



deltathree

The IP Communications Network



Founded in 1996, deltathree is a leading provider of hosted SIP-based VoIP products and services. deltathree provides private-label products, including PC-to-Phone, Phone-to-Phone, and Broadband Phone, as well as back-office services such as billing, operations management, marketing support, and network management to service providers worldwide. deltathree's consumer division, iConnectHere, provides award-winning VoIP products directly to consumers. Our high quality Internet telephony solutions are viable and cost-effective alternatives to traditional telephone services.

Dear deltathree stockholders, customers, partners and employees,

Looking back, 2001 was a volatile and challenging time for the telecommunications sector and the economy in general. The year was marked by a significant deceleration in telecommunications investments and the demise of many emerging and competitive carriers. Within the Voice over Internet Protocol (VoIP) segment of the telecommunications market, we witnessed a fundamental shift from the "Free Service" business model, which was typically supported by advertising, to a "Paid Service" business model. deltathree pioneered this market transition, implementing a bottom line oriented approach that centered on quality of revenue and higher margin offerings.

The primary financial focus for deltathree in 2001 was cost cutting and the strategic realignment of the Company to match economic and sector conditions. By aggressively driving down our fixed cost structure, we ensured deltathree was financially positioned to weather the current economic downturn and emerge a healthier organization. The results of our actions to streamline the organization are clear.

From the December 31, 2000 to December 31, 2001, we...

- Reduced our quarterly operational cash burn rate by 84%;
- Reduced our quarterly operating expenses by 51%;
- Reduced employee headcount by 46%;
- Reduced our quarterly net loss by 45%;
- And improved our EPS loss by 33%.

Operationally, in 2001 we successfully secured our independence from our former parent and largest shareholder RSL Communications. When analyzing the full year 2001 financial comparisons, it is important to note that the decline in revenue is related to the bankruptcy of deltathree's previous parent company and largest customer, RSL Communications, as well as the shift in our business model away from low margin carrier traffic sales.

The most significant evolution in the deltathree product offering during 2001 was the simultaneous launch of our state-of-the-art Session Initiation Protocol or "SIP" infrastructure and our partnership with Microsoft, which provides worldwide PC-to-Phone service to Microsoft MSN Messenger and Windows XP operating system users.

Through our consumer division, iConnectHere, deltathree PC-to-Phone service is now accessible by more than 43 million active MSN Messenger subscribers, and that number is expected to grow dramatically. Based on the initial success of the service launch, Microsoft and deltathree expanded internationally to provide service to MSN Messenger and Windows Messenger users in 18 countries in Europe, Asia, North America, and the Middle East.

As we proceed through 2002, we will continue to execute on the strict cost controls we have put in place over the last twelve months while shifting additional resources towards revenue generating initiatives. There are several catalysts that investors should look for as part of our revenue roadmap.

Today, our core iConnectHere business and international reseller network continue to gain traction in the retail consumer space and serve as the primary revenue drivers. The launch of our Microsoft consumer offering provides another major revenue driver for fiscal year 2002. As we look to the future and examine the long-term drivers of deltathree's business model, we continue to make progress in the commercialization of our family of broadband communications services. We believe that the widespread deployment of this technology remains a market timing issue.

The commitment of the management team at deltathree remains stronger than ever. As market volatility peaked in trying days of September 2001, we reaffirmed our confidence in the value of the deltathree opportunity by implementing a stock repurchase program. We have aligned the entire company around building high quality revenue and achieving our breakeven goal as we travel down the road to profitability. With a complete offering of market leading, value oriented communications solutions for consumers and businesses; I am pleased to say that deltathree enters 2002 a more focused and efficient organization.

As deltathree looks ahead, the market for telecommunications and broadband services remain large and lucrative opportunities. With the exit of many smaller VoIP competitors from the marketplace, deltathree is an industry leader with ample capital liquidity, no debt and a clean balance sheet. Since I co-founded the company in 1996, deltathree stands in its best strategic position ever to capitalize on the evolution of the telecommunications industry.

I would like to thank our customers, employees, strategic partners and stockholders for their contributions and support throughout 2001. I look forward to updating all of these groups throughout 2002 with exciting new VoIP innovations and solutions from deltathree.

Sincerely,



Noam Bardin
President & Chief Executive Officer

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, 2001

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 National 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. Yes No

The aggregate market value of the Registrant's Class A common stock held by non-affiliates of the Registrant on March 27, 2002 was approximately \$8.68 million. On such date, the last sale price of the Registrant's Class A common stock was \$1.07 per share. 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 27, 2002 is as follows:

Title of Each Class

Class A Common Stock, \$0.001 par value

**Number of Shares Outstanding
at March 27, 2002**

29,143,206

DELTATHREE, INC.
2001 ANNUAL REPORT ON FORM 10-K

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DELTATHREE, INC.
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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 a total "Hosted Communications Solution" that enables 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; 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. 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.

On June 28, 2001, RSL Communications, Ltd. ("RSL COM"), our then majority stockholder and sole owner of our Class B Common Stock, par value \$0.001, entered into a share purchase agreement with Atarey Hasharon Chevra Lepituach Vehashkaot Benadlan (1991) Ltd., an Israeli company ("Atarey"), to sell to Atarey all of our Class B Common Stock owned by RSL COM. On June 29, 2001, the sale was consummated, and all of RSL COM's shares of Class B Common Stock, which carried ten votes per share, were automatically converted into shares of Class A Common Stock, which carry one vote per share. As a result of the sales transaction, Atarey became the majority stockholder, owning approximately 72% of our outstanding Class A Common Stock. No shares of Class B Common Stock remain outstanding. Simultaneously with the completion of the transaction on June 29, 2001, all of the contracts and inter-company agreements between us and RSL COM (and all of its subsidiaries) were terminated. At the same time, we severed our reliance on RSL COM as our primary pan-European wholesale telecommunications carrier, and shifted to other service providers.

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 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.

Gartner Group, a market research firm, estimates that by 2004, voice over packet communications services will grow to represent 24% of what they project will be a \$1.8 trillion market for global telecommunications in total. 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 use the Internet for transmission, rather than a privately-managed IP network. In using the 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 54.8% and 44.8% of our revenues in 2001 and 2000, 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 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 Internet 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 PSTN, but travel primarily over our privately-managed IP network. Through our privately-managed IP network, we are able to carry phone-to-phone voice communications traffic. 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 now 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, Web functionality, integration with calendar and memo tools and integration between voice and data. 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 (the device plugs 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 line customer care functions onto the Web for ease and flexibility and support this with second line 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. We 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 to private individuals as either Phone-to-Phone calling cards or PC-to-Phone accounts.

Microsoft Messenger Affiliation. Through our relationship with Microsoft, we provide PC-to-Phone service for Microsoft Windows XP and Microsoft MSN Messenger users, to any phone number in the world. Within the Microsoft 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 over 42 million current Microsoft Messenger users.

Our Hosted Communications Solution

Our "Hosted Communications Solution" leverages our VoIP expertise and delivers to our 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. 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 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 powers our new 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 2002, we intend to migrate our existing products and services to this new 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 Internet. While operating as a private extension of the Internet, the backbone has a high level of security that isolates it from security threats found on the 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. Termination decisions are based on a complex 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.

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 patent, 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 "deltathreeTM" and "iConnectHere.comTM" 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 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 60% 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. However, we cannot assure you that our services will not be regulated in the future. Several efforts have been made 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 or other common carrier regulations upon some providers of Internet and IP telephony. The FCC stated in April 1998 that it did not have an adequate record on which to make a definitive ruling, but that the record suggested that certain forms of phone-to-phone IP telephony appear to have the same functionality as non-IP telecommunications services and lack the characteristics that would render them information services.

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.

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.

With respect to the European Union, we believe that our services fall outside the classification of regulated voice telephony services. The current European Union regulatory regime distinguishes between voice telephony services and other telecommunications services. In January 1998 and again in December 2000, the European Commission concluded that IP telephony did not at that time meet the definition of "voice telephony" subject to member state's regulation. However, the Commission noted that some forms of IP telephony could be considered voice telephony, for example, where an IP telephony service is marketed as an alternative form of voice telephony service, users can dial out to any telephone number, and the provider guarantees the quality of the IP voice service by bandwidth reservation and

claims that the quality of the IP voice service is the same as traditional voice telephony service.

