

8X8 INC /DE/
Form 10-Q
February 05, 2010

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

FORM 10-Q

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

For the quarterly period ended December 31, 2009

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, including Zip Code)

(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 " Non-accelerated filer x 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 February 3, 2010 was 63,130,350.

FORM 10-Q [PDF](#)
TABLE OF CONTENTS

| PART I. FINANCIAL INFORMATION | <u>Page No.</u> |
|--|------------------------|
| Item 1. Financial Statements: | |
| Condensed Consolidated Balance Sheets at December 31, 2009 and March 31, 2009 | <u>3</u> |
| Condensed Consolidated Statements of Income for the three and nine months ended December 31, 2009 and 2008 | <u>4</u> |
| Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2009 and 2008 | <u>5</u> |
| Notes to Unaudited Condensed Consolidated Financial Statements | <u>6</u> |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | <u>18</u> |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | <u>25</u> |
| Item 4. Controls and Procedures | <u>25</u> |
| PART II. OTHER INFORMATION | |
| Item 1. Legal Proceedings | <u>26</u> |
| Item 1A. Risk Factors | <u>26</u> |
| Item 6. Exhibits | <u>29</u> |
| Signature | <u>30</u> |

Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

| | <u>December 31,</u> <u>2009</u> | <u>March 31,</u> <u>2009</u> |
|---|------------------------------------|---------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 17,070 | \$ 16,376 |
| Accounts receivable, net | 476 | 414 |
| Inventory | 2,789 | 2,297 |
| Deferred cost of goods sold | 94 | 193 |
| Other current assets | 624 | 648 |
| Total current assets | <u>21,053</u> | <u>19,928</u> |
| Long-term investments | - | - |
| Property and equipment, net | 1,617 | 1,485 |
| Other assets | 405 | 443 |
| Total assets | <u>\$ 23,075</u> | <u>\$ 21,856</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 4,008 | \$ 4,810 |
| Accrued compensation | 1,491 | 1,264 |
| Accrued warranty | 356 | 328 |
| Accrued taxes | 1,724 | 1,777 |
| Deferred revenue | 1,657 | 2,254 |
| Other accrued liabilities | 1,290 | 2,081 |
| Total current liabilities | <u>10,526</u> | <u>12,514</u> |
| Other liabilities | 112 | 291 |
| Fair value of warrant liability | 382 | 21 |
| Total liabilities | <u>11,020</u> | <u>12,826</u> |
| Commitments and contingencies (Note 8) | | |
| Stockholders' equity: | | |
| Common stock | 63 | 63 |
| Additional paid-in capital | 211,947 | 211,686 |
| Accumulated deficit | (199,955) | (202,719) |
| Total stockholders' equity | <u>12,055</u> | <u>9,030</u> |
| Total liabilities and stockholders' equity | <u>\$ 23,075</u> | <u>\$ 21,856</u> |

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 | | Nine Months Ended | |
|--|--------------------|---------------|-------------------|-----------------|
| | December 31, | | December 31, | |
| | 2009 | 2008 | 2009 | 2008 |
| Service revenues | \$ 14,737 | \$ 14,366 | \$ 44,095 | \$ 44,288 |
| Product revenues | 1,207 | 1,837 | 3,434 | 4,621 |
| Total revenues | 15,944 | 16,203 | 47,529 | 48,909 |
| Operating expenses: | | | | |
| Cost of service revenues | 3,254 | 3,699 | 10,290 | 11,535 |
| Cost of product revenues | 1,925 | 1,681 | 5,432 | 4,786 |
| Research and development | 1,239 | 1,183 | 3,741 | 3,674 |
| Selling, general and administrative | 8,251 | 9,562 | 24,980 | 27,980 |
| Total operating expenses | 14,669 | 16,125 | 44,443 | 47,975 |
| Income from operations | 1,275 | 78 | 3,086 | 934 |
| Other income, net | 7 | 74 | 50 | 266 |
| Income (loss) on change in fair value of warrant liability | (265) | 66 | (362) | 325 |
| Income before provision for income taxes | 1,017 | 218 | 2,774 | 1,525 |
| Provision for income taxes | 3 | 38 | 10 | 113 |
| Net income | \$ 1,014 | \$ 180 | \$ 2,764 | \$ 1,412 |
| Net income per share: | | | | |
| Basic | \$ 0.02 | \$ 0.00 | \$ 0.04 | \$ 0.02 |
| Diluted | \$ 0.02 | \$ 0.00 | \$ 0.04 | \$ 0.02 |
| Weighted average number of shares: | | | | |
| Basic | 62,852 | 62,332 | 62,768 | 62,236 |
| Diluted | 63,393 | 62,394 | 62,978 | 62,428 |

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)

| | Nine Months Ended December 31, | |
|---|---|------------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,764 | \$ 1,412 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 775 | 976 |
| Stock-based compensation | 182 | 870 |
| Income (loss) on change in fair value of warrant liability | 361 | (325) |
| Change in inventory reserve | (347) | 57 |
| Other | 69 | 118 |
| Changes in assets and liabilities: | | |
| Accounts receivable, net | (135) | 997 |
| Inventory | (145) | (419) |
| Other current and noncurrent assets | (39) | 12 |
| Deferred cost of goods sold | 99 | 291 |
| Accounts payable | (731) | (1,010) |
| Accrued compensation | 227 | 387 |
| Accrued warranty | 28 | 13 |
| Accrued taxes and fees | (53) | (1,307) |
| Deferred revenue | (597) | 73 |
| Other current and noncurrent liabilities | (974) | (38) |
| Net cash provided by operating activities | <u>1,484</u> | <u>2,107</u> |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (929) | (677) |
| Sale of property and equipment | 2 | - |
| Restricted cash decrease | 100 | - |
| Maturities of short-term investments | - | 3,385 |
| Net cash provided by (used in) investing activities | <u>(827)</u> | <u>2,708</u> |
| Cash flows from financing activities: | | |
| Capital lease payments | (42) | (28) |
| Repurchase of common stock | (212) | - |
| Proceeds from issuance of common stock under employee stock plans | 291 | 223 |
| Net cash provided by financing activities | <u>37</u> | <u>195</u> |
| Net increase in cash and cash equivalents | 694 | 5,010 |
| Cash and cash equivalents at the beginning of the period | <u>16,376</u> | <u>11,185</u> |
| Cash and cash equivalents at the end of the period | <u>\$ 17,070</u> | <u>\$ 16,195</u> |

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 communication technology and services for Internet protocol, or IP, telephony and video applications. The Company was incorporated in California in February 1987, and in December 1996 was reincorporated in Delaware.

The Company offers a suite of voice and video communications services that work over existing high speed Internet connections. In November 2002, the Company launched the 8x8 residential service offering and in March 2004, the Company launched its first business service offering. 8x8's primary product focus is on replacing private branch exchange, or PBX, telephone systems in the small and medium-sized business marketplace with a hosted business solution. To accomplish this 8x8 sells a business service called 8x8 Virtual Office that offers feature-rich communications services to small and medium-sized business, eliminating the need for traditional telecommunications services and business phone systems. The service typically consists of IP telephony equipment which is purchased upfront, and a monthly subscription to a service plan that provides dialtone, voice service and other features to the telephone equipment. 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.

