings, we may lose existing users and be unable to attract additional users. In addition, many of our competitors, especially traditional carriers, enjoy economies of scale that result in a lower cost structure for transmission and related costs, which cause significant pricing pressures within the industry. Although the minutes of use we sell are increasing, revenues are not increasing at the same rate due primarily to a decrease in revenue per minute for our carrier transmission services. In order to remain competitive we intend to increase our efforts to promote our services, and we cannot be sure that we will be successful in doing this.

In addition to these competitive factors, recent and pending deregulation in some of our markets may encourage new entrants. We cannot assure you that additional competitors will not enter markets that we plan to serve or that we will be able to compete effectively.

Decreasing Telecommunications Rates May Diminish or Eliminate Our Competitive Pricing Advantage

Decreasing telecommunications rates may diminish or eliminate the competitive pricing advantage of our services. International and domestic telecommunications rates have decreased significantly over the last few years in most of the markets in which we operate, and we anticipate that rates will continue to be reduced in all of the markets in which we do business or expect to do business. Users who select our services to take advantage of the current pricing differential between traditional telecommunications rates and our rates may switch to traditional telecommunications carriers as such pricing differentials diminish or disappear, and we will be unable to use such pricing differentials to attract new customers in the future. In addition, our ability to market our carrier transmission services to telecommunications carriers depends upon the existence of spreads between the rates offered by us and the rates offered by traditional telecommunications carriers, as well as a spread between the retail and wholesale rates charged by the carriers from which we obtain wholesale service. Continued rate decreases will require us to lower our rates to remain competitive and will reduce or possibly eliminate our gross profit from our carrier transmission services. If telecommunications rates continue to decline, we may lose users for our services.

Government Regulation and Legal Uncertainties Relating to IP Telephony Could Harm Our Business

Historically, voice communications services have been provided by regulated telecommunications common carriers. We offer voice communications to the public for international and domestic calls using IP telephony, and we do not operate as a licensed telecommunications common carrier in any jurisdiction. Based on specific regulatory classifications and recent regulatory decisions, we believe we qualify for certain exemptions from telecommunications common carrier regulation in many of our markets. However, the growth of IP telephony has led to close examination of its regulatory treatment in many jurisdictions making the legal status of our services uncertain and subject to change as a result of future regulatory action, judicial decisions or legislation in any of the jurisdictions in which we operate. Established regulated telecommunications carriers have sought and may continue to seek regulatory actions to restrict the ability of companies such as ours to provide services or to increase the cost of providing such services. In addition, our services may be subject to regulation if regulators distinguish phone-to- phone telephony service using IP technologies over privately-managed networks such as our services from integrated PC-to-PC and PC-originated voice services over the Internet. Some regulators may decide to treat the former as regulated common carrier services and the latter as unregulated enhanced or information services.

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

We May Not Be Able to Keep Pace with Rapid Technological Changes in the Communications Industry

Our industry is subject to rapid technological change. We cannot predict the effect of technological changes on our business. In addition, widely accepted standards have not yet developed for the technologies we use. We expect that new services and technologies will emerge in the market in which we compete. These new services and technologies may be superior to the services and technologies that we use, or these new services may render our services and technologies obsolete.

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

Risks Related to Our Relationship with Atarey

Atarey Controls All Matters Submitted to a Stockholder Vote

Atarey owns approximately 51% of the voting power and economic interest in us. As long as Atarey continues to beneficially own shares of capital stock representing more than 50% of the voting power of our outstanding capital stock, Atarey will be able to exercise a controlling influence over decisions affecting us, including:

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

In addition, three of our seven directors are officers and/or directors of Atarey, or otherwise affiliated with Atarey. As a result, the ability of any of our other stockholders to influence the management of our company is limited, which could have an adverse effect on the market price of our stock.

Risks Related to Our Common Stock

A Third Party May Be Deterred from Acquiring Our Company

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

Volatility of Our Stock Price Could Adversely Affect Our Stockholders

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

- variations in our actual or anticipated quarterly operating results or those of our competitors;
- announcements by us or our competitors of technological innovations;
- introduction of new products or services by us or our competitors;
- changes in financial estimates by securities analysts;
- conditions or trends in the Internet industry;
- changes in the market valuations of other Internet companies;
- announcements by us or our competitors of significant acquisitions;
- our entry into strategic partnerships or joint ventures;
- sales of our common stock by Atarey.

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

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

The Liquidity of Our Common Stock Could Be Adversely Affected by Changes in Our Nasdaq Listing.

Our common stock is currently listed on the Nasdaq SmallCap Market. The listing of our common stock was transferred from the Nasdaq National Market to the Nasdaq SmallCap Market effective on September 17, 2002. We currently meet all criteria for continued inclusion in the Nasdaq SmallCap Market. However, based on the volatile nature of our stock price, we can make no assurances that we will continue to do so. Failure to meet these criteria could result in our delisting from the Nasdaq SmallCap Market. If our shares were to be delisted from the Nasdaq SmallCap Market, our shares would continue to trade, if at all, on the OTC Bulletin Board, upon application by the requisite market makers. This would adversely impact our stock price, as well as the liquidity of the market for our shares which, as a result, would adversely affect the ability of our stockholders to purchase and sell their shares in an orderly manner, or at all. Furthermore, a delisting of our shares could damage our general business reputation and impair our ability to raise additional funds. Any of the foregoing events could have a material adverse effect on our business, financial condition and operating results.

We Do Not Intend to Pay Dividends

We have never declared or paid any cash dividends on our common stock. We intend to retain any future earnings to finance our operations and to expand our business and, therefore, do not expect to pay any cash dividends in the foreseeable future.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

The Securities and Exchange Commission's rule related to market risk disclosure requires that we describe and quantify our potential losses from market risk sensitive instruments attributable to reasonably possible market changes. Market risk sensitive instruments include all financial or commodity instruments and other financial instruments (such as investments and debt) that are sensitive to future changes in interest rates, currency exchange rates, commodity prices or

other market factors. We believe our exposure to market risk is immaterial. We currently do not invest in, or otherwise hold, for trading or other purposes, any financial instruments subject to market risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Company's Consolidated Financial Statements required by this Item are included in Item 14 of this report.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) *Evaluation of Disclosure Controls and Procedures.* 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 Annual Report on Form 10-K, have concluded that, based on such evaluation, our disclosure controls and procedures were adequate and effective to ensure that material information relating to us, including our consolidated subsidiaries, was made known to them by others within those entities, particularly during the period in which this Annual Report on Form 10-K was being prepared.

(b) *Changes in Internal Controls.* There were no changes in our internal control over financial reporting, identified in connection with the evaluation of such internal control that occurred during the fourth quarter of our last fiscal year, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this Item is incorporated herein by reference to the sections entitled “Management” and “Principal Stockholders” in the proxy statement for our 2004 Annual Meeting of Stockholders.

On March 25, 2004, we adopted a Corporate Code of Conduct and Ethics applicable to all employees and directors of deltatthree, including our principal executive officer, principal financial and accounting officer and controller. A copy of the Code of Conduct and Ethics is attached as an exhibit to this Annual Report. We intend to post on our website any amendments to, or waivers from, our Code of Conduct and Ethics that apply to our principal executive officer, principal financial and accounting officer and controller.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the section entitled “Executive Compensation” in the proxy statement for our 2004 Annual Meeting of Stockholders.

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

The information required by this Item is incorporated herein by reference to the section entitled “Principal Stockholders” in the proxy statement for our 2004 Annual Meeting of Stockholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item is incorporated herein by reference to the section entitled “Related Party Transactions” in the proxy statement for our 2004 Annual Meeting of Stockholders.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is incorporated herein by reference to the section entitled “Principal Accounting Fees and Services” in the proxy statement for our 2004 Annual Meeting of Stockholders.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a)(1) Financial Statements.

The Consolidated Financial Statements filed as part of this Annual Report on Form 10-K are identified in the Index to Consolidated Financial Statements on page F-1 hereto.

(a)(2) Financial Statement Schedules.

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

(a)(3) Exhibits.

The following exhibits are filed herewith or are incorporated by reference to exhibits previously filed with the Securities and Exchange Commission.

<u>Exhibit Number</u>	<u>Description</u>
3.1.1*	Form of Restated Certificate of Incorporation of deltathree, Inc.
3.1.2***	Form of Amendment to Restated Certificate of Incorporation of deltathree, Inc.
3.2*	Form of Amended and Restated By-laws of deltathree, Inc.
4.1*	Specimen Certificate of Common Stock.
4.2*	Specimen Certificate of Class B Common Stock.
10.1*	Form of deltathree, Inc. 1999 Stock Incentive Plan.
10.2*	Form of deltathree, Inc. 1999 Employee Stock Purchase Plan.
10.3*	Form of deltathree, Inc. 1999 Performance Incentive Plan.
10.4*	Form of deltathree, Inc. 1999 Directors' Plan.
10.5*	Employment Agreement, effective as of April 1, 1999, between Noam Bardin and deltathree, Inc.
10.6**	Amendment No. 1 to Employment Agreement, effective as of June 1, 2000, between Noam Bardin and deltathree, Inc.
10.7*	Employment Agreement, effective as of April 1, 1999, between Shimmy Zimels and deltathree, Inc.
10.8**	Amendment No. 1 to Employment Agreement, effective as of June 1, 2000, between Shimmy Zimels and deltathree, Inc.
10.9**	Employment Agreement, effective as of August 28, 2000, between Paul White and deltathree, Inc.
10.10#	Amendment No. 2 to Employment Agreement, effective as of March 25, 2002, between Shimmy Zimels and deltathree, Inc.
10.11#	Amendment No. 3 to Employment Agreement, effective as of September 1, 2002, between Shimmy Zimels and deltathree, Inc.
10.12#	Amendment No. 1 to Employment Agreement, effective as of September 1, 2002, between Paul C. White and deltathree, Inc.
14.1	deltathree, Inc. Corporate Code of Conduct and Ethics
23.1	Consent of Brightman Almagor & Co.
31.1	Certification of the Chief Executive Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Incorporated by reference to the Company's registration statement on Form S-1 (Registration No. 333-86503).

