

8X8 INC /DE/  
Form 10-Q  
January 31, 2011

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

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FORM 10-Q

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

For the quarterly period ended December 31, 2010

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-21783

[8X8, INC.](#)

(Exact name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

77-0142404

(I.R.S. Employer Identification Number)

810 West Maude Avenue  
Sunnyvale, CA 94085

(Address of Principal Executive Offices)

(408) 727-1885

(Registrant's Telephone Number, including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).    YES

" NO "

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

Large accelerated filer    Accelerated filer    x    Non-accelerated filer    "    Smaller reporting company  
"    (Do not check if a smaller reporting company)    "

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

The number of shares of the Registrant's Common Stock outstanding as of January 26, 2011 was 62,436,804.

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## Part I -- FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

8X8, Inc.  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, unaudited)

|   | <b>December 31,<br/>2010</b> | <b>March 31,<br/>2010</b> |
|---|------------------------------|---------------------------|
|   | <hr/>                        | <hr/>                     |
| <b>ASSETS</b>                               |                              |                           |
| Current assets:                             |                              |                           |
| Cash and cash equivalents                   | \$ 18,586                    | \$ 18,056                 |
| Investments                                 | 1,920                        | -                         |
| Accounts receivable, net                    | 758                          | 554                       |
| Inventory                                   | 2,600                        | 2,174                     |
| Deferred cost of goods sold                 | 105                          | 107                       |
| Other current assets                        | 721                          | 558                       |
|   | <hr/>                        | <hr/>                     |
| Total current assets                        | 24,690                       | 21,449                    |
| Property and equipment, net                 | 2,614                        | 1,871                     |
| Intangible assets, net                      | 239                          | -                         |
| Goodwill                                    | 1,210                        | -                         |
| Other assets                                | 699                          | 392                       |
|   | <hr/>                        | <hr/>                     |
| Total assets                                | \$ 29,452                    | \$ 23,712                 |
|   | <hr/>                        | <hr/>                     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                              |                           |
| Current liabilities:                        |                              |                           |
| Accounts payable                            | \$ 4,795                     | \$ 3,780                  |
| Accrued compensation                        | 1,683                        | 1,444                     |
| Accrued warranty                            | 417                          | 331                       |
| Accrued taxes                               | 2,105                        | 1,804                     |
| Deferred revenue                            | 1,039                        | 1,310                     |
| Other accrued liabilities                   | 2,029                        | 1,465                     |
|   | <hr/>                        | <hr/>                     |
| Total current liabilities                   | 12,068                       | 10,134                    |
| Other liabilities                           | 67                           | 111                       |
| Fair value of warrant liability             | -                            | 167                       |
|   | <hr/>                        | <hr/>                     |
| Total liabilities                           | 12,135                       | 10,412                    |
|   | <hr/>                        | <hr/>                     |
| Commitments and contingencies (Note 9)      |                              |                           |
| Stockholders' equity:                       |                              |                           |
| Common stock                                | 63                           | 63                        |
| Additional paid-in capital                  | 211,691                      | 212,077                   |
| Accumulated other comprehensive loss        | (80)                         | -                         |
| Accumulated deficit                         | (194,357)                    | (198,840)                 |
|   | <hr/>                        | <hr/>                     |
| Total stockholders' equity                  | 17,317                       | 13,300                    |
|   | <hr/>                        | <hr/>                     |
| Total liabilities and stockholders' equity  | \$ 29,452                    | \$ 23,712                 |
|   | <hr/>                        | <hr/>                     |

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



## 8X8, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts; unaudited)

|  | Three Months Ended<br>December 31, |                 | Nine Months Ended<br>December 31, |                 |
|--|------------------------------------|-----------------|-----------------------------------|-----------------|
|  | 2010                               | 2009            | 2010                              | 2009            |
| Service revenues   | \$ 16,664                          | \$ 14,737       | \$ 48,098                         | \$ 44,095       |
| Product revenues   | 1,114                              | 1,207           | 3,881                             | 3,434           |
| <b>Total revenues</b>                                      | <b>17,778</b>                      | <b>15,944</b>   | <b>51,979</b>                     | <b>47,529</b>   |
| Operating expenses:  |                                    |                 |                                   |                 |
| Cost of service revenues                                   | 3,819                              | 3,254           | 10,790                            | 10,290          |
| Cost of product revenues                                   | 1,840                              | 1,925           | 5,897                             | 5,432           |
| Research and development                                   | 1,131                              | 1,239           | 3,628                             | 3,741           |
| Selling, general and administrative                        | 9,570                              | 8,251           | 27,453                            | 24,980          |
| <b>Total operating expenses</b>                            | <b>16,360</b>                      | <b>14,669</b>   | <b>47,768</b>                     | <b>44,443</b>   |
| Income from operations                                     | 1,418                              | 1,275           | 4,211                             | 3,086           |
| Other income, net  | 78                                 | 7               | 112                               | 50              |
| Income (loss) on change in fair value of warrant liability | -                                  | (265)           | 167                               | (362)           |
| Income before provision for income taxes                   | 1,496                              | 1,017           | 4,490                             | 2,774           |
| Provision for income taxes                                 | -                                  | 3               | 7                                 | 10              |
| <b>Net income</b>  | <b>\$ 1,496</b>                    | <b>\$ 1,014</b> | <b>\$ 4,483</b>                   | <b>\$ 2,764</b> |
| Net income per share:                                      |                                    |                 |                                   |                 |
| Basic  | \$ 0.02                            | \$ 0.02         | \$ 0.07                           | \$ 0.04         |
| Diluted  | \$ 0.02                            | \$ 0.02         | \$ 0.07                           | \$ 0.04         |
| Weighted average number of shares:                         |                                    |                 |                                   |                 |
| Basic  | 63,281                             | 62,852          | 63,365                            | 62,768          |
| Diluted  | 66,873                             | 63,393          | 65,622                            | 62,978          |

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

8X8, Inc.  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands, unaudited)

|   | <b>Nine Months Ended<br/>December 31,</b> |                  |
|---|---|------------------|
|   | <b>2010</b>                               | <b>2009</b>      |
| <b>Cash flows from operating activities:</b>                                      |   |                  |
| Net income  | \$ 4,483                                  | \$ 2,764         |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |                  |
| Depreciation and amortization   | 960                                       | 775              |
| Stock-based compensation  | 228                                       | 182              |
| Change in fair value of warrant liability   | (167)                                     | 361              |
| Change in inventory reserve   | 32  | (347)            |
| Other   | 25  | 69               |
| Changes in assets and liabilities:  |   |                  |
| Accounts receivable, net  | (231)                                     | (135)            |
| Inventory   | (458)                                     | (145)            |
| Other current and noncurrent assets   | (75)                                      | (39)             |
| Deferred cost of goods sold   | 2   | 99               |
| Accounts payable  | 1,272                                     | (731)            |
| Accrued compensation  | 239                                       | 227              |
| Accrued warranty  | 86  | 28               |
| Accrued taxes and fees  | 301                                       | (53)             |
| Deferred revenue  | (271)                                     | (597)            |
| Other current and noncurrent liabilities  | 548                                       | (974)            |
|   | <b>6,974</b>                              | <b>1,484</b>     |
| <b>Cash flows from investing activities:</b>                                      |   |                  |
| Purchases of property and equipment   | (1,891)                                   | (929)            |
| Restricted cash decrease  | -   | 100              |
| Purchase of investments   | (2,000)                                   | -                |
| Purchase of strategic investment  | (315)                                     | -                |
| Acquisition of Central Host, Inc., net of cash acquired                           | (998)                                     | -                |
| Sale of property and equipment  | 2   | 2                |
|   | <b>(5,202)</b>                            | <b>(827)</b>     |
| <b>Cash flows from financing activities:</b>                                      |   |                  |
| Capital lease payments  | (28)                                      | (42)             |
| Repurchase of common stock  | (4,026)                                   | (212)            |
| Buyback of employee stock options   | (101)                                     | -                |
| Proceeds from exercise of warrants  | 880                                       | -                |
| Proceeds from issuance of common stock  | 278                                       | -                |
| Proceeds from issuance of common stock under employee stock plans                 | 1,755                                     | 291              |
|   | <b>(1,242)</b>                            | <b>37</b>        |
| Net increase in cash and cash equivalents   | 530                                       | 694              |
| Cash and cash equivalents at the beginning of the period                          | 18,056                                    | 16,376           |
|   | <b>\$ 18,586</b>                          | <b>\$ 17,070</b> |

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





8X8, Inc.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED  
FINANCIAL STATEMENTS

## 1. DESCRIPTION OF THE BUSINESS

### THE COMPANY

8x8, Inc. ("8x8" or the "Company") develops and markets telecommunications services for Internet protocol, or IP, telephony and video applications as well as web-based conferencing, unified communications services, managed hosting and cloud-based computing services. The Company was incorporated in California in February 1987 and was reincorporated in Delaware in December 1996.

The Company offers the 8x8 VoIP (Voice over Internet Protocol) voice and video digital phone service, 8x8 Virtual Office hosted PBX (private branch exchange) service, 8x8 Complete Contact Center service, 8x8 Trunking service, 8x8 Hosted Key System service, 8x8 MobileTalk service, 8x8 Virtual Meeting web conferencing service, 8x8 Virtual Office Pro unified communications solution and 8x8 Managed Hosting and Cloud-Based Computing solutions. Between November 2002 and April 2009, the Company marketed its services under the Packet8 brand. In May 2009, the Company began marketing its services under the 8x8 brand. As of December 31, 2010, the Company had more than 23,000 business customers. Each business customer subscribes to a number of various lines and services (*e.g.* physical phone extensions, virtual extensions, fax lines, toll free numbers, receptionist software, unified communications services, etc.).

The 8x8 voice and video broadband phone service enables broadband Internet users to add digital voice and video communications services to their high-speed Internet connections. Customers can choose a regular direct-dial phone number from any of the rate centers offered by the service and then use an existing telephone to make and receive calls over a standard broadband Internet connection.

The 8x8 Virtual Office suite of business phone services offers small and medium-sized businesses feature-rich, HD (high definition) audio-enhanced communications services that eliminate the need for traditional telecommunications services and business phone systems. The 8x8 Virtual Office solution essentially replaces an on-premise PBX telephone system with a hosted, Internet-based business phone service that is delivered over a managed or unmanaged Internet connection. The Company sells pre-programmed IP telephones with speakerphones and a display screen, in conjunction with our Virtual Office service plans, which enable its business customers to access additional Virtual Office features through on-screen phone menus. The 8x8 Virtual Office Pro unified communications solution, introduced in January 2010, bundles the 8x8 Virtual Office hosted PBX phone service with essential businesses communications services such as web conferencing, call recording and archiving, Internet fax, chat, voicemail and presence management and a mobile iPhone extension in a competitively priced offering. 8x8 Virtual Office Pro takes the functionality of an already powerful hosted PBX phone service to a superior feature set with high fidelity HD voice, remote accessibility via any web browser or smart phone, and integration with vital phone management and collaboration tools. As of October 2010, the Virtual Office Pro services were offered on a standalone basis so that a business customer was no longer required to buy a physical IP telephone to access the Company's Virtual Office services; such access was provided by a web-based softphone and/or a mobile iPhone extension. All of the Company's services are sold on a subscription basis at price points that are disruptive to legacy solutions because they are implemented in 8x8 software that is running on servers in leased data center space that are monitored and managed by the Company.

