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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**FORM 10-K**

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(MARK ONE)

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

**For the fiscal year ended March 31, 2003**

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**

**77-0142404**

(State or Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification Number)

**2445 Mission College Blvd.**

**Santa Clara, CA 95054**

(Address of Principal Executive Offices including Zip Code)

**(408) 727-1885**

(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: COMMON STOCK, PAR  
VALUE \$.001 PER SHARE

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 121(b)2 of the Securities Exchange Act of 1934). YES [ ☐ ] NO [ ☒ ]

Based on the closing sale price of the Registrant's common stock on the NASDAQ SmallCap Market System on September 30, 2002, the aggregate market value of the voting stock held by non-affiliates of the Registrant was \$9,083,000.

The number of shares of the Registrant's common stock outstanding as of May 22, 2003 was 28,475,370.

#### DOCUMENTS INCORPORATED BY REFERENCE

Items 10, 11, 12, and 13 of Part III incorporate information by reference from the Proxy Statement for the Annual Meeting of Stockholders to be held on August 12, 2003.

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8X8, INC.

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FOR YEAR ENDED MARCH 31, 2003**

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## **PART I**

### **ITEM 1. BUSINESS**

#### **Forward-Looking Statements and Risk Factors**

Statements contained in this Report on Form 10-K regarding our expectations, beliefs, estimates, intentions or strategies are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act and include statements regarding our research and development plans for our various product groups; our expectation concerning the adequacy of our facilities; our estimates of litigation exposure and our beliefs about the sufficiency of our manufacturing arrangements. All forward-looking statements included in this Report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including a shifting of internal research and development focus based on changes in the market or adequacy of funding; a failure of customers to adopt voice and video over internet protocol technology or advances in competing systems and services; our business may grow in an unanticipated manner causing us to require different types of facilities; ordinary course litigation may cause a greater than anticipated impact due to factual matters or issues beyond our control; and our ability to source our products may be interrupted if our manufacturers cease operations or no longer desire to do business with us. Please also see the section entitled "Factors That May Affect Future Results" for additional risks that may impact our business.

#### **Overview**

8x8, Inc., or 8x8, and its subsidiaries (collectively, the Company) develop and market telecommunication technology for internet protocol, or IP, telephony and video applications. The Company was founded as Integrated Information Technology, Inc. in 1987 and completed its initial public offering on July 2, 1997 under the name 8x8, Inc. In August 2000, the Company changed its name to Netergy Networks, Inc., but subsequently changed it back to 8x8, Inc. in July 2001. The Company's principal offices are located at 2445 Mission College Boulevard, Santa Clara, California 95054, and its telephone number at that location is (408) 727-1885.

The Company has three product lines: voice and video communications services that are marketed under the Packet8 brand name (collectively Packet8), voice and video semiconductors and related software, and software that implements the functionality of a private branch exchange, or PBX, over data networks. The Company has two primary subsidiaries, Netergy Microelectronics, Inc., or Netergy, and Centile, Inc., or Centile, that comprise two of its three product lines.

Within the parent company, 8x8 offers the Packet8 service that enables broadband internet users to add digital telephone service to their high-speed internet connection. In addition, 8x8 offers videophones for use on both traditional telephone networks and in conjunction with the Packet8 service.

Netergy, formed in December 2000, provides voice and video semiconductors and related communication software to original equipment manufacturers, or OEMs, of telephones, terminal adapters, and other endpoint communication devices and to other semiconductor companies. Netergy's technologies are used to make IP telephones and media hubs and to voice-enable cable and digital subscriber line, or DSL, modems, wireless devices, and other broadband technologies.

Centile, formed in March 2001, develops and markets hosted iPBX solutions that allow service providers to offer, to small and medium-sized businesses over broadband networks, the features and functions found in a typical business phone system. A hosted iPBX solution is a software application that implements the functionality of a business phone system over the same data connection that a business uses for connection to the internet. The phone system software runs on servers that are located at a central data center so that the only phone system equipment that is

required at the customer site are telephones.

### **Available Information**

The Company's website address is <http://www.8x8.com>. The contents of this website are not incorporated in or otherwise to be regarded as part of this annual report on Form 10-K. The Company files reports with the Securities and Exchange Commission (SEC), which are available on 8x8's website free of charge. These reports include annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports, each of which is provided on 8x8's website as soon as reasonably practicable after the Company electronically files such materials with or furnishes them to the SEC. You can also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You can obtain additional information about the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a website (<http://www.sec.gov>) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including the Company.