A determination by the European Commission that IP telephony constitutes "voice telephony" may trigger significant regulatory consequences with respect to, among other things, licensing requirements and contributions to universal service funding. The Commission has announced that it is drafting a report on regulating the quality of voice telephony services and related consumer protection issues, as well as another report discussing the new Internet telecommunications services and their impact on the European Union's regulatory and policy framework. In addition, the Commission has 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. We cannot predict what the content of such reports will be, or what impact, if any, such reports and directives may have on our business.

Based on the Commission's current position, we believe that 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.

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 prohibits certain taxes on Internet uses through November 1, 2003. We cannot predict whether substantial new taxes will be imposed on our services after that date. 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 network 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
- 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.

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

Traditional Telecommunications Carriers. Several traditional telecommunications companies, including industry leaders such as AT&T, Sprint, Deutsche Telekom, WorldCom and Qwest Communications International, 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, 2001, we employed 99 full-time and 53 part-time employees, of which 123 were located in Israel, and 29 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 \$870,000 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.

We lease a 1,440 square meter office, which houses our research and development facilities, at the Jerusalem Technology Park, Jerusalem, Israel. The term of this lease extends until February 2003, with an option to extend the lease for an additional five-year period. We pay annual rent of approximately \$240,000. We sublease a portion of our facility to third parties.

ITEM 3. LEGAL PROCEEDINGS

On October 8, 1999, Aerotel, Ltd. and Aerotel U.S.A. commenced a suit against us, RSL COM and an RSL COM subsidiary in the United States District Court for the Southern District of New York. Aerotel alleges that we are infringing on a patent issued to Aerotel in November 1987 by making, using, selling and offering for sale prepaid telephone card products in the United States. Aerotel seeks an injunction to stop us from using the technology covered by this patent, monetary damages in an unspecified amount and reimbursement of attorneys' fees. We have answered the complaint, and the parties are currently engaged in pre-trial discovery. As we continue to evaluate these claims, we believe that we have meritorious defenses to the claims and we intend to defend the lawsuit vigorously. However, the outcome of the litigation is inherently unpredictable and an unfavorable result may have a material adverse effect on our business, financial condition and results of operations. Regardless of the ultimate outcome, the litigation could result in substantial expenses to us and significant diversion of efforts by our managerial and other personnel.

We, as well as certain of our former officers and directors, have been named as a defendant 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. By Order dated October 12, 2001, Judge Scheindlin adjourned all defendants' time to respond to or answer any of the complaints until

further order of the Court. 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 vigorously against them.

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

None.

PART II

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

Market Information

Our common stock has traded on the Nasdaq National Market under the symbol "DDDC" since November 22, 1999. The following table sets forth the per share range of high and low closing sales prices of our common stock for the periods indicated:

	High	Low
Year ended December 31, 2000		
First quarter	\$62.38	\$18.00
Second quarter.....	21.38	5.75
Third quarter.....	15.00	3.56
Fourth quarter.....	5.44	1.19
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	1.35	0.74

On March 27, 2002, the last reported sale price for our common stock on the Nasdaq National Market was \$1.07 per share. The market price for our stock is highly volatile and fluctuates in response to a wide variety of factors.

Holders

As of March 27, 2002, we had approximately 125 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.

Recent Sales of Unregistered Securities

Pursuant to a stock and warrant purchase agreement, on October 18, 1999, we issued to Yahoo! Inc. 125,275 shares of common stock and a warrant to purchase 125,275 shares of common stock with an exercise price of \$7.98 per share for \$1,000,000, in a transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof.

Pursuant to a stock and warrant purchase agreement, on October 20, 1999, we issued to CNET Investments, Inc. ("CNET") 1,085,943 shares of common stock and warrants to purchase 466,028 shares of common stock at an exercise price of \$19.31 per share for \$10,999,994.76 in a transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof.

In connection with our initial public offering consummated on November 29, 1999, shares of common stock outstanding prior to the offering were converted into shares of Class B common stock. This conversion was effected without registration under the Securities Act in reliance on Section 3(a)(9) of the Securities Act on a one-for-one basis.

Pursuant to an Agreement and Plan of Merger dated as of February 3, 2000, YourDay Acquisition Corp., our wholly-owned subsidiary, was merged with and into YourDay.com, Inc. Pursuant to the merger, we issued 229,443 shares of common stock to stockholders of YourDay.com, Inc., in a transaction exempt from the registration requirements of the Securities Act pursuant to Section 4(2) thereof.

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.

For the year ended December 31, 2001, we used approximately \$29 million of the net proceeds for sales, marketing and promotional activities, \$19 million for capital expenditures and \$12 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, 1997, 1998, 1999, 2000 and 2001. Their report appears elsewhere in this annual report.

	<u>Year Ended December 31,</u>				
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
	(In thousands, except share data)				
Statement of Operations Data:					
Revenues:					
Affiliates	\$468	\$3,896	\$7,431	\$13,977	\$1,669
Non-affiliates	778	1,742	3,621	16,399	13,991
Total revenues.....	1,246	5,638	11,052	30,376	15,660
Costs and operating expenses:					
Cost of revenues, net	(892)	(4,459)	(9,723)	(24,932)	(13,486)
Research and development expenses, net	(294)	(650)	(1,233)	(6,625)	(5,648)
Selling and marketing expenses	(632)	(2,431)	(7,403)	(20,548)	(7,800)
General and administrative expenses (exclusive of non-cash compensation expense)	(1,388)	(1,842)	(2,754)	(6,694)	(6,982)
Non-cash compensation expense.....	-	(743)	(19,116)	(6,331)	(825)
Depreciation and amortization	(370)	(2,671)	(3,721)	(7,919)	(8,996)
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	(3,576)	(12,796)	(43,950)	(81,954)	(52,519)
Loss from operations	(2,330)	(7,158)	(32,898)	(51,578)	(36,859)
Interest income (expense), net.....	(37)	(186)	(873)	3,632	1,677
Minority interest	-	223	-	-	-
Income taxes	-	-	-	(311)	(552)
Net loss	\$(2,367)	\$(7,121)	\$(33,771)	\$(48,257)	\$(35,734)
Net loss per share – basic and diluted.....	\$(0.19)	\$(0.37)	\$(1.65)	\$(1.67)	\$(1.23)
Weighted average shares outstanding – basic and diluted	12,390	19,254	20,418	28,833	29,035

	<u>Year Ended December 31,</u>				
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
	(In thousands)				
Balance Sheet Data:					
Cash and cash equivalents	\$3,196	\$1,357	\$89,957	\$20,857	\$13,583
Working capital (deficiency).....	2,763	(3,232)	82,942	43,538	23,374
Total assets	8,403	25,676	126,832	86,169	45,869
Long-term debt due to affiliates	-	5,107	-	-	-
Total stockholder's equity (deficiency)	6,272	12,370	102,580	72,479	38,921

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.

Overview

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 a total "Hosted Communications Solution" that enables 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. 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. In early 2001, we deployed our Broadband Phone offering – 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.

Factors Affecting Future Results

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.

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.

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 10.7% of our total revenues in 2001 and 16.1% of our total revenues in 2000.