The 8x8 Managed Hosting and Cloud-Based Computing solutions enable business customers to reduce costs and gain performance and reliability advantages by eliminating in-house ownership of server equipment and costly information technology (IT) systems management staff. Subscribers to these services use 8x8 servers and other hardware that are monitored and managed by the Company in its leased data center space, just like the servers that host 8x8's

communications software.

The Company's fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in these notes to the consolidated financial statements refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2011 refers to the fiscal year ending March 31, 2011).

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## 2. BASIS OF PRESENTATION

The accompanying interim condensed consolidated financial statements are unaudited and have been prepared on substantially the same basis as our annual financial statements for the fiscal year ended March 31, 2010. In the opinion of the Company's management, these financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of our financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from these estimates.

The March 31, 2010 year-end condensed consolidated balance sheet data in this document were derived from audited consolidated financial statements and do not include all of the disclosures required by U.S. generally accepted accounting principles. These financial statements should be read in conjunction with the Company's audited consolidated financial statements as of and for the fiscal year ended March 31, 2010 and notes thereto included in the Company's fiscal 2010 Annual Report on Form 10-K.

The results of operations and cash flows for the interim periods included in these financial statements are not necessarily indicative of the results to be expected for any future period or the entire fiscal year.

### Service Revenue

The Company recognizes new subscriber revenue in the month the new order is shipped, net of an allowance for expected cancellations. The allowance for expected cancellations is based on the Company's history of subscriber cancellations within the 30-day trial period offered with all new services.

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 605-25 requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if the deliverables in the arrangement meet specific criteria. In addition, arrangement consideration must be allocated among the separate units of accounting based on their relative fair values, with certain limitations. The provisioning of the 8x8 service with the accompanying IP phone equipment constitutes a revenue arrangement with multiple deliverables. In accordance with the guidance of ASC 605-25, the Company allocates revenue from new subscriptions, including activation fees, between the IP phone equipment and subscriber services. Revenue allocated to the IP phone equipment is recognized as product revenue during the period of the sale less the allowance for estimated returns during the 30-day trial period. All other revenue is recognized when the related services are provided.

### Product revenue

The Company recognizes revenue from product sales for which there are no related services to be rendered upon shipment to partners and end users provided that persuasive evidence of an arrangement exists, the price is fixed, title has transferred, collection of resulting receivables is reasonably assured, there are no customer acceptance requirements, and there are no remaining significant obligations. Gross outbound shipping and handling charges are recorded as revenue, and the related costs are included in cost of goods sold. Reserves for returns and allowances for partner and end user sales are recorded at the time of shipment. In accordance with the ASC 985-605, the Company records shipments to distributors, retailers, and resellers, where the right of return exists, as deferred revenue. The Company defers recognition of revenue on sales to distributors, retailers, and resellers until products are resold to the end user.

### Deferred Cost of Goods Sold

Deferred cost of goods sold represents the cost of products sold for which the customer has a right of return. The cost of the products sold is recognized contemporaneously with the recognition of revenue.

#### Warrant Liability

The Company accounts for its warrants in accordance with ASC 480-10 which requires warrants to be classified as permanent equity, temporary equity or as assets or liabilities. In general, warrants that either require net-cash settlement or are presumed to require net-cash settlement are recorded as assets and liabilities at fair value and warrants that require settlement in shares are recorded as equity instruments. The Company had two outstanding warrants that were

classified as liabilities. Both warrants include a provision that specifies that the Company must deliver freely tradable shares upon exercise by the warrant holder. Because there are circumstances, irrespective of likelihood, that may not be within the control of the Company that could prevent delivery of registered shares, ASC 480-10 requires the warrants be recorded as a liability at fair value, with subsequent changes in fair value recorded as income (loss) in change in fair value of warrant liability. The fair value of the warrant is determined using a Black-Scholes option pricing model, and is affected by changes in inputs to that model including our stock price, expected stock price volatility and contractual term. The two warrants classified as liabilities expired on December 19, 2010.

#### Accounting for Stock-Based Compensation

The Company accounts for stock-based compensation under ASC 718 - Stock Compensation which establishes standards for the accounting for equity instruments exchanged for employee services. Under the provisions of ASC 718, share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant), net of estimated forfeitures.

Stock-based compensation expense recognized in the Company's condensed consolidated statements of income for the three and nine months ended December 31, 2010 included the unvested portion of stock-based awards granted. Stock-based awards were measured based on ASC 718 criteria and the compensation expense for all share-based payment awards granted is recognized using the straight-line single-option method. Stock-based compensation expense includes the impact of estimated forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

#### Stock-based Compensation Plans

The Company has several stock-based compensation plans that are described in Note 4 "Stockholders' Equity" of the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2010. The Company, under its various equity plans, grants stock-based awards for shares of common stock to employees, non-employee directors and consultants.

As of December 31, 2010, the 1992 Stock Plan, 1996 Stock Plan and 1996 Director Option Plan had expired and the 1999 Nonstatutory Stock Option Plan had been cancelled by the Board, but options granted under these four plans remained outstanding. Options granted under these plans generally vest over four years, were granted at fair market value on the date of the grant and expire ten years from that date.

The Company has reserved a total of 7,000,000 shares of common stock for issuance under its 2006 Stock Plan (the "2006 Plan") of which 6,128,281 shares remain available for issuance as of December 31, 2010. The 2006 Plan is the Company's only active plan for providing stock-based incentive compensation ("awards") to its eligible employees, non-employee directors or consultants. Awards that may be granted under the 2006 Plan include incentive stock-based awards, nonstatutory stock options and stock purchase rights. The exercise price of incentive stock options granted and purchase price of stock purchase rights may not be less than the fair market value on the effective date of the grant. Other types of options and awards under the 2006 Plan may be granted at any price approved by the administrator, which generally will be the board of directors. Options and stock purchase rights generally vest over four years and expire ten years after grant. The 2006 Plan expires in May 2016.

#### Option and Stock Purchase Right Activity

Stock purchase right activity since March 31, 2010 is summarized as follows:

| Weighted<br>Average | Weighted<br>Average |
|---------------------|---------------------|
|---------------------|---------------------|

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|                              | <u>Number of<br/>Shares</u> | <u>Grant-Date<br/>Fair Market<br/>Value</u> | <u>Remaining<br/>Contractual<br/>Term (in Years)</u> |
|------------------------------|-----------------------------|---|--|
| Balance at March 31, 2010    | 353,720                     | \$ 0.71                                     |  |
| Awarded                      | 621,432                     | 1.38  |  |
| Released                     | (118,002)                   | 0.91  |  |
| Forfeited                    | (108,438)                   | 1.23  |  |
|                              | <u>748,712</u>              | <u>\$ 1.16</u>                              | <u>3.28</u>  |
| Balance at December 31, 2010 |                             |   |  |

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Option activity since March 31, 2010 is summarized as follows:

|                              | Shares<br>Available<br>for Grant | Shares<br>Subject to<br>Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price<br>Per Share |
|------------------------------|----------------------------------|--|---|
| Balance at March 31, 2010    | 2,869,411                        | 9,267,403                                      | \$ 1.90   |
| Stock purchase right         | (621,432)                        | -  |   |
| Exercised                    | -                                | (1,044,426)                                    | 1.45  |
| Buyout (Note 11)             | 144,250                          | (144,250)                                      | 2.31  |
| Canceled/forfeited           | 782,000                          | (782,000)                                      | 5.96  |
| Termination of plans         | (903,250)                        | -  | -   |
| Balance at December 31, 2010 | 2,270,979                        | 7,296,727                                      | \$ 1.52   |

The following table summarizes the stock options outstanding and exercisable at December 31, 2010:

|                 | Options Outstanding |   |   |                                 | Options Exercisable |   |                                 |
|-----------------|---------------------|---|---|---------------------------------|---------------------|---|---------------------------------|
|                 | Shares              | Weighted<br>Average<br>Exercise<br>Price<br>Per Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Aggregate<br>Intrinsic<br>Value | Shares              | Weighted<br>Average<br>Exercise<br>Price<br>Per Share | Aggregate<br>Intrinsic<br>Value |
| \$0.01 - \$1.15 | 1,519,325           | \$ 0.87   | 7.15  | \$ 2,292,485                    | 1,519,325           | \$ 0.87   | \$ 2,292,485                    |
| \$1.16 - \$1.27 | 1,909,878           | \$ 1.25   | 5.70  | 2,156,919                       | 1,909,878           | \$ 1.25   | 2,156,919                       |
| \$1.28 - \$1.72 | 1,472,350           | \$ 1.50   | 4.74  | 1,299,456                       | 1,472,350           | \$ 1.50   | 1,299,456                       |
| \$1.73 - \$1.87 | 1,807,224           | \$ 1.81   | 2.31  | 1,034,590                       | 1,807,224           | \$ 1.81   | 1,034,590                       |
| \$1.88 - \$4.68 | 587,950             | \$ 3.20   | 3.77  | 27,796                          | 587,950             | \$ 3.20   | 27,796                          |
|                 | 7,296,727           |   |   | \$ 6,811,246                    | 7,296,727           |   | \$ 6,811,246                    |

#### Stock-based Compensation Expense

As of December 31, 2010, there was \$1.0 million of unamortized stock-based compensation expense related to unvested stock awards which is expected to be recognized over a weighted average period of 3.28 years.

To value option grants and other awards for actual and pro forma stock-based compensation, the Company has used the Black-Scholes option valuation model. When the measurement date is certain, the fair value of each option grant is estimated on the date of grant. Fair value determined using Black-Scholes varies based on assumptions used for the expected stock price volatility, expected life, risk-free interest rates and future dividend payments. During the three and nine month periods ended December 31, 2010 and 2009, the Company used historical volatility of the common stock over a period equal to the expected life of the options to estimate their fair value. The expected life assumption represents the weighted-average period stock-based awards are expected to remain outstanding. These expected life assumptions are established through the review of historical exercise behavior of stock-based award grants with similar vesting periods. The risk-free interest rate is based on the closing market bid yields on actively traded U.S. treasury securities in the over-the-counter market for the expected term equal to the expected term of the option. The dividend yield assumption is based on the Company's history and expectation of future dividend payouts.