### **INDUSTRY BACKGROUND**

Traditional telecommunication networks use a fixed electrical path that travels through a series of switches across the network. These networks were designed solely to carry low-fidelity audio signals with a high level of reliability. Although these networks are indeed reliable for their initially intended use, these networks are not well suited to service the explosive growth of digital communications applications.

Traditional networks transmit data at very low rates and resolutions, making them poorly suited for delivering high-fidelity audio, entertainment-quality video or other rich multimedia content. Traditional networks are also expensive to build because each subscriber's telephone must be individually connected to the central office switch, which is usually several miles away from a typical subscriber's location. The digital component of the traditional telecommunications infrastructure is also less efficient than modern networks because it allots fixed bandwidth throughout the duration of each call, whether or not voice is actually being transmitted. Further, it is difficult for telecommunication service providers to provide new or differentiated services or functions, like video communications, that the network was not designed to accommodate.

In contrast to the traditional telecommunications infrastructure or public switched telephone network, or PSTN, data networks -- such as the internet or a corporate LAN -- utilize a "packet-switched" system in which information between two communicating terminals (for example, a PC downloading a page from a web server) is transmitted in the form of small data packets that travel through a series of switches, routers, and hubs across the network. Packet-switched networks have been built mainly for carrying non real-time data. The advantages of such networks are their efficiency, flexibility, and scalability. Bandwidth is only consumed when needed. Networks can be built in a variety of configurations to suit the number of users, client/server application requirements and desired availability of bandwidth. Furthermore, many terminals can share the same connection to the network. The exponential growth of the internet in recent years has proven the scalability of these underlying packet networks. The most common protocol used for communicating on these packet networks is internet protocol, or IP.

As broadband connectivity has become more available and less expensive, it is now possible for service providers to offer voice and video services that run over these IP networks to businesses and consumers. Providing such services has the potential to both substantially lower the cost of telephone and equipment costs to these customers and to increase the breadth of features available to the end-user. Services like full-motion, two-way video are now supported by the bandwidth spectrum commonly available to broadband customers, whether business or residential. To enable such new products, service and equipment suppliers need semiconductor products and software to connect packet-based communication devices to the networks and the software that runs on the network that enables these communication devices to be easily installed, operated, and managed, as well as to replace commonly used functionality of the legacy switched network, such as billing and customer assistance.

### **PACKET8 AND CONSUMER SYSTEMS**

#### **Technology**

8x8 has deployed an end-to-end voice and video communication service called Packet8. Packet8 is an internet-based communication solution that works on virtually any ethernet network in the world, and allows calls to or from

any phone in the world, whether that phone is an IP phone or a regular PSTN phone on the PSTN network. 8x8 utilizes IP communication endpoints which, when used in conjunction with the Packet8 network software, enable plug and play installation and a regular dialtone user interface. The Packet8 service also uses web-based technologies to enable account setup, account management, billing and customer support. The Company has developed all of the underlying technologies of the Packet8 service, except for the trunking PSTN gateways (that are used to terminate IP calls on the PSTN network). Packet8 works with industry-standard PSTN gateways to terminate these calls.

**CONSUMER SYSTEMS** -- 8x8 is currently reselling private-branded telephone IP terminal adapters, which allow a regular analog telephone to be connected to an IP network, and analog and IP videophones, all of which are manufactured by several of Netergy's OEM semiconductor customers. These devices incorporate certain unique software modifications to the protocol and application code that enable them to take advantage of 8x8's Packet8 IP services platform. The original designs of these devices are based on some of Netergy's semiconductor reference designs.

## **Products**

**PACKET8 IP TELEPHONE SERVICE** -- 8x8's Packet8 telephone service was introduced in November 2002. Customers enter into a service agreement with 8x8, and select a service plan based on their anticipated use of the service. Service plans provide various minutes of usage, up to unlimited, for calls in North America and Canada that are made to non-Packet8 customers. Subscribers are charged at a per-minute rate for international calls, and, depending on the level of plan selected, may be charged for calls to the PSTN if they exceed the minutes allowed under their plan. Depending on the service plan selected, 8x8 will either sell or provide at no cost to the user an 8x8 Desktop Terminal Adapter model DTA310 or Desktop Videophone model DV325 to use with the Packet8 service. Each subscriber is assigned a telephone number in any of the more than 1,500 United States ratecenters currently offered by the service. All Packet8 customers receive access to a variety of telephone features, including voice mail, caller ID, call forwarding, online account management and billing (including real-time access to current bills), virtual phone lines, international call blocking and caller ID blocking.