Revenues from non-affiliates consist of revenues from end-users of our enhanced IP communications services, including PC-to-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 32.7% and 18.3% of our total revenues in 2001 and 2000, respectively, while the provision of enhanced IP communications services through our Hosted Communications Solution sales efforts accounted for 22.1% and 26.5% of our total revenues in 2001 and 2000, respectively. Carrier transmission services to non-affiliates accounted for 11.2% and 9.2% of our total revenues in 2001 and 2000, 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. We incurred extraordinary costs of approximately \$1.4 million in 1999 in integrating the hardware and software purchased from Ericsson into our network. To compensate us for our costs, Ericsson agreed to offset our payable to them for network telecommunications equipment that we previously purchased from them with a fair market value of \$3 million, representing Ericsson’s reimbursement of costs incurred by us. As a result, we classified this payable as deferred revenues and costs, which we recognized as an offset to cost of revenues and research and development expenses as they are incurred.
- 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 business customers and service providers for our Hosted Communications Solution. We expect to decrease our overall selling and marketing expenses as we focus our attention on growing the percentage of sales related to 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 costs of directors' and officers' insurance.
- Amortization of goodwill consists of amortization of the goodwill related to the purchase by RSL COM of all of the outstanding shares of our capital stock. In July 1997, we issued shares representing 51% of our outstanding share capital to RSL COM for \$5 million. No goodwill was recorded as a result of this issuance. However, as a result of acquiring a controlling interest in us, RSL COM recorded goodwill in the amount of \$450,000, representing our net liabilities. RSL COM then proceeded to offer to purchase from our stockholders all of our outstanding shares it did not already own. By April 1998, RSL COM had paid approximately \$14.7 million in cash and securities for the remaining 49% of our shares that it did not own and RSL COM recorded goodwill in the amount of \$14.7 million. As a result of these transactions, RSL COM "pushed down" a total of approximately \$15.2 million of goodwill to our financial statements, accounted for in our financial statements as an increase in both goodwill and additional paid-in capital of approximately \$15.2 million in the aggregate. We have recorded amortization expense of approximately \$11.0 million through December 31, 2001. During the fourth quarter of 2001, the net carrying amount of goodwill was written-off and there will be no amortization relating to the RSL COM acquisition in 2002.
- Write down of fixed assets represents a one-time charge due to the write down of equipment in the second quarter of 2001 that was purchased in previous periods to support contracts and inter-company agreements between RSL COM and us that were cancelled at the time of RSL COM's sale of its majority ownership interest in us to Atarey.
- Expenses due to cancellation of a supplier agreement consists of a one-time expense due to the early termination of a long-term marketing and promotion agreement with CNET during the second quarter of 2001. Under the remaining terms of the original agreement, we were required to pay CNET \$ 5.5 million. We negotiated the early termination of this agreement for a one-time cash payment of \$1.75 million. The remainder of the \$3.6 million CNET related charge includes approximately \$1.5 million in previously deferred non-cash compensation.
- Impairment of goodwill is an expense resulting from our determination that events or changes in circumstances have occurred that impact the net carrying amount of goodwill on our financial statements. During the fourth quarter of 2001, we determined that as a result of the sale of majority ownership of us by RSL COM to Atarey, a full write-off of the net carrying amount of goodwill pushed down into our books at the time of the RSL acquisition was necessary. Accordingly, approximately \$4.2 million was written-off in accordance with generally accepted accounting principles. During the fourth quarter of 2000, we decided to de-emphasize our consumer offering, iConnectHere and focus our efforts on generating revenues primarily through sales of our Hosted Communications Solution. As a result, the technology we acquired through our acquisition of YourDay.com, Inc. was not incorporated into iConnectHere as originally planned. Accordingly, we determined that a full write-off of approximately \$8.9 million was required in accordance with generally accepted accounting principles.

We have not recorded any income tax benefit for net losses and credits incurred for any period from inception to December 31, 2001. 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.

Deferred Compensation Charge

We recognized approximately \$24.3 million of deferred compensation charges in 1999 related to non-cash compensation expense due to the issuance of 2,198,025 shares of our common stock to our employees granted with exercise prices below the fair market value in periods prior to December 31, 1999. We recorded additional deferred compensation charges of approximately \$4.4 million in 1999 in connection with our sale of common stock and warrants to both Yahoo!, Inc. and CNET. The deferred compensation charge represents the difference between each of the purchase prices of the common stock and the exercise price of the warrants as compared to the fair value of the common stock at the date of sale. We began amortizing this deferred compensation charge during the fourth quarter of 1999. The deferred compensation charge has been fully amortized for Yahoo! and the remaining CNET balance was accelerated and fully amortized along with the cancellation of the marketing and promotion agreement.

We recognized \$6.3 million in non-cash compensation expense in 2000 and \$825,000 in 2001, and we will recognize an additional \$270,000 during the period January 1, 2002 through May 31, 2002.

Results of Operations

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

	<u>1999</u>	<u>2000</u>	<u>2001</u>
	<u>Year Ended December 31,</u>		
Revenues:			
Affiliates	67.2%	46.0%	10.7%
Non-affiliates	<u>32.8</u>	<u>54.0</u>	<u>89.3</u>
Total revenues.....	100.0	100.0	100.0
Costs and operating expenses:			
Cost of revenues, net	88.0	82.1	86.0
Research and development expenses, net	11.2	21.8	36.0
Selling and marketing expenses	67.0	67.6	49.8
General and administrative expenses (exclusive of non-cash compensation expense).....	24.9	22.0	44.6
Non-cash compensation expense.....	173.0	20.8	5.3
Depreciation and amortization	33.7	26.1	57.4
Write down of fixed assets	-	-	6.4
Expenses due to cancellation of supplier agreement.....	-	-	23.2
Impairment of goodwill	<u>-</u>	<u>29.3</u>	<u>26.5</u>
Total costs and operating expenses	<u>397.6</u>	<u>269.8</u>	<u>335.3</u>
Loss from operations	(297.6)	(169.8)	(235.3)
Interest income (expense), net.....	(7.9)	12.0	10.7
Income taxes	<u>-</u>	<u>1.0</u>	<u>(3.5)</u>
	<u>(305.5)%</u>	<u>(158.9)%</u>	<u>(227.4)%</u>

Comparison of 2001 and 2000

Revenues

Affiliates. Revenues from affiliates decreased by \$12.3 million or 87.9% to \$1.7 million in 2001 from \$14.0 million in 2000, due to the sale of all of our Class B Common Stock on June 29, 2001 by RSL COM to Atarey 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 by \$2.4 million or 14.6% to \$14.0 million in 2001 from \$16.4 million in 2000. Revenues from enhanced IP communications services (including our Hosted Communications Solution) decreased by \$1.4 million or 10.3% to \$12.2 million in 2001 from \$13.6 million in 2000, due to a lesser number of new Hosted Communications Solution partners, yielding lower up-front integration fees, 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 \$1.0 million or 35.7% to \$1.8 million in 2001 from \$2.8 million in 2000, due primarily to decreased demand from a smaller customer base.

Revenues from carrier transmission services to RSL COM and other telecommunications carriers accounted for 19.5% and 25.3% of revenues in 2001 and 2000, respectively. As revenues from our enhanced IP communication services continue to grow as a percentage of total revenue, we expect that our revenues from carrier transmission services will continue to account for a declining percentage of our revenues. Other than RSL COM, no other customer accounted for greater than 10% of our revenues during these periods.

Costs and Operating Expenses

Cost of revenues. Cost of revenues decreased by \$11.4 million or 45.8% to \$13.5 million in 2001 from \$24.9 million in 2000, due primarily to a decrease in the amount of traffic being terminated.

Research and development expenses. Research and development expenses decreased by \$1.0 million or 15.2% to \$5.6 million in 2001 from \$6.6 million in 2000, 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 \$12.8 million or 62.1% to \$7.8 million in 2001 from \$20.6 million in 2000, due to a significant decrease in branding and promotional activities.

General and administrative expenses. General and administrative expenses increased by \$0.3 million or 4.5% to \$7.0 million in 2001 from \$6.7 million in 2000, primarily due to increased personnel and occupancy costs.

Non-cash compensation expenses. Non-cash compensation expenses decreased by \$5.5 million or 87.3% to \$0.8 million in 2001 from \$6.3 million in 2000, due to the completed amortization of costs incurred during 1998. Remaining amortization of costs related to the 1999 grants of options and warrants below the then fair market value will continue to be reflected in future financial statements.

Depreciation and amortization of goodwill. Depreciation and amortization of goodwill increased by \$1.1 million or 13.9% to \$9.0 million in 2001 from \$7.9 million in 2000, due to our on-going purchase, and subsequent depreciation of fixed assets.

Impairment of goodwill. We incurred a one-time expense of \$4.2 million for the year ended December 31, 2001 related to the impairment of goodwill. This one-time charge was due to the write-off of 'pushed-down' goodwill associated with the acquisition of us by RSL COM, the valuation of which was impacted by the sale of majority ownership by RSL COM to Atarey. We incurred a one-time expense of \$8.9 million for the year ended December 31, 2000 related to the impairment of goodwill. This one-time charge was due to the write-off of goodwill associated with the technology acquired through our acquisition of Yourday.com, which was not incorporated into iConnectHere as

originally planned.

Write down of fixed assets from RSL sale. We incurred a one-time expense of approximately \$7.0 million from the write down of equipment that was purchased in previous periods to support contracts and inter-company agreements between us and RSL COM that were cancelled at the time of RSL COM's sale of its majority ownership interest to Atarey. See Note 12 to the accompanying financial statements for further details.

Expenses due to the cancellation of a supplier agreement . We incurred a one-time expense of approximately \$3.6 million that resulted from the cancellation of a development and promotion agreement between CNET and us. Expenses included a payment to terminate the contract and the acceleration of the amortization of compensation charges deferred in previous years.