In accordance with ASC 718, the Company recorded \$67,000 and \$19,000 in compensation expense relative to stock-based awards for the three months ended December 31, 2010 and 2009 and \$123,000 and \$37,000 for the nine months ended December 31, 2010 and 2009, respectively.

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan, eligible employees can participate and purchase common stock semi-annually through payroll deductions at a price equal to 85% of the fair market value of the common stock at the beginning of each one year offering period or the end of the applicable six month purchase period within that offering period, whichever is lower. The contribution amount may not exceed 10% of an employee's base compensation,

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including commissions but not including bonuses and overtime. The Company accounts for the Employee Stock Purchase Plan as a compensatory plan and recorded compensation expense of \$32,000 and \$51,000 for the three months ended December 31, 2010 and 2009 and \$105,000 and \$145,000 for the nine months ended December 31, 2010 and 2009, respectively in accordance with ASC 718.

The estimated fair value of stock purchase rights granted under the Employee Stock Purchase Plan was estimated at the date of grant using the Black-Scholes pricing model with the following weighted-average assumptions:

|  | Three Months Ended<br>December 31, |            | Nine Months Ended<br>December 31, |            |
|--|------------------------------------|------------|-----------------------------------|------------|
|  | 2010                               | 2009       | 2010                              | 2009       |
| Expected volatility                            | 64%                                | 90%        | 64%                               | 90%        |
| Expected dividend yield                        | -                                  | -          | -                                 | -          |
| Risk-free interest rate                        | 0.24%                              | 0.33%      | 0.24%                             | 0.33%      |
| Weighted average expected option term          | 0.75 years                         | 0.83 years | 0.75 years                        | 0.83 years |
| Weighted average fair value of options granted | \$ 0.53                            | \$ 0.34    | \$ 0.53                           | \$ 0.34    |

As of December 31, 2010, there was \$26,000 of total unrecognized compensation cost related to employee stock purchases. These costs are expected to be recognized over a weighted average period of 0.5 years.

ASC 718 requires the benefits of tax deductions in excess of recognized compensation costs to be reported as a financing cash flow, rather than as an operating cash flow. The future realization of tax benefits related to stock compensation is dependent upon the timing of employee exercises and future taxable income, among other factors. The Company did not realize any tax benefit from the stock compensation charge incurred during the three and nine months ended December 31, 2010 and 2009 as the Company believes that it is more likely than not that it will not realize the benefit from tax deductions related to such equity compensation.

The following table summarizes the distribution of stock-based compensation expense related to employee stock options and employee stock purchases under ASC 718 among the Company's operating functions for the three and nine months ended December 31, 2010 and 2009 which was recorded as follows (in thousands):

|  | Three Months Ended<br>December 31, |       | Nine Months Ended<br>December 31, |        |
|--|------------------------------------|-------|-----------------------------------|--------|
|  | 2010                               | 2009  | 2010                              | 2009   |
| Cost of service revenues   | \$ 11                              | \$ 7  | \$ 27                             | \$ 18  |
| Research and development   | 27                                 | 23    | 64                                | 60     |
| Selling, general and administrative  | 61                                 | 40    | 137                               | 104    |
| Total stock-based compensation expense related to employee stock options and employee stock purchases, pre-tax | 99                                 | 70    | 228                               | 182    |
| Tax benefit  | -                                  | -     | -                                 | -      |
| Stock based compensation expense related to employee stock options and employee stock purchases, net of tax    | \$ 99                              | \$ 70 | \$ 228                            | \$ 182 |

### Recent Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update ("ASU") No. 2009-13, "Multiple-Deliverable Revenue Arrangements-a consensus of the FASB Emerging Issues Task Force" ("ASU 2009-13"). ASU 2009-13 updates the existing multiple-element revenue arrangements guidance currently included under ASC 605-25, which originated primarily from the guidance in EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables"

("EITF 00-21"). The revised guidance primarily provides two significant changes: 1) it eliminates the need for objective and reliable evidence of the fair value for the undelivered element in order for a delivered item to be treated as a separate unit of accounting, and 2) it eliminates the residual method to allocate the arrangement consideration. In addition, the

guidance also expands the disclosure requirements for revenue recognition. ASU 2009-13 will be effective for the first annual reporting period beginning on or after June 15, 2010, with early adoption permitted provided that the revised guidance is retroactively applied to the beginning of the year of adoption. The adoption of ASU 2009-13 did not have a material impact on the Company's consolidated results of operation and financial condition.

In October 2009, the FASB issued ASU No. 2009-14, "Certain Revenue Arrangements that Include Software Elements—a consensus of the FASB Emerging Issues Task Force" ("ASU 2009-14"). ASU 2009-14 amends the scope of pre-existing software revenue guidance by removing from the guidance non-software components of tangible products and certain software components of tangible products. ASU 2009-14 will be effective for the first annual reporting period beginning on or after June 15, 2010, with early adoption permitted provided that the revised guidance is retroactively applied to the beginning of the year of adoption. The adoption of ASU 2009-14 did not have a material impact on the Company's consolidated results of operation and financial condition.

In January 2010, FASB issued ASU 2010-6, "Improving Disclosures about Fair Measurements." ASU 2010-6 provides amendments to subtopic 820-10 of the FASB Accounting Standards Codification ("ASC"), originally issued as FASB Statement No. 157, "Fair Value Measurements" that require separate disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the presentation of separate information regarding purchases, sales, issuances and settlements for Level 3 fair value measurements. Additionally, ASU 2010-6 provides amendments to subtopic 820-10 that clarify existing disclosures about the level of disaggregation and inputs and valuation techniques. ASU 2010-6 is effective for financial statements issued for interim and annual periods ending after December 15, 2010. The adoption of ASU 2010-6 did not have a material impact on the Company's consolidated results of operation and financial condition.

In December 2010, FASB issued ASU 2010-28, "Intangibles-Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)

." ASU 2010-28 provides amendments to Topic 350 that modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. As a result, goodwill impairments may be reported sooner than under current practice. ASU 2010-28 is effective for fiscal years and interim periods within those years, beginning after December 15, 2010, with early adoption not permitted. The Company does not expect that the adoption of ASU 2010-28 to have a material impact on the Company's consolidated results of operation and financial condition.

In December 2010, FASB issued ASU 2010-29, "Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)." ASU 2010-29 provides amendments to subtopic 805-10 of the FASB ASC, that requires a public entity to disclose pro forma information for business combinations that occurred in the current reporting period. ASU 2010-29 is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010, with early adoption permitted.

The Company does not expect that the adoption of ASU 2010-28 to have a material impact on the Company's consolidated results of operation and financial condition.

### 3. FAIR VALUE MEASUREMENT

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal market or the most advantageous market in which it would transact.

The accounting guidance for fair value measurement requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs are inputs that reflect the

assumptions market participants would use in valuing the asset or liability and are developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors that market participants would use in valuing the asset or liability developed based on the best information available in the circumstances.

The standard establishes a fair value hierarchy based on the level of independent, objective evidence surrounding the inputs used to measure fair value by requiring that the most observable inputs be used when available. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The fair value hierarchy is as follows:

- Level 1 applies to assets or liabilities for which there are quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.
- Level 2 applies to assets or liabilities for which there are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets).
- Level 3 applies to assets or liabilities for which fair value is derived from valuation techniques in which one or more significant inputs are unobservable, including the Company's own assumptions.

The following table presents the Company's fair value hierarchy for assets and liabilities measured at fair value on a recurring basis at December 31, 2010 (in thousands):

|                         | <b>Quoted Prices<br/>in Active<br/>Markets<br/>for Identical<br/>Assets<br/>(Level 1)</b> | <b>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> | <b>Balance at<br/>12/31/2010</b> |
|-------------------------|---|--|--|----------------------------------|
|                         | <u>                    </u>   | <u>                    </u>                          | <u>                    </u>                                  | <u>                    </u>      |
| Cash equivalents:       |   |  |  |                                  |
| Money market funds      | \$ 14,353   | \$ -   | \$ -   | \$ 14,353                        |
| Short-term investments: |   |  |  |                                  |
| Mutual funds (1)        | 1,920   | -  | -  | 1,920                            |
|                         | <u>                    </u>   | <u>                    </u>                          | <u>                    </u>                                  | <u>                    </u>      |
| Total                   | \$ 16,273   | \$ -   | \$ -   | \$ 16,273                        |
|                         | <u>                    </u>   | <u>                    </u>                          | <u>                    </u>                                  | <u>                    </u>      |

(1)

The fair value of mutual funds is determined based on published net asset values on a daily basis in an active market. The Company uses such pricing data as the primary input to make its assessments and determinations as to the ultimate valuation of its investment portfolio.

#### 4. BALANCE SHEET DETAIL

|                           | <b>December 31,<br/>2010</b> | <b>March 31,<br/>2010</b>   |
|---------------------------|------------------------------|-----------------------------|
|                           | <u>                    </u>  | <u>                    </u> |
| Inventory (in thousands): |                              |                             |
| Work-in-process           | \$ 1,994                     | \$ 1,701                    |
| Finished goods            | 606                          | 473                         |
|                           | <u>                    </u>  | <u>                    </u> |
|                           | \$ 2,600                     | \$ 2,174                    |
|                           | <u>                    </u>  | <u>                    </u> |

## 5. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income available to common stockholders (numerator) by the weighted average number of vested, unrestricted common shares outstanding during the period (denominator). Diluted net income per share is computed on the basis of the weighted average number of shares of common stock outstanding plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include shares issuable upon exercise of outstanding stock options and warrants and under the employee stock purchase plan.

|   | Three Months Ended<br>December 31,       |               | Nine Months Ended<br>December 31, |               |
|---|--|---------------|-----------------------------------|---------------|
|   | 2010                                     | 2009          | 2010                              | 2009          |
|   | (in thousands, except per share amounts) |               |                                   |               |
| Numerator:                                  |  |               |                                   |               |
| Net income available to common stockholders | \$ 1,496                                 | \$ 1,014      | \$ 4,483                          | \$ 2,764      |
| Denominator:                                |  |               |                                   |               |
| Common shares                               | <u>63,281</u>                            | <u>62,852</u> | <u>63,365</u>                     | <u>62,768</u> |
| Denominator for basic calculation           | 63,281                                   | 62,852        | 63,365                            | 62,768        |
| Employee stock options                      | 3,173                                    | 515           | 2,010                             | 193           |
| Stock purchase rights                       | 319                                      | -             | 188                               | -             |
| Employee stock purchase plan                | <u>100</u>                               | <u>26</u>     | <u>59</u>                         | <u>17</u>     |
| Denominator for diluted calculation         | <u>66,873</u>                            | <u>63,393</u> | <u>65,622</u>                     | <u>62,978</u> |
| Net income per share                        |  |               |                                   |               |
| Basic                                       | \$ 0.02                                  | \$ 0.02       | \$ 0.07                           | \$ 0.04       |
| Diluted                                     | \$ 0.02                                  | \$ 0.02       | \$ 0.07                           | \$ 0.04       |