**DTA310 DESKTOP TERMINAL ADAPTER** -- 8x8's DTA310 product is a telephone handset-to-Ethernet adapter that interfaces regular analog phones with IP-based telephony networks. The DTA-310 is installed at the subscriber's premises and supports a single voice port with its own direct dial phone number. This adapter runs a variety of communication and network protocols, including Session Initiation Protocol, or SIP.

**DV325 DESKTOP SIP IP VIDEOPHONE** -- 8x8's DV325 product is an IP videophone that contains all of the voice features of a regular Packet8 account. In addition, when a Packet8 subscriber with a DV325 calls another Packet8 subscriber with a DV325, the videophones connect with instant-on high-speed video sent over the Internet. The videophones can be configured by the user to use a maximum total data bandwidth between 84 kilobits per second and 640 kilobits per second. The video quality of the call varies with the data bandwidth selected and other network conditions. The DV325 videophone is designed to be compatible with other SIP protocol devices. 8x8 began trials of the product in April 2003.

**DV324 DESKTOP VIDEOPHONE** -- 8x8's DV324 product is a videophone with an integrated display and camera that is compatible with the H.324 standard, and therefore works over standard analog phone lines. The videophone can also be used to make a normal audio PSTN call. Controls on the videophone and the on-screen menu system enable the user to adjust the quality of the video that is sent and received, electronically pan/tilt/zoom the near-end and far-end cameras, take a high-resolution snapshot image, and turn on privacy mode to block outgoing video. The phone supports two sets of audio/video inputs (for connecting external cameras, camcorders or digital cameras) and one audio/video output port (for connecting an external TV or other display device) and supports caller-ID, auto-answer (so the phone can be used as a monitoring device), and 10 configurable speed-dial numbers.

## **Customers**

8x8 sells and markets the Packet8 service to end users through its web site and third party resellers of the service. In addition, 8x8 is marketing the Packet8 service offering to service providers and cable television and digital subscriber line, or DSL, providers. Packet8 is offered to these third parties through reseller agreements, hosted and prepaid service agreements or OEM technology license agreements. The DV324 Desktop Videophone is sold direct

to end-users from 8x8's website, as well as through distributors and value-added resellers.

## **Sales and Marketing**

8x8 markets the Packet8 IP services via its own direct sales force and through third-party resellers. 8x8 markets its consumer systems through its direct sales force and third-party resellers. Sales of the products to end-users are also conducted from 8x8's website.

## **Competition**

Competitors for the Packet8 service include Vonage, Net2Phone and iConnectHere and Voice Pulse, as well as incumbent telephone carriers, and other providers of traditional and legacy telephone service. 8x8's consumer systems products compete with other providers of videophones and videoconferencing systems, including Vialta, Inc., Innomedia, MotionMedia, and various software offerings that implement videophone functionality on a personal computer. Principal competitive factors in the market for 8x8's products include product feature parity, interface design, product reliability, performance, time-to-market, adherence to standards, price, functionality, customer service and IP network delivery/design.

## **SEMICONDUCTORS AND EMBEDDED SOFTWARE**

Netergy develops and markets a range of technology products, including semiconductors, embedded software, system software, and reference designs, that allow telecommunication equipment OEMs to: i) build voice and video IP phones, ii) build IP-to-analog phone adapter products, and iii) add IP telephony functions to DSL, cable, and wireless modems. Additionally, Netergy provides semiconductors and embedded software for use in videoconferencing applications.

## **Technology**

**SEMICONDUCTOR ARCHITECTURE** -- Netergy's semiconductors are based on programmable processor architectures that enable implementation of IP telephony and videoconferencing applications in a highly efficient manner. Netergy's semiconductor architectures employ 32-bit reduced instruction set computing, or RISC, microprocessor cores, which execute the embedded applications software. Some of Netergy's semiconductors also employ a 64-bit Single Instruction Multiple Data, or SIMD, digital signal processor, or DSP, to accelerate the execution of signal processing intensive operations. Furthermore, Netergy's Audacity-T2 and T2U semiconductors benefit from the unique feature of not requiring any external SRAM or DRAM to operate.

**EMBEDDED SOFTWARE** -- Netergy has developed a broad range of embedded application software that runs on its semiconductor products. Netergy's application software allows the use of its semiconductors in systems that conform to various emerging and established international telephony standards for audio and video encoders and decoders (also known as codecs) and call signaling protocols. By refining its software, Netergy can enhance quality, address new standards, and add significant features and functionality to systems that contain the semiconductor products. In addition, certain customers have licensed source code to which they add proprietary features and custom interfaces and, in some cases, port to other semiconductor or processor architectures.