** Incorporated by reference to the Company's quarterly report on Form 10-Q filed on November 14, 2000.

*** Incorporated by reference to the Company's annual report on Form 10-K/A filed on April 30, 2001.

Incorporated by reference to the Company's quarterly report on Form 10-Q filed on November 14, 2002.

(b) Reports on Form 8-K.

We furnished a report on Form 8-K dated November 6, 2003 reporting under Item 12 our press release regarding our earnings for the quarter ended September 30, 2003.

DELTATHREE, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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INDEPENDENT AUDITORS' REPORT

To the Stockholders of
Deltathree, Inc.

We have audited the accompanying consolidated balance sheets of Deltathree, Inc. ("the Company") as of December 31, 2003 and 2002 and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2003 and 2002, and the consolidated results of its operations and its consolidated cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

Brightman Almagor & Co.
Certified Public Accountants
A member firm of Deloitte Touche Tohmatsu

Tel Aviv, Israel
February 25, 2004

**DELTATHREE, INC.
CONSOLIDATED BALANCE SHEETS**

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	(\$ in thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 1,682	\$ 5,681
Short-term investments	16,442	15,552
Accounts receivable, net (Note 3)	363	652
Prepaid expenses and other current assets (Note 4).....	684	760
Inventory.....	<u>60</u>	<u>—</u>
Total current assets	<u>19,231</u>	<u>22,645</u>
Property and equipment:		
Telecommunications equipment	14,548	14,344
Furniture, fixtures and other.....	534	570
Leasehold improvements.....	4,615	4,615
Computers hardware & software	<u>7,091</u>	<u>6,891</u>
	26,788	26,420
Less accumulated depreciation	<u>(22,481)</u>	<u>(16,968)</u>
Property and equipment, net	<u>4,307</u>	<u>9,452</u>
Deposits	<u>105</u>	<u>100</u>
Total assets	<u>\$ 23,643</u>	<u>\$ 32,197</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,139	\$ 2,306
Deferred revenues	172	334
Other current liabilities (Note 5).....	<u>2,100</u>	<u>2,330</u>
Total current liabilities	<u>4,411</u>	<u>4,970</u>
Long-term liabilities:		
Severance pay obligations (Note 6)	<u>91</u>	<u>113</u>
Total liabilities.....	<u>4,502</u>	<u>5,083</u>
Commitments and contingencies (Note 7)		
Stockholders' equity (Note 8):		
Share capital:		
Class A Common stock, - par value \$0.001; authorized 75,000,000 shares; issued and outstanding: 29,490,796 at December 31, 2003; 29,159,772 at December 31, 2002	29	29
Class B Common stock - par value \$0.001; authorized 1,000; issued and outstanding: no shares at December 31, 2003 and 2002	—	—
Preferred stock, par value \$0.001; authorized 25,000,000 shares; issued and outstanding: no shares at December 31, 2003 and 2002	—	—
Additional paid-in capital.....	167,168	166,801
Accumulated deficit	(147,846)	(139,506)
Treasury stock at cost: 257,600 shares of Class A Common Stock as of December 31, 2003 and 2002	<u>(210)</u>	<u>(210)</u>
Total stockholder's equity.....	<u>19,141</u>	<u>27,114</u>
Total liabilities and stockholder's equity.....	<u>\$ 23,643</u>	<u>\$ 32,197</u>

The accompanying notes are an integral part of these financial statements

DELTATHREE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	<u>Year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(\$ in thousands, except share data)		
Revenues (Note 13):			
Affiliates.....	\$ -	\$ -	\$ 1,669
Non-affiliates.....	<u>13,162</u>	<u>12,929</u>	<u>13,991</u>
Total revenues.....	13,162	12,929	15,660
Costs and operating expenses:			
Cost of revenues (exclusive of \$1,539, \$1,703 and \$1,579			
depreciation included in a separate line below, respectively)	8,393	8,934	13,486
Research and development expenses (Note 9).....	2,326	3,435	5,648
Selling and marketing expenses.....	3,325	3,910	7,800
General and administrative expenses (exclusive of			
non-cash compensation expense shown below)	2,062	2,158	6,982
Non-cash compensation expense.....	-	270	825
Depreciation and amortization.....	5,584	6,606	8,996
Write-down of fixed assets (Note 10).....	-	-	1,003
Expenses due to cancellation of agreement with a supplier			
(including non-cash compensation of \$1,493) (Note 8b).....	-	-	3,628
Impairment of goodwill (Note 11).....	<u>-</u>	<u>-</u>	<u>4,151</u>
Total costs and operating expenses.....	<u>21,690</u>	<u>25,313</u>	<u>52,519</u>
Loss from operations.....	(8,528)	(12,384)	(36,859)
Interest income, net.....	245	448	1,677
Loss before income taxes.....	(8,283)	(11,936)	(35,182)
Income taxes (Note 12).....	57	141	552
Net loss.....	<u>\$ (8,340)</u>	<u>\$ (12,077)</u>	<u>\$ (35,734)</u>
Net loss per share - basic and diluted	<u>\$ (0.29)</u>	<u>\$ (0.42)</u>	<u>\$ (1.23)</u>
Weighted average number of shares outstanding -			
basic and diluted (number of shares).....	<u>28,988,589</u>	<u>28,888,367</u>	<u>29,035,319</u>

The accompanying notes are an integral part of these financial statements

DELTATHREE, INC.
STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
(\$ in thousands, except share data)

	<u>Class A Common stock</u>		<u>Class B Common stock</u>		<u>Additional paid-in capital</u>	<u>Deferred compensation</u>	<u>Treasury Stock (at cost)</u>	<u>Accumulated deficit</u>	<u>Total Stockholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>					
Balance at January 1, 2001	9,465,099	\$ 9	19,569,459	\$ 20	\$ 166,733	\$ (2,588)	\$ -	\$ (2,588)	\$ 72,479
Exercise of employee options....	108,648				68				68
Purchase of treasury stock	(257,600)						(210)		(210)
Cancellation of class B shares ...	19,569,459	20	(19,569,459)	(20)					-
Amortization of deferred compensation expense						2,318			2,318
Loss for the year.....								(35,734)	(35,734)
Balance at December 31, 2001 ..	<u>28,885,606</u>	<u>29</u>	<u>-</u>	<u>-</u>	<u>166,801</u>	<u>(270)</u>	<u>(210)</u>	<u>(127,429)</u>	<u>38,921</u>
Exercise of employee options....	16,566	-*			-				-
Amortization of deferred compensation expense						270			270
Loss for the year.....								(12,077)	(12,077)
Balance at December 31, 2002..	<u>28,902,172</u>	<u>29</u>	<u>-</u>	<u>-</u>	<u>166,801</u>	<u>-</u>	<u>(210)</u>	<u>(139,506)</u>	<u>27,114</u>
Exercise of employee options....	331,024	-*			367				367
Loss for the year.....								(8,340)	(8,340)
Balance at December 31, 2003..	<u>29,233,196</u>	<u>\$ 29</u>	<u>-</u>	<u>\$ -</u>	<u>\$ 167,168</u>	<u>\$ -</u>	<u>\$ (210)</u>	<u>\$ (147,846)</u>	<u>\$ 19,141</u>

* - Less than \$ 1 thousand.

The accompanying notes are an integral part of these financial statements

DELTATHREE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	<u>2003</u>	<u>Year ended December 31,</u> <u>2002</u>	<u>2001</u>
	(\$ in thousands)		
Cash flows from operating activities:			
Net loss.....	\$ (8,340)	\$ (12,077)	\$ (35,734)
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization.....	5,584	6,606	8,996
Write-down of fixed assets	-	-	1,003
Impairment of goodwill	-	-	4,151
Amortization of deferred compensation	-	270	2,318
Capital loss (gain), net	(17)	(56)	1
Increase (decrease) in liability for severance pay, net.....	(22)	(78)	22
Provision for losses on accounts receivable	65	81	1,104
Changes in assets and liabilities:			
Decrease in accounts receivable	224	359	1,272
Decrease in other current assets and due from affiliates	76	504	928
Increase in inventory.....	(60)	-	-
Decrease in accounts payable	(269)	(975)	(3,053)
Decrease in deferred revenues.....	(162)	(171)	254
Increase in current liabilities and due to affiliates	(230)	(667)	(3,965)
	<u>5,189</u>	<u>5,873</u>	<u>13,031</u>
Net cash used in operating activities.....	<u>(3,151)</u>	<u>(6,204)</u>	<u>(22,703)</u>
Cash flows from investing activities:			
Purchase of property and equipment	(368)	(403)	(1,558)
Proceeds from sale of property and equipment	48	62	467
Increase (decrease) in deposits	(5)	3	(30)
Net cash used in investing activities	<u>(325)</u>	<u>(338)</u>	<u>(1,121)</u>
Cash flows from financing activities:			
Decrease (increase) in short-term investments	(890)	(1,360)	16,692
Purchase of treasury stock	-	-	(210)
Proceeds from exercise of employee options	367	-	68
Net cash provided by (used in) financing activities.....	<u>(523)</u>	<u>(1,360)</u>	<u>16,550</u>
Decrease in cash and cash equivalents	(3,999)	(7,902)	(7,274)
Cash and cash equivalents at beginning of year	5,681	13,583	20,857
Cash and cash equivalents at end of year	<u>\$ 1,682</u>	<u>\$ 5,681</u>	<u>\$ 13,583</u>
Supplemental disclosures of cash flow information:			
Cash paid for:			
Taxes	\$ 57	\$ 236	\$ 552
Supplemental schedule of non cash investing and financing activities:			
Acquisition of fixed assets on credit	\$ 102	\$ 194	\$ -
Cancellation of fixed assets in exchange of a payable	\$ -	\$ 136	\$ -

The accompanying notes are an integral part of these financial statements

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - The Company

Deltathree, Inc. (the "Company"), a Delaware corporation, is a global provider of integrated Voice over Internet Protocol (VoIP) telephony services. The Company was founded in 1996 to capitalize on the growth of the Internet as a communication tool by commercially offering Internet Protocol (IP) telephony services. IP telephony is the real time transmission of voice communications in the form of digitized "packets" of information over the public Internet or a private network, similar to the way in which e-mail and other data is transmitted. The Company's business currently includes the transmission of voice and data traffic for communications carriers, the provision of enhanced Web-based and other communications services to individual consumers and the provision of a total "Hosted Communication Solution" that enables corporate customers and service providers to offer private label telecommunications to their customer bases.