The following shares attributable to outstanding stock options and warrants were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive (in thousands):

|                      | Three Months Ended<br>December 31, |              | Nine Months Ended<br>December 31, |               |
|----------------------|------------------------------------|--------------|-----------------------------------|---------------|
|                      | 2010                               | 2009         | 2010                              | 2009          |
| Common stock options | 690                                | 7,471        | 2,242                             | 8,553         |
| Warrants             | -                                  | 1,786        | -                                 | 1,786         |
|                      | <u>690</u>                         | <u>9,257</u> | <u>2,242</u>                      | <u>10,339</u> |

## 6. COMPREHENSIVE INCOME

Comprehensive income, as defined, includes all changes in equity (net assets) during a period from non-owner sources. The difference between the Company's net income and comprehensive income is due primarily to unrealized losses on investments classified as available-for-sale. Comprehensive income for the three and nine months ended December 31, 2010 and 2009 was as follows (in thousands):

|  | Three Months Ended<br>December 31, |          | Nine Months Ended<br>December 31, |          |
|--|------------------------------------|----------|-----------------------------------|----------|
|  | 2010                               | 2009     | 2010                              | 2009     |
| Net income, as reported                      | \$ 1,496                           | \$ 1,014 | \$ 4,483                          | \$ 2,764 |
| Unrealized loss on investments in securities | (80)                               | -        | (80)                              | -        |
| Comprehensive income                         | \$ 1,416                           | \$ 1,014 | \$ 4,403                          | \$ 2,764 |

## 7. SEGMENT REPORTING

ASC 280 - Segment Reporting establishes annual and interim reporting standards for an enterprise's business segments and related disclosures about its products, services, geographic areas and major customers. The method for determining what information to report is based upon the way management organizes the operating segments within the Company for making operating decisions and assessing financial performance. The Company has determined that it has only one reportable segment. Revenue for this segment is presented by groupings of similar products and services (in thousands) in the following table:

|   | Three Months Ended<br>December 31, |           | Nine Months Ended<br>December 31, |           |
|---|------------------------------------|-----------|-----------------------------------|-----------|
|   | 2010                               | 2009      | 2010                              | 2009      |
| 8x8 service, equipment and other          | \$ 17,759                          | \$ 15,928 | \$ 51,877                         | \$ 47,471 |
| Technology licensing and related software | 19                                 | 16        | 102                               | 58        |
| Total revenues                            | \$ 17,778                          | \$ 15,944 | \$ 51,979                         | \$ 47,529 |

No customer represented greater than 10% of the Company's total revenues for the three and nine months ended December 31, 2010 or 2009. Revenues from customers outside the United States were not material for the three and nine months ended December 31, 2010 or 2009.

## 8. INCOME TAXES

Income taxes are accounted for using the asset and liability approach. Under the asset and liability approach, a current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year. A deferred tax liability or asset is recognized for the estimated future tax effects attributed to temporary differences and carryforwards. If necessary, the deferred tax assets are reduced by a valuation allowance that takes into account the amount of benefits that the Company determines, based on available evidence, is more likely than not to be realized. Other than the state gross receipt and franchise taxes and the foreign subsidiary taxes, the Company made no provision for income taxes in any periods presented in the accompanying condensed consolidated financial statements because of net losses incurred, or because it expects to utilize net operating loss carryforwards for which there is a valuation allowance.

The Company accounts for the uncertainty in income taxes under the provisions of ASC 740 - *Income Taxes* which clarifies the accounting and disclosure for uncertainty in income taxes recognized in an enterprise's financial statements. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not to be sustained on audit, based on the technical merits of the position. The Company believes that any income tax filing positions and deductions not sustained on audit will not result in a material change to its financial position or results of operations.

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At March 31, 2010, the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$1.7 million, but any effect would have been fully offset by the application of the valuation allowance. The Company does not believe that there has been any change in the unrecognized tax benefits in the nine-month period ended December 31, 2010 and does not believe it is reasonably possible that the unrecognized tax benefit will materially change in the next 12 months. To the extent that the unrecognized tax benefits are ultimately recognized they may have an impact on the effective tax rate in future periods; however, such impact on the effective tax rate would only occur if the recognition of such unrecognized tax benefits occurs in a future period when the Company has already determined it is more likely than not that its deferred tax assets are realizable.

The Company is subject to taxation in the U.S., California and various other states and foreign jurisdictions in which we have or had a subsidiary or branch operations or we are collecting sales tax. All tax returns from fiscal 1995 to fiscal 2010 may be subject to examination by the Internal Revenue Service, California and various other states. The Company extended the filing date of the 2010 federal tax return and all state income tax returns. As of January 26, 2010, the federal return and all state returns that the Company believes it is required to file, with the exception of two state returns, had been filed. In addition, as of December 31, 2010, there were no active federal or state income tax audits. Returns filed in foreign jurisdictions may be subject to examination for the fiscal years 2005 to 2010.

The Company's policy for recording interest and penalties associated with audits is to record such items as a component of operating expense income before taxes. During the three and nine months ended December 31, 2010 and 2009, the Company did not recognize any interest or penalties related to unrecognized tax benefits.

## 9. COMMITMENTS AND CONTINGENCIES

### Guarantees

### Indemnifications

In the normal course of business, the Company indemnifies other parties, including customers, lessors and parties to other transactions with the Company, with respect to certain matters. Under these arrangements, the Company typically agrees to hold the other party harmless against losses arising from a breach of representations or covenants, intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. In addition, the Company has entered into indemnification agreements with its officers and directors.

It is not possible to determine the maximum potential amount of the Company's exposure under these indemnification agreements due to the limited history of indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material impact on the Company's operating results, financial position or cash flows. Under some of these agreements, however, the Company's potential indemnification liability might not have a contractual limit.

### Product Warranties

The Company accrues for the estimated costs that may be incurred under its product warranties upon revenue recognition. Changes in the Company's product warranty liability, which is included in cost of product revenues in the condensed consolidated statements of income, during the three and nine months ended December 31, 2010 and 2009 were as follows (in thousands):

| Three Months Ended<br>December 31, |      | Nine Months Ended<br>December 31, |      |
|------------------------------------|------|-----------------------------------|------|
| 2010                               | 2009 | 2010                              | 2009 |

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|                                |                   |                   |                   |                   |
|--------------------------------|-------------------|-------------------|-------------------|-------------------|
| Balance at beginning of period | \$ 380            | \$ 370            | \$ 331            | \$ 328            |
| Accruals for warranties        | 119               | 66                | 397               | 304               |
| Settlements                    | (82)              | (80)              | (311)             | (276)             |
|                                | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Balance at end of period       | \$ 417            | \$ 356            | \$ 417            | \$ 356            |
|                                | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

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## Leases

In May 2009, the Company entered into a three-year lease for a new primary facility in Sunnyvale, California that expires in fiscal 2013. The Company has the option to accelerate the termination date of the lease to the 12<sup>th</sup>, 18<sup>th</sup>, 24<sup>th</sup>, or 30<sup>th</sup> full calendar month of the lease term by providing six months advance notice. In the event the Company exercises this early termination option, the Company will be required to pay a fee to the landlord equal to the unamortized portion of any leasing commission and the unamortized portion of the initial alteration expenses incurred by the landlord as summarized in a current report on Form 8-K filed by the Company with the SEC on May 7, 2009. At December 31, 2010, future minimum annual lease payments under current and new operating leases were as follows (in thousands):

|                        |    |       |
|------------------------|----|-------|
| Year ending March 31:  |    |       |
| Remaining 2011         | \$ | 155   |
| 2012                   |    | 657   |
| 2013                   |    | 284   |
|                        |    | <hr/> |
| Total minimum payments | \$ | 1,096 |
|                        |    | <hr/> |

In each of March 2007 and August 2009, the Company entered into a series of noncancelable capital lease agreements for office equipment bearing interest at various rates. At December 31, 2010, future minimum annual lease payments under noncancelable capital leases were as follows (in thousands):

|   |    |       |
|---|----|-------|
| Year ending March 31:                                 |    |       |
| Remaining 2011  | \$ | 10    |
| 2012  |    | 40    |
| 2013  |    | 7     |
|   |    | <hr/> |
| Total minimum payments                                |    | 57    |
| Less: Amount representing interest                    |    | (4)   |
|   |    | <hr/> |
|   |    | 53    |
| Less: Short-term portion of capital lease obligations |    | (39)  |
|   |    | <hr/> |
| Long-term portion of capital lease obligations        | \$ | 14    |
|   |    | <hr/> |

Capital leases included in office equipment were \$156,000 at December 31, 2010. Total accumulated depreciation was \$105,000 at December 31, 2010. Amortization expense for assets recorded under capital leases is included in depreciation expense.

## Minimum Third Party Customer Support Commitments

In the third quarter of fiscal 2010, the Company amended a contract with one of its third party customer support vendors containing a minimum monthly commitment of approximately \$430,000. The agreement requires a rolling 150-day notice to terminate. The total remaining obligation under the amended contract is \$2.2 million.

## Legal Proceedings

From time to time, the Company may become involved in various legal claims and litigation that arise in the normal course of its operations. While the results of such claims and litigation cannot be predicted with certainty, the Company is not currently aware of any such matters that it believes would have a material adverse effect on its financial position, results of operations or cash flows. On October 8, 2010, the Company was named a defendant in a lawsuit, Ceres Communications Technologies, LLC ("Ceres"), v. 8x8, Inc. et al., filed by a patent holder. The Company believes it has factual and legal defenses to these claims and is presenting a vigorous defense. On November 19, 2010, the Company filed motions to dismiss the lawsuit. On November 24, 2010, the Company filed a lawsuit in

the Southern District of Texas against Adaptive Networks and Ceres alleging false patent marking under Title 35, Section 292, of the United States Code relating to the patent that Ceres is asserting against the Company. On December 10, 2010, Ceres filed an answer to 8x8's motion to dismiss. On December 21, 2010, the Company amended its motion to dismiss. The plaintiff has not made a specific monetary demand and the Company cannot estimate potential liability in this case at this early stage of litigation.

On January 27, 2010, the Company was named a defendant in a lawsuit, Nikki Meierdiercks et al. v. 8x8, Inc., filed by three former employees in Santa Clara County Superior Court as a putative class action seeking damages and various penalties under the California Labor Code for alleged unpaid overtime, meal breaks, rest breaks and alleged late wage payments and unreimbursed business expenses. On November 9, 2010, the Company entered into a memorandum of understanding with the plaintiffs to settle the lawsuit for \$625,000. We accrued this \$625,000 during the three and nine months ended December 31, 2010. The settlement amount is still subject to approval by the Court, though the Company does not expect to incur any substantial amounts related to this litigation in the future.