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 2010 refers to the fiscal year ending March 31, 2010).

LIQUIDITY

The Company generated positive cash flows from operating activities for the fiscal years ended March 31, 2009 and 2008 and the nine months ended December 31, 2009. Management believes that current cash and cash equivalents will be sufficient to finance the Company's operations for at least the next twelve months. However, the Company continually evaluates its cash needs and may pursue additional equity or debt financing in order to achieve the Company's overall business objectives. There can be no assurance that such financing will be available, or, if available, at a price that is acceptable to the Company. Failure to generate sufficient revenue, raise additional capital or reduce certain discretionary spending could have an adverse impact on the Company's ability to achieve its longer term business objectives.

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, 2009. 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 Company has evaluated subsequent events through February 4, 2010, which is the day preceding the date on which this report was filed with the Securities and Exchange Commission or SEC. 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, 2009 year-end condensed consolidated balance sheet data was derived from audited consolidated financial statements and does 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, 2009 and notes thereto included in the Company's fiscal 2009 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.

Investments

The Company's investments are comprised of money market funds. All short-term investments are classified as available-for-sale.

8x8 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.

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 605-25 (formerly Emerging Issues Task Force consensus No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables") 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 desktop terminal or videophone adapter constitutes a revenue arrangement with multiple deliverables. In accordance with the guidance of ASC 605-25, the Company allocates 8x8 revenue from new subscriptions, including activation fees, between the desktop terminal adapter or videophone and subscriber services. Revenue allocated to the desktop terminal adapter or videophone 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 (formerly Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock") 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 has two investor warrants that are classified as liabilities because they 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.

Accounting for Stock-Based Compensation

The Company accounts for stock-based compensation under ASC 718 - Stock Compensation (formerly Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment"), 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, 2009 included the unvested portion of stock-based awards granted subsequent to January 29, 2009. Stock-based awards granted in periods subsequent to April 1, 2006 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 (the "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, 2009. 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, 2009, the 1992 Stock Plan, 1996 Stock Plan and 1996 Director Option Plan had expired and the 1999 Nonstatutory Stock Option Plan was cancelled by the Board, but there are still options outstanding under these plans. Options generally vest over four years, are 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 6,797,410 shares remain available for issuance as of December 31, 2009. The 2006 Plan is the Company's only active plan for providing stock-based incentive compensation ("awards") to our 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 stock option price of incentive stock options granted and 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 compensation committee of 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, 2009 is summarized as follows:

| | Number of Shares | Weighted Average Grant-Date Fair Market Value | Weighted Average Remaining Contractual Term (in Years) |
|------------------------------|---------------------|---|--|
| Balance at March 31, 2009 | 100,000 | \$ 0.57 | |
| Granted | 326,464 | 0.74 | |
| Vested | (32,965) | 0.74 | |
| Forfeited | - | - | |
| | <hr/> | | |
| Balance at December 31, 2009 | 393,499 | \$ 0.70 | 3.49 |

Option activity since March 31, 2009 is summarized as follows:

| | Shares Available for Grant | Shares Subject to Options Outstanding | Weighted Average Exercise Price Per Share |
|------------------------------|----------------------------------|--|---|
| Balance at March 31, 2009 | 2,415,875 | 10,736,279 | \$ 1.85 |
| Stock purchase rights | (326,464) | - | |
| Exercised | - | (172,000) | 0.75 |
| Canceled/forfeited | 1,035,376 | (1,035,376) | 1.75 |
| Termination of plans | (467,376) | - | - |
| Balance at December 31, 2009 | 2,657,411 | 9,528,903 | \$ 1.88 |

The following table summarizes the stock options outstanding and exercisable at December 31, 2009:

| | Options Outstanding | | | Options Exercisable | | | |
|------------------|---------------------|---|---|---------------------------------|-----------|---|---------------------------------|
| | Shares | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value | Shares | Weighted Average Exercise Price Per Share | Aggregate Intrinsic Value |
| \$0.55- \$1.18 | 2,065,262 | \$ 0.91 | 7.10 | \$ 1,217,145 | 2,065,262 | \$ 0.91 | \$ 1,217,145 |
| \$1.19 - \$1.27 | 2,030,500 | \$ 1.26 | 7.41 | 484,605 | 2,030,500 | \$ 1.26 | 484,605 |
| \$1.28 - \$1.72 | 2,179,210 | \$ 1.55 | 5.34 | 86,105 | 2,179,210 | \$ 1.55 | 86,105 |
| \$1.73 - \$2.31 | 1,991,431 | \$ 1.89 | 2.93 | - | 1,991,431 | \$ 1.89 | - |
| \$2.32 - \$14.94 | 1,262,500 | \$ 5.02 | 2.28 | - | 1,262,500 | \$ 5.02 | - |
| | 9,528,903 | | | \$ 1,787,855 | 9,528,903 | | \$ 1,787,855 |

Stock-based Compensation Expense

As of December 31, 2009, there was \$261,000 of total unrecognized compensation cost related to stock options and stock purchase rights. These costs are expected to be recognized over a weighted average period of 3.49 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, 2009 and 2008, 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.

The following table summarizes the assumptions used to compute stock-based compensation to employees and directors for the three and nine months ended December 31, 2009 and 2008:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|------------|-----------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Expected volatility | - | 77% | - | 79% |
| Expected dividend yield | - | - | - | - |
| Risk-free interest rate | - | 2.07% | - | 2.79% |
| Weighted average expected option term | - | 4.74 years | - | 4.69 years |
| Weighted average fair value of options granted | \$ - | \$ 0.37 | \$ - | \$ 0.54 |

In accordance with ASC 718, the Company recorded compensation expense relative to stock options and stock purchase rights collectively of \$19,000 and \$176,000 for the three months ended December 31, 2009 and 2008, respectively, and \$37,000 and \$787,000 for the nine months ended December 31, 2009 and 2008, 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 a six month purchase period, whichever is lower. The contribution amount may not exceed ten percent of an employee's base compensation, 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 \$51,000 and \$30,000 for the three months ended December 31, 2009 and 2008, respectively, and \$145,000 and \$83,000 for the nine months ended December 31, 2009 and 2008, respectively, in accordance with ASC 718.