Loss from Operations

Loss from operations decreased by \$14.7 million or 28.5% to \$36.8 million in 2001 from \$51.5 million in 2000, due primarily to the decrease in costs and operating expenses, including non-cash compensation expenses and selling and marketing expenses. We expects to continue to incur losses for the foreseeable future.

Interest (Expense) Income, Net

Interest income decreased by \$1.9 million or 52.8% to \$1.7 million in 2001 from \$3.6 million in 2000, 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 \$0.6 million in 2001 compared to \$0.3 million in 2000.

Net Loss

Net loss decreased \$12.5 million or 25.9% to \$35.7 million in 2001 from \$48.2 million in 2000, due to the foregoing factors.

Comparison of 2000 and 1999

Revenues

Affiliates. Revenues from affiliates increased by \$6.6 million or 88.1% to \$14.0 million in 2000 from \$7.4 million in 1999, due to an increase in sales of calling card products through our affiliate, RSL COM USA, and an increase in sales to RSL COM due to increased demand for our carrier transmission services, partially offset by decreases in prices.

Non-affiliates. Revenues from non-affiliates increased by \$12.8 million or 352.9% to \$16.4 million in 2000 from \$3.6 million in 1999. Revenues from enhanced IP communications services (including our Hosted Communications Solution) increased by \$11.6 million or 473.8% to \$13.6 million in 2000 from \$2.0 million in 1999, due to integration and other service fees received from partners in our Hosted Communications Solution as well as 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 increased by \$1.4 million or 100% to \$2.8 million in 2000 from \$1.4 million in 1999, due primarily to an increased demand from a larger customer base.

Revenues from carrier transmission services to RSL COM and other telecommunications carriers accounted for 25.3% and 59.8% of revenues in 2000 and 1999, respectively. As revenues from our enhanced IP communication services continue to grow as a percentage of total revenue, we expect that our revenues from carrier transmission services will continue to account for a declining percentage of our revenues. Other than RSL COM, no other customer accounted for greater than 10% of our revenues during these periods.

Costs and Operating Expenses

Cost of revenues. Cost of revenues increased by \$15.2 million or 156.4% to \$24.9 million in 2000 from \$9.7 million in 1999, due primarily to an increase in the costs associated with the increase in the amount of traffic being terminated over our network.

Research and development expenses. Research and development expenses increased by \$5.4 million or 437.3% to \$6.6 million in 2000 from \$1.2 million in 1999, due to greater costs incurred in hiring personnel to develop several new services and enhancements to our existing services.

Selling and marketing expenses. Selling and marketing expenses increased by \$13.2 million or 177.6% to \$20.6 million in 2000 from \$7.4 million in 1999, due to the expansion of our marketing and promotional activities during the first half of 2000 and an increase in our direct sales activities during the second half of 2000.

General and administrative expenses. General and administrative expenses increased by \$3.9 million or 143.1% to \$6.7 million in 2000 from \$2.8 million in 1999, due primarily to additional personnel and increased occupancy costs.

Non-cash compensation expenses. Non-cash compensation expenses decreased by \$12.8 million or 67.0% to \$6.3 million in 2000 from \$19.1 million in 1999, due to the completed amortization of costs incurred during 1997. Remaining amortization of costs related to the 1998 and 1999 grants of employee stock options and warrants to Yahoo! and CNET below the then fair market value will continue to be reflected in future financial statements.

Depreciation and amortization of goodwill. Depreciation and amortization of goodwill increased by \$4.2 million or 112.8% to \$7.9 million in 2000 from \$3.7 million in 1999, due to the continued increase in our fixed assets and the acquisition of YourDay.com, Inc. during the first quarter of 2000.

Impairment of goodwill. We incurred a one-time expense of \$8.9 million in 2000 related to the impairment of goodwill. This one-time charge was due to the write-off of goodwill associated with the technology acquired through our acquisition of Yourday.com, which was not incorporated into iConnectHere as originally planned.

Loss from Operations

Loss from operations increased by \$18.7 million or 56.8% to \$51.6 million in 2000 from \$32.9 million in 1999, due primarily to the increase in costs and operating expenses, including non-cash compensation expenses, sales and marketing expenses, and a one-time expense for goodwill impairment, as well as a decrease in prices we charged for carrier transmission services.

Interest (Expense) Income, Net

Interest income increased by \$4.5 million or 515.5% to \$3.6 million in 2000 from \$0.9 million in 1999 due to interest earned on the remaining proceeds from our initial public offering, less the interest expense we incurred in connection with our borrowings from RSL COM, which were repaid in November 2000.

Income Taxes, Net

We paid income taxes, net of \$0.3 million in 2000 compared to no income taxes in 1999.

Net Loss

Net loss increased by \$14.5 million or 42.9% to \$48.3 million in 2000 from \$33.8 million in 1999, 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, 2001, we had an accumulated deficit of approximately \$127.4 million. We anticipate that we will continue to incur operating and net losses as we implement our growth strategy.

As of December 31, 2001, we had cash and cash equivalents of approximately \$13.6 million, marketable securities and other short-term investments of approximately \$14.2 million and working capital of approximately \$23.4 million. We generated negative cash flow from operating activities of approximately \$22.7 million during 2001 compared with negative cash flow from operating activities of \$23.4 million during 2000. Accounts receivable were approximately \$1.1 million and \$3.2 million at December 31, 2001 and December 31, 2000, respectively.

Our capital expenditures decreased from approximately \$13.6 million in the year ended December 31, 2000 compared to approximately \$1.6 million in the year ended December 30, 2001, as we better utilize 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 2001 rates, which were significantly reduced during 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 during the year due to the foregoing factors to approximately \$3.0 million in the fourth quarter of 2001, continues to improve throughout 2002 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. 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.

Certain Relationships and Related Transactions

We believe that all of the transactions described below were made on an arms-length basis. All future transactions between us and our officers, directors, principal stockholders and affiliates will be approved by a majority of the Board of Directors, including a majority of the outside directors, and will continue to be on terms no less favorable to us than could be obtained from unaffiliated third parties.

RSL COM

Prior to June 28, 2001, we had various inter-company contracts and agreements with RSL COM (and all of its subsidiaries). Simultaneously with the completion of the transaction on June 29, 2001, when RSL COM sold their entire holding of us to Atarey, all of these contracts and inter-company agreements were terminated.

Atarey

There are no inter-company contracts or agreements with Atarey.

CNET

On October 20, 1999, we issued to CNET Investments, Inc., for approximately \$11 million, 1,085,943 shares of our Class A Common Stock and warrants to purchase 466,028 shares of our Common Stock at an exercise price of \$19.31 per share exercisable for the term of our promotion agreement with CNET. CNET was entitled to request that we register their shares under the Securities Act and to include their shares in our future registered equity offerings. On July 6, 2001, CNET, entered into a share purchase agreement with Atarey. Under this agreement, Atarey purchased 1,085,943 shares of our Class A Common Stock owned by CNET in accordance with the "tag-along" rights granted to CNET pursuant to the Investor Rights Agreement, dated as of October 20, 1999, by and among us, RSL COM and CNET.

Simultaneously with its equity investment in us, in October 1999, we entered into a marketing and promotion agreement with CNET. Under this agreement, merchants on CNET's shopping sites were able to integrate our PC-to-phone software to enable users to make a PC-to-phone call directly to such merchant from the CNET shopping site using the our Click IT service. In addition, CNET had agreed to display banners and other promotions on its Web sites that will link to our Web site. The initial term of the contract was two years. This contract was mutually terminated on May 24, 2001.

Risk Factors

In addition to the other information in this report, the following factors should be carefully considered in evaluating our business and prospects.

Risks Related to Our Company

We Have a History of Losses and We Anticipate Our Losses 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 \$35.7 million in 2001, approximately \$48.3 million in 2000, and approximately \$33.8 million in 1999. As of December 31, 2001, our accumulated deficit was approximately \$127.4 million. As a percentage of revenues, our net loss was 228.2% in 2001, 158.9% in 2000 and 305.5% in 1999. Our revenues may not grow or even continue at their current level. In addition, we expect to maintain our operating expenses at current levels as we develop and expand our business. As a result, 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. 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. 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 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 and 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. Enhanced IP communications services generated 54.8%, 44.8%, and 18.4% of our total revenues in 2001, 2000 and 1999, 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 multiple sources, many of which are unproven, including the commercial sale of our Hosted Communications Solution and enhanced IP communications services. We expect that our revenues for the foreseeable future will be dependent on, among other factors:

- sales of enhanced IP communications services and 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, 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 or 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 and our Hosted Communications Solutions 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 and 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.