Note 2 - Summary of significant accounting policies

a. Basis of presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

b. Principles of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. All significant intercompany accounts and transactions have been eliminated.

c. Financial statements in U.S. dollars

The reporting currency of the Company is the U.S. dollar ("dollar"). The dollar is the functional currency of the Company and its subsidiary. Transactions and balances originally denominated in dollars are presented at their original amounts. Non-dollar transactions and balances are remeasured into dollars in accordance with the principles set forth in Statement of Financial Accounting Standards ("SFAS") No. 52. All exchange gains and losses from translation of monetary balance sheet items resulting from transactions in non-dollar currencies are recorded in the statement of operations as they arise.

d. Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions, primarily for allowances for doubtful accounts receivable and the useful lives of fixed assets and intangible assets, that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

e. Cash and cash equivalents

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

f. Short-term investments

Short-term investments consist primarily of high liquid debt instruments purchased with an original maturity at the date of purchase of greater than 90 days and investments in mutual funds. Short-term investments are stated at market value.

g. Inventory

Inventory is stated at the lower of cost (principally on a standard cost basis which approximates FIFO) or market.

h. Property and equipment

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

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 - Summary of significant accounting policies (Cont.)

i. Long lived assets

The Company complies with provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

j. Revenue recognition and deferred revenue

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

k. Cost of revenues

Cost of revenues is comprised primarily of access, transmission and termination costs based on actual minutes in addition to monthly circuit lease costs.

l. Research and development expenses

Research and development expenses are expensed as incurred.

m. Income taxes

The company provides for income taxes using the liability approach defined by SFAS No. 109, Accounting for Income Taxes. Deferred tax assets and liabilities are recognized for the expected tax consequences between the tax bases of the assets and liabilities and their reported amounts. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized and are reversed at such time that realization is believed to be more likely than not.

n. Stock-based compensation

The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and in accordance with FASB Interpretation No. 44. Pursuant to these accounting pronouncements, the Company records compensation for stock options granted to employees over the vesting period of the options based on the difference, if any, between the exercise price of the options and the market price of the underlying shares at that date. Deferred compensation is amortized to compensation expense over the vesting period of the options.

Had compensation cost for the Company's option plans been determined on the basis of the fair value at the grant dates in accordance with the provisions of SFAS No. 123 "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, the Company's pro forma net loss and pro forma basic and diluted net loss per share would have been as follows:

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 - Summary of significant accounting policies (Cont.)

n. Stock-based compensation (Cont.)

	<u>Year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>(\$ in thousands)</u>		
Pro forma net loss:			
Net loss for the year, as reported	\$ (8,340)	\$ (12,077)	\$ (35,734)
Deduct: stock-based compensation determined under APB 25 ..	-	270	825
Add: stock-based compensation determined under SFAS 123 ...	<u>(374)</u>	<u>(2,102)</u>	<u>(3,434)</u>
Pro forma net loss	<u>\$ (8,714)</u>	<u>\$ (13,909)</u>	<u>\$ (38,343)</u>
Net loss per share - basic and diluted:			
As reported.....	\$ (0.29)	\$ (0.42)	\$ (1.23)
Pro forma	\$ (0.30)	\$ (0.48)	\$ (1.35)

The following assumptions were used for the years 2003, 2002 and 2001: dividend yield of 0.00% for all periods; risk-free interest rate of 2.2%, 4.8% and 6% respectively; an expected life of 3-years for all periods; a volatility rate of 140%, 150% and 70% respectively.

Because the determination of the fair value of all options granted includes an expected volatility factor and since additional option grants are expected to be made each year, the above pro forma disclosures are not representative of the pro forma effects of reported net income for future years.

o. Net loss per share

Basic and diluted net loss per share have been computed in accordance with SFAS No. 128, "Earnings Per Share", using the weighted average number of common stock outstanding. Diluted earnings per share give effect to all potential dilutive issuances of ordinary shares that were outstanding during the period. A total of 222,553; 32,746; and 168,212 incremental shares were excluded from the calculation of diluted net loss per ordinary share for 2003, 2002 and 2001 respectively.

p. Concentration of credit risk

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

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

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

q. Fair value of financial instruments

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

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 - Summary of significant accounting policies (Cont.)

r. Derivatives

The Company adopted Statement of Financial Accounting Standard (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, at the beginning of fiscal year 2001. The standard requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through the statement of operations. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings, or recognized in other comprehensive income (loss) until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company use of derivatives is immaterial.

s. Recently issued accounting standards

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an interpretation of ARB 51." The primary objectives of this interpretation are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities") and how to determine when and which business enterprise (the "primary beneficiary") should consolidate the variable interest entity. This new model for consolidation applies to an entity in which either (i) the equity investors (if any) do not have a controlling financial interest; or (ii) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN 46 requires that the primary beneficiary, as well as all other enterprises with a significant variable interest in a variable interest entity, make additional disclosures. Certain disclosure requirements of FIN 46 were effective for financial statements issued after January 31, 2003. In December 2003, the FASB issued FIN 46 (revised December 2003), "Consolidation of Variable Interest Entities" ("FIN 46-R") to address certain FIN 46 implementation issues. The effective dates and impact of FIN 46 and FIN 46-R are as follows: (i) Special-purpose entities ("SPEs") created prior to February 1, 2003. The company must apply either the provisions of FIN 46 or early adopt the provisions of FIN 46-R at the end of the first interim or annual reporting period ending after December 15, 2003. (ii) Non-SPEs created prior to February 1, 2003. The company is required to adopt FIN 46-R at the end of the first interim or annual reporting period ending after March 15, 2004. (iii) All entities, regardless of whether an SPE, that were created subsequent to January 31, 2003. The provisions of FIN 46 were applicable for variable interests in entities obtained after January 31, 2003. The adoption of the provisions applicable to SPEs and all other variable interests obtained after January 31, 2003 did not have a material impact on the company's consolidated financial position, consolidated results of operations, or liquidity.

In April 2003, the FASB issued SFAS No. 149, "Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. In particular, this Statement clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative. It also clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003 and did not have an impact on the Company's financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how a company classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify certain financial instruments as a liability (or as an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have an impact on the Company's financial statements.

Note 3 - Accounts receivable, net

Accounts receivable are stated net of an allowance for doubtful accounts of \$ 40,000 and \$ 81,000 at December 31, 2003 and 2002, respectively.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4 - Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	(\$ in thousands)	
Government of Israel (VAT refund and other)	\$ 24	\$ 26
Deposits with suppliers.....	364	378
Prepaid expenses	228	350
Other	68	6
Total prepaid expenses and other current assets	<u>\$ 684</u>	<u>\$ 760</u>

Note 5 - Other current liabilities

Other current liabilities consist of the following:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	(\$ in thousands)	
Accrued expenses.....	\$ 1,017	\$ 977
Employees and related expenses.....	806	1,127
Other.....	277	226
Total other current liabilities.....	<u>\$ 2,100</u>	<u>\$ 2,330</u>

Note 6 - Severance pay obligations

Deltathree Ltd., the Company's Israeli subsidiary, is subject to certain Israeli law and labor agreements that determine the obligations of Deltathree Ltd. to make severance payments to dismissed employees and to employees leaving the Company under certain other circumstances. The obligation for severance pay benefits, as determined by Israeli law, is based upon length of service and the employee's most recent salary. This obligation is partially funded through regular deposits made by Deltathree Ltd. into unaffiliated companies for managers' insurance policies. Amounts funded are controlled by the fund trustees and insurance companies and are not under the control and management of Deltathree Ltd.

Expenses (income) relating to employee termination benefits were \$ (8,375), \$ 5,000 and \$ 128,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

The aggregate value of the insurance policies as of December 31, 2003 and 2002 was \$409,000 and \$408,000 respectively.

Note 7 - Commitments and contingencies

a. Lease commitments

The Company leases offices in New York City for the headquarters of its United States operation with an initial cost of approximately \$650,000, increasing annually to \$815,000 during the final year of the lease. The lease extends until July 2010 with an option to extend the lease for an additional five years.

On October 2003 the company entered into a sub-lease agreement with a third party to sub-lease approximately 30% of the overall the New York office space. The annual sub-lease income is approximately \$148,000 for the first year, increasing annually to \$168,000 during the final year of the lease. The sub-lease extends until July 2010.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 - Commitments and contingencies (Cont.)

a. Lease commitments (Cont.)

Rent expense, net was \$ 695,067, \$ 681,545 and \$ 667,261 for the years ended December 31, 2003, 2002 and 2001, respectively.