Call signaling protocol stacks are complex software programs required to make voice calls over IP networks, including the internet. Codecs format and compress digital audio and video signals so they can be represented and efficiently transmitted in a digital form. Developing functional VoIP and video software and obtaining interoperability with other VoIP and video systems requires significant development time, which is why many OEMs choose to license it. Netergy's protocol stacks support the four most commonly deployed VoIP protocols, along with seven codecs.

Netergy is also developing new video compression algorithm technology based on the H.264 (formerly called H.26L) standard. The H.264 standard is a new set of algorithms being jointly specified by standards bodies in the International Teleconferencing Union, or ITU, and the Moving Pictures Expert Group, or MPEG, with the goal of improving video compression ratios by a factor of two versus any current video algorithm specification at any bit rate. For a given bit rate, implementations of the new H.264 video codec are expected to improve the picture quality of video streaming, telephony, and entertainment applications beyond the quality of pictures that are available today from either the MPEG-2 or MPEG-4 algorithms.

**SYSTEM DESIGN** -- Netergy has developed expertise in integrating its semiconductors and software with peripheral components to produce complete IP telephony and multimedia communication systems. Netergy's system technology consists of modular subsystems that can be combined and rearranged to interface to various networks (such as analog telephone, ISDN, Ethernet LAN, wireless, and home networks) and to various telephony devices, such as the analog phones in a home or facsimile machines in an office environment.

## **Products**

**AUDACITY-T2 IP TELEPHONY PROCESSOR** -- The Audacity-T2 semiconductor performs the digital processing functions required to build an IP phone, including formatting digital audio data for transmission over packet networks (such as Ethernet, the internet, DSL links and digital cable systems). The chip can also be used in two-port analog telephone terminal adapters or gateway applications.

**AUDACITY-T2U IP TELEPHONY PROCESSOR** -- The Audacity-T2U semiconductor has all of the functionality of the Audacity-T2 processor but runs at faster processing speeds, has more on-chip memory, and contains an extra interface for connecting the chip to interfaces commonly found on DSL modem chipsets. The additional on-chip memory and higher processing speed enable the Audacity-T2U to address more advanced products, such as higher-end IP phones and four-port terminal adapters or gateways.

**VERACITY SOFTWARE** -- The Veracity software suite is a comprehensive package of VoIP call control protocols, standard network protocols, and audio processing functions. Veracity software stacks can run on either the Audacity family of semiconductors or on third-party VoIP processors. These stacks are designed for cost competitive, high quality applications, including VoIP/VoDSL gateways, Ethernet PBXs, and IP phones.

**REFERENCE DESIGN KITS** -- Netergy currently supplies the following reference design kits for its semiconductor products:

- The Media Hub MHx reference design is a one- to four-line VoIP gateway based on the Audacity-T2U processor. The MHx supports up to four analog telephone interfaces and one to two 10/100 Mbps Ethernet ports;
- The Media Hub MHw reference design is a stand-alone design for wireless media hub and small office/home office gateway applications based on the 802.11b wireless ethernet standard;
- The IPPU phone reference design includes plastics, keypad, display, and handset and is based on the Audacity-T2U processor; and
- The IPPW reference design is a T2U based stand-alone platform for a wireless IP phone based on the 802.11b wireless ethernet standard.

Netergy's reference design kits are intended to serve as prototype system products and allow a customer to leverage Netergy's system design expertise to accelerate the time to market for new products. Each reference design package includes schematics, bills of materials, documentation, embedded software, and a software development environment that enables a customer to add new features and otherwise customize the software.

## **Customers**

Netergy sells its IP telephony semiconductors, embedded software, and reference designs to OEMs of VoIP and VoDSL products, such as Kinpo, Ericsson and Telsey. In addition, Netergy signed a license and development agreement with a large OEM of video communications devices in 2002 for its new video firmware and semiconductor, which is designed for use in videoconferencing and video telephony applications. Netergy has also separately licensed a VoIP semiconductor core and embedded VoIP software to STMicroelectronics, or STM.

## **Sales and Marketing**

Netergy markets its semiconductor, embedded software, and reference design products through its own direct sales force and third-party sales representatives. Netergy supports its domestic and international direct sales efforts from its headquarters in Santa Clara, California. Netergy's sales and marketing personnel typically provide support to



OEM customers through its application engineering team and periodic training sessions. Netergy sells its products to customers on an order-to-order basis and has long-term agreements with only a limited number of customers. As such, order backlog at any given time is generally not significant and may not be a reliable indicator of future revenues.