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|------------|-----------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Expected volatility | 90% | 47% | 90% | 47% |
| Expected dividend yield | - | - | - | - |
| Risk-free interest rate | 0.33% | 1.69% | 0.33% | 1.69% |
| Weighted average expected option term | 0.83 years | 0.75 years | 0.83 years | 0.75 years |
| Weighted average fair value of options granted | \$ 0.34 | \$ 0.35 | \$ 0.34 | \$ 0.35 |

As of December 31, 2009, there was \$55,000 of total unrecognized compensation cost related to employee stock purchases. These costs are expected to be recognized over a weighted average period of 0.2 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 realizability 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 months ended December 31, 2009 and 2008 as the Company believes that it is more likely than not that it will not realize the benefit from tax deductions related to 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, 2009 and 2008 which was recorded as follows (in thousands):

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|--------|-----------------------------------|--------|
| | 2009 | 2008 | 2009 | 2008 |
| Cost of service revenues | \$ 7 | \$ 9 | \$ 18 | \$ 16 |
| Cost of product revenues | - | 7 | - | 16 |
| Research and development | 23 | 12 | 60 | 137 |
| Selling, general and administrative | 40 | 178 | 104 | 701 |
| Total stock-based compensation expense related to employee stock options and employee stock purchases, pre-tax | 70 | 206 | 182 | 870 |
| Tax benefit | - | - | - | - |
| Stock based compensation expense related to employee stock options and employee stock purchases, net of tax | \$ 70 | \$ 206 | \$ 182 | \$ 870 |

Recent Accounting Pronouncements

In July 2009, the FASB issued Accounting Standards Update ("ASU") No. 2009-1, "Topic 105 - Generally Accepted Accounting Principles," ("ASU 2009-1") which amended ASC 105, "Generally Accepted Accounting Principles," to establish the Codification as the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date, the Codification superseded all then-existing non-SEC accounting and reporting standards. The adoption of ASU 2009-1 did not have a material impact on the Company's financial position or results of operation.

In May 2009, the FASB issued ASC 855 - *Subsequent Events* (formerly SFAS No. 165, "Subsequent Events"). The statement is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. SFAS No. 165 is effective for interim and annual periods ending after June 15, 2009. The adoption of ASC 855 did not have a material impact on the Company's financial position or results of operation.

3. BALANCE SHEET DETAIL

| | December 31, 2009 | March 31, 2009 |
|---------------------------|----------------------|-------------------|
| Inventory (in thousands): | | |
| Work-in-process | \$ 2,244 | \$ 1,695 |
| Finished goods | 545 | 602 |
| | \$ 2,789 | \$ 2,297 |

4. 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 December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|---------|-----------------------------------|----------|
| | 2009 | 2008 | 2009 | 2008 |
| Numerator: | | | | |
| Net income available to common stockholders | \$ 1,014 | \$ 180 | \$ 2,764 | \$ 1,412 |
| Denominator: | | | | |
| Common shares | 62,852 | 62,332 | 62,768 | 62,236 |
| Denominator for basic calculation | 62,852 | 62,332 | 62,768 | 62,236 |
| Employee stock options | 515 | 38 | 193 | 71 |
| Employee stock purchase plan | 26 | 24 | 17 | 121 |
| Warrants | - | - | - | - |
| Denominator for diluted calculation | 63,393 | 62,394 | 62,978 | 62,428 |
| Net income per share | | | | |
| Basic | \$ 0.02 | \$ 0.00 | \$ 0.04 | \$ 0.02 |
| Diluted | \$ 0.02 | \$ 0.00 | \$ 0.04 | \$ 0.02 |

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 December 31, | | Nine Months Ended December 31, | |
|----------------------|------------------------------------|--------|-----------------------------------|--------|
| | 2009 | 2008 | 2009 | 2008 |
| Common stock options | 7,471 | 11,365 | 8,553 | 10,588 |
| Warrants | 1,786 | 5,445 | 1,786 | 5,445 |
| | 9,257 | 16,810 | 10,339 | 16,033 |

5. COMPREHENSIVE INCOME

Comprehensive income 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, 2009 and 2008 was as follows (in thousands):

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|------|-----------------------------------|------|
| | 2009 | 2008 | 2009 | 2008 |
| | | | | |

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| | | | | |
|--|----------|--------|----------|----------|
| Net income, as reported | \$ 1,014 | \$ 180 | \$ 2,764 | \$ 1,412 |
| Unrealized loss on investments in securities | - | - | - | (5) |
| Comprehensive income | \$ 1,014 | \$ 180 | \$ 2,764 | \$ 1,407 |

- 12 -

6. SEGMENT REPORTING

ASC 280 - Segment Reporting (formerly SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information"), 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 December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|-----------|-----------------------------------|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| 8x8 service, equipment and other | \$ 15,928 | \$ 16,186 | \$ 47,471 | \$ 48,637 |
| Technology licensing and related software | 16 | 17 | 58 | 272 |
| Total revenues | \$ 15,944 | \$ 16,203 | \$ 47,529 | \$ 48,909 |

No customer represented greater than 10% of the Company's total revenue for the three and nine months ended December 31, 2009 or 2008. Revenue from customers outside the United States was not material for the three and nine months ended December 31, 2009 or 2008.

7. 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 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 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* (formerly FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: an Interpretation of FASB Statement No. 109"), 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.

At March 31, 2009, the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$2.2 million, but any affect 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, 2009 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 2009 may be subject to examination by the Internal Revenue Service, California and various other states. The Company extended the filing date of the 2009 federal tax return and all state income tax returns. As of February 5, 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, 2009, there were no active federal, state or local income tax audits. Returns filed in foreign jurisdictions may be subject to examination for the fiscal years 2005 to 2009.

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 nine months ended December 31, 2009 and 2008, the Company did not recognize any interest or penalties related to unrecognized tax benefits.

8. 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 revenue in the condensed consolidated statements of operations, during the three and nine months ended December 31, 2009 and 2008 were as follows (in thousands):

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--------------------------------|--|---------------|---|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Balance at beginning of period | \$ 370 | \$ 298 | \$ 328 | \$ 314 |
| Accruals for warranties | 66 | 120 | 304 | 259 |
| Settlements | (80) | (91) | (276) | (246) |
| Balance at end of period | <u>\$ 356</u> | <u>\$ 327</u> | <u>\$ 356</u> | <u>\$ 327</u> |

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 12th, 18th, 24th, or 30th 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 would 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, 2009, future minimum annual lease payments under current and new operating leases were as follows (in thousands):

| | | |
|------------------------|----|-------|
| Year ending March 31: | | |
| Remaining 2010 | \$ | 139 |
| 2011 | | 594 |
| 2012 | | 657 |
| 2013 | | 284 |
| | | <hr/> |
| Total minimum payments | \$ | 1,674 |
| | | <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, 2009, future minimum annual lease payments under noncancelable capital leases were as follows (in thousands):

| | | |
|---|----|-------|
| Year ending March 31: | | |
| Remaining 2010 | \$ | 10 |
| 2011 | | 41 |
| 2012 | | 40 |
| 2013 | | 7 |
| | | <hr/> |
| Total minimum payments | | 98 |
| Less: Amount representing interest | | (7) |
| | | <hr/> |
| | | 91 |
| Less: Short-term portion of capital lease obligations | | (39) |
| | | <hr/> |
| Long-term portion of capital lease obligations | \$ | 52 |
| | | <hr/> |

Capital leases included in office equipment were \$212,000 at December 31, 2009. Total accumulated depreciation was \$121,000 at December 31, 2009. 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 be 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 currently believes that it is not a party to any litigation the final outcome of which is likely to have a material adverse effect on the Company's financial position, results of operations or cash flows. However, should the Company not prevail in any such litigation it could have a material adverse impact on the Company's operating results, cash flows or

financial position. Even if the Company prevails in such litigation, it may divert the attention of management and require the expenditure of significant financial resources to resolve.