#### State and Municipal Taxes

From time to time, the Company has received inquiries from a number of state and municipal taxing agencies with respect to the remittance of taxes. The Company collects or has accrued for taxes that it believes are required to be remitted. The amounts that have been remitted have historically been within the accruals established by the Company.

#### 10. STOCK REPURCHASES

In July 2009, the Company's board of directors authorized the Company to purchase up to \$2.0 million of its common stock from time to time until July 28, 2010. On July 27, 2010, the Company's board of directors extended the stock repurchase period from July 28, 2010 to July 27, 2011 and on August 31, 2010, the Company's board of directors authorized an increase in the stock repurchase plan from \$2.0 million to \$3.0 million. As of October 18, 2010, the Company had repurchased \$2,999,985 worth of shares under the stock repurchase plan originally approved in July 2009. On October 19, 2010 the Company's board of directors determined that this \$3.0 million was complete with only \$15 remaining under the plan. On October 19, 2010, the Company's board of directors authorized the Company to create a new stock repurchase plan to purchase an additional \$10.0 million of its common stock from time to time until October 19, 2011. Share repurchases, if any, will be funded with available cash. Repurchases under the repurchase plans may be made through open market purchases at prevailing market prices or in privately negotiated transactions. The timing, volume and nature of share repurchases are subject to market prices and conditions, applicable securities laws and other factors, and are at the discretion of the Company's management. Share repurchases under the repurchase plans may be commenced, suspended or discontinued at any time. The remaining authorized repurchase amount at December 31, 2010 under the \$10.0 million repurchase plan is \$8.8 million. The stock repurchase activity for the nine months ended December 31, 2010 is summarized as follows:

|                              | Shares<br>Repurchased | Weighted<br>Average<br>Price<br>Per Share | Amount<br>Repurchased |
|------------------------------|-----------------------|---|-----------------------|
| Balance at March 31, 2010    | 282,376               | \$ 0.75                                   | \$ 211,741            |
| Repurchase of common stock   | 2,202,572             | 1.90                                      | 4,025,957             |
| Balance at December 31, 2010 | 2,484,948             | \$ 1.84                                   | \$ 4,237,698          |

The total purchase prices of the common stock repurchased and retired were reflected as a reduction to stockholders' equity during the period of repurchase.

The Company has repurchased an additional 928,037 shares at an average share price of \$2.72 and a total cost of \$2,522,798 between January 1 and January 27, 2011.

## 11. BUYOUT OF EMPLOYEE STOCK OPTIONS

In accordance with existing buyout provisions of the Company's 1996 Stock Plan and 1999 Nonstatutory Stock Option Plan, in November 2010, the Company's Board of Directors approved the purchase of employee stock options which were expiring in December 2010. The Company purchased the employee stock options at an amount equal to the average closing price of a share of the Company's stock as reported on the Nasdaq Capital Market for the five trading days ending prior to the purchase date ("Purchase Price") less the exercise price of the employee stock option. The following table provides information with respect to the buyout of stock options from employees during the three month period ended December 31, 2010:

|                                | Aggregate Amounts                 |                           |                      | Weighted Average Per Share Amount |                           |                      |
|--------------------------------|-----------------------------------|---------------------------|----------------------|-----------------------------------|---------------------------|----------------------|
|                                | Total Number of Options Purchased | Purchase Price of Options | Purchase Premium (1) | Exercise Price of Option          | Purchase Price of Options | Purchase Premium (1) |
| October 1 - October 31, 2010   | -                                 | \$ -                      | \$ -                 | \$ -                              | \$ -                      | \$ -                 |
| November 1 - November 30, 2010 | 144,250                           | 434,903                   | 101,252              | 2.31                              | 3.01                      | 0.70                 |
| December 1 - December 31, 2010 | -                                 | -                         | -                    | -                                 | -                         | -                    |
| <b>Total</b>                   | <b>144,250</b>                    | <b>\$ 434,903</b>         | <b>\$ 101,252</b>    | <b>\$ 2.31</b>                    | <b>\$ 3.01</b>            | <b>\$ 0.70</b>       |

(1) The purchase premium is calculated as the difference between (a) the Purchase Price of the employee stock option and (b) the exercise price of the employee stock option.

## 12. ACQUISITION

On May 1, 2010, the Company entered into an agreement with Central Host, Inc. pursuant to which the Company acquired this provider of managed hosting services from its sole shareholder. Under the terms of the agreement, the Company paid \$1,000,000 in cash and issued 432,276 shares of 8x8 common stock, at an average price of \$1.388 per share, to the sole shareholder in exchange for 100% of the outstanding shares of capital stock of Central Host, Inc. The share price was based on the trailing five-day average closing price of 8x8 common stock on the NASDAQ Capital Market as of the effective date of the transaction. The shares of the Company's common stock were not registered for sale and were issued pursuant to an exemption from the registration requirements under section 5 of the Securities Act of 1933, as amended, provided by section 4(2) thereof.

The Company recorded a total acquisition price as follows (in thousands):

|   |    |       |
|---|----|-------|
| Cash, net of cash acquired                              | \$ | 998   |
| Issuance of common stock in connection with acquisition |    | 600   |
| Liabilities assumed                                     |    | 96    |
|   |    | <hr/> |
| Total acquisition costs                                 | \$ | 1,694 |

The Company allocated the purchase price of the acquisition to tangible assets and identifiable intangible assets acquired, based on their estimated fair values. The excess of purchase price over the aggregate fair values was recorded as goodwill. The fair value assigned to identifiable intangible assets acquired was based on estimates and assumptions made by management. Intangible assets will be amortized on a straight-line basis.



The allocation of the acquisition price for net tangible and intangible assets was as follows (in thousands):

|  |    |       |
|--|----|-------|
| Net tangible assets                      | \$ | 176   |
| Intangible asset - customer relationship |    | 308   |
| Goodwill                                 |    | 1,210 |
|  |    | <hr/> |
| Total acquisition costs                  | \$ | 1,694 |
|  |    | <hr/> |

Intangible assets of \$1,518,000 consist of goodwill and customer relationship. Total accumulated amortization on customer relationship intangible asset was \$68,000 at December 31, 2010. Amortization expense for the customer relationship intangible asset is included in selling, general and administrative expenses.

### 13. STRATEGIC INVESTMENT

In April 2010, the Company invested \$250,000 cash, transferred its wholly-owned French research and development subsidiary, 8x8 Europe SARL, and granted a non-exclusive license to certain 8x8 technology, to Stonyfish, a privately-held company in Los Altos, California in exchange for a 17% interest in Stonyfish following its initial round of external fundraising.

The total investment in Stonyfish is as follows (in thousands):

|                                       |    |       |
|---------------------------------------|----|-------|
| Cash - 8x8, Inc.                      | \$ | 250   |
| Cash - 8x8 Europe SARL                |    | 65    |
| Net tangible assets - 8x8 Europe SARL |    | 41    |
|                                       |    | <hr/> |
| Total investment                      | \$ | 356   |
|                                       |    | <hr/> |

The strategic investment is included in other assets on the condensed consolidated balance sheet.



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### FORWARD-LOOKING STATEMENTS

This Management Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends," and similar expressions are intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results and trends may differ materially from historical results or those projected in any such forward-looking statements depending on a variety of factors. These factors include, but are not limited to, customer acceptance and demand for our voice over Internet protocol, or VoIP, telephony products and services, the reliability of our services, the prices for our services, customer renewal rates, customer acquisition costs, actions by our competitors, including price reductions for their telephone services, potential federal and state regulatory actions, compliance costs, potential warranty claims and product defects, our needs for and the availability of adequate working capital, our ability to innovate technologically, the timely supply of products by our contract manufacturers, potential future intellectual property infringement claims that could adversely affect our business and operating results, and our ability to retain our listing on the NASDAQ Capital Market. All forward-looking statements included in this report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In addition to those factors discussed elsewhere in this Form 10-Q, see the Risk Factors discussion in Item 1A of our 2010 Form 10-K and Part II, Item 1A of this Form 10-Q. The forward-looking statements included in this Form 10-Q are made only as of the date of this report, and we undertake no obligation to update the forward-looking statements to reflect subsequent events or circumstances.

### BUSINESS OVERVIEW

We develop and market telecommunications services for Internet protocol, or IP, telephony and video applications as well as web-based conferencing, unified communications services, managed hosting, and cloud-based computing services. We offer the 8x8 VoIP (Voice over Internet Protocol) voice and video digital phone service, 8x8 Virtual Office hosted PBX (private branch exchange) service, 8x8 Complete Contact Center service, 8x8 Trunking service, 8x8 Hosted Key System service, 8x8 MobileTalk service, 8x8 Virtual Meeting web conferencing service, the 8x8 Virtual Office Pro unified communications solution and 8x8 Managed Hosting and Cloud-Based Computing solutions. As of December 31, 2010, we had more than 23,000 business customers. Each business customer subscribes to a number of various lines of service (*e.g.* physical phone extensions, virtual extensions, fax lines, toll free numbers, receptionist software, unified communications services, etc.). Since fiscal 2004, substantially all of our revenues have been generated from the sale, license and provision of VoIP products, services and technology. Prior to fiscal 2003, our focus was on our VoIP semiconductor business.

Our fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in this report refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2011 refers to the fiscal year ending March 31, 2011).

### CRITICAL ACCOUNTING POLICIES & ESTIMATES

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of assets and liabilities. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical

experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended March 31, 2010. As of December 31, 2010, there had been no material changes to our critical accounting policies and estimates.

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## RECENT ACCOUNTING PRONOUNCEMENTS

See Item 1 of Part I, "Financial Statements - Note 2 - Basis of Presentation - Recent Accounting Pronouncements."