In addition, the Company leases offices in Israel at an annual cost of \$ 292,000. The lease term that expired on February 2003 contained an option to extend the lease for up to an additional five years. In June 2002 the Company signed an extension agreement for an additional three years, commencing February 2003, at an annual cost of \$202,000.

b. Legal proceedings

The Company, as well as certain of its former officers and directors, have been named as defendants in a number of purported securities class actions in Federal District Court for the Southern District of New York, arising out of our initial public offering in November 1999 (the "IPO"). Various underwriters of the IPO also are named as defendants in the actions. The complaints allege, among other things, that the registration statement and prospectus filed with the Securities and Exchange Commission for purposes of the IPO were false and misleading because they failed to disclose that the underwriters allegedly (i) solicited and received commissions from certain investors in exchange for allocating to them shares of the Company's stock in connection with the IPO and (ii) entered into agreements with their customers to allocate such stock to those customers in exchange for the customers agreeing to purchase additional shares in the aftermarket at predetermined prices. On August 8, 2001, the court ordered that these actions, along with hundreds of IPO allocation cases against other issuers, be transferred to Judge Scheindlin for coordinated pre-trial proceedings. In July 2002, omnibus motions to dismiss the complaints based on common legal issues were filed on behalf of all issuers and underwriters. On February 19, 2003, the Court issued an opinion granting in part and denying in part those motions to dismiss. The complaint against the Company was not dismissed as a matter of law. These cases remain at a preliminary stage and no discovery proceedings have taken place. The Company believes that the claims asserted against it in these cases are without merit and intends to defend vigorously against them. A proposed settlement agreement between the plaintiffs and issuer defendants is in the process of being negotiated and approved.

c. Other marketing and cooperation agreements

The Company has entered into marketing and cooperation agreements with various other companies that maintain sites on the Web. Pursuant to certain of these agreements, the Company is obligated to pay commissions based on revenues derived from such Web links.

Note 8 - Stockholders' equity

a. Share capital

Following the Company's initial public offering, effective December 1999, the Company's stock was listed on the NASDAQ National Market System. On September 17, 2002 the listing of the Company's common stock was transferred from the Nasdaq National Market to the Nasdaq SmallCap Market.

b. CNET transaction

On October 20, 1999, the Company issued to CNET Investments, Inc. ("CNET") 1,085,943 shares of common stock and a warrant to purchase 466,028 shares of Class A common stock at an exercise price of \$ 19.31 per share, or approximately \$ 11.0 million in the aggregate, which was received in cash by the Company upon the issuance of the shares. The Company recorded approximately \$ 2.7 million of deferred compensation expense in 1999 related to the issuance of the shares representing the difference between each of the purchase price of the Class A common stock as compared to the initial public offering price of the Class A common stock and the issuance of the warrant (using the Black-Scholes option pricing model for determining the fair value of the warrant).. On July 6, 2001, CNET entered into a share purchase agreement with Atarey (the "CNET Purchase Agreement"). Under the CNET Purchase Agreement, among other things, Atarey purchased all of the shares owned by CNET in accordance with the "tag-along" rights granted to CNET pursuant to their purchase. In addition, the Company entered into a binding development and promotion agreement with CNET in September 1999, which was amended effective July 1, 2000,

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 - Stockholders' equity (Cont.)

b. CNET transaction (Cont.)

whereby CNET provided various promotions to the Company to assist it in promoting its PC-to-Phone product and related services. In consideration for these services, the Company was obligated to pay CNET a total of \$11,000,000.

In May 2001 the agreement with CNET was terminated. The Company incurred a one-time expense of approximately \$3,628,000 resulting from the cancellation of the agreement. Expenses included a payment to terminate the contract of \$1,750,000, the acceleration of the amortization of compensation charges deferred in previous years of \$1,493,000 and other related expenses.

c. Stock Options

In November 1999, the Company adopted the 1999 Stock Incentive Plan ("the Plan"). Under the Plan, 4,000,000 shares of Class A were reserved for issuance upon exercise of awards to be granted. In addition, the Company's compensation committee may grant both incentive and non-incentive stock options for shares of Class A common stock of the Company. The options generally have a term of seven years and become exercisable in three equal installments commencing on the first anniversary of the date of the grant. The purchase price per share payable upon exercise of an option is no less than the fair market value of the share at the date of grant.

As of December 31, 2003, options to purchase 2,753,130 shares of Class A were outstanding with exercise prices ranging between \$ 0.004 and \$15.00 per share.

A summary of the status of the Company's stock option plans as of December 31, 2003, 2002 and 2001 and changes during the years then ended, is presented below:

	<u>December 31, 2003</u>		<u>December 31, 2002</u>		<u>December 31, 2001</u>	
	Weighted average		Weighted average		Weighted average	
	<u>Shares</u>	<u>Exercise price</u>	<u>Shares</u>	<u>Exercise price</u>	<u>Shares</u>	<u>Exercise price</u>
Options outstanding at beginning of year	3,449,520	\$ 2.87	2,591,205	\$ 4.24	1,626,843	\$ 8.72
Granted during the year	344,500	\$ 1.75	1,335,348	\$ 0.98	1,978,416	\$ 3.68
Exercised during the year	331,024	\$ 1.088	16,566	\$ 0.004	50,961	\$ 0.004
Forfeited during the year	709,866	\$ 4.39	460,467	\$ 5.20	963,093	\$ 8.77
Outstanding at end of year	<u>2,753,130</u>	\$ 2.55	<u>3,449,520</u>	\$ 2.87	<u>2,591,205</u>	\$ 4.24
Weighted average fair value of options granted during the year ..	<u>\$ 1.75</u>		<u>\$ 0.95</u>		<u>\$ 2.39</u>	

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 - Stockholders' equity (Cont.)

c. Stock Options (Cont.)

Additional information regarding options outstanding as of December 31, 2003 is as follows:

<u>Range of Exercise Prices</u>	<u>Number of Outstanding</u>	<u>Options Outstanding</u>		<u>Options Exercisable</u>	
		<u>Weighted average Remaining Contractual Life (Years)</u>	<u>Weighted Average Exercise Price</u>	<u>Number of Exercisable Options</u>	<u>Weighted Average Exercise Price</u>
\$0.00 – \$0.00	11,596	4.0	\$ 0.00	11,596	\$ 0.00
\$0.44 – \$0.44	51,500	8.5	\$ 0.44	16,162	\$ 0.44
\$0.74 – \$1.07	918,435	7.4	\$ 0.99	396,417	\$ 0.95
\$1.13 – \$1.38	847,684	7.0	\$ 1.33	847,684	\$ 1.33
\$1.75 – \$2.08	366,763	9.7	\$ 1.76	11,596	\$ 2.08
\$5.11 – \$5.11	357,152	5.2	\$ 5.11	357,152	\$ 5.11
\$10.25 – \$15.00	200,000	4.6	\$ 12.55	200,000	\$ 12.55
	<u>2,753,130</u>	7.1	\$ 2.55	<u>1,840,607</u>	\$ 3.19

Note 9 - Research and development expenses

Research and development expenses consist of the following:

	<u>Year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(\$ in thousands)		
Salaries and related expenses.....	\$ 1,689	\$ 2,462	\$ 3,255
Consulting and advisory fees.....	96	78	655
Travel.....	22	41	126
Other.....	519	854	1,612
Total research and development expenses	<u>\$ 2,326</u>	<u>\$ 3,435</u>	<u>\$ 5,648</u>

Note 10 - Write-down of fixed assets

In 2001 the Company incurred a one-time expense of approximately \$1,003,000 from the write down of equipment that was purchased in previous periods to support contracts and inter-company agreements between RSL COM and the Company that were cancelled at the time of RSL COM's sale of their majority ownership interest in the Company to Atarey in accordance with FAS 121 (See Note 1).

Note 11 - Impairment of goodwill

During 2001, the telecommunications industries experienced significant and rapid contraction, which was accompanied by a decrease in revenues. In the fourth quarter of fiscal 2001 the Company assessed the value and future benefit of its goodwill pursuant to Accounting Principles Board Opinion No. 17, Intangible Assets ("APB 17") and consequently made a full write-off of the goodwill in the amount of \$4,151,000.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 - Income taxes

a. Provision for income taxes

No provision for income taxes was required for the years ended December 31, 2003, 2002 and 2001 due to net losses in these periods

b. Tax loss carryforwards

As of December 31, 2003, the Company had net operating loss carryforwards generated in the U.S. and Israel of approximately \$127,574,000 and \$ 6,583,000, respectively. The Company's U.S. net operating loss carryforwards will expire at various dates beginning in 2011 if not utilized. In addition, a portion of those net operating loss carryforwards could be subject to limitation due to changes in ownership of the Company. The Company's net operating losses generated in Israel may be carried forward indefinitely.

c. In accordance with SFAS No. 109, the components of deferred income taxes are as follows:

	December 31,	
	2003	2002
	(\$ in thousands)	
Net operating losses carryforwards	\$ 48,297	\$ 45,595
Less valuation allowance	<u>(48,297)</u>	<u>(45,595)</u>
Net deferred tax assets	<u>\$ -</u>	<u>\$ -</u>

As of December 31, 2003, and 2002, a valuation allowance of \$ 48,297,000 and \$45,595,000 respectively, is provided as the realization of the deferred tax assets are not assured.

d. Loss before income taxes:

	Year ended December 31,		
	2003	2002	2001
	(US\$ in thousands)		
Domestic	\$ 8,240	\$ 9,820	\$ 26,330
Foreign	<u>43</u>	<u>2,116</u>	<u>8,852</u>
Total	<u>\$ 8,283</u>	<u>\$ 11,936</u>	<u>\$ 35,182</u>

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 - Segment reporting, geographical information and major customers

The Company operates in a single industry segment, IP communications services, and makes business decisions and allocates resources accordingly.