- 15 -

State and Municipal Taxes

For a period of time, the Company did not collect or remit state or municipal taxes (such as sales, excise, and *ad valorem* taxes), fees or surcharges ("Taxes") on the charges to the Company's customers for its services, although the Company has historically complied with the California sales tax and financial contributions to the 9-1-1 system and universal service fund. The Company has received inquiries or demands from a number of state and municipal taxing agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although the Company has consistently maintained that these Taxes do not apply to its service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes as part of the streamlined sales tax initiatives and the Company has begun collecting and remitting Taxes in those states. Some of these Taxes could apply to the Company retroactively. Three states and one city currently are conducting sales tax audits of the Company's records. In October 2009, we received notices of proposed assessment as a result of two of the sales tax audits amounting to approximately \$1.9 million, which the Company considers to be unsubstantiated. The Company has accrued a tax liability of \$0.2 million as of December 31, 2009 to account for its estimated liability for past sales tax obligations related to these proposed assessments.

Regulatory Matters

The effect of any future laws, regulations and orders on the Company's operations, including, but not limited to, the 8x8 service, cannot be determined. But as a general matter, increased regulation and the imposition of additional funding obligations increases the Company's costs of providing service that may or may not be recoverable from the Company's customers. This could result in making the Company's services less competitive with traditional telecommunications services if the Company increases its retail prices or decreases the Company's profit margins if it attempts to absorb such costs.

On March 17, 2010, the Federal Communications Commission (FCC) will present its national broadband plan to Congress. The purpose of the plan is to stimulate demand for broadband Internet access with the hopes of creating a virtuous cycle of increased consumer use of broadband applications and devices which will, in turn, spur the deployment of more broadband facilities creating a positive feedback loop. While the details of the plan are unknown at this time, it is expected that many elements of the current telecommunications regulatory structure will be impacted including, among many other things, universal service, intercarrier compensation, and principles concerning open Internet access rules. It is possible that the FCC could propose the adoption of new rules or legislation that could negatively impact our service in a number of ways that are not possible for us to foresee at this time.

In 2005, the Federal Communications Commission (FCC) adopted four general Internet policy principles that it would use in evaluating broadband Internet access providers conduct. The enforceability of these principles remains an open question and is the subject of ongoing litigation. On October 22, 2009, the FCC released a Notice of Proposed Rulemaking seeking comment on whether it should adopt these policy principles, in addition to other obligations, as enforceable rules in order to preserve the open Internet and, if so, what rules should be adopted. In particular, the agency is considering adopting enforceable rules that would, subject to reasonable network management, prohibit a provider of broadband Internet access service from: (1) preventing any of its users from sending or receiving the lawful content of the user's choice over the Internet; (2) preventing any of its users from running the lawful applications or using the lawful services of the user's choice; (3) preventing any of its users from connecting to and using on its network the user's choice of lawful devices that do not harm the network; and (4) depriving any of its users of the user's entitlement to competition among network providers, application providers, service providers and content providers. Additionally, the FCC is considering rules that would require broadband Internet access service providers, subject to reasonable network management, to treat lawful content, applications, and services in a nondiscriminatory manner, as well as to disclose information concerning network management and other practices as is reasonably required for users and content, application, and service providers to enjoy the protections ensured by any rules adopted as a result of this proceeding. If the FCC were to adopt enforceable rules concerning the open Internet,

the Company would have greater protection for its service offerings than it does today. The Company is wholly reliant on providers of broadband Internet access service providers to access its customers and to provide its services. While the Company has not encountered any material difficulties with regard to the issues being considered by the FCC in this proceeding, increased network congestion in the future may result in broadband Internet access providers engaging in actions that would either reduce the quality of the services provided by us today, or impede our ability to rollout new services that use more bandwidth. The Company cannot predict whether the FCC will adopt the proposed rules or any rules that are the subject of this proceeding nor can it predict what impact such rules will have on the business at this time.

- 16 -

On July 10, 2009, AT&T filed a "Petition for Immediate Commission Action" to reform the Federal Communications Commission's universal service fund contribution methodology. The AT&T petition requests that the Commission reform its contribution mechanism and adopt a telephone-numbers based contribution methodology where parties would make federal universal service fund contributions on the basis of "assessable telephone numbers." Under the current federal universal service fund contribution mechanism, nomadic interconnected VoIP providers, like the Company, are required to contribute to the federal universal service fund which the Company does. The Company's current contribution methodology is based on a traffic study that it completed where it determined the percentage of its customers' calls that are interstate in nature. The Company cannot predict whether the FCC will adopt AT&T's proposal nor can it predict what the impact on its business will be at this time.

Certain states continue to attempt to subject the Company's service to state universal service fund contribution obligations. At this time, at least three states, including Nebraska, contend that providers of interconnected VoIP services, like the Company, should contribute to its universal service fund. On March 3, 2008, the U.S. District Court for Nebraska issued a preliminary injunction and found that Nebraska Public Service Commission (NPSC) does not have jurisdiction to require universal service fund contributions from nomadic interconnected VoIP providers, like the Company. 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. But on May 14, 2009, the NPSC requested a rehearing or a rehearing en banc of the decision handed down by the three-judge panel. On June 5, 2009, the Eighth Circuit denied the request for rehearing of the NPSC. Following this denial, another state, outside of the Eighth Circuit, attempted to require the Company to continue to contribute its state's Universal Service Fund. The Company continues to maintain that under current laws, and in light of the decisions in the Eighth Circuit, its interpretation that it is not currently subject to any state's universal service fund contribution obligations for its nomadic interconnected VoIP service offering is correct. Should this stance change, the Company plans to pass any increased cost of state universal service fund contributions through to its customers that would increase its retail prices making the Company's services less competitive with traditional telecommunications services.

On July 16, 2009, the NPSC and the Kansas Corporation Commission (KCC) filed a joint petition with the FCC seeking a declaratory ruling that the FCC has not preempted states from assessing universal service charges on the intrastate revenue of nomadic interconnected VoIP service providers, like the Company. Additionally, the petitioners ask the FCC to rule that states have discretion to adopt any mechanism to assess state universal service fund contributions so long as the methodology does not assess interstate revenue and contains procedures designed to ensure that no provider pays assessments to more than one state on the same intrastate revenue. The joint petitioners also seek a retroactive ruling that states have the authority to impose state universal service fund contribution obligations on providers of nomadic interconnected VoIP services. It is unclear from the petition how far back the period of retroactivity would extend. On August 10, 2009, the FCC requested comments on the petition filed by the NPSC and the KCC. The Company cannot predict the outcome of this FCC proceeding, nor its potential impact on the Company, at this time.