## **Competition**

Netergy competes with both manufacturers of digital signal processing semiconductors and software products developed for the OEM VoIP marketplace. Netergy also competes with manufacturers of videoconferencing semiconductors and related firmware. Intense competition, declining average selling prices, and rapid technological changes characterize the markets for Netergy's products. The principal competitive factors in the market for IP telephony and videoconferencing semiconductors and embedded software include product definition, product design, system integration, chip size, code size, functionality, time-to-market, adherence to industry standards, price, and reliability. Netergy has a number of competitors in this market including: Agere Systems, Analog Devices, Atmel, Broadcom, DSP Group, Motorola, Radvision, Texas Instruments/Telogy Networks, TriMedia Technologies, Winbond, and Zarlink Semiconductor.

## ***HOSTED IPBX SOLUTIONS***

Centile has developed and markets a hosted iPBX, which is a software-driven telephony solution that allows network service providers and PBX resellers to offer PBX functionality as a business communication service over broadband IP networks.

## **Technology**

Typically, today's businesses require an individual phone for each office worker. The phones provide various functions, such as voicemail, transfer and hold capability, and other services. Until recently, there were two ways that businesses could obtain this type of phone service: i) subscribe to Centrex services from their local telephone company, or ii) buy a dedicated piece of hardware that operates as a business PBX system.

With the availability of broadband IP connectivity to businesses, however, a third alternative has emerged: hosted iPBX services. In this model, the service provider delivers PBX functionality over an IP connection, which reduces the scaling problems by allowing many extensions to share a single connection. This solution also offers many of the advantages of an enterprise-owned PBX and further enables integration with enterprise data processing systems and support of call centers, while eliminating the capital and maintenance investments required for dedicated on-site hardware that provides the PBX functionality.

## **Products**

**TELEPHONY CALL MANAGEMENT SOFTWARE** -- Centile's telephony call management uses an IP network for its switching fabric and media connections, and provides the call routing, setup, and teardown necessary to establish a connection between two terminals on an IP network. It also provides a variety of more complex PBX features such as call transfers, web-based control, voice message retrieval, and conferencing.

**IPBX SERVER SOFTWARE** -- The Centile iPBX server software runs on a cluster of five Sun Microsystems carrier grade server platforms and provides software PBX functionality over IP networks. The iPBX software was designed specifically to allow service providers to deliver hosted iPBX services to small and medium-sized business customers. The Centile iPBX allows service providers to support up to eighty discrete iPBXs per cluster, each dedicated to an individual customer, and up to five thousand total extensions.

Service providers control and configure the iPBX server software via a Web interface, allowing the system administrator to manage the iPBX from any location using any workstation with a browser. The administrator interface is designed to provide control of phone number block assignments, dial plans, service provisioning, direct dial phone number assignments, iPBX status, and bandwidth management. The iPBX supports voicemail, interactive voice response, automatic call distribution, auto attendants, directory service, unified messaging modules, and operation, service, and support integration.

**MULTIPBX** -- Introduced in 2002, the MultiPBX combines the iPBX server software with a complete package of

VoIP and data equipment that enables a building owner to offer converged voice and data services through a multi-tenant building. The product can support thousands of user extensions in its standard configuration and can be located anywhere within the building. Regular PSTN phones can be used with the MultiPBX and all regular PSTN functions are supported with these phones (e.g., message waiting indicator, caller ID, etc.). IP phones can also be used to enable the more advanced features of the system at the user's desktop. The MultiPBX is able to place and receive local and long distance calls via a PSTN gateway integrated with the product. Interoffice and telecommuter calls can be carried directly via a Virtual Private Network, or VPN, or directly across the internet, thus offsetting communication costs for distant offices and remote facilities.

**MH4 & MH16 MEDIA HUBS** -- Terminal adapters and media hubs are customer premise equipment that adapt conventional telephony equipment, such as analog telephones and fax machines, for IP service. Centile's MH4 and MH16 media hub products support four and sixteen analog lines, or ports, respectively. Centile currently uses its MH4 and MH16 products, along with certain IP phones and terminal adapters developed by third parties, in its hosted iPBX and MultiPBX business communication service deployments.

**IPBX USER INTERFACE SOFTWARE** -- Centile has three user interface applications for its hosted iPBX solution: ComCenter, Switchboard, and Administrator. All of these applications are designed to harness the graphical capabilities of personal computers and workstations to make the hosted iPBX easy to use.