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

	Year ended December 31,		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(\$ in thousands)		
Revenues:			
United States.....	\$ 4,602	\$ 5,077	\$ 9,123
Europe.....	966	984	2,654
South America.....	817	903	-
Far East.....	540	1,109	1,413
Middle East.....	4,040	3,041	1,457
Other.....	2,197	1,815	1,013
Total revenues.....	<u>\$ 13,162</u>	<u>\$ 12,929</u>	<u>\$ 15,660</u>
Revenues from major customers exceeding 10% of revenues:			
Affiliates.....	-	-	11%
Master Reseller - A.....	19%	-	-

	December 31,	
	<u>2003</u>	<u>2002</u>
	(\$ in thousands)	
Long-lived assets:		
United States.....	\$ 3,229	\$ 7,054
Israel.....	653	1,554
Europe.....	360	690
Other.....	65	154
Total long-lived assets.....	<u>\$ 4,307</u>	<u>\$ 9,452</u>

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Selected Quarterly Financial Information (Unaudited)

	<u>March 31</u>	<u>Three Months Ended,</u>		<u>December 31</u>
		<u>June 30</u>	<u>September 30</u>	
	(\$ in thousands, except per share data)			
<u>2003</u>				
Total revenues	\$ 2,972	\$ 2,985	\$ 3,320	\$ 3,885
Costs and operating expenses:				
Cost of revenues	1,862	1,955	2,010	2,566
Research and development expenses	663	555	562	546
Selling and marketing expenses	783	871	888	783
General and administrative expenses (exclusive of non cash compensation expense shown below)	661	478	463	460
Depreciation and amortization	1,604	1,527	1,313	1,140
Total costs and operating expenses	<u>5,573</u>	<u>5,386</u>	<u>5,236</u>	<u>5,495</u>
Loss from operations	(2,601)	(2,401)	(1,916)	(1,610)
Interest income, net	104	42	73	26
Loss before income taxes	(2,497)	(2,359)	(1,843)	(1,584)
Income taxes	18	4	24	11
Net loss	<u>\$ (2,515)</u>	<u>\$ (2,363)</u>	<u>\$ (1,867)</u>	<u>\$ (1,595)</u>
Net loss per share - basic and diluted	<u>\$ (0.09)</u>	<u>\$ (0.08)</u>	<u>(0.06)</u>	<u>\$ (0.06)</u>
Weighted average number of shares outstanding - basic and diluted	<u>28,923,296</u>	<u>28,923,296</u>	<u>28,976,345</u>	<u>29,138,244</u>
<u>2002</u>				
Total revenues	\$ 3,337	\$ 3,154	\$ 3,214	\$ 3,224
Costs and operating expenses:				
Cost of revenues	2,557	2,179	2,193	2,005
Research and development expenses	992	880	772	791
Selling and marketing expenses	1,051	1,168	808	883
General and administrative expenses (exclusive of non cash compensation expense shown below)	610	511	623	414
Non cash compensation expense	162	108	-	-
Depreciation and amortization	1,635	1,643	1,675	1,653
Total costs and operating expenses	<u>7,007</u>	<u>6,489</u>	<u>6,071</u>	<u>5,746</u>
Loss from operations	(3,670)	(3,335)	(2,857)	(2,522)
Interest income, net	129	52	194	73
Loss before income taxes	(3,541)	(3,283)	(2,663)	(2,449)
Income taxes	11	-	45	85
Net loss	<u>\$ (3,552)</u>	<u>\$ (3,283)</u>	<u>\$ (2,708)</u>	<u>\$ (2,534)</u>
Net loss per share - basic and diluted	<u>\$ (0.12)</u>	<u>\$ (0.11)</u>	<u>\$ (0.09)</u>	<u>\$ (0.09)</u>
Weighted average number of shares outstanding - basic and diluted	<u>28,885,606</u>	<u>28,885,606</u>	<u>28,885,606</u>	<u>28,898,738</u>

SIGNATURES

Pursuant to the requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this annual report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of New York, New York on the 26th day of March, 2004.

DELTATHREE, INC.

By:

/s/ Paul C. White

Paul C. White

Chief Financial Officer

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Shimmy Zimels and Paul C. White his true and lawful attorney-in-fact, each acting alone, with full power of substitution and resubstitution for him and in his name, place and stead, in any and all capacities to sign this Annual Report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorney-in-fact or his substitutes, each acting alone, may lawfully do or cause to be done by virtue thereof.

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

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Shimmy Zimels</u> Shimmy Zimels	Chief Executive Officer, President and Director (Principal Executive Officer)	March 26, 2004
<u>/s/ Paul C. White</u> Paul C. White	Chief Financial Officer (Principal Accounting and Financial Officer)	March 26, 2004
<u>/s/ Noam Bardin</u> Noam Bardin	Chairman of the Board of Directors	March 26, 2004
<u>/s/ Ilan Biran</u> Ilan Biran	Director	March 26, 2004
<u>/s/ Ehud Erez</u> Ehud Erez	Director	March 26, 2004
<u>/s/ Amir Gera</u> Amir Gera	Director	March 26, 2004
<u>/s/ Joshua Maor</u> Joshua Maor	Director	March 26, 2004
<u>/s/ Lior Samuelson</u> Lior Samuelson	Director	March 26, 2004

**DELTATHREE, INC.
CORPORATE CODE OF CONDUCT AND ETHICS
FOREWORD**

This Corporate Code of Conduct and Ethics, referred to as the “Code,” is intended to provide our associates, as defined below, with a clear understanding of the principles of business conduct and ethics that are expected of them. The standards set forth in the Code apply to us all. Every associate of the company must acknowledge his or her review of and agreement to comply with the Code as a condition of his or her relationship with the company. The term “associate” means every full and part-time employee of the company and its subsidiaries, all members of the company’s senior management, including the company’s Chief Executive Officer and Chief Financial Officer, and every member of the company’s Board of Directors, even if such member is not employed by the company.

Many of the standards outlined on the following pages will be familiar, for they reflect the fundamental values of fairness and integrity that are a part of our daily lives. Applying these standards to our business lives is an extension of the values by which we are known as individuals and by which we want to be known as a company. To that end, the company has made the Code publicly available as an exhibit to its Annual Report on Form 10-K.

It is our responsibility to conduct ourselves in an ethical business manner and also to ensure that others do the same. If any one of us violates these standards, he or she can expect a disciplinary response, up to and including termination of any employment or other relationship with the company, and possibly other legal action. If any breach of the Code is known to you, you are obligated to report violations to the Chief Compliance Officer, a member of the Compliance Committee, a member of the Board of Directors or to the third party reporting service that the Company has retained to receive such reports. Through establishing a confidential and anonymous option to accept and process such reports, we ensure that the good faith efforts of all of us to comply with the Code are not undermined.

The ultimate responsibility for maintaining our Code rests with each of us. As individuals of personal integrity, we can do no less than to behave in a way that will continue to bring credit to ourselves and our company.

While it is impossible for this Code to describe every situation that may arise, the standards explained in this Code are guidelines that should govern our conduct at all times. If you are confronted with situations not covered by this Code, or have questions regarding the matters that are addressed in the Code, you are urged to consult with the Corporate Compliance Officer, a member of the Compliance Committee, or another member of management.

The provisions of the Code regarding the actions the company will take are guidelines which the company intends to follow. There may be circumstances, however, that in the company’s judgment require different measures or actions and in such cases it may act accordingly while still attempting to fulfill the principles underlying this Code.

I. IMPLEMENTATION OF THE CODE

The following questions and answers address the company’s implementation of the Code. The company has attempted to design procedures that ensure maximum confidentiality, anonymity, and, most importantly, freedom from the fear of retaliation for complying with and reporting violations under the Code.

Q: Who is responsible for administering, updating and enforcing the Code?

A: The company’s has appointed a Corporate Compliance Officer and a Compliance Committee, to administer, update and enforce the Code. Ultimately, the Board of Directors of the company must ensure that the Corporate Compliance Officer and the Compliance Committee fulfill their responsibilities. The contact information for these individuals is listed in the employee handbook.

The Corporate Compliance Officer has overall responsibility for overseeing the implementation of the Code. Specific

responsibilities of the position are to:

- Develop the Code based on legal requirements, regulations and ethical considerations that are raised in the company's operations;
- Ensure that the Code is distributed to all associates and that all associates acknowledge the principles of the Code;
- Work with the company's Audit Committee to provide a reporting mechanism so that associates have a confidential and anonymous method of reporting not only suspected violations of the Code but concerns regarding federal securities or antifraud laws, accounting issues, or any federal law relating to fraud against shareholders;
- Implement a training program around the Code;
- Audit and assess compliance success with the Code;
- Serve as a point person for reporting violations and asking questions under the Code; and
- Revise and update the Code as necessary to respond to detected violations and changes in the law.

The primary responsibilities of the Compliance Committee are to:

- Assist the Corporate Compliance Officer in developing and updating the Code;
- Develop internal procedures to monitor and audit compliance with the Code;
- Serve as point persons for reporting violations and asking questions under the Code;
- Set up a mechanism for anonymous reporting of suspected violations of the Code by associates and refer, when appropriate, such reports to the Audit Committee;
- Conduct internal investigations, with the assistance of counsel, of suspected compliance violations;
- Evaluate disciplinary action for associates who violate the Code;
- In the case of more severe violations of the Code, make recommendations regarding disciplinary action to the Board of Directors or a committee thereof; and
- Evaluate the effectiveness of the Code and improve the Code.

The Compliance Committee will provide a summary of all matters considered under the Code to the Board of Directors or a committee thereof at each regular meeting thereof, or sooner if warranted by the severity of the matter. All proceedings and the identity of the person reporting will be kept confidential to the extent required by applicable law.