On October 8, 1999, we were named as a defendant in a lawsuit alleging that we are infringing on a patent by making, using, selling and offering for sale prepaid telephone card products in the United States. The plaintiffs are seeking an injunction to stop us from using the technology covered by this patent, monetary damages in an unspecified

amount and reimbursement of attorneys' fees. We have answered the complaint, and the parties are currently engaged in pre-trial discovery. As we continue to evaluate these claims, we believe that we have meritorious defenses to the claim and we intend to defend the lawsuit vigorously. However, the outcome of the litigation is inherently unpredictable and an unfavorable result may have a material adverse effect on our business, financial condition and results of operations. Regardless of the ultimate outcome, the litigation could result in substantial expenses to us and significant diversion of efforts by our managerial and other personnel.

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. In 2001, we experienced losses from fraud of less than 2% of our revenues. Callers have obtained our services without rendering payment by unlawfully using our access numbers and personal identification numbers. Although we have implemented anti-fraud measures in order to control losses relating to these practices, these measures may not be sufficient to effectively limit all of our exposure in the future from fraud and we continue to experience losses from fraud. While we have established reserves for bad debts in accordance with historical levels of uncollectible receivables resulting primarily from these fraudulent practices, our losses may exceed our reserves and could rise significantly above anticipated 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 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 72% 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 eight 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 Internet-related and technology companies in particular, has been highly volatile. We cannot assure you that our common stock will trade at the same levels of other Internet stocks or that Internet stocks in general will sustain their current market prices. We also cannot assure you that our common stock will continue to be quoted on the Nasdaq National Market if the price of our common stock falls below \$1 for a period of 30 consecutive days.

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.

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 2002 Annual Meeting of Stockholders.

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 2002 Annual Meeting of Stockholders.

ITEM 12. SECURITY OWNERSHIP OF MANAGEMENT AND PRINCIPAL STOCKHOLDERS

The information required by this Item is incorporated herein by reference to the section entitled "Principal Stockholders" in the proxy statement for our 2002 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 2002 Annual Meeting of Stockholders.

PART IV

ITEM 14. 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.

Exhibit Number	Description
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.

* 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.

(b) Reports on Form 8-K.

During fiscal 2001, we filed the following reports on Form 8-K:

On May 4, 2001, we filed a current report on Form 8-K to report under Item 5 the appointment of a new Board of Directors and an amendment to our By-Laws to reduce the size of the Board of Directors pursuant to actions taken by RSL COM.

On July 10, 2001, we filed a current report on Form 8-K to report under Item 1 a change in control resulting from Atarey's purchase of majority ownership in our company from RSL COM and appointing new directors to our Board of Directors.

On September 24, 2001, we filed a current report on Form 8-K to report under Item 5 that we were in the final stages of negotiation of an Integration and Marketing Agreement with Microsoft Corporation.

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, 2001 and 2000 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, 2001. 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 generally accepted auditing standards. 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, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2001 and 2000, and the consolidated results of its operations and cash flows for each of the three years in the period ended December 31, 2001 in conformity with generally accepted accounting principles.

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

Tel Aviv, Israel
February 11, 2002

DELTATHREE, INC.
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2001	2000
	(US\$ in thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 13,583	\$ 20,857
Short-term investments	14,192	30,542
Accounts receivable, net (Note 3)	1,092	3,245
Due from affiliates (Note 4)	--	331
Prepaid expenses and other current assets (Note 5).....	1,264	2,084
Total current assets	30,131	57,059
Property and equipment:		
Telecommunications equipment	14,068	14,686
Furniture, fixtures and other.....	591	2,169
Leasehold improvements.....	4,631	4,927
Computers hardware & software	6,751	4,579
	26,041	26,361
Less accumulated depreciation	(10,406)	(4,091)
Property and equipment, net	15,635	22,270
Goodwill, net (Note 6)	--	6,425
Deposits.....	103	415
Total assets	\$ 45,869	\$ 86,169
LIABILITIES AND STOCKHOLDER'S EQUITY		
Current liabilities:		
Accounts payable	\$ 3,417	\$ 5,236
Due to affiliates (Note 4).....	--	2,721
Deferred revenues	505	251
Other current liabilities (Note 7).....	2,835	5,313
Total current liabilities	6,757	13,521
Long-term liabilities:		
Severance pay obligations (Note 8)	191	169
Total liabilities	6,948	13,690
Commitments and contingencies (Note 9)		
Stockholder's equity: (Note 10)		
Share capital:		
Class A Common stock, - par value		
\$0.001; authorized 200,000,000 shares; issued and outstanding		
29,143,206 at December 31, 2001; 9,465,099 at December 31, 2000.....	29	9
Class B Common stock - par value \$0.001; authorized 200,000,000;		
issued and outstanding 19,569,459 at December 31, 2000	--	20
Preferred stock, par value \$0.001;		
authorized 25,000,000 shares; no shares		
issued and outstanding at December 31, 2001 and 2000	--	--
Additional paid-in capital.....	166,801	166,733
Deferred compensation	(270)	(2,588)
Accumulated deficit	(127,429)	(91,695)
Treasury stock at cost: 257,600 shares of Class A Common Stock as of		
December 31, 2001	(210)	--
Total stockholder's equity.....	38,921	72,479
Total liabilities and stockholder's equity.....	\$ 45,869	\$ 86,169

The accompanying notes are an integral part of these financial statements

DELTATHREE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year ended December 31,		
	2001	2000	1999
	(\$ in thousands, except share data)		
Revenues: (Note 15)			
Affiliates	\$ 1,669	\$ 13,977	\$ 7,431
Non-affiliates	13,991	16,399	3,621
Total revenues	15,660	30,376	11,052
Costs and operating expenses:			
Cost of revenues, net	13,486	24,932	9,723
Research and development expenses, net (Note 11).....	5,648	6,625	1,233
Selling and marketing expenses	7,800	20,548	7,403
General and administrative expenses (exclusive of non-cash compensation expense shown below).....	6,982	6,694	2,754
Non-cash compensation expense	825	6,331	19,116
Depreciation and amortization	8,996	7,919	3,721
Write-down of fixed assets (Note 12)	1,003	-	-
Expenses due to cancellation of agreement with a supplier (including non-cash compensation of \$1,493) (Note 10b)	3,628	-	-
Impairment of goodwill (Note 13)	4,151	8,905	-
Total costs and operating expenses	52,519	81,954	43,950
Loss from operations	(36,859)	(51,578)	(32,898)
Interest income (expense), net.....	1,677	3,632	(873)
Loss before income taxes	(35,182)	(47,946)	(33,771)
Income taxes (Note 14)	552	311	--
Net loss	\$ (35,734)	\$ (48,257)	\$ (33,771)
Net loss per share - basic and diluted (in US\$).....	\$ (1.23)	\$ (1.67)	\$ (1.65)
Weighted average number of shares outstanding - basic and diluted (number of shares)	29,035,319	28,832,708	20,418,457

The accompanying notes are an integral part of these financial statements

DELTA THREE, INC
STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
 (US\$ in thousands, except share data)

	Class A Common stock Shares	Class B Common stock Shares	Class B Common stock Amount	Additional paid-in capital	Receivable for capital Deficit	Deferred compensation	Treasury stock (at cost)	Accumulated deficit	Total Stockholders' Equity (deficiency)
Balance at January 1, 1999.....	-	-	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Issuance of common stock in initial public offering, net of expenses (including over- allotment of shares).....	6,900,000	7		93,855					93,862
Issue of shares to employees	748,288	1		232	(232)				1
Issue of shares to Yahoo!	183,901	*		1,000	(1,000)				*
Issue of shares to CNET	1,085,943	1		11,000					11,001
Deferred compensation expense to Yahoo! And CNET				4,397		(4,397)			--
Deferred compensation expense to employees.....				24,323		(24,323)			--
Amortization of deferred compensation expense.....						19,116			19,116
Net loss					(1,232)	(10,670)		(33,771)	(33,771)
Balance at December 31, 1999	8,918,132	9	19,569,459	157,891				(43,438)	102,580
Issuance of common stock in purchase of subsidiary	227,738			10,500					10,500
Issuance expenses				(272)					(272)
Cancellation of options				(2,751)		2,751			--
Exercise of employee options	319,229			1,365	232				1,597
Offset of receivable against debt to Yahoo! for services rendered Amortization of deferred					1,000				1,000
compensation expense.....						5,331			5,331
Net loss								(48,257)	(48,257)
Balance at December 31, 2000	9,465,099	9	19,569,459	166,733		(2,588)		(91,695)	72,479
Exercise of employee options	108,648			68					
Purchase of treasury stock	(257,600)						(210)		(210)
Cancellation of class B shares... ..	19,569,459	20	(20)						
Amortization of deferred						2,318			2,318
compensation expense.....									
Net loss								(35,734)	(35,734)
Balance at December 31, 2001	28,885,606	29		166,801		(270)		(127,429)	38,921

* - Less than \$1 thousand.