## SELECTED OPERATING STATISTICS

We periodically review certain key business metrics, within the context of our articulated performance goals, in order to evaluate the effectiveness of our operational strategies, allocate resources and maximize the financial performance of our business. The selected operating statistics include the following:

Selected Operating Statistics

|  | Dec. 31,<br>2010 | Sept. 30,<br>2010 | June 30,<br>2010 | March 31,<br>2010 | Dec. 31,<br>2009 | Sept. 30,<br>2009 | June 30,<br>2009 | March 31,<br>2009 | Dec. 31,<br>2008 |
|--|------------------|-------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|------------------|
| Gross business customer additions (1)  | 2,798            | 2,450             | 2,756            | 2,875             | 2,785            | 2,609             | 2,907            | 2,792             | 2,437            |
| Gross business customer cancellations (less cancellations within 30 days of sign-up) | 1,524            | 1,459             | 1,592            | 1,616             | 1,331            | 1,416             | 1,371            | 1,245             | 1,224            |
| Business customer churn (less cancellations within 30 days of sign-up) (2)           | 2.2%             | 2.2%              | 2.5%             | 2.7%              | 2.4%             | 2.7%              | 2.7%             | 2.7%              | 2.9%             |
| Total business customers (3)   | 23,251           | 22,167            | 21,362           | 20,428            | 19,407           | 18,199            | 17,266           | 16,013            | 14,706           |
| Business customer average monthly service revenue per customer (4)                   | \$ 209           | \$ 209            | \$ 208           | \$ 204            | \$ 204           | \$ 201            | \$ 196           | \$ 202            | \$ 208           |
| Overall service margin   | 77%              | 78%               | 78%              | 77%               | 78%              | 76%               | 76%              | 71%               | 74%              |
| Overall product margin   | -65%             | -57%              | -38%             | -43%              | -59%             | -42%              | -75%             | -50%              | 9%               |
| Overall gross margin   | 68%              | 68%               | 68%              | 68%               | 68%              | 67%               | 66%              | 59%               | 67%              |
| Business subscriber acquisition cost per service (5)                                 | \$ 99            | \$ 108            | \$ 109           | \$ 97             | \$ 102           | \$ 90             | \$ 93            | \$ 118            | \$ 141           |
| Average number of services subscribed to per business customer                       | 7.8              | 7.7               | 7.5              | 7.5               | 7.3              | 7.1               | 6.9              | 6.6               | 6.6              |
| Business customer subscriber acquisition cost (6)                                    | \$ 768           | \$ 826            | \$ 818           | \$ 723            | \$ 749           | \$ 638            | \$ 638           | \$ 785            | \$ 933           |

- (1) Includes 49 hosting customers acquired in the first quarter of fiscal 2011 from Central Host, Inc. ("Central Host").
- (2) Business customer churn is calculated by dividing the number of business customers that terminated (after the expiration of the 30 day trial) during that period by the simple average number of business customers during the period and dividing the result by the number of months in the period. The simple average number of business customers during the period is the number of business customers on the first day of the period plus the number of business customers on the last day of the period divided by two.
- (3) Business customers are defined as customers paying for service. Customers that are currently in the 30-day trial period are considered to be customers that are paying for service.
- (4) Business customer average monthly service revenue per customer is service revenue from business customers in the period divided by the number of months in the period divided by the simple average number of business customers during the period.
- (5) Business subscriber acquisition cost per service is defined as the combined costs of advertising, marketing, promotions, commissions and equipment subsidies for business services sold during the period divided by the number of gross business services added during the period.
- (6) Business customer subscriber acquisition cost is business subscriber acquisition cost per service times the average number of services subscribed to per business customer.



## RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our condensed consolidated financial statements and the notes thereto.

|                              | December 31,                  |           | Dollar<br>Change | Percent<br>Change |
|------------------------------|-------------------------------|-----------|------------------|-------------------|
|                              | 2010                          | 2009      |                  |                   |
| <b>Service revenues</b>      |                               |           |                  |                   |
|                              | (dollar amounts in thousands) |           |                  |                   |
| Three months ended           | \$ 16,664                     | \$ 14,737 | \$ 1,927         | 13.1%             |
| Percentage of total revenues | 93.7%                         | 92.4%     |                  |                   |
| Nine months ended            | \$ 48,098                     | \$ 44,095 | \$ 4,003         | 9.1%              |
| Percentage of total revenues | 92.5%                         | 92.8%     |                  |                   |

Service revenues consist primarily of revenues attributable to the provision of our service and royalties earned under our VoIP technology licenses. We expect that service revenues will continue to comprise nearly all of our revenues for the foreseeable future. Service revenues increased in the third quarter of fiscal 2011 primarily due to the increase in our business customer subscriber base, which grew from 19,407 business customers on December 31, 2009, to 23,251 on December 31, 2010. The increase in service revenues for the first nine months of fiscal 2011 compared with the comparable period in fiscal 2010 also stemmed from the increase in our business customer base, which consisted of 16,013 businesses on April 1, 2009.

|                              | December 31,                  |          | Dollar<br>Change | Percent<br>Change |
|------------------------------|-------------------------------|----------|------------------|-------------------|
|                              | 2010                          | 2009     |                  |                   |
| <b>Product revenues</b>      |                               |          |                  |                   |
|                              | (dollar amounts in thousands) |          |                  |                   |
| Three months ended           | \$ 1,114                      | \$ 1,207 | \$ (93)          | -7.7%             |
| Percentage of total revenues | 6.3%                          | 7.6%     |                  |                   |
| Nine months ended            | \$ 3,881                      | \$ 3,434 | \$ 447           | 13.0%             |
| Percentage of total revenues | 7.5%                          | 7.2%     |                  |                   |

Product revenues consist primarily of revenues from sales of IP telephones, attributable to our service. Product revenues decreased in the third quarter of fiscal 2011 primarily due to addition of the Polycom IP phones to our product mix during the third quarter of fiscal 2011 at a lower price point than the Aastra IP Phones sold in third quarter of fiscal 2010. The increase in product revenues for the first nine months of fiscal 2011 compared with the comparable period in fiscal 2010 was primarily due to an increase in equipment sales to new business customers. No customer represented greater than 10% of our total revenues for the three and nine months ended December 31, 2010 and 2009. Revenues from customers outside the United States were not material for the three and nine months ended December 31, 2010 or 2009.

|                                 | December 31,                  |           | Dollar<br>Change | Percent<br>Change |
|---------------------------------|-------------------------------|-----------|------------------|-------------------|
|                                 | 2010                          | 2009      |                  |                   |
| <b>Cost of service revenues</b> |                               |           |                  |                   |
|                                 | (dollar amounts in thousands) |           |                  |                   |
| Three months ended              | \$ 3,819                      | \$ 3,254  | \$ 565           | 17.4%             |
| Percentage of service revenues  | 22.9%                         | 22.1%     |                  |                   |
| Nine months ended               | \$ 10,790                     | \$ 10,290 | \$ 500           | 4.9%              |
| Percentage of service revenues  | 22.4%                         | 23.3%     |                  |                   |

The cost of service revenues primarily consists of costs associated with network operations and related personnel, telephony origination and termination services provided by third party carriers and technology license and royalty expenses. Cost of service revenues for the three months ended December 31, 2010 increased over the comparable period in the prior fiscal year primarily due to a \$0.3 million increase in payroll and related costs, a \$0.1 million increase in



depreciation expense, and a \$0.1 million increase in expensed computer equipment and furniture and fixtures.

Cost of service revenues for the nine months ended December 31, 2010 increased from the comparable period in the prior fiscal year primarily due to a \$0.6 million increase in payroll and related costs, a \$0.2 million increase in depreciation expense, a \$0.2 million increase in expensed computer equipment and furniture and fixtures, and a \$0.1 million increase in license and fee expenses. The increase in expenses was partially offset by a \$0.6 million reduction in pricing by third party network service vendors and our use of multiple third party network provider vendors.

|                                 | December 31,                  |          | Dollar<br>Change | Percent<br>Change |
|---------------------------------|-------------------------------|----------|------------------|-------------------|
|                                 | 2010                          | 2009     |                  |                   |
| <b>Cost of product revenues</b> |                               |          |                  |                   |
|                                 | (dollar amounts in thousands) |          |                  |                   |
| Three months ended              | \$ 1,840                      | \$ 1,925 | \$ (85)          | -4.4%             |
| Percentage of product revenues  | 165.2%                        | 159.5%   |                  |                   |
| Nine months ended               | \$ 5,897                      | \$ 5,432 | \$ 465           | 8.6%              |
| Percentage of product revenues  | 151.9%                        | 158.2%   |                  |                   |

The cost of product revenues consists of costs associated with systems, components, system manufacturing, assembly and testing performed by third-party vendors, estimated warranty obligations and direct and indirect costs associated with product purchasing, scheduling, quality assurance, shipping and handling. We allocate a portion of service revenues to product revenues but these revenues are less than the cost of the IP phone equipment. The cost of product revenues for the three months ended December 31, 2010 decreased slightly in absolute dollar amounts over the comparable period in the prior fiscal year primarily due to \$0.1 million reduction in the shipment of equipment to customers and related freight.

Cost of product revenues for the nine months ended December 31, 2010 increased from the comparable period in the prior fiscal year primarily due to a \$0.5 million increase in the shipments of equipment to customers and a \$0.1 million increase in warranty expense. The increase in expense was partially offset by a \$0.1 million reduction in freight expense.

|                                 | December 31,                  |          | Dollar<br>Change | Percent<br>Change |
|---------------------------------|-------------------------------|----------|------------------|-------------------|
|                                 | 2010                          | 2009     |                  |                   |
| <b>Research and development</b> |                               |          |                  |                   |
|                                 | (dollar amounts in thousands) |          |                  |                   |
| Three months ended              | \$ 1,131                      | \$ 1,239 | \$ (108)         | -8.7%             |
| Percentage of total revenues    | 6.4%                          | 7.8%     |                  |                   |
| Nine months ended               | \$ 3,628                      | \$ 3,741 | \$ (113)         | -3.0%             |
| Percentage of total revenues    | 7.0%                          | 7.9%     |                  |                   |

Historically, our research and development expenses have consisted primarily of personnel, system prototype design, and equipment costs necessary for us to conduct our engineering and development efforts. We expense research and development costs, including software development costs, as they are incurred. The research and development expenses for the three and nine months ended December 31, 2010 decreased by \$0.1 million over the comparable period in the prior fiscal year primarily due to a decrease in payroll and related costs.

|  | December 31,                  |           | Dollar<br>Change | Percent<br>Change |
|--|-------------------------------|-----------|------------------|-------------------|
|  | 2010                          | 2009      |                  |                   |
| <b>Selling, general and administrative</b> |                               |           |                  |                   |
|  | (dollar amounts in thousands) |           |                  |                   |
| Three months ended                         | \$ 9,570                      | \$ 8,251  | \$ 1,319         | 16.0%             |
| Percentage of total revenues               | 53.8%                         | 51.7%     |                  |                   |
| Nine months ended                          | \$ 27,453                     | \$ 24,980 | \$ 2,473         | 9.9%              |
| Percentage of total revenues               | 52.8%                         | 52.6%     |                  |                   |

Selling, general and administrative expenses consist primarily of personnel and related overhead costs for sales, marketing, customer support, finance, human resources and general management. Such costs also include outsourced customer service call center operations, sales commissions, as well as trade show, advertising and other marketing and promotional expenses. Selling, general and administrative expenses for the third quarter of fiscal 2011 increased over the same quarter in the prior fiscal year primarily because of a \$0.8 million increase in legal expenses, including a \$0.6 million accrual related to the memorandum of understanding to settle a lawsuit against us, a \$0.6 million increase in payroll and related costs and a \$0.1 million increase in sales promotion expenses. The increase in expenses was partially offset by a \$0.2 million reduction in consulting and outside service expenses and a \$0.1 million reduction in third party rep commission expenses.