Q: How can I contact the Corporate Compliance Officer and the Compliance Committee?

A: The names and phone numbers of the Corporate Compliance Officer and each member of the Compliance Committee are provided in the employee handbook. Any one of these individuals can assist you in answering questions or reporting violations or suspected violations under the Code.

Q: How can I report any concerns that I have in a confidential and anonymous manner?

A: The Company, has a retained a third party reporting service that each associate may contact to report any suspected violations of the Code, federal securities or antifraud laws, accounting issues, or any federal law relating to fraud against shareholders. Associates may also report to this service any other concerns an associate may have with respect to the Company's business or operations. Associates may make such reports on a completely anonymous and confidential basis. The third party service, will, in turn, provide reports directly to the Audit Committee regarding the confidential reports it receives. The third party service provider, may be reached 24 hours a day, 7 days a week at the toll-free number and internet address included in the employee handbook.

II. GENERAL REQUIREMENTS

Each associate of the company is expected to be honest, fair, and accountable in all business dealings and obligations, and to ensure:

- the ethical handling of conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely and understandable disclosure in the reports required to be filed by the company with the Securities and Exchange Commission and in other public communications made by the company; and

- compliance with applicable governmental laws, rules and regulations.

III. CONFLICTS OF INTEREST

Associates should avoid any situation that may involve, or even appear to involve, a conflict between their personal interests and the interests of the company. In dealings with current or potential customers, suppliers, contractors, and competitors, each associate should act in the best interests of the company to the exclusion of personal advantage. For purposes of this section, a “significant” amount or interest shall be deemed to be any amount in excess of \$1,000. Associates are prohibited from any of the following activities which could represent an actual or perceived conflict of interest:

- No associate or immediate family member of an associate shall have a significant financial interest in, or obligation to, any outside enterprise which does or seeks to do business with the company or which is an actual or potential competitor of the company, without prior approval of the Compliance Committee, or in the case of executive officers or members of the Board of Directors, the full Board of Directors or a committee thereof.
- No associate shall conduct a significant amount of business on the company’s behalf with an outside enterprise which does or seeks to do business with the company if an immediate family member of the associate is a principal or officer of such enterprise, or an employee of such enterprise who will play a significant role in the business done or to be done between the company and such enterprise, without prior approval of the Compliance Committee, or in the case of executive officers or members of the Board of Directors, the full Board of Directors or a committee thereof.
- No executive officer or employee, or an immediate family member of an executive officer or an employee, shall serve as a director, officer or in any other management or consulting capacity of any actual competitor of the company.
- No director, or an immediate family member of a director, shall serve as a director, officer or in any other management or consulting capacity of any actual competitor of the company, without the prior approval of the full Board of Directors or a committee thereof.
- No associate shall use any company property or information or his or her position at the company for his or her personal gain.
- No associate shall engage in activities that are directly competitive with those in which the company is engaged.
- No associate shall divert a business opportunity from the company to such individual’s own benefit. If an associate becomes aware of an opportunity to acquire or profit from a business opportunity or investment in which the company is or may become involved or in which the company may have an existing interest, the associate should disclose the relevant facts to the Corporate Compliance Officer or a member of the Compliance Committee. The associate may proceed to take advantage of such opportunity only if the company is unwilling or unable to take advantage of such opportunity as notified in writing by the Compliance Committee.
- No associate or immediate family member of an associate shall receive any loan or advance from the company, or be the beneficiary of a guarantee by the company of a loan or advance from a third party, except for customary advances or corporate credit in the ordinary course of business or approved by the Compliance Committee. Please see Section IV.E. below, “Corporate Advances”, for more information on permitted corporate advances.
- In addition, the Audit Committee of the Board of Directors will review and approve, in advance, all related-party transactions, as required by the Securities and Exchange Commission, The Nasdaq Stock Market or any other regulatory body to which the company is subject.

Each associate should make prompt and full disclosure in writing to the Corporate Compliance Officer or a member of the Compliance Committee of any situation that may involve a conflict of interest. Failure to disclose any actual or perceived conflict of interest is a violation of the Code.

IV. PROTECTION AND PROPER USE OF COMPANY ASSETS

Proper protection and use of company assets and assets entrusted to it by others, including proprietary information, is a fundamental responsibility of each associate of the company. Associates must comply with security programs to safeguard such assets against unauthorized use or removal, as well as against loss by criminal act or breach of trust. The provisions hereof relating to protection of the company’s property also apply to property of others entrusted to it (including proprietary and

confidential information).

A. Proper Use of Company Property

The removal from the company's facilities of the company's property is prohibited, unless authorized by the company. This applies to furnishings, equipment, and supplies, as well as property created or obtained by the company for its exclusive use – such as client lists, files, personnel information, reference materials and reports, computer software, data processing programs and data bases. Neither originals nor copies of these materials may be removed from the company's premises or used for purposes other than the company's business without prior written authorization from the Compliance Committee. The company's products and services are its property; contributions made by any associate to their development and implementation are the company's property and remain the company's property even if the individual's employment or directorship terminates.

Each associate has an obligation to use the time for which he or she receives compensation from the company productively. Work hours should be devoted to activities directly related to the company's business.

B. Confidential Information

The company provides its associates with confidential information relating to the company and its business with the understanding that such information is to be held in confidence and not communicated to anyone who is not authorized to see it, except as may be required by law. The types of information that each associate must safeguard include (but are not limited to) the company's plans and business strategy, unannounced products and/or contracts, sales data, significant projects, customer and supplier lists, patents, patent applications, trade secrets, manufacturing techniques and sensitive financial information, whether in electronic or conventional format. These are costly, valuable resources developed for the exclusive benefit of the company. No associate shall disclose the company's confidential information to an unauthorized third party or use the company's confidential information for his or her own personal benefit.

C. Accurate Records and Reporting

Under law, the company is required to keep books, records and accounts that accurately and fairly reflect all transactions, dispositions of assets and other events that are the subject of specific regulatory record keeping requirements, including generally accepted accounting principles and other applicable rules, regulations and criteria for preparing financial statements and for preparing periodic reports filed with the Securities and Exchange Commission. All company reports, accounting records, sales reports, expense accounts, invoices, purchase orders, and other documents must accurately and clearly represent the relevant facts and the true nature of transactions. Reports and other documents should state all material facts of a transaction and not omit any information that would be relevant in interpreting such report or document. Under no circumstance may there be any unrecorded liability or fund of the company, regardless of the purposes for which the liability or fund may have been intended, or any improper or inaccurate entry knowingly made on the books or records of the company. No payment on behalf of the company may be approved or made with the intention, understanding or awareness that any part of the payment is to be used for any purpose other than that described by the documentation supporting the payment. In addition, intentional accounting misclassifications (e.g., expense versus capital) and improper acceleration or deferral of expenses or revenues are unacceptable reporting practices that are expressly prohibited.

The company has developed and maintains a system of internal controls to provide reasonable assurance that transactions are executed in accordance with management's authorization, are properly recorded and posted, and are in compliance with regulatory requirements. The system of internal controls within the company includes written policies and procedures, budgetary controls, supervisory review and monitoring, and various other checks and balances, and safeguards, such as password protection to access certain computer systems. The company has also developed and maintains a set of disclosure controls and procedures to ensure that all of the information required to be disclosed by the company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission's rules and forms.

Associates are expected to be familiar with, and to adhere strictly to, these internal controls and disclosure controls and procedures.

Responsibility for compliance with these internal controls and disclosure controls and procedures rests not solely with the company's accounting personnel, but with all associates involved in approving transactions, supplying documentation for transactions, and recording, processing, summarizing and reporting of transactions and other information required by periodic reports filed with the Securities and Exchange Commission. Because the integrity of the company's external reports to shareholders and the Securities and Exchange Commission depends on the integrity of the company's internal reports and record-keeping, all associates must adhere to the highest standards of care with respect to our internal records and reporting.

The company is committed to full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by it with the Securities and Exchange Commission, and it expects each associate to work diligently towards that goal.

Any associate who believes the company's books and records are not in accord with these requirements should immediately report the matter to the Corporate Compliance Officer or a member of the Compliance Committee. The company has adopted explicit non-retaliation policies with respect to these matters, as described in Section VIII below.

D. Document Retention

Numerous federal and state statutes require the proper retention of many categories of records and documents that are commonly maintained by companies. In consideration of those legal requirements and the company's business needs, all associates must maintain appropriate records in accordance with the company's business needs.

In addition, any record, in paper or electronic format, relevant to a threatened, anticipated or actual internal or external inquiry, investigation, matter or lawsuit may not be discarded, concealed, falsified, altered, or otherwise made unavailable, once an associate has become aware of the existence of such threatened, anticipated or actual internal or external inquiry, investigation, matter or lawsuit. Associates must provide such records to the Company's Corporate Compliance Officer. When in doubt regarding retention of any record, an associate must not discard or alter the record in question and should seek guidance from the Corporate Compliance Officer or a member of the Compliance Committee. Associates should also direct all questions regarding our Document Retention Policy and related procedures to the Corporate Compliance Officer or a member of the Compliance Committee.

E. Corporate Advances

Under law, the company may not loan money to associates except in limited circumstances. It shall be a violation of the Code for any associate to advance company funds to any other associate or to himself or herself except for usual and customary business advances for legitimate corporate purposes which are approved by a supervisor or pursuant to a corporate credit card for usual and customary, legitimate business purposes. It is the company's policy that any advance to an associate over \$2,500 be approved in advance by the Compliance Committee.

Company credit cards are to be used only for authorized, legitimate business purposes. An associate will be responsible for any unauthorized charges to a company credit card.