The Centile ComCenter software with Call Announcer is designed for the end users of the iPBX. It provides Caller ID, call transfers, conference call setup, on-screen directories, contact management, and call logging. It also lets users set up and control their voicemail, listen to messages, set call forwarding numbers and filters, and set up personal speed dial numbers.

The Centile Switchboard software is the attendant interface for the iPBX. Switchboard runs on a personal computer or workstation to allow attendants to route incoming calls to an enterprise with a point-and-click interface. Switchboard provides caller ID for multiple incoming calls, extension status, two-click call transfers, corporate voice mailbox management, and multi-attendant support.

Centile Administrator enables customers to control their own moves, adds, and changes. The customer uses Administrator to assign extension numbers, associate user names, and create a voicemail account for each line. Administrator also allows the customer to define hunt groups, set user permissions, define phone button functions, and set voicemail parameters, all with a point-and-click interface.

## **Customers**

Centile is marketing the product to service providers and resellers in Europe, Asia and North America. Centile has signed licensing agreements with Lucent Technologies (formerly AG Communication Systems) Dialink, Song Networks AB, and Oy Datatie AB (an ELISA group company).

## **Sales and Marketing**

Centile markets the hosted iPBX software product through a direct sales force, and distributors. In addition, in 2002, Centile signed a license and distribution with AG Communication Systems, or AGCS, now Lucent Technologies (Lucent). Lucent is marketing the hosted iPBX as the SoftConnect business communication service. Lucent's SoftConnect product provides a single source for consolidated voice and data services on IP networks, enabling enterprises to consolidate multiple separate office data and telephone networks into a single unified corporate network. Under the terms of the agreement with Lucent, Centile is entitled to receive license fees and royalties for each SoftConnect customer.

Centile's sales force operates from the Company's headquarters in Santa Clara, California and from its European office in Sophia Antipolis, France.

## **Competition**

Centile currently competes with suppliers of traditional PBXs, Centrex equipment, and newer generation IP-based PBX or Centrex solutions that seek to sell such products to telecommunication service providers or to the small and medium-size enterprise marketplace. The main competition includes Avaya, UT Starcom, Mitel, Nortel Networks,

and several other providers of traditional and newer generation IP-based solutions, such as Broadsoft, Inc., Cisco Systems, Shoreline Communications, Syndeo Corporation, Sylantro, VocalData, Inc., Vocaltec Communications, and Vertical Networks.

## ***MANUFACTURING***

8x8 outsources the manufacturing of its videophones and DTA 310 terminal adapters, and Centile outsources the manufacturing of its media hubs, to third-party manufacturers, which are generally also semiconductor customers of Netergy. Neither Centile nor 8x8 have long-term purchase agreements with their contract manufacturers.

Netergy outsources the manufacturing of its semiconductors to independent foundries, and its primary semiconductor supplier is STMicroelectronics NV, or STM, which primarily uses Taiwan Semiconductor Manufacturing, or TSMC, for the production of Netergy's product. Our reliance on STM and its vendors for overseas wafer fabrication, sort, assembly and test services entails certain political and economic risks, including political instability and expropriation, currency controls and exchange fluctuations, and changes in tariff and freight rates. Furthermore, in the event overseas wafer fabrication, sort, assembly or test operations, or air transportation to or from foreign foundries or contractors, were disrupted for any reason, our operations could be severely harmed. Netergy does not have long-term purchase agreements with its contract manufacturers or its component suppliers.

## ***RESEARCH AND DEVELOPMENT***

Research and development expenses in each of the fiscal years ended March 31, 2003, 2002 and 2001 were \$7.8 million, \$12.6 million and \$20 million, respectively. The development of new products and the enhancement of existing products by the Company and its subsidiaries are essential to their success.

The Company's current and future research and development efforts relate primarily to its Packet8 service offering and the development of new endpoints for subscribers of the service, and Netergy's next generation video semiconductor and embedded software. Areas of emphasis will include: enhanced versions of 8x8's Packet8 telecommunication services offering and related endpoints, and enhanced versions of Netergy's video communication processor technology to provide support for the H.264 video compression algorithm. Future development may also focus on emerging audio and video telephony standards and protocols, quality and performance enhancements to multimedia compression algorithms, and additional features supporting all of the Company's products.

## ***INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS***

Our ability to compete depends, in part, on our ability to obtain and enforce intellectual property protection for our technology in the United States and internationally. We currently rely primarily on a combination of trade secrets, patents, copyrights, trademarks and licenses to protect our intellectual property. As of March 31, 2003, we had fifty-four United States patents and a number of United States and foreign patents pending, none of which we consider critical to our business. Our patents expire on dates ranging from 2009 to 2018. We cannot predict whether our pending patent applications will result in issued patents. Due to rapid technological change, we believe that factors such as the technological and creative skills of our personnel, new product developments and enhancements to existing products are more important than the various legal protections of our technology to establishing and maintaining technology leadership.