9. 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 (the "Repurchase Plan"). Share repurchases, if any, will be funded with available cash. Repurchases under the Repurchase Plan 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 Plan may be commenced, suspended or discontinued at any time. The remaining authorized repurchase amount at December 31, 2009 is approximately \$1.8 million. The activity under the Repurchase Plan for the nine months ended December 31, 2009 is summarized as follows:

Weighted

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| | <u>Shares Repurchased</u> | <u>Average Price Per Share</u> | <u>Amount Repurchased</u> |
|------------------------------|-------------------------------|--|-------------------------------|
| Repurchase of common stock | 282,376 | \$ 0.75 | \$ 211,741 |
| Balance at December 31, 2009 | <u>282,376</u> | \$ 0.75 | <u>\$ 211,741</u> |

- 17 -

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

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

FORWARD-LOOKING STATEMENTS

This Management's 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 VoIP 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. The forward-looking statements may also be impacted by the additional risks faced by us as described in this Report, including those set forth in the Risk Factors discussion in Part II, Item 1A of this Form 10-Q. In addition to those factors discussed elsewhere in this Form 10-Q, see the Risk Factors discussion in Part I, Item 1A of our 2009 Form 10-K. 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 telecommunication technology for Internet protocol, or IP, telephony and video applications. We offer the 8x8 broadband and video communications service and launched the 8x8 residential service offering in November 2002 and the 8x8 business service offering in March 2004. Substantially all of our revenue is generated from the sale, license and provisioning of VoIP products, services and technologies.

Our fiscal year ends 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 2010 refers to the fiscal year ending March 31, 2010).

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, revenue 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, 2009. As of December 31, 2009, there had been no material changes to our critical accounting

policies and estimates.

RECENT ACCOUNTING PRONOUNCEMENTS

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

- 18 -

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, 2009 | Sept. 30, 2009 | June 30, 2009 | March 31, 2009 | Dec. 31, 2008 | Sept. 30, 2008 | June 30, 2008 | March 31, 2008 |
| Gross business customer additions (1) | 2,785 | 2,609 | 2,907 | 2,792 | 2,437 | 3,324 | 2,398 | 2,162 |
| Gross business customer cancellations (less cancellations within 30 days of sign-up) | 1,331 | 1,416 | 1,371 | 1,245 | 1,224 | 1,187 | 1,098 | 1,138 |
| Business customer churn (less cancellations within 30 days of sign-up) (2) | 2.4% | 2.7% | 2.7% | 2.7% | 2.9% | 3.1% | 3.2% | 3.6% |
| Total business customers (3) | 19,407 | 18,199 | 17,266 | 16,013 | 14,706 | 13,744 | 11,898 | 10,845 |
| Business customer average monthly service per customer (4) | \$ 204 | \$ 201 | \$ 196 | \$ 202 | \$ 208 | \$ 220 | \$ 237 | \$ 229 |
| Revenue from business customers (in '000s) | \$ 12,650 | \$ 11,842 | \$ 10,722 | \$ 10,728 | \$ 10,614 | \$ 9,826 | \$ 9,077 | \$ 8,111 |
| Revenue from residential and video customers (in '000s) | \$ 3,278 | \$ 4,168 | \$ 4,811 | \$ 5,236 | \$ 5,572 | \$ 6,356 | \$ 7,192 | \$ 7,685 |
| Revenue from technology licensing (in '000s) | \$ 16 | \$ 17 | \$ 25 | \$ (199) | \$ 17 | \$ 243 | \$ 12 | \$ 536 |
| Total Revenue | \$ 15,944 | \$ 16,027 | \$ 15,558 | \$ 15,765 | \$ 16,203 | \$ 16,425 | \$ 16,281 | \$ 16,332 |
| Percentage of revenue from business customers | 79.3% | 73.9% | 68.9% | 68.1% | 65.5% | 59.8% | 55.8% | 49.7% |
| Percentage of revenue from residential and video customers | 20.6% | 26.0% | 30.9% | 33.2% | 34.4% | 38.7% | 44.1% | 47.0% |
| Percentage of revenue from technology licensing | 0.1% | 0.1% | 0.2% | -1.3% | 0.1% | 1.5% | 0.1% | 3.3% |
| Total Revenue | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Overall service margin | 78% | 76% | 76% | 71% | 74% | 73% | 75% | 74% |
| Overall product margin | -59% | -42% | -75% | -50% | 9% | -10% | -13% | -23% |
| Overall gross margin | 68% | 67% | 66% | 59% | 67% | 65% | 68% | 67% |
| Total (business, residential and video) subscriber acquisition cost per service (5) | \$ 102 | \$ 88 | \$ 108 | \$ 119 | \$ 135 | \$ 163 | \$ 162 | \$ 155 |
| Business subscriber acquisition cost per service (6) | \$ 102 | \$ 90 | \$ 93 | \$ 118 | \$ 141 | \$ 171 | \$ 171 | \$ 158 |
| Average number of services subscribed to per business customer | 7.3 | 7.1 | 6.9 | 6.6 | 6.6 | 6.9 | 7.1 | 7.2 |
| Business customer subscriber acquisition cost (7) | \$ 749 | \$ 638 | \$ 638 | \$ 785 | \$ 933 | \$ 1,174 | \$ 1,217 | \$ 1,135 |
| Residential lines in service | 56,547 | 68,682 | 74,809 | 81,569 | 86,992 | 93,865 | 100,937 | 107,260 |
| Total (business, residential and video) customer churn (less cancellations within 30 days of sign-up) (8) | 3.3% | 4.3% | 3.7% | 3.5% | 3.9% | 4.2% | 3.5% | 4.0% |

(1) Includes 1,154 "Find me, Follow me" and 40 8x8 Virtual Office customers acquired in the second quarter of fiscal 2009 from Avtex Solutions, LLC ("Avtex").

(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. Prior to April 1, 2008, 8x8 included customers in the business customer count that were using the service as a trial or evaluation and not yet paying for service. The numbers in this table prior to and after April 1, 2008, only include business customers that are paying for service. Customers that have prepaid for their first month of service and 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) Total (business, residential and video) subscriber acquisition cost per service is defined as the combined costs of advertising, marketing, promotions, commissions and equipment subsidies during the period divided by the number of gross services added during the period.
- (6) 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. The addition of 1,154 Avtex customers that migrated to 8x8 in the second fiscal quarter of 2009 but subscribed to "Find me, Follow me" services rather than 8x8 Virtual Office service, and the \$79,230 in expense related to the acquisition of these 1,154 customers, is excluded from this calculation.
- (7) Business customer subscriber acquisition cost is business subscriber acquisition cost per service times the average number of services subscribed to per business customer.

- (8) Total (business, residential and video) customer churn is calculated by dividing the number of services terminated (after the expiration of the 30 day trial) during that period by the simple average number of services during the period and dividing the result by the number of months in the period.

OUTLOOK

As reflected in the Selected Operating Statistics above, revenue from business customers continues to increase while revenue from residential and video customers continues to decrease. The sequential rate of decline in revenue from residential customers in the third quarter of 2010 was a record high both in absolute revenue and percentage of revenue. While our IP-based communications services are innately designed to save businesses money on monthly telecommunications costs, we are conscious that, in light of the current macroeconomic environment, our new sales could potentially decline if business customers are forced to reduce their telecommunication spending. In addition, we actively monitor business customer cancellations for non-payment. While our business customer churn declined to 2.4% in the third quarter of 2010 compared with 2.9% in the same period a year ago, we have determined that in the first and second quarter of fiscal 2010, cancellations for non-payment and economic hardship represented 35% and 45% of our total business customer cancellations while in the third quarter of fiscal 2010, cancellations for non-payment and economic hardship of our business customer cancellations increased to 49% of total business customer cancellations. Management remains focused on monitoring these metrics in light of the current U.S. macroeconomic conditions.