V. FAIR DEALING WITH CUSTOMERS, SUPPLIERS, COMPETITORS, AND ASSOCIATES

The company does not seek to gain any advantage through the improper use of favors or other inducements. Good judgment and moderation must be exercised to avoid misinterpretation and adverse effect on the reputation of the company or its associates. Offering, giving, soliciting or receiving any form of bribe to or from an employee of a customer or supplier to influence that employee's conduct is strictly prohibited.

A. Giving Gifts

Cash or cash-equivalent gifts must not be given by an associate to any person or enterprise. Gifts, favors and entertainment may be given to non-governmental employees if what is given:

- is consistent with customary business practice;
- is not excessive in value and cannot be construed as a bribe or pay-off;
- is not in violation of applicable law or ethical standards; and
- will not embarrass the company or the associate if publicly disclosed.

See also subsection E below for considerations relating to gifts to foreign officials and Section VI. B below for considerations relating to gifts to government employees.

B. Receiving Gifts

Gifts, favors, entertainment or other inducements may not be accepted by associates or members of their immediate families from any person or organization that does or seeks to do business with, or is a competitor of, the company, except as common courtesies usually associated with customary business practices. If the gift is of more than token value, the Compliance Committee must approve its acceptance.

An especially strict standard applies when suppliers are involved. If a gift unduly influences or makes an associate feel obligated to “pay back” the other party with business, receipt of the gift is unacceptable. It is never acceptable to accept a gift in cash or cash equivalent. Even gifts of token value must be declined and returned to the sender.

C. Unfair Competition

Although the free enterprise system is based upon competition, rules have been imposed stating what can and what cannot be done in a competitive environment. The following practices can lead to liability for “unfair competition” and should be avoided. They are violations of the Code.

Disparagement of Competitors. It is not illegal to point out weaknesses in a competitor’s service, product or operation; however, associates may not spread false rumors about competitors or make misrepresentations about their businesses. For example, an associate may not pass on anecdotal or unverified stories about a competitor’s products or services as the absolute truth (e.g., the statement that “our competitors’ diagnostic testing procedures have poor quality control”).

Disrupting a Competitor’s Business. This includes bribing a competitor’s employees, posing as prospective customers or using deceptive practices such as enticing away employees in order to obtain secrets or destroy a competitor’s organization. For example, it is not a valid form of “market research” to visit a competitor’s place of business posing as a customer.

Misrepresentations of Price and Product. Lies or misrepresentations about the nature, quality or character of the company’s services and products are both illegal and contrary to company policy. An associate may only describe our services and products based on their documented specifications, not based on anecdote or his or her belief that our specifications are too conservative.

D. Antitrust Concerns

Federal and state antitrust laws are intended to preserve the free enterprise system by ensuring that competition is the primary regulator of the economy. Every corporate decision that involves customers, competitors, and business planning with respect to output, sales and pricing raises antitrust issues. Compliance with the antitrust laws is in the public interest, in the interest of the business community at large, and in our company’s interest.

Failing to recognize antitrust risk is costly. Antitrust litigation can be very expensive and time-consuming. Moreover, violations of the antitrust laws can, among other things, subject you and the company to the imposition of injunctions, treble damages, and heavy fines. Criminal penalties may also be imposed, and individual employees can receive heavy fines or even be imprisoned. For this reason, antitrust compliance should be taken seriously at all levels within the company. A primary focus of antitrust laws is on dealings between competitors. In all interactions with actual or potential competitors all associates must follow these rules:

- Never agree with a competitor or a group of competitors to charge the same prices or to use the same pricing methods, to allocate services, customers, private or governmental payor contracts or territories among yourselves, to boycott or refuse to do business with a provider, vendor, payor or any other third party, or to refrain from the sale or marketing of, or limit the supply of, particular products or services.
- Never discuss past, present, or future prices, pricing policies, bundling, discounts or allowances, royalties, terms or conditions of sale, costs, choice of customers, territorial markets, production quotas, allocation of customers or territories, or bidding on a job with a competitor.
- Be careful of your conduct. An “agreement” that violates the antitrust laws may be not only a written or oral agreement, but also a “gentlemen’s agreement” or a tacit understanding. Such an “agreement” need not be in writing. It can be inferred from conduct, discussions or communications of any sort with a representative of a competitor.
- Make every output-related decision (pricing, volume, etc.) independently, in light of costs and market conditions and competitive prices.
- Carefully monitor trade association activity. These forums frequently create an opportunity for competitors to engage in antitrust violations.

Another focus of antitrust law is how a company deals with customers, suppliers, contractors and other third parties. The following practices could raise issues, and associates should always consult with the Corporate Compliance Officer or the Compliance Committee before doing any of the following:

- Refuse to sell to any customers or prospective customer;
- Enter into any new distribution or supply agreement which differs in any respect from those previously approved;
- Condition a sale on the customer’s purchasing another product or service, or on not purchasing the product of a competitor;
- Agree with a customer on a minimum or maximum resale price of our products;
- Impose restrictions on the geographic area to which our customers may resell our products;
- Require a supplier to purchase products from the company as a condition of purchasing products from that supplier;
- Enter into an exclusive dealing arrangement with a supplier or customer; or
- Offer different prices, terms, services or allowances to different customers who compete or whose customers compete in the distribution of commodities.

If our company has a dominant or potentially dominant position with respect to a particular product or market, especially rigorous standards of conduct must be followed. In these circumstances, all associates should:

- Consult with the Corporate Compliance Officer or the Compliance Committee before selling at unreasonably low prices or engaging in any bundling practices; and
- Keep the Corporate Compliance Officer or the Compliance Committee fully informed of competitive strategies and conditions in any areas where the company may have a significant market position.

Finally, always immediately inform the Corporate Compliance Officer or the Compliance Committee if local, state or

federal law enforcement officials request information from the company concerning its operations.

E. Unfair Practices in International Business

Under the Foreign Corrupt Practices Act (“FCPA”), associates of the company are prohibited from making certain gifts to foreign officials. “Foreign officials” include not only persons acting in an official capacity on behalf of a foreign government, agency, department or instrumentality, but also representatives of international organizations, foreign political parties and candidates for foreign public office. The gift is “corrupt” under the FCPA if it is made for the purpose of:

- Influencing any act or decision of a foreign official in his official capacity;
- Inducing a foreign official to do or omit to do any act in violation of his lawful duty;
- Inducing a foreign official to use his position to affect any decision of the government; or
- Inducing a foreign official to secure any “improper advantage.”

A gift is still “corrupt” even when paid through an intermediary. Any associate who has any questions whatsoever as to whether a particular gift might be “corrupt” under the FCPA, please contact the Corporate Compliance Officer or any member of the Compliance Committee.

VI. GOVERNMENT RELATIONS

Associates must adhere to the highest standards of ethical conduct in all relationships with government employees and must not improperly attempt to influence the actions of any public official.

A. Government Procurement

The U.S. Government and many state and local governments have adopted comprehensive laws and regulations governing their purchases of products from private contractors. These laws and regulations are intended to assure that governmental entities receive pricing, terms, and conditions equivalent to those granted to the company’s most favored commercial customers and that there is full and open competition in contracting.

When selling products or services to government procurement agencies, the company is accountable for complying with all applicable procurement laws, regulations, and requirements. Certifications to, and contracts with, government agencies are to be signed by a company associate authorized by the Board of Directors to sign such documents, based upon knowledge that all requirements have been fully satisfied.

B. Payments to Officials

Payments or gifts shall not be made directly or indirectly to any government official or associate if the gift or payment is illegal under the laws of the country having jurisdiction over the transaction, or if it is for the purpose of influencing or inducing the recipient to do, or omit to do, any act in violation of his or her lawful duty. Under no circumstances should gifts be given to employees of the United States Government.

C. Political Contributions

Company funds, property or services may not be contributed to any political party or committee, or to any candidate for or holder of any office of any government. This policy does not preclude, where lawful, company expenditures to support or oppose public referendum or separate ballot issues, or, where lawful and when reviewed and approved in advance by the Compliance Committee, the formation and operation of a political action committee.

VII. COMPLIANCE WITH LAWS, RULES AND REGULATIONS

A. Insider Trading Policy

The company expressly forbids any associate from trading on material non-public information or communicating material non-public information to others in violation of the law. This conduct is frequently referred to as “insider trading.” This policy applies to every associate of the company and extends to activities both within and outside their duties to the company, including trading for a personal account.

The concept of who is an “insider” is broad. It includes officers, directors and employees of a company. In addition, a person can be a “temporary insider” if he or she enters into a special confidential relationship in the conduct of a company’s affairs and as a result is given access to information solely for the company’s purpose. A temporary insider can include, among others, a company’s investment advisors, agents, attorneys, accountants and lending institutions, as well as the employees of such organizations. An associate may also become a temporary insider of another company with which our company has a contractual relationship, to which it has made a loan, to which it provides advice or for which it performs other services.

Trading on inside information is not a basis for liability unless the information is material. This is information that a reasonable investor would consider important in making his or her investment decisions, or information that is likely to have a significant effect on the price of a company’s securities.

Information is non-public until it has been effectively communicated to the marketplace. Tangible evidence of such dissemination is the best indication that the information is public. For example, information found in a report filed with the Securities and Exchange Commission or appearing in a national newspaper would be considered public.

B. Equal Employment Opportunity

The company makes employment-related decisions without regard to a person’s race, color, religious creed, age, sex, sexual orientation, marital status, national origin, ancestry, present or past history of mental disorder, mental retardation, learning disability or physical disability, including, but not limited to, blindness and genetic predisposition, or any other factor unrelated to a person’s ability to perform the person’s job. “Employment decisions” generally mean decisions relating to hiring, recruiting, training, promotions and compensation, but the term may encompass other employment actions as well.