To protect our trade secrets and other proprietary information, we require our employees to sign agreements providing for the maintenance of confidentiality and also the assignment of rights to inventions made by them while in our employ. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competition will not independently develop technologies that are similar or superior to our technology, duplicate our technology or design around any of our patents. We are also subject to the risks of adverse claims and litigation alleging infringement of the intellectual property rights of others. The semiconductor and software industries are subject to frequent litigation regarding patent and other intellectual property rights. In addition, the laws of foreign countries in which our products are or may be sold do not protect our intellectual property rights to the same extent as do the laws of the United States. Our failure to protect our proprietary information could cause our business and operating results to suffer.

We rely upon certain technology, including hardware and software, licensed from third parties. There can be no

assurance that the technology licensed by us will continue to provide competitive features and functionality or that licenses for technology currently utilized by us or other technology which we may seek to license in the future will be available to us on commercially reasonable terms or at all. The loss of, or inability to maintain existing licenses could result in shipment delays or reductions until equivalent technology or suitable alternative products could be developed, identified, licensed and integrated, and could harm our business. These licenses are on standard commercial terms made generally available by the companies providing the licenses. The cost and terms of these licenses individually are not material to our business.

### ***LICENSING AND DEVELOPMENT ARRANGEMENTS***

The Company has entered into licensing and development arrangements with its customers to promote the design, development, manufacture, and sale of the Company's products.

In order to encourage the use of its semiconductors, Netergy has licensed portions of its systems technology and software object code for its semiconductors to virtually all of its semiconductor customers. Moreover, many of Netergy's OEM customers have licensed portions of the software source code for its semiconductors currently being sold and under development. Netergy intends to continue to license its semiconductor, software, and systems technology to other companies, many of which are current or potential competitors. Such arrangements may enable these companies to use Netergy's technology to produce products that compete with the Company's IP telephony and video products.

Netergy has also licensed the right to manufacture certain of its videoconferencing and IP telephony semiconductor products to several original equipment manufacturers, or OEMs. These licenses generally provide for the payment of royalties. Only certain of these OEM licensees, such as STM, may sell semiconductors based on the licensed technology to third parties, while other licensees are limited to sales of such semiconductors as part of multimedia communication systems or sub-systems. Item 13 of this Report provides further information regarding the Company's license and other arrangements with STM. In addition, in April 2002, Netergy licensed all of its Veracity software and the H.264 and MPEG software under development to a third party, and granted that party rights to use the technology on Netergy's semiconductors.

Centile may, in the future, license its source code for portions or all of the hosted iPBX technology to other companies. For example, the license and distribution agreement between Centile and AGCS, provides AGCS with the opportunity to purchase a source code license under certain conditions. Such arrangements may enable these companies to use the technology to produce products that compete with Centile's products.

In March 2002, 8x8 licensed certain Very Long Instruction Word, or VLIW, microprocessor cores, related tools and MPEG4 video compression firmware from STM for use in Netergy's IP video communication processor development initiatives. Additionally, the Company agreed to license STM certain of its existing and future H.263 and H.264 firmware implementations for use with STM's semiconductor products. The licenses are non-exclusive, non-transferable and non-assignable and provide for the sharing of updates and enhancements to the licensed technology, subject to certain limitations. The agreement includes provisions that allow the Company to manufacture semiconductor devices that contain the STM VLIW core at STM or at other third-party fabrication facilities. The Company is required to pay STM per-unit royalties based upon shipments of products that incorporate the VLIW technology. In addition, STM is required to pay the Company certain per-unit royalties based upon shipments of STM semiconductor products that contain the Company's H.263 and H.264 video technology.

The Company expects to continue licensing its technology to others, many of whom may be located outside of the United States. In addition to licensing its technology to others, the Company from time to time will take a license to technology owned by third parties and currently relies upon certain technology, including hardware and software, licensed from third parties.

### ***INFORMATION ABOUT SEGMENTS AND GEOGRAPHIC AREAS***

Financial information relating to our segments and information on revenues generated in different geographic areas are set forth in Note 12 to our consolidated financial statements contained in Part II, Item 8 of this Report. In addition, information regarding risks attendant to our foreign operations are set forth under the heading "Factors that May Affect Future Results" later in this Report.