Selling, general and administrative expenses for the first nine months of fiscal 2011 increased over the same period in the prior fiscal year primarily because of a \$1.7 million increase in payroll and related expenses, a \$0.9 million increase in advertising, public relations and other marketing and promotional expenses, a \$0.9 million increase in legal expenses, including a \$0.6 million accrual related to the memorandum of understanding to settle lawsuit against us, a \$0.1 million increase in amortization of intangibles expenses, and a \$0.1 million increase in recruiting expenses. The increase in expenses was partially offset by a \$0.6 million reduction in consulting and outside service expenses, \$0.3 million reduction in third party rep commission expenses, \$0.1 million reduction in printing expenses, a \$0.1 million reduction in sales promotion expenses, and a \$0.1 million reduction in telephone expenses.

|                              | December 31,                  |       | Dollar<br>Change | Percent<br>Change |
|------------------------------|-------------------------------|-------|------------------|-------------------|
|                              | 2010                          | 2009  |                  |                   |
| <b>Other income, net</b>     |                               |       |                  |                   |
|                              | (dollar amounts in thousands) |       |                  |                   |
| Three months ended           | \$ 78                         | \$ 7  | \$ 71            | 1,014.3%          |
| Percentage of total revenues | 0.4%                          | 0.0%  |                  |                   |
| Nine months ended            | \$ 112                        | \$ 50 | \$ 62            | 124.0%            |
| Percentage of total revenues | 0.2%                          | 0.1%  |                  |                   |

In the three and nine months ended December 31, 2010, other income, net primarily consisted of distribution of capital gains on investments and interest income earned on our cash, cash equivalents and investments. The increase in other income, net for the three and nine months ended December 31, 2010 was primarily due to distribution of capital gains on investments.

|   | December 31,                  |          | Dollar<br>Change | Percent<br>Change |
|---|-------------------------------|----------|------------------|-------------------|
|   | 2010                          | 2009     |                  |                   |
| <b>Income (loss) on change in fair value of warrant liability</b> |                               |          |                  |                   |
|   | (dollar amounts in thousands) |          |                  |                   |
| Three months ended  | \$ -                          | \$ (265) | \$ 265           | -100.0%           |
| Percentage of total revenues                                      | 0.0%                          | -1.7%    |                  |                   |
| Nine months ended   | \$ 167                        | \$ (362) | \$ 529           | -146.1%           |
| Percentage of total revenues                                      | 0.3%                          | -0.8%    |                  |                   |

In connection with the sale of shares of our common stock in fiscal 2005 and 2006, we issued warrants in three different equity financings. The change in income on change in fair value of the warrant liability for the three and nine months ended December 31, 2010 is due to the partial exercise and expiration of the warrants in the third quarter of fiscal 2011.



|                                 | December 31,                  |       | Dollar<br>Change | Percent<br>Change |
|---------------------------------|-------------------------------|-------|------------------|-------------------|
|                                 | 2010                          | 2009  |                  |                   |
| <b>Provision for income tax</b> |                               |       |                  |                   |
|                                 | (dollar amounts in thousands) |       |                  |                   |
| Three months ended              | \$ -                          | \$ 3  | \$ (3)           | -100.0%           |
| Percentage of total revenues    | 0.0%                          | 0.0%  |                  |                   |
| Nine months ended               | \$ 7                          | \$ 10 | \$ (3)           | -30.0%            |
| Percentage of total revenues    | 0.0%                          | 0.0%  |                  |                   |

The income tax provision for the three and nine months ended December 31, 2010 was primarily due to the state gross receipt and franchise taxes in several states compared to the federal alternative minimum tax, state gross receipt and franchise taxes in several states and estimated foreign subsidiary taxes offset by the federal research and development credits in lieu of bonus depreciation (Sec. 168(k)(4) election) in the three and nine months ended December 31, 2009.

### Liquidity and Capital Resources

As of December 31, 2010, we had approximately \$20.5 million in cash, cash equivalents and short-term investments.

Net cash provided by operating activities for the nine months ended December 31, 2010 was approximately \$7.0 million, compared with \$1.5 million for the nine months ended December 31, 2009. The increase in cash flow was primarily due to an increase in service and product revenues and reduction in the discounting of equipment sold in the first nine months of fiscal 2011. Cash provided by operating activities has historically been affected by the amount of net income, sales of subscriptions, changes in working capital accounts particularly in deferred revenue due to timing of annual plan renewals, add-backs of non-cash expense items such as depreciation and amortization, the expense associated with stock-based awards and the change in fair value of warrant liability.

Net cash used in investing activities was \$5.2 million during the nine months ended December 31, 2010, compared with \$0.8 million used in investing activities for the nine months ended December 31, 2009. The increase in cash used in investing activities during the nine months ended December 31, 2010 primarily related to the acquisition of investments (\$2.0 million), the acquisition of Central Host, Inc. in May 2010 (\$1.0 million), the purchase of additional equipment (\$1.9 million), and the strategic investment in Stonyfish in April 2010 (\$0.3 million).

Our financing activities for the nine months ended December 31, 2010 consisted primarily of cash used to repurchase shares of our common stock (\$4.0 million) and buyback of employee stock options (\$0.1 million) which was partially offset by the issuance of shares due to exercise of employee stock options and warrants (\$2.6 million) and the sale of restricted shares (\$0.3 million).

### Contractual Obligations

In March 2007 and August 2009, we entered into a series of noncancelable capital lease agreements for office equipment bearing interest at various rates. Assets under capital lease at December 31, 2010 totaled \$156,000 with accumulated amortization of \$105,000.

On May 1, 2009, we entered into a three-year lease for a new headquarters facility in Sunnyvale, California that expires in fiscal 2013. The facility lease includes rent escalation clauses and requires us to pay utilities and normal maintenance costs. Rent expense is reflected in our consolidated financial statements on a straight-line basis over the term of the leases.

In the third quarter of 2010, we amended the contract with one of our third party customer support vendors containing a minimum monthly commitment of approximately \$430,000. The agreement requires a rolling 150-day notice to terminate. At December 31, 2010, the total remaining obligation under the contract was \$2.2 million.



### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Foreign Currency

Our financial market risk consists primarily of risks associated with international operations and related foreign currencies. We derive a portion of our revenues from customers in Europe and Asia. In order to reduce the risk from fluctuation in foreign exchange rates, the vast majority of our sales are denominated in U.S. dollars. In addition, almost all of our arrangements with our contract manufacturers are denominated in U.S. dollars. We have not entered into any currency hedging activities. To date, our exposure to exchange rate volatility has not been significant; however, there can be no assurance that there will not be a material impact in the future.

#### Investments

We maintain an investment portfolio of various holdings, types and maturities. These marketable securities and investments are generally classified as available for sale and, consequently, are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive loss. Part of this portfolio includes investments in mutual funds.

### ITEM 4. CONTROLS AND PROCEDURES

#### Evaluation of Effectiveness of Disclosure Controls and Procedures

We maintain disclosure controls and procedures as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 ("Disclosure Controls") that are designed to ensure that information we are required to disclose in reports filed or submitted under the Securities and Exchange Act of 1934 is accumulated and communicated to management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our Disclosure Controls. Based on this evaluation our Chief Executive Officer and our Chief Financial Officer have concluded that our Disclosure Controls were effective as of December 31, 2010.

#### Limitations on the Effectiveness of Controls

Our management, including the Chief Executive Officer and Chief Financial Officer, do not expect that our Disclosure Controls or internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

#### Changes in Internal Control over Financial Reporting.

During the third quarter of fiscal 2011, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II -- OTHER INFORMATION

### ITEM 1. Legal Proceedings

Descriptions of our legal proceedings are contained in Part I, Item 1, Financial Statements — Notes to Condensed Consolidated Financial Statements — Note 8 - "Legal Proceedings."

### ITEM 1A. Risk Factors

We face many significant risks in our business, some of which are unknown to us and not presently foreseen. These risks could have a material adverse impact on our business, financial condition and results of operations in the future. We have disclosed a number of material risks under Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended March 31, 2010, which we filed with the Securities and Exchange Commission on May 27, 2010, and in quarterly reports on Form 10-Q filed subsequent to that date, in addition to the following updated risk factor disclosures.

Our infringement of a third party's proprietary technology would disrupt our business.

There has been substantial litigation in the communications, VoIP services, semiconductor, electronics, and related industries regarding intellectual property rights and, from time to time, third parties may claim infringement by us of their intellectual property rights. Our broad range of current and former technology, including IP telephony systems, digital and analog circuits, software, and semiconductors, increases the likelihood that third parties may claim infringement by us of their intellectual property rights. For example, on May 2, 2008, we received a letter from AT&T Intellectual Property, L.L.C. ("AT&T IP") expressing the belief that we must license a specified patent for use in our 8x8 broadband telephone service, as well as suggesting that we obtain a license to its portfolio of MPEG-4 patents for use with our video telephone products and services. At the same time, we began an evaluation of whether AT&T IP's affiliated entities may need to license any of our patents or other intellectual property. We have continued to engage in discussions with AT&T IP to explore a mutually agreeable resolution of the parties' respective assertions regarding these intellectual property issues. We are unable at this time to state whether we will enter into any license or cross-license agreements with AT&T IP or whether we ultimately anticipate any material effects on our operating results or financial condition as a consequence of these matters.

On October 8, 2010, we were named as one of eight companies sued for infringement of U.S. Patent No. 5,774,526 in the case of Ceres Communication Technologies LLC v. 8x8, Inc. et al., filed in U.S. District Court for the District of Delaware. We believe we have valid and meritorious defenses to this action and intend to contest it vigorously.

If we were found to be infringing on the intellectual property rights of any third party, we could be subject to liabilities for such infringement, which could be material. We could also be required to refrain from using, manufacturing or selling certain products or using certain

processes, either of which could have a material adverse effect on our business and operating results. From time to time, we have received, and may continue to receive in the future, notices of claims of infringement, misappropriation or misuse of other parties' proprietary rights. There can be no assurance that we will prevail in these discussions and actions or that other actions alleging infringement by us of third party patents will not be asserted or prosecuted against us.

Certain technology necessary for us to provide our services may, in fact, be patented by other parties either now or in the future. If such technology were held under patent by another person, we would have to negotiate a license for the use of that certain technology. We may not be able to negotiate such a license at a price that is acceptable. The existence of such a patent, or our inability to negotiate a license for any such technology on acceptable terms, could force us to cease using such technology and offering products and services incorporating such technology. For example, on April 22, 2009, we were named as a defendant, along with Comcast, Microsoft, Avaya, Embarq, and

Qwest, in a complaint filed by Web Telephony, LLC in the Eastern District of Texas. On April 29, 2009, we entered into a settlement agreement with Web Telephony, which filed a motion to dismiss the lawsuit on May 8, 2009, under which we have made significant payments as described in Part II, Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Acquired Product Rights."

We may become subject to state regulation for certain service offerings.