The accompanying notes are an integral part of these financial statements

DELTATHREE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,		
	2001	2000	1999
	(US\$ in thousands)		
Cash flows from operating activities:			
Net loss	\$ (35,734)	\$ (48,257)	\$ (33,771)
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization	8,996	7,919	3,721
Write-down of fixed assets	1,003	-	-
Impairment of goodwill	4,151	8,905	-
Amortization of deferred compensation	2,318	6,331	19,116
Capital gain, net	1	11	-
Minority interest	-	-	(21)
Increase (decrease) in liability for severance pay, net	22	(39)	(25)
Provision for losses on accounts receivable	1,104	199	(275)
Changes in assets and liabilities:			
Decrease (increase) in accounts receivable	1,272	(2,541)	(85)
Increase in other current assets and due from affiliates	928	(168)	(2,037)
Increase (decrease) in accounts payable	(3,053)	2,656	(793)
Decrease in deferred revenues	254	(287)	(1,072)
Increase in current liabilities and due to affiliates	(3,965)	1,860	5,467
	<u>13,028</u>	<u>24,846</u>	<u>23,996</u>
Net cash used in operating activities	<u>(22,703)</u>	<u>(23,411)</u>	<u>(9,775)</u>
Cash flows from investing activities:			
Purchase of property and equipment	(1,558)	(13,585)	(2,848)
Proceeds from sale of property and equipment	467	54	-
Proceeds from sale of investment	-	150	-
Increase (decrease) in deposits	(30)	385	(685)
Net cash used in investing activities	<u>(1,121)</u>	<u>(12,996)</u>	<u>(3,533)</u>
Cash flows from financing activities:			
Decrease (increase) in short-term investments	16,692	(19,266)	(11,276)
Proceeds from issuance of capital stock	-	-	104,864
Proceeds (repayment) of short-term debt from affiliates	-	(14,752)	8,320
Expenses relating to share issuance in 1999	-	(272)	-
Purchase of treasury stock	(210)	-	-
Proceeds from exercise of employee options	68	1,597	-
Net cash provided by (used in) financing activities	<u>16,550</u>	<u>(32,693)</u>	<u>101,908</u>
Increase (decrease) in cash and cash equivalents	(7,274)	(69,100)	88,600
Cash and cash equivalents at beginning of year	20,857	89,957	1,357
Cash and cash equivalents at end of year	<u>\$ 13,583</u>	<u>\$ 20,857</u>	<u>\$ 89,957</u>
Supplemental disclosures of cash flow information:			
Cash paid for:			
Interest	\$ -	\$ 1,332	\$ -
Taxes	\$ 552	\$ 311	\$ -
Supplemental schedule of non cash investing and financing activities:			
Assets purchased in exchange for a receivable	\$ -	\$ 2,500	\$ -
Assets purchased in exchange for shares (See Note 13)	\$ -	\$ 10,500	\$ -

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

Prior to 1999, the Company's business primarily consisted of carrying and transmitting traffic for communications carriers over its network. Beginning in 1999, the Company began to diversify its offering by layering enhanced IP telephony services over its privately managed network. These enhanced services were targeted at consumers and were primarily accessible through a consumer-oriented Web site. During 2000, the Company 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.

The Company's headquarters are located in New York City, New York. The Company's research and development activities are conducted in Israel by its wholly owned subsidiary, Delta Three Israel Ltd. ("Delta Ltd.").

Prior to its November 1999 initial public offering, the Company was a wholly owned subsidiary of RSL Communications Ltd., a multinational telecommunications company. RSL Communications Ltd. and its subsidiaries and affiliates (excluding the Company) are collectively referred to herein as "RSL COM" or "affiliates." Approximately 11%, 46 % and 67% of the Company's revenues for the year ended December 31, 2001, 2000 and 1999, respectively, were derived from transactions with RSL COM.

Since the Company's initial public offering in November 1999, RSL COM owned 100% of the outstanding Class B common stock (which carried ten votes per share), which represented approximately 95.5% of the combined voting power of all the Company's outstanding capital stock and approximately 67.4% of the economic interest in the Company. In March 2001, RSL COM commenced insolvency proceedings in Bermuda. On June 28, 2001, RSL COM entered into a share purchase agreement with Atarey Hasharon Chevra Lepituach Vehashkaot Benadlan (1991) Ltd., an Israeli company ("Atarey"), to sell to Atarey all of the Class B Common Stock of the Company owned by RSL COM. On June 29, 2001, the sale was consummated, and all of RSL COM's shares of Class B Common Stock, were automatically converted into shares of Class A Common Stock, which carry one vote per share. As a result of the sales transaction, Atarey is now the majority stockholder of the Company, owning approximately 72% of the outstanding Class A Common Stock of the Company. Simultaneously with the completion of the transaction on June 29, 2001, all of the contracts and inter-company agreements by and between RSL COM (and all of its subsidiaries) and the Company were terminated. At the same time, the Company severed its reliance on RSL COM as its primary pan-European wholesale telecommunications carrier, and shifted to other service providers.

Note 2 - Summary of significant accounting policies

a. Principles of consolidation and basis of presentation

The consolidated financial statements include the accounts of Deltathree, Inc. and its subsidiary. All significant inter-company accounts and transactions have been eliminated in consolidation.

b. 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.

c. Cash and cash equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

d. Revenue recognition and deferred revenue

The Company records revenue 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.

e. 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 and is net of reimbursements from vendors.

f. Research and development expenses

Research and development expenses, net of reimbursements from vendors, are expensed as incurred.

g. Advertising expenses

Advertising expenses are expensed as incurred. For the years ended December 31, 2001, 2000 and 1999, advertising expenses were approximately \$ 7,000 \$ 170,000 and \$ 87,000, respectively.

h. Allowance for doubtful accounts

The Company estimates the allowance for doubtful accounts by reviewing the status of significant past due receivables and analyzing historical bad debt trends and the Company then reduces accounts receivables by such allowance for doubtful accounts to expected net realizable value.

i. Property and equipment and related depreciation

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.

j. Goodwill and related amortization

Goodwill represents the excess of cost over the fair value of the Company's net assets, which were "pushed down" as a result of RSL COM's acquisitions of the Company in 1997 and 1998, and was amortized using the straight-line method over five years.

k. Impairment of long-lived assets

In accordance with SFAS 121, the Company's 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. The Company reviews 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, the Company 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.

l. Income taxes

The Company accounts for income taxes under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes". SFAS No. 109 establishes financial accounting and reporting standards for the effect of income taxes that result from activities during the current and preceding years.

SFAS No. 109 requires an asset and liability approach for financial reporting for income taxes. The Company's foreign subsidiary files separate income tax returns in the jurisdiction of their operations.

DELTATHREE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

m. 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 -168,212, 832,600 and 388,099 incremental shares were excluded from the calculation of diluted net loss per ordinary share for 2001, 2000 and 1999 respectively.

n. 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 with 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.

o. Fair value of financial instruments

The carrying amounts of cash and cash equivalents, accounts and other receivables and accounts payable approximate fair value due to the short-term maturity of these instruments. The carrying amounts of outstanding borrowings approximate fair value due to their short-term interest rate.

p. 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 its 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's use of derivative financial instruments is discussed in Note 5 to these Notes to the Consolidated Financial Statements.