The company encourages its associates to bring any problem, complaint or concern regarding any alleged employment discrimination to the attention of the Human Resources Department. Associates who have concerns regarding conduct they believe is discriminatory should also feel free to make any such reports to the Corporate Compliance Officer, a member of the Compliance Committee, or the Hotline.

C. Sexual Harassment Policy

The company is committed to maintaining a collegial work environment in which all individuals are treated with respect and dignity and which is free of sexual harassment. In keeping with this commitment, the company will not tolerate sexual harassment of associates by anyone, including any supervisor, co-worker, vendor, client or customer, whether in the workplace, at assignments outside the workplace, at company-sponsored social functions or elsewhere.

D. Health, Safety & Environment Laws

Health, safety, and environmental responsibilities are fundamental to the company’s values. Associates are responsible for ensuring that the company complies with all provisions of the health, safety, and environmental laws of the United States and of other countries where the company does business.

The penalties that can be imposed against the company and its associates for failure to comply with health, safety, and environmental laws can be substantial, and include imprisonment and fines.

VIII. REPORTING VIOLATIONS UNDER THE CODE: NON-RETALIATION POLICY

A. Obligation to Make Reports; Procedure

Any associate of the company having any information or knowledge regarding the existence of any violation or suspected violation of the Code has a duty to report the violation or suspected violation to the Hotline, the Corporate Compliance Officer, or any other member of the Compliance Committee. Associates are also encouraged to raise any issues or concerns regarding the Company's business or operations. Failure to report suspected or actual violations is itself a violation of the Code and may subject the associate to disciplinary action, up to and including termination of employment or legal action. Reports may be made on a completely confidential and anonymous basis. To the extent any investigation is necessitated by a report, the Company will endeavor to keep the proceedings and the identity of the reporting associate confidential to the fullest extent required by applicable law.

B. Anti-Retaliation Pledge

Any associate who reports a suspected violation under the Code by the company, or its agents acting on behalf of the company, or who raises issues or concerns regarding the company's business or operations, to the Hotline, the Corporate Compliance Officer or any other member of the Compliance Committee, may not be fired, demoted, reprimanded or otherwise harmed for, or because of, the reporting of the suspected violation, issues or concerns, regardless of whether the suspected violation involves the associate, the associate's supervisor or senior management of the company. In addition, any associate who reports a suspected violation under the Code which the associate reasonably believes constitutes a violation of a federal statute by the company, or its agents acting on behalf of the company, to a federal regulatory or law enforcement agency, may not be reprimanded, discharged, demoted, suspended, threatened, harassed or in any manner discriminated against in the terms and conditions of the associate's employment for, or because of, the reporting of the suspected violation, regardless of whether the suspected violation involves the associate, the associate's supervisor or senior management of the company.

IX. QUESTIONS UNDER THE CODE AND WAIVER PROCEDURES

Associates are encouraged to consult with the Corporate Compliance Officer and Compliance Committee about any uncertainty or questions they may have under the Code.

If any situation should arise where a course of action would likely result in a violation of the Code but for which the associate thinks that a valid reason for the course of action exists, the associate should contact the Corporate Compliance Officer or a member of the Compliance Committee to obtain a waiver prior to the time the action is taken. No waivers will be granted after the fact for actions already taken. Except as noted below, the Compliance Committee will review all the facts surrounding the proposed course of action and will determine whether a waiver from any policy in the Code should be granted.

Waiver Procedures for Executive Officers and Directors. Waiver requests by an executive officer or member of the Board of Directors shall be referred by the Compliance Committee, with its recommendation, to the Board of Directors or a committee thereof for consideration. If either (i) a majority of the independent directors on the Board of Directors, or (ii) a committee comprised solely of independent directors agrees that the waiver should be granted, it will be granted. The company will disclose the nature and reasons for the waiver on a Form 8-K to be filed with the Securities and Exchange Commission within five days. If the Board denies the request for a waiver, the waiver will not be granted and the associate may not pursue the intended course of action.

It is the company's policy only to grant waivers from the Code in limited and compelling circumstances.

X. FREQUENTLY ASKED QUESTIONS AND ANSWERS

The following questions and answers address each associate's obligation to comply with the Code. The company has

attempted to design procedures that ensure maximum confidentiality and, most importantly, freedom from the fear of retaliation for complying with and reporting violations under the Code.

Q: Do I have a duty to report violations under the Code?

A: Yes, participation in the Code and its compliance program is mandatory. You must immediately report any suspected or actual violation of the Code to the Hotline, the Corporate Compliance Officer or a member of the Compliance Committee. The Company will keep reports confidential to the fullest extent required by applicable law. Failure to report suspected or actual violations is itself a violation of the Code and may subject you to disciplinary action, up to and including termination of employment or legal action.

Q: I'm afraid of being fired for raising questions or reporting violations under the Code. Will I be risking my job if I do?

A: The Code contains a clear non-retaliation policy, meaning that if you in good faith report a violation of the Code by the company, or its agents acting on behalf of the company, to the Hotline, the Corporate Compliance Officer or another member of the Compliance Committee, the Company will undertake to protect you from being fired, demoted, reprimanded or otherwise harmed for reporting the violation, even if the violation involves you, your supervisor, or senior management of the company. You are entitled to make the report on a confidential and anonymous basis. To the extent an investigation must be initiated, the Company will keep confidential any report you make to the Corporate Compliance Officer or another member of the Compliance Committee to the extent required by applicable law.

In addition, if you report a suspected violation under the Code which you reasonably believe constitutes a violation of a federal statute by the company, or its agents acting on behalf of the company, to a federal regulatory or law enforcement agency, you may not be reprimanded, discharged, demoted, suspended, threatened, harassed or in any manner discriminated against in the terms and conditions of your employment for reporting the suspected violation, regardless of whether the suspected violation involves you, your supervisor or senior management of the company.

Q: How are suspected violations investigated under the Code?

A: When a suspected violation is reported to the Hotline, the Corporate Compliance Officer or a member of the Compliance Committee, the Compliance Committee will gather information about the allegation by interviewing the associate reporting the suspected violation, the associate who is accused of the violation and/or any co-workers or associates of the accused associates to determine if a factual basis for the allegation exists. The reporting associate's immediate supervisor will not be involved in the investigation if the reported violation involved that supervisor. The Company will keep the identity of the reporting associate confidential to the fullest extent required by applicable law.

If the report is not substantiated, the reporting associate will be informed and at that time will be asked for any additional information not previously communicated. If there is no additional information, the Corporate Compliance Officer will close the matter as unsubstantiated.

If the allegation is substantiated, the Compliance Committee will make a judgment as to the degree of severity of the violation and the appropriate disciplinary response. In more severe cases, the Compliance Committee will make a recommendation to the Board of Directors of the company for its approval. The Board's decision as to disciplinary and corrective action will be final. In the case of less severe violations, the Corporate Compliance Officer may refer the violation to the Human Resources Department for appropriate disciplinary action.

The Compliance Committee shall provide a summary of all matters considered under the Code to the Board of Directors or a committee thereof at each regular meeting thereof, or sooner if warranted by the severity of the matter.

Q: Do I have to participate in any investigation under the Code?

A: Your full cooperation with any pending investigation under the Code is a condition of your continued relationship with the company. The refusal to cooperate fully with any investigation is a violation of the Code and grounds for discipline, up to and including termination.

Q: What are the consequences of violating the Code?

A: As explained above, associates who violate the Code may be subject to discipline, up to and including termination of employment. Associates who violate the Code may simultaneously violate federal, state, local or foreign laws, regulations or policies. Such associates may be subject to prosecution, imprisonment and fines, and may be required to make reimbursement to the company, the government or any other person for losses resulting from the violation. They may be subject to punitive or treble damages depending on the severity of the violation and applicable law.

Q: What if I have questions under the Code or want to obtain a waiver under any provision of the Code?

A: The Corporate Compliance Officer and any member of the Compliance Committee can help answer questions you may have under the Code. Particularly difficult questions will be answered with input from the Compliance Committee as a whole. In addition, Section IX of the Code provides information on how you may obtain a waiver from the Code; waivers will be granted only in very limited circumstances. You should never pursue a course of action that is unclear under the Code without first consulting the Corporate Compliance Officer or the Compliance Committee, and if necessary, obtaining a waiver from the Code.

Independent Auditors' Consent

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3 (File No. 333-109495) and Form S-8 (File No. 333-34156) of deltathree, Inc. (the "Company"), our report, dated March 4, 2004, relating to our audit of the financial statements of the Company as of December 31, 2002 and 2003 and for the years ended December 31, 2001, 2002, and 2003 contained in this Annual Report on Form 10-K.

/s/ Brightman Almagor & Co.
Brightman Almagor & Co.
Certified Public Accountants
A member firm of Deloitte Touche Tohmatsu

Tel Aviv, Israel
March 4, 2004

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Shimmy Zimels, certify that:

1. I have reviewed this annual report on Form 10-K of deltathree, Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual 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)) 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 annual report is being prepared;
 - b) 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 annual report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 26, 2004

/s/ Shimmy Zimels
Shimmy Zimels
Title: Chief Executive Officer and President
(Principal Executive Officer)

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Paul C. White, certify that:

1. I have reviewed this annual report on Form 10-K of deltathree, Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual 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)) 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 annual report is being prepared;
 - b) 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 annual report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 26, 2004

/s/ Paul C. White
Paul C. White
Title: Chief Financial Officer
(Principal Financial Officer)

Certification
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
(Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code)

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

The Annual Report on Form 10-K for the year ended December 31, 2003 (the “Form 10-K”) of the Company fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 26, 2004

/s/ Shimmy Zimels
Shimmy Zimels
Chief Executive Officer

Dated: March 26, 2004

/s/ Paul C. White
Paul C. White
Chief Financial Officer

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