Certain states take the position that offerings by VoIP companies, like us, are intrastate and therefore subject to state regulation. These states argue that if the beginning and end points of communications are known, and if some of these communications occur entirely within the boundaries of a state, the state can regulate that offering. We believe that the Federal Communications Commission ("FCC") has pre-empted states from regulating VoIP offerings. We cannot predict how this issue will be resolved or its impact on our business at this time. Moreover, the FCC recently granted a petition that allows states to require interconnected VoIP providers, like us, to contribute to state USF. The FCC's ruling may also result in states asserting increased jurisdiction over our services. Such an occurrence could require us to comply with regulation at the state level increasing our costs.

Our business depends on continued and unimpeded access to the Internet by us and our users. Internet access providers and Internet backbone providers may be able to block, degrade or charge for access to certain of our products and services, which could lead to additional expenses and the loss of users.

Our products and services depend on the ability of our users to access the Internet, and certain of our products require significant bandwidth to work effectively. Currently, this access is provided by companies that have significant and increasing market power in the broadband and Internet access marketplace, including incumbent telephone companies, cable companies and mobile communications companies. Some of these providers have stated that they may take measures that could degrade, disrupt or increase the cost of user access to certain of our products by restricting or prohibiting the use of their infrastructure to support or facilitate our offerings, or by charging increased fees to us or our users to provide our offerings, while others, including some of the largest providers of broadband Internet access services, have committed to not engaging in such behavior. The ability of the FCC to regulate broadband Internet access services has been called into question by a recent ruling of the United States Court of Appeals for the D.C. Circuit ("D.C. Circuit").

On December 23, 2010, the FCC adopted an order that would impose rules on providers of fixed and wireless broadband Internet access services, with wireless providers subject to a more limited set of rules. While the substance of the rules and the process used by the FCC in adopting the rules differs than the FCC's previous Internet policy principles that were called into question by the D.C. Circuit, questions remain concerning the FCC's ability to adopt rules governing the conduct of fixed and wireless broadband Internet access providers. The FCC's rules are not effective yet and there is uncertainty as to whether the rules will become effective. The FCC's Order has been appealed and certain members of Congress have announced their intention to repeal the rules through legislative action. We cannot predict whether the rules will become effective and enforceable, nor can we predict what impact these rules may have on our business at this time. While interference with access to our products and services seems unlikely such broadband Internet access provider interference has occurred, in very limited circumstances in the U.S., and could result in a loss of existing users and increased costs, and could impair our ability to attract new users, thereby harming our revenue and growth.

Future legislation or regulation of the Internet and/or voice and video over IP services could restrict our business, prevent us from offering service or increase our cost of doing business.

There are an increasing number of regulations and rulings that specifically address access to commerce and communications services on the Internet, including IP telephony. We are unable to predict the impact, if any, that future legislation, legal decisions or regulations concerning the Internet may have on our business, financial condition, and results of operations. For example, a bill has been introduced to the U.S. House of Representatives that would revise the federal Universal Service Fund. Should new legislation pass concerning this issue, the FCC may obtain new authority to change the manner in which it calculates USF contribution obligations and may also expand the services subject to such contribution obligation.

Regarding regulation, the FCC is actively considering ways to reform USF in a manner that does not require additional statutory authority. The FCC could adopt a number of different reforms that change the methodology for contributing to USF. Depending on the reform adopted, this could result in increasing what we contribute to USF which could result in increasing the price of our offerings. We cannot predict the outcome of this proceeding on our business at this time. Additionally, the U.S. Congress, the FCC, state legislatures or state agencies may target, among other things, access or settlement charges, that are exchanged between carriers upon which we rely, imposing taxes related to Internet communications, imposing tariffs or other regulations based on encryption concerns, or the characteristics and quality of products and services that we may offer. Any new laws or regulations concerning these or other areas of our business could restrict our growth or increase our cost of doing business. The increasing growth of the broadband IP telephony

market and popularity of broadband IP telephony products and services heighten the risk that governments or other legislative bodies will seek to regulate broadband IP telephony and the Internet. In addition, large, established telecommunication companies may devote substantial lobbying efforts to influence the regulation of the broadband IP telephony market, which may be contrary to our interests.

Many regulatory actions are underway or are being contemplated by federal and state authorities, including the FCC and other state and local regulatory agencies. On February 12, 2004, the FCC initiated a notice of public rule-making to update FCC policy and consider the appropriate regulatory classification for VoIP and other IP enabled services. On November 9, 2004, the FCC ruled that Vonage DigitalVoice and similar services are jurisdictionally interstate and not subject to state certification, tariffing and other common carrier regulations. This ruling was subsequently appealed by several states. On March 21, 2007, the United States Court of Appeals for the Eighth Circuit affirmed the FCC's declaratory ruling.

There is risk that a regulatory agency will require us to conform to rules that are unsuitable for IP communications technologies or rules that cannot be complied with due to the nature and efficiencies of IP routing, or are unnecessary or unreasonable in light of the manner in which we offer services to our customers. It is not possible to separate the Internet, or any service offered over it, into intrastate and interstate components as we currently have no means to automatically identify the physical location of one of our subscribers on the Internet. While suitable alternatives may be developed in the future, the current IP network does not enable us to identify the geographic nature of the traffic traversing the Internet, or dynamically pinpoint or update the location of our customers' telephony devices. In the United States, the FCC as well as our competitors have made statements in the past suggesting that we should be required to automatically determine the physical location of our customers' equipment as a precondition for offering telecommunications services to them.

There may be risks associated with our ability to comply with funding requirements of the Universal Service Fund, or USF, Telecommunications Relay Service, or TRS, fund, federal regulatory recovery fees and similar state or federal funds, or that our customers will cancel service due to the impact of these price increases to their services

On June 21, 2006, the FCC expanded the base of Universal Service Fund, or USF, contributions to interconnected VoIP providers. The FCC established a safe harbor percentage of interstate revenue of 64.9% of total VoIP service revenue. We were allowed to calculate our contribution based on the safe harbor or by preparing a traffic study. We began contributing to the federal USF on October 1, 2006. For a period of at least two quarters beginning October 1, 2006, we were required to contribute to the USF for all subscribers' retail revenues as well as through its underlying carriers' wholesale charges. The FCC order applying USF contributions to interconnected VoIP providers was appealed and on June 1, 2007, the U.S. Court of Appeals for the District of Columbia ruled that the FCC was within its authority when it required interconnected VoIP service providers to contribute to the Universal Service Fund, though it struck down the provision of the order which required pre-approval of traffic studies by the FCC and the provision that required double contributions to the fund for two quarters from our underlying carriers' wholesale charges. We pass through our federal USF fees to our customers like the large majority of interconnected VoIP providers and traditional providers of telecommunications services.

There is also a risk that state Universal Service Funds may attempt to impose state USF contribution obligations and other state and local charges. As of March 31, 2009, we were collecting or remitting state USF in one state. Effective June 1, 2009, we ceased collecting and remitting state USF. At this time, at least three states, Kansas, Nebraska and New Mexico, contend that providers of interconnected VoIP services, like us, should contribute to their USF fund. On March 3, 2008, the U.S. District Court for Nebraska issued a preliminary injunction and found that Nebraska's state Public Service Commission does not have jurisdiction to require Universal Service contributions from VoIP providers. On May 1, 2009, a panel of the U.S. Circuit Court of Appeals for the Eighth Circuit affirmed the U.S. District court ruling. Subsequently, the Kansas and Nebraska state commissions filed a joint petition with the FCC seeking the



ability to assess state USF contribution obligations on VoIP providers, like us, retroactively. Subsequently, the Kansas and Nebraska state commissions revised their petition dropping their request for retroactive authority to impose state USF. The FCC granted the modified petition of these two state commissions. While the FCC Order does not address the issue of retroactive contribution, it is possible that Kansas and Nebraska will continue to seek retroactive contribution obligations through alternative means. Moreover, as a result of this ruling, a number of other states have either subjected our offering to state USF or are considering imposing such obligations. We would likely pass through such fees to consumers potentially making our services less competitive with offerings available from traditional providers of telecommunications services which may result in losing customers and reducing our profits. We cannot predict the outcome of this proceeding at this time nor its impact on our business at this time.

Similar to federal USF fees, we are allowed to pass state USF fees through to consumers. However, should the FCC or another entity with jurisdiction rule that states can apply such fees on a retroactive basis, we would likely be unable to recoup such fees from our customers. Accordingly, any finding of retroactive liability would likely reduce our profits. Prospectively, should the FCC allow states to subject companies like us to state USF contribution obligations, our inability to recoup our costs or liabilities in remitting federal and state USF contributions, or other factors, could have a material adverse effect on our financial position, results of operations and cash flows.

The FCC and various state commissions are considering the imposition of additional fees on interconnected VoIP providers, like us. Several states are either considering extending or have imposed state USF, state TRS fees, and other taxes and fees on interconnected VoIP providers like us. If we pass through the taxes, fees and surcharges that may be applied to our service, the impact of this price increase on our customers or our inability to recoup our costs or liabilities in remitting such taxes, fees and surcharges could have a material adverse effect on our financial position, results of operations and cash flows. We may also be at a competitive disadvantage to other providers who choose not to comply with these payment obligations.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

## Issuer Purchases of Equity Securities

The activity under the Repurchase Plan for the three months ended December 31, 2010 is summarized as follows:

|                                | <u>Total Number<br/>of Shares<br/>Purchased</u> | <u>Average<br/>Price Paid<br/>Per Share</u> | <u>Total Number<br/>of Shares Purchased<br/>as Part of Publicly<br/>Announced Program</u> | <u>Approximate Dollar<br/>Value of Shares that<br/>May Yet be Purchased<br/>Under the Program</u> |
|--------------------------------|---|---|---|---|
| October 1 - October 31, 2010   | 60,000  | \$ 2.30                                     | 60,000  | \$ 9,862,000  |
| November 1 - November 30, 2010 | 36,900  | 2.70  | 36,900  | 9,762,276   |
| December 1 - December 31, 2010 | 442,259   | 2.26  | 442,259   | \$ 8,762,286  |
| Total                          | <u>539,159</u>                                  | <u>\$ 2.30</u>                              | <u>539,159</u>  |   |

- (1) On October 19, 2010, our board of directors had authorized us to repurchase up to \$10.0 million of our common stock from time to time until October 19, 2011. The repurchases were made through open market purchases at prevailing market prices.

## ITEM 6. EXHIBITS

| Exhibit<br>Number | Description  |
|-------------------|--|
| 31.1              | <u>Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u> |
| 31.2              | <u>Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u> |
| 32.1              | <u>Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u>  |
| 32.2              | <u>Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u>  |

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: January 28, 2011

8X8, INC.

(Registrant)

By: /s/ DANIEL WEIRICH

Daniel Weirich

Chief Financial Officer

(Principal Financial and Chief Accounting Officer and Duly Authorized Officer)