The adoption of SFAS No. 133 did not have a material effect on the financial statements of the Company.

q. Effects of recently issued accounting standards

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations." SFAS 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The Company does not believe that the adoption of SFAS 141 will have a significant impact on its financial statements.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets", which is effective January 1, 2002. SFAS 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the identification of reporting units for purposes of assessing potential future impairments of goodwill. SFAS 142 also requires the Company to complete a transitional goodwill impairment test six months from the date of adoption. The Company does not believe that the adoption of SFAS 142 will have a significant impact on its financial statements.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("FAS 143"), which is effective for years beginning after June 15, 2002, which will be the Company's fiscal year 2003. FAS 143 addresses legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development or normal operation of a long-lived asset. The standard requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. Any associated asset retirement costs are to be capitalized as part of the carrying amount of the long-lived asset and expensed over the life of the asset. The Company does not believe that the adoption of SFAS 143 will have a significant impact on its financial statements.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations, for a disposal of a segment of a business. FAS 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The Company has not yet determined what the effect of FAS 144 will be on the earnings and financial position of the Company.

r. Stock-based compensation

The Company accounts for employee stock compensation arrangements in accordance with the provisions of Financial Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" and Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." and complies with the disclosure provisions of SFAS No. 123 "Accounting for Stock-Based Compensation,". Under APB No. 25, stock compensation is based on the difference, if any, on the grant date, between the estimated fair value of the Company's common stock and the exercise price.

s. Reclassifications

Certain previously reported amounts have been reclassified to conform with the 2001 presentation.

Note 3 - Accounts receivable, net

Accounts receivable are stated net of an allowance for doubtful accounts of \$ 1,356,000 and \$ 251,000 at December 31, 2001 and 2000, respectively.

Note 4 - Due from/to affiliates

The balances due from and due to affiliates as at December 31, 2000 were for services rendered by and to the Company and were non-interest bearing.

Note 5 - Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	December 31,	
	2001	2000
	(US\$ in thousands)	
Government of Israel (VAT refund and other)	\$ 57	\$ 59
Deposits with suppliers	380	189
Prepaid expenses	714	1,141
Other	<u>113</u>	<u>695</u>
Total prepaid expenses and other current assets	<u>\$ 1,264</u>	<u>\$ 2,084</u>

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6 - Goodwill, net

Goodwill consists of the following:

	December 31,	
	2001	2000
	(US\$ in thousands)	
Goodwill from acquisition of the Company by RSL COM (see Note 1 & 13)	\$ -	\$ 15,158
Less - accumulated amortization	-	(8,733)
Total goodwill, net	<u>\$ -</u>	<u>\$ 6,425</u>

Note 7 - Other current liabilities

Other current liabilities consist of the following:

	December 31,	
	2001	2000
	(US\$ in thousands)	
Accrued expenses	\$ 1,143	\$ 3,461
Employees and related expenses	1,582	1,099
Other	<u>110</u>	<u>753</u>
Total other current liabilities	<u>\$ 2,835</u>	<u>\$ 5,313</u>

Note 8 - Severance pay obligations

Delta Three Ltd., the Company's Israeli subsidiary, is subject to certain Israeli law and labor agreements that determine the obligations of Delta Three 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 Delta Three Ltd.

Expenses relating to employee termination benefits were \$ 128,000, \$ 101,000 and \$ 42,000 for the years ended December 31, 2001, 2000 and 1999, respectively.

Note 9 - Commitments and contingencies

a. Services agreement with RSL COM

In July 1997, the Company entered into a three-year services agreement with RSL COM which was subsequently amended and restated as of September 1999 to extend to September 2004. Pursuant to this agreement, RSL COM was required to use its reasonable best efforts to provide the Company with certain office and equipment space and to assist the Company in obtaining Internet, frame-relay and dedicated lines from third parties. In addition, RSL COM was required under the agreement to provide the Company with various communications services at rates set forth in the agreement. The agreement also provided that the Company was required, at RSL COM's request, to use up to 50% of its network capacity to route RSL COM's international telecommunications traffic at rates set forth in the agreement.

In June 2001, RSL COM sold its interests in the Company and all inter-company agreements, including the service agreement were terminated effective that date (see Note 1).

b. 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.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 - Commitments and contingencies (contd.)

c. Indentures governing debt of RSL COM

The Company was subject to covenants by reason of its status as a restricted subsidiary of RSL COM under the indentures governing a substantial amount of RSL COM's debt. In June 2001, RSL COM sold its interest in the Company and the restrictions on the Company expired (see Note 1).

d. 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 \$870,000 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.

The Company leased office space from RSL COM in New York at an annual cost of \$ 96,000. The lease was terminated in June 2000.

In addition, the Company leases offices in Israel at an annual cost of \$ 292,000. The lease term extends until February 2003, with an option to extend the lease for an additional five years.

e. Legal proceedings

On October 8, 1999, Aerotel, Ltd. and Aerotel U.S.A. commenced a suit against the Company, RSL COM and an RSL COM subsidiary in the United States District Court for the Southern District of New York. Aerotel alleges that the Company is infringing on a patent issued to Aerotel in November 1987 by making, using, selling and offering for sale prepaid telephone card products in the United States. Aerotel seeks an injunction to stop the Company and its co-defendant from using the technology covered by this patent, monetary damages in an unspecified amount and reimbursement of attorneys' fees. The Company has answered the complaint, and the parties are currently still engaged in a pre-trial discovery. As the Company continues to evaluate these claims, the Company believes that it has meritorious defenses to the claim and it intends to defend the lawsuit vigorously. However, the outcome of the litigation is inherently unpredictable and an unfavorable result may have a material adverse effect on the Company's business, financial condition and results of operations. Regardless of the ultimate outcome, the litigation could result in substantial expenses to the Company and significant diversion of efforts by the Company's managerial and other personnel.

The Company, as well as certain of its former officers and directors, has been named as a defendant in a number of purported securities class actions in Federal District Court for the Southern District of New York, arising out of the Company's 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 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 Company 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. By order dated October 12, 2001, Judge Scheindlin adjourned all defendants' time to respond to the complaints until further order of the Court. 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.

Note 10 - Stockholders' equity

a. Share capital

Following the Company's initial public offering, effective December 1999, the Company's Class A common stock is listed on the NASDAQ National Market. Holders of the Class A common stock are entitled to one vote per share. The Company also issued shares of Class B common stock to RSL COM, (which carried ten votes per share). Each share of Class B common stock was convertible into one share of Class A common stock at any time.

In June 2001, Atarey acquired the controlling interest in the Company. As part of the transaction all shares of Class B common stock were automatically converted to shares of Class A common stock (see Note 1).

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 - Stockholders' equity (contd.)

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). Amortization of the deferred compensation for the year ended December 31, 2000 amounted to \$ 1,062,000. On July 6, 2001, CNET entered into a share purchase agreement with Atarey (the "CNET Purchase Agreement"). Under the CNET Purchase Agreement, 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, 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 and other related expenses.

c. Stock Options

In April 1999, the Company agreed to grant options to purchase an aggregate of 1,076,761 shares of the Company's Class A common stock at an exercise price of \$ 5.11 to executive officers of the Company. Such options vest over a three-year period from the date of grant and are exercisable for a period of seven years from the date of grant.

The Company recorded deferred compensation related to the stock options of approximately \$ 9,930,000 as of December 31, 1999, representing the difference between the exercise price and the initial offering price of \$ 15. Such amount is included as a reduction of stockholders' equity and is being amortized by charges to operations over the three-year vesting period.

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, 2001, options to purchase 2,591,205 shares of Class A were outstanding with exercise prices ranging between \$ 0.004 and \$15.00 per share.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 - Stockholders' equity (contd.)