In January 2009, our board of directors approved the acceleration of unvested stock options to purchase 3,902,186 shares of common stock. The acceleration of the unvested stock options resulted in the recognition of \$2.4 million stock-based compensation in the fourth quarter of fiscal 2009, and substantially reduced the amount of SFAS 123(R) stock compensation expense reported in the first nine months of fiscal 2010. We expect such expense to continue to be much lower for the remainder of fiscal 2010 and at least through fiscal 2011 due to that vesting acceleration in fiscal 2009.

RESULTS OF OPERATIONS

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

| | December 31, | | Dollar Change | Percent Change |
|-------------------------------|--------------|-----------|------------------|-------------------|
| | 2009 | 2008 | | |
| (dollar amounts in thousands) | | | | |
| <u>Service revenues</u> | | | | |
| Three months ended | \$ 14,737 | \$ 14,366 | \$ 371 | 2.6% |
| Percentage of total revenues | 92.4% | 88.7% | | |
| Nine months ended | \$ 44,095 | \$ 44,288 | \$ (193) | -0.4% |
| Percentage of total revenues | 92.8% | 90.6% | | |

Service revenue consists primarily of revenue attributable to the provision of our 8x8 service and royalties earned under our VoIP technology licenses. We expect that 8x8 service revenue will continue to comprise nearly all of our service revenue for the foreseeable future.

The increase for the third quarter of fiscal 2010 was primarily due to a \$2.6 million increase in revenue attributable to the growth in the business customer base, partially offset by a decrease of \$2.2 million in revenue attributable to the decline in the residential and videophone service customer base. These changes are consistent with the redirection of most of our marketing efforts toward our business customer service and we expect the trends to continue in future periods. The business customer base grew from serving approximately 14,700 businesses on December 31, 2008 to approximately 19,400 on December 31, 2009. Service revenue from residential and video customers declined primarily because the number of residential and video lines in service fell from approximately 87,000 in the third quarter of fiscal 2009 to approximately 57,000 in the third quarter of fiscal 2010.

The decrease for the first nine months of fiscal 2010 was primarily due to a \$6.6 million decrease in revenue attributable to the decline in the residential and videophone services as the number of residential and video lines in service declined from approximately 107,000 at the beginning of fiscal 2009 to approximately 57,000 in the third quarter of fiscal 2010. We also had a \$0.2 million reduction in royalty revenue. The decrease in service revenue during the third quarter of fiscal 2010 was partially offset by an increase of \$6.6 million in revenue attributable to the growth in the business customer base, which grew from serving approximately 10,800 businesses on April 1, 2008 to approximately 19,400 on December 31, 2009.

- 20 -

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| <u>Product revenues</u> | December 31, | | <u>Dollar Change</u> | <u>Percent Change</u> |
|------------------------------|-------------------------------|-------------|--------------------------|---------------------------|
| | <u>2009</u> | <u>2008</u> | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 1,207 | \$ 1,837 | \$ (630) | -34.3% |
| Percentage of total revenues | 7.6% | 11.3% | | |
| Nine months ended | \$ 3,434 | \$ 4,621 | \$ (1,187) | -25.7% |
| Percentage of total revenues | 7.2% | 9.4% | | |

Product revenue consists of revenue from sales of VoIP terminal adapters, telephones and videophones, primarily attributable to our 8x8 service.

Product revenue for the three and nine months ended December 31, 2009 was lower primarily because of a decrease in new residential customers and discounting of equipment sold to business service customers in the three and nine months ended December 31, 2009.

No customer represented greater than 10% of our total revenue for the three and nine months ended December 31, 2009 and 2008. Revenue from customers outside the United States was not material for the three and nine months ended December 31, 2009 or 2008.

| <u>Cost of service revenues</u> | December 31, | | <u>Dollar Change</u> | <u>Percent Change</u> |
|---------------------------------|-------------------------------|-------------|--------------------------|---------------------------|
| | <u>2009</u> | <u>2008</u> | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 3,254 | \$ 3,699 | \$ (445) | -12.0% |
| Percentage of service revenues | 22.1% | 25.7% | | |
| Nine months ended | \$ 10,290 | \$ 11,535 | \$ (1,245) | -10.8% |
| Percentage of service revenues | 23.3% | 26.0% | | |

The cost of service revenue 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.

The decrease in cost of service revenue for the three and nine month periods ended December 31, 2009 over the comparable periods in the prior fiscal year are primarily due to a reduction in pricing by third party network service vendors and our use of multiple third party network provider vendors, which allows us to route call traffic to the third party network provider vendor with the most favorable pricing. The reduction in pricing by third party network service vendors was partially offset by an increase in personnel costs over the comparable periods in the prior fiscal year.

| <u>Cost of product revenues</u> | December 31, | | <u>Dollar Change</u> | <u>Percent Change</u> |
|---------------------------------|-------------------------------|-------------|--------------------------|---------------------------|
| | <u>2009</u> | <u>2008</u> | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 1,925 | \$ 1,681 | \$ 244 | 14.5% |
| Percentage of product revenues | 159.5% | 91.5% | | |
| Nine months ended | \$ 5,432 | \$ 4,786 | \$ 646 | 13.5% |
| Percentage of product revenues | 158.2% | 103.6% | | |

The cost of product revenue 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 generally do not charge residential subscribers for the equipment used to provide our service when they subscribe through our website. We also have offered incentives to customers who purchase equipment to offset the customer's cost of the equipment. We allocate a portion of service revenue to product revenue but this revenue is less than the cost of the equipment.

The increase in the cost of product revenue for the three and nine month periods ended December 31, 2009 compared with the same periods in the prior fiscal year was primarily due to an increase in the shipment of equipment to our business service customers. The increase in cost of product revenue was partially offset by decreases in warranty expense, in shipments of equipment to residential subscribers and in personnel costs over the comparable period in the prior fiscal year.

The cost of product revenue as a percentage of product revenue increased largely due to corresponding decreases in product revenues (attributable in part due to an increase in discounting of product sales) during the three and nine months ended December 31, 2009.

| | December 31, | | Dollar Change | Percent Change |
|---------------------------------|--------------|----------|------------------|-------------------|
| | 2009 | 2008 | | |
| (dollar amounts in thousands) | | | | |
| Research and development | | | | |
| Three months ended | \$ 1,239 | \$ 1,183 | \$ 56 | 4.7% |
| Percentage of total revenues | 7.8% | 7.3% | | |
| Nine months ended | \$ 3,741 | \$ 3,674 | \$ 67 | 1.8% |
| Percentage of total revenues | 7.9% | 7.5% | | |

Research and development expenses consist primarily of personnel, system prototype, software 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 increase in research and development expenses for the three and nine months ended December 31, 2009 compared with the same periods in the prior fiscal year was primarily attributable to an increase in personnel costs due to an increase in employee profit sharing partially offset by a decrease in non-personnel costs.

| | December 31, | | Dollar Change | Percent Change |
|--|--------------|-----------|------------------|-------------------|
| | 2009 | 2008 | | |
| (dollar amounts in thousands) | | | | |
| Selling, general and administrative | | | | |
| Three months ended | \$ 8,251 | \$ 9,562 | \$ (1,311) | -13.7% |
| Percentage of total revenues | 51.7% | 59.0% | | |
| Nine months ended | \$ 24,980 | \$ 27,980 | \$ (3,000) | -10.7% |
| Percentage of total revenues | 52.6% | 57.2% | | |

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 sales commissions, trade show, advertising and other marketing and promotional expenses.

Selling, general and administrative expenses for the third quarter of fiscal 2010 decreased over the same quarter in the prior fiscal year primarily because of a \$0.5 million reduction in personnel costs, a \$0.5 million decrease in sales agent and retailer commissions, and a \$0.3 million decrease in advertising, public relations and other marketing and promotional expenses.

Selling, general and administrative expenses for the first nine months of fiscal 2010 decreased over the same period in the prior fiscal year primarily because of a \$1.5 million decrease in advertising, public relations and other marketing and promotional expenses, a \$1.4 million reduction in sales agent and retailer commissions, a \$0.4 million reduction in personnel costs and a \$0.2 million reduction in credit card processing fees. The comparative significance of these decreases from the same quarter of last fiscal year is minimized due to a one time reduction in the sales and use tax accrual of \$0.6 million in the first nine months of fiscal 2009, when we released a sales and use tax expense accrual after determining that we had a sufficient sales and use tax accrual for any deemed exposure.

The primary reason for the significant decline of selling, general and administrative expenses over the same period in the prior fiscal year was a shift in sales focus to primarily selling direct rather than through third parties. We believe the growth in business customers has validated the strategic shift to direct sales.

- 22 -

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| <u>Other income, net</u> | December 31, | | Dollar Change | Percent Change |
|------------------------------|-------------------------------|--------|------------------|-------------------|
| | 2009 | 2008 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 7 | \$ 74 | \$ (67) | -90.5% |
| Percentage of total revenues | 0.0% | 0.5% | | |
| Nine months ended | \$ 50 | \$ 266 | \$ (216) | -81.2% |
| Percentage of total revenues | 0.1% | 0.5% | | |

In the three and nine months ended December 31, 2009, other income, net consists of interest income earned on cash and cash equivalents. The decrease in other income, net for the three and nine months ended December 31, 2009 was primarily due to lower average interest rates.

| <u>Income (loss) on change in fair value of warrant liability</u> | December 31, | | Dollar Change | Percent Change |
|---|-------------------------------|--------|------------------|-------------------|
| | 2009 | 2008 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ (265) | \$ 66 | \$ (331) | -501.5% |
| Percentage of total revenues | -1.7% | 0.4% | | |
| Nine months ended | \$ (362) | \$ 325 | \$ (687) | -211.4% |
| Percentage of total revenues | -0.8% | 0.7% | | |

In connection with the sale of shares of our common stock in fiscal 2006, we issued warrants. The warrants included a provision that we must deliver freely tradable shares upon exercise of the warrant. Because there are circumstances that may not be within our control that could prevent delivery of registered shares, ASC 480 requires the warrants to be recorded as a liability at fair value with subsequent changes in fair value recorded as a gain or loss. The fair value of the warrants 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. To the extent the fair value of the warrant liability increases or decreases, we record a loss or income in our statement of operations. The loss on change in fair value of the warrant liability in the three and nine months ended December 31, 2009 is primarily due to the change in the current expected stock price, volatility, interest rates and contractual life of the warrants which are the primary assumptions applied to the Black-Scholes model which we have used to calculate the fair value of the warrants.

| <u>Provision for income tax</u> | December 31, | | Dollar Change | Percent Change |
|---------------------------------|-------------------------------|--------|------------------|-------------------|
| | 2009 | 2008 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 3 | \$ 38 | \$ (35) | -92.1% |
| Percentage of total revenues | 0.0% | 0.2% | | |
| Nine months ended | \$ 10 | \$ 113 | \$ (103) | -91.2% |
| Percentage of total revenues | 0.0% | 0.2% | | |

The decreases in the income tax provision for the three and nine months ended December 31, 2009 were primarily due 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) compared with a 10% foreign withholding tax on royalty revenue related to one of our technology licensee customers in the three and nine months ended December 31, 2008.

Liquidity and Capital Resources

As of December 31, 2009, we had approximately \$17.1 million in cash and cash equivalents.

Net cash provided by operating activities for the nine months ended December 31, 2009 was \$1.5 million, compared with \$2.1 million for the nine months ended December 31, 2008. The decrease in cash flow was primarily due to a decline in residential customers and discounting of equipment sold to business service customers offset partially by

the increase in business service customers during the first nine months of fiscal 2010. Cash used in or 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, and the expense associated with stock-based awards.

Net cash used in investing activities was \$0.8 million during the nine months ended December 31, 2009, compared with \$2.7 million provided by investing activities for the nine months ended December 31, 2008. The decrease in cash flow from investing activities during the nine months ended December 31, 2009 is primarily related to the investment of operating cash balances.

Our financing activities for the nine months ended December 31, 2009 provided cash of \$0.3 million from the issuance of common stock under our stock option and employee stock purchase plans which was offset by \$0.2 million used to repurchase shares of common stock under our Repurchase Plan. Our financing activities for the nine months ended December 31, 2008 provided cash of \$0.2 million from the issuance of common stock under the employee stock purchase plan.

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, 2009 totaled \$212,000 with accumulated amortization of \$121,000.

On May 1, 2009, we entered into a three-year lease for a new primary facility in Sunnyvale, California that expires in fiscal 2013. We also have a leased facility in France. 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 our 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-days notice to terminate. At December 31, 2009, the total remaining obligation under the amended contract was \$2.2 million.

At December 31, 2009, we had open purchase orders of approximately \$2.9 million, primarily related to inventory purchases from our contract manufacturers. These purchase commitments are reflected as liabilities in our consolidated financial statements once goods or services have been received or at such time when we are obligated to make payments related to these goods or services.

At December 31, 2009, we had a \$382,000 liability related to warrants issued to two investors in an equity financing transaction in fiscal 2006. The warrants expire in December 2010. We account for these warrants as liabilities because of the possibility, however likely or unlikely, that we would be unable to deliver registered shares upon a future exercise of these warrants. The required accounting for a warrant with an assumed "net cash settlement" provision under ASC 480 is to estimate the fair value on the date of issuance and to record a liability equal to that value with subsequent changes in the fair value recorded as income or expense at the end of each reporting period. The amount we record as a liability under ASC 480 is not, nor do we intend for it to be, an admission or stipulation of the amount that we would owe or be obligated to pay the warrant holder in the event that we are unable to deliver registered shares to the warrant holder. In fact, we have made no determination of the amount of liability, if any, that we would owe to the warrant holder in the event of such a breach.

Based upon our current expectations, we believe that our current cash and cash equivalents and short-term investments, together with cash expected to be generated from future operations, will be sufficient to satisfy our expected working capital and capital expenditure requirements for at least the next 12 months. Nevertheless, our future capital requirements will depend on many factors, including the amount of revenue we generate, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new services or products, the costs to ensure access to our telecommunications services, and the continuing market acceptance of our services and products. However, if we do not meet our plan, we could be

required, or might elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all. We also might decide to raise additional capital at such times and upon such terms as management considers favorable and in our interests.