A summary of the status of the Company's stock option plans as of December 31, 2001 and 2000 and changes during the years then ended, is presented below:

	<u>December 31, 2001</u>		<u>December 31, 2000</u>		<u>December 31, 1999</u>	
	<u>Shares</u>	<u>Weighted average Exercise price</u>	<u>Shares</u>	<u>Weighted average Exercise price</u>	<u>Shares</u>	<u>Weighted average Exercise price</u>
Options outstanding at beginning of year.....	1,626,843	\$ 8.72	1,952,537	\$ 7.54	—	\$ —
Granted during the year.....	1,978,416	3.68	475,000	7.85	1,952,537	7.54
Exercised during the year.....	50,961	0.004	319,229	4.10	—	—
Forfeited during the year.....	963,093	8.77	481,465	6.54	—	—
Outstanding at end of year.....	<u>2,591,205</u>	<u>4.24</u>	<u>1,626,843</u>	<u>8.72</u>	<u>1,952,537</u>	<u>\$ 7.54</u>
Weighted average fair value of options granted during the year...	<u>\$ 2.39</u>		<u>\$ 4.00</u>		<u>\$ 9.00</u>	

If compensation cost for the Company's stock options and restricted units had been determined based on fair value at the grant date in accordance with SFAS No. 123, the Company's pro forma net loss and pro forma basic and diluted net loss per share would have been as follows:

	<u>2001</u>	<u>December 31, 2000</u>	<u>1999</u>
	(US\$ in thousands)		
Net loss:			
As reported.....	\$ (35,734)	\$ (48,257)	\$ (33,771)
Pro forma.....	\$ (38,343)	\$ (50,453)	\$ (34,357)
Net loss per share - basic and diluted:			
As reported.....	\$ (1.23)	\$ (1.67)	\$ (1.65)
Pro forma.....	\$ (1.35)	\$ (1.75)	\$ (1.68)

For the purpose of presenting pro forma information required under SFAS 123, the fair value option grant has been estimated on the date of grant using the minimum value method for grants through the period of November 22, 1999 (the date of the Company's initial public offering) and the Black-Scholes option pricing model for grants made after the Company became a public entity. The following assumptions were used for the years 2001, 2000 and 1999: dividend yield of 0.00% for all periods; risk-free interest rate of 6% for all periods; an expected life of 3-years for all periods; a volatility rate of 100%, 70% and 70% respectively.

Because the determination of the fair value of all options granted after the Company became a public entity included an expected volatility factor, in addition to the factors described in the preceding paragraph 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.

e. Employee Stock Purchase Plan

During 1999, the Board of Directors approved an Employee Stock Purchase Plan (the "ESPP"), effective beginning November 23, 1999. Under the ESPP, the maximum number of shares to be made available under the ESPP is 5% of the number of outstanding shares.

All full-time employees who have been employed by the Company for at least one calendar quarter are eligible to participate in the ESPP. Employee stock purchases are made through payroll deductions. Under the terms of the ESPP, employees may not deduct an amount that exceeds \$25,000 in total value of stock in any one year. The purchase price of the stock will be the lower of 85% of the fair market value on the first trading day of the offering period or the last trading day of the purchase period. The ESPP shall terminate upon the first to occur of (i) December 31, 2009 or (ii) the date on which the ESPP is terminated by the Board of Directors. During 2001, there were aggregate purchases of 57,687 shares under the ESPP.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11 - Research and development expenses, net

Research and development expenses consist of the following:

	Year ended December 31,		
	2001	2000	1999
	(US\$ in thousands)		
Salaries and related expenses	\$ 3,255	\$ 5,388	\$ 1,735
Consulting and advisory fees	655	-	225
Travel.....	126	344	125
Other	1,612	893	253
	5,648	6,625	2,338
Less - reimbursement by Ericsson.....	-	-	(1,105)
Total research and development expenses.....	\$ 5,648	\$ 6,625	\$ 1,233

Note 12 – Write-down of fixed assets

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 Note1).

Note 13 – Impairment of goodwill

During the year 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.

In February 2000, the Company issued 227,738 shares of Class A common stock, at an average market price of \$46 per share, amounting to \$ 10,500,000 in the aggregate to acquire all the outstanding shares of YourDay.com, Inc. In November 2000, the Company decided to de-emphasize its consumer business, and communications portal, and focus on generating revenues primarily through sales of its Hosted Communications Solution. As a result, the Yourday.com technology was not incorporated into the Company's offerings. Accordingly, the Company made a full write-off of the Yourday.com technology in the amount of \$ 8,905,000.

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 14 - Income taxes

a. Tax loss carryforwards

As of December 31, 2001, the Company had net operating loss carryforwards generated in the U.S. and Israel of approximately \$124,859,000 and \$ 3,447,000, 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.

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

	2001	December 31, 2000	1999
	(US\$ in thousands)		
Net operating losses carryforwards.....	\$ 46,190	\$ 34,822	\$ 14,403
Less valuation allowance	<u>(46,190)</u>	<u>(34,822)</u>	<u>(14,403)</u>
Net deferred tax assets	<u>\$ --</u>	<u>\$ --</u>	<u>\$ --</u>

As of December 31, 2001, 2000 and 1999, a valuation allowance of \$46,190,000, \$34,822,000 and \$ 14,403,000 respectively, is provided as the realization of the deferred tax assets are not assured.

Note 15 - 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.

	2001	December 31, 2000	1999
	(US\$ in thousands)		
Revenues by geographical location:			
United States.....	\$ 9,123	\$ 20,862	\$ 7,521
Europe	2,654	5,289	1,326
Argentina		--	113
Far east.....	1,413	3,162	1,174
Other	2,470	1,063	918
Total revenues	<u>\$ 15,660</u>	<u>\$ 30,376</u>	<u>\$ 11,052</u>
Revenues from major customers:			
Affiliates	<u>\$ 1,669</u>	<u>\$ 13,977</u>	<u>\$ 7,431</u>

	December 31,	
	2001	2000
	(US\$ in thousands)	
Long-lived assets:		
United States.....	\$ 11,864	\$ 14,972
Israel	1,797	3,251
Europe	1,426	2,747
Other	548	1,300
Total long-lived assets.....	<u>\$ 15,635</u>	<u>\$ 22,270</u>

DELTATHREE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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 29th day of March, 2002.

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 Noam Bardin 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/ Noam Bardin</u> Noam Bardin	Chief Executive Officer, President and Director (Principal Executive Officer)	March 29, 2002 (Principal Executive Officer)
<u>/s/ Paul C. White</u> Paul C. White	Chief Financial Officer (Principal Accounting and Financial Officer)	March 29, 2002
<u>/s/ Lenny Roth</u> Lenny Roth	Chairman of the Board of Directors	March 29, 2002
<u>/s/ Ehud Erez</u> Ehud Erez	Director	March 29, 2002
<u>/s/ Amir Gera</u> Amir Gera	Director	March 29, 2002
<u>/s/ Issakhar Hacmun</u> Issakhar Hacmun	Director	March 29, 2002
<u>/s/ Elie Housman</u> Elie Housman	Director	March 29, 2002
<u>/s/ Joshua Maor</u> Joshua Maor	Director	March 29, 2002
<u>/s/ Lior Samuelson</u> Lior Samuelson	Director	March 29, 2002
<u>/s/ Shimmy Zimels</u> Shimmy Zimels	Director	March 29, 2002

Officers

Noam Bardin
Chairman of the Board, CEO and
President

Paul C. White
Chief Financial Officer

Shimmy Zimels
Chief Operating Officer

Directors

Noam Bardin
Chairman of the Board, CEO and
President of deltathree, Inc.

Ehud Erez
CEO of Atarey Hasharon Chevra
Lepituach Vehashkaot Benadlan

Amir Gera
CEO of Green Venture Capital Ltd.,
CEO of Commutech Holding &
Investments Ltd.

Issakhar Hacmun
Independent real estate investor and
developer

Elie Housman
Chairman of InkSure, Inc.

Joshua Maor
Chairman of Green Venture Capital
Ltd., Chairman of Commutech
Holding & Investments Ltd.

Lior Samuelson
Founder and Managing Partner of
Mercator Broadband Partners,
Founder and Managing Partner of
Mercator Capital

Shimmy Zimels
Chief Operating Officer of deltathree, Inc.

Independent Auditors

Brightman Almagor & Co.
(member firm of Deloitte & Touche)
3 Daniel Firsch Street
Tel Aviv, Israel 64731

Legal Counsel
Skadden, Arps, Slate, Meagher &
Flom LLP
Four Times Square
New York, NY 10036

Investor Relations

Members of the financial community and
shareholders seeking additional
information should contact deltathree
Investor Relations:

Thomson Financial Investor Relations
75 Wall Street
18th Floor
New York, NY 10005
Attention: Erik Knettel
(212) 701-1963

Requests for additional financial infor-
mation, such as Forms 10K or 10Q, which
are filed with the Securities and Exchange
Commission, are available the Investor
Relations on deltathree's corporate website:
Corp.deltathree.com.

Nasdaq National Market Common
Stock Symbol: DDDC

Shareholder Account Assistance

Questions concerning stock transfer, lost
certificates, address changes, shareholder
registration changes or other shareholder
matters should be directed to deltathree
Stock Transfer Agent and Registrar

American Stock Transfer & Trust Company
40 Wall Street
New York, NY 10005
(212) 936-5100