- 24 -

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 revenue 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 a foreign subsidiary in France and are exposed to market risk from changes in exchange rates. 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 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 federal agency securities and corporate bonds.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Effectiveness of Disclosure Controls and Procedures

We maintain disclosure controls and procedures ("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, 2009.

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 2010, 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

The discussion of legal matters in Part I, Item 1, Financial Statements - Notes to Condensed Consolidated Financial Statements - "Note 8" is hereby incorporated by reference in response to this Part II, Item 1.

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, 2009, which we filed with the Securities and Exchange Commission on May 26, 2009. The following discussion is of material changes to risk factors disclosed in that report.

We have a history of losses and are uncertain as to our future profitability.

We recorded operating income of \$3.1 million for the nine months ended December 31, 2009 and ended the period with an accumulated deficit of \$200 million. We recorded an operating loss of \$3.1 million for the year ended March 31, 2009 and ended the period with an accumulated deficit of \$203 million. In addition, we recorded operating losses of \$3.7 million and \$14.3 million for the fiscal years ended March 31, 2008 and 2007, respectively. We may incur operating losses in the foreseeable future, and such losses may be substantial. We may need to increase revenue in order to generate sustainable and increasing operating profit. Given our history of fluctuating revenue and operating losses, we cannot be certain that we will be able to achieve profitability consistently or to increase our profitability on either a quarterly or annual basis in the future.

We may not be able to maintain our listing on the NASDAQ Capital Market.

Our common stock trades on the NASDAQ Capital Market, which has certain compliance requirements for continued listing of common stock. We have in the past been subject to delisting procedures due to a drop in the price of our common stock. If our minimum closing bid price per share falls below \$1.00 for a period of 30 consecutive trading days in the future, we may again be subject to delisting procedures. As of the close of business on February 3, 2010, our common stock had a closing bid price of approximately \$1.27 per share. We must also meet additional continued listing requirements contained in NASDAQ Marketplace Rule 5550(b), which requires that we have either (1) a minimum of \$2,500,000 in stockholders' equity, (2) \$35,000,000 market value of listed securities held by non-affiliates or (3) \$500,000 of net income from continuing operations for the most recently completed fiscal year (or two of the three most recently completed fiscal years). As of February 3, 2010, based on our closing price as of that day, the market value of our securities held by non-affiliates approximated \$78,975,000 and we were in compliance with NASDAQ Marketplace Rule 5550(b). There can be no assurance that we will continue to meet the continued listing requirements.

Delisting could reduce the ability of our shareholders to purchase or sell shares as quickly and as inexpensively as they have done historically. For instance, failure to obtain listing on another market or exchange may make it more difficult for traders to sell our securities. Broker-dealers may be less willing or able to sell or make a market in our common stock. Not maintaining our NASDAQ Capital Market listing may (among other effects):

- result in a decrease in the trading price of our common stock;
- lessen interest by institutions and individuals in investing in our common stock;
- make it more difficult to obtain analyst coverage; and

- make it more difficult for us to raise capital in the future.

Increased taxes on our service will increase our customers' cost of using our service and/or reduce our profit margins (to the extent the costs are not passed through to our customers) and we may be subject to liabilities for past sales and additional taxes, surcharges and fees.

Until 2007, we did not collect or remit state or municipal taxes, such as sales, excise, and ad valorem taxes, fees or surcharges on the charges to our customers for our services, except that we have historically complied with the collection of California sales tax and financial contributions to the 9-1-1 system and Universal Service Fund. We have received inquiries or demands from a number of state and municipal taxing agencies seeking payment of taxes, fees or

surcharges that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these taxes, fees or surcharges do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes as part of streamlined sales tax initiatives and we are now collecting and remitting sales taxes in those states. The collection of these taxes, fees or surcharges will have the effect of decreasing any price advantage we may have over other providers who have historically paid these taxes and fees. Our compliance with these tax initiatives will also make us less competitive with those competitors who choose not to comply with these tax initiatives. Three states and one city currently are conducting sales tax audits of our records. In October 2009, we received notices of proposed assessment as a result of two of the sales tax audits amounting to approximately \$1.9 million, which we consider to be unsubstantiated and have accrued a tax liability of \$0.2 million as of December 31, 2009 to account for our estimated liability for past sales tax obligations related to these proposed assessments. If our ultimate liability exceeds that amount, it could result in significant charges to our earnings.

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. These activities may be permitted in the U.S. after recent regulatory changes, including recent decisions by the U.S. Supreme Court and the Federal Communications Commission. While interference with access to our products and services seems unlikely, such carrier interference has occurred 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.

We may need to increase the ultimate retail price for our services or reduce our profit margins due to federal regulatory changes.

AT&T recently filed a petition with the Federal Communications Commission seeking reform of the federal universal service fund that is applicable to us. The way we calculate our contribution may change if the AT&T proposal is adopted. While we cannot predict the outcome of this proceeding, nor can we determine the impact on our business at this time, should the Commission adopt a new federal universal service fund contribution mechanism that increases our contribution obligation, we will either need to raise the amount we currently collect from our customers to cover this obligation or reduce our profit margins. Our services may become less competitive with other providers should we raise the price customers ultimately pay for the services we offer.

We may need to increase the ultimate retail price for our services or reduce our profit margins due to state regulatory changes

Certain states continue to attempt to apply state universal service fund obligations on our service though we do not believe that the current state of the law requires us to make such contributions. Recently, two states, Kansas and Nebraska, filed a petition with the Federal Communications Commission seeking the authority to impose state universal service fund contribution obligations on our service and also sought retroactive application of such authority. We cannot predict the outcome of this proceeding, nor can we determine the impact on our business at this time. Should the Commission allow states to impose state universal service fund obligations on our nomadic interconnected VoIP service, we would pass any increased cost of state universal service fund contributions through to our customers. Our services may become less competitive with other providers should we raise the price customers

ultimately pay for the services we offer. The potential impact of allowing states to retroactively impose state universal service fund obligations is too ambiguous at this time for us to determine the impact on our business.

- 27 -

We may be subject to new rules or legislation that could either increase the retail price of our service or reduce our net profit margins due to the FCC's National Broadband Plan

In mid-March 2010, the FCC will present its national broadband plan to the U.S. Congress. It is unclear what specific proposals the FCC will make but there is a chance the FCC will attempt to revise rules or request new legislation pertaining to intercarrier compensation, universal service funding obligations and open Internet access obligations. We could be negatively impacted by any changes that cause our underlying service providers to incur greater cost either through a new rate structure, a new contribution metric, or paired down protections related to open Internet access. Of course, any litigation that may result from the new rules could also increase our costs. We cannot predict how the FCC's national broadband plan will impact us at this time.

ITEM 6. EXHIBITS

| Exhibit 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: February 5, 2010

8X8, INC.

(Registrant)

By: /s/ DANIEL WEIRICH

Daniel Weirich

Chief Financial Officer

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

- 30 -