## ***EMPLOYEES***

As of March 31, 2003, the Company employed 54 persons, including 4 in manufacturing operations, 25 in research and development, 8 in sales and marketing, and 17 in general and administrative capacities. None of the Company's employees are represented by a labor union or are subject to a collective bargaining arrangement. The Company believes that relations with employees are good.

## **ITEM 2. PROPERTIES**

The Company's principal operations are located in an approximately 45,000 square foot facility in Santa Clara, California that is leased through November 2004. Design, limited manufacturing, research and development, sales and marketing, and administrative activities are performed in this facility.

The Company also leases a facility for its research and development operation in Sophia-Antipolis, France. The Company believes that its existing facilities are adequate to meet its current and foreseeable future needs. For additional information regarding the Company's obligations under leases see Note 9 to the consolidated financial statements contained in Part II, Item 8.

## **ITEM 3. LEGAL PROCEEDINGS**

The Company is involved in various legal claims and litigation that have arisen in the normal course of the Company's operations. While the results of such claims and litigation cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a significantly adverse effect on the Company's financial position or results of operations. However, should the Company not prevail in any such litigation, its operating results and financial condition could be adversely impacted.

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

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2003.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED SECURITY HOLDER MATTERS

The Company completed its initial public offering on July 2, 1997 under the name 8x8, Inc. From that date through April 3, 2000, the Company's common stock was traded on the NASDAQ National Market (the NASDAQ) under the symbol "EGHT." From April 4, 2000 through July 18, 2001, the Company's common stock was traded on the NASDAQ under the symbol "NTRG." Since July 19, 2001 the Company's common stock has traded under the symbol "EGHT." The Company has never paid cash dividends on its common stock and has no plans to do so in the foreseeable future. As of May 22, 2003, there were 295 holders of record of the Company's common stock.

The following table sets forth the range of high and low closing prices for each period indicated:

Period	High	Low
Fiscal 2003:		
First quarter	\$ 1.05	\$ 0.31
Second quarter	\$ 0.60	\$ 0.29
Third quarter	\$ 0.43	\$ 0.20
Fourth quarter	\$ 0.37	\$ 0.18
Fiscal 2002:		
First quarter	\$ 2.32	\$ 0.65
Second quarter	\$ 1.48	\$ 0.60
Third quarter	\$ 1.11	\$ 0.68
Fourth quarter	\$ 1.30	\$ 0.84

### ITEM 6. SELECTED FINANCIAL DATA

	Years Ended March 31, (1)(8)				
	2003 (7)	2002 (2)	2001(6)(3)	2000(4)(6)	1999(5)
	(in thousands, except per share amounts)				
Total revenues.....	\$ 11,003	\$ 14,691	\$ 18,228	\$ 25,384	\$ 31,682
Net loss.....	\$ (11,403)	\$ (9,105)	\$ (74,399)	\$ (24,848)	\$ (19,224)
Net loss per share:					
Basic.....	\$ (0.40)	\$ (0.33)	\$ (2.99)	\$ (1.38)	\$ (1.28)
Diluted.....	\$ (0.40)	\$ (0.33)	\$ (2.99)	\$ (1.38)	\$ (1.28)
Total assets.....	\$ 6,705	\$ 19,653	\$ 39,145	\$ 59,983	\$ 28,709
Convertible subordinated debentures.....	\$ --	\$ --	\$ 6,238	\$ 5,498	\$ --
Contingently redeemable common stock.....	\$ 669	\$ 813	\$ --	\$ --	\$ --
Accumulated deficit.....	\$ (148,679)	\$ (137,276)	\$ (128,146)	\$ (53,747)	\$ (28,899)
Total stockholders' equity.....	\$ 2,164	\$ 13,234	\$ 21,632	\$ 47,390	\$ 18,823

(1) Fiscal 2001 was a 52 week and 2 day fiscal year. Fiscal year 2000 was a 53-week fiscal year, while fiscal 2003, 2002 and 1999 were 52-week fiscal years.

(2) Net loss and net loss per share include an extraordinary gain of \$779,000 resulting from the early extinguishment of our convertible subordinated debentures.

- (3) Net loss and net loss per share include a restructuring charge of \$33.3 million, an in-process research and development charge of \$4.6 million, and a \$1.1 million charge for the cumulative effect of a change in accounting principle.
- (4) Net loss and net loss per share include a \$6.4 million charge for a discount on the issuance of common stock and an in-process research and development charge of \$10.1 million.
- (5) Net loss and net loss per share include a \$5.7 million charge associated with the write off of ViaTV consumer videophone inventories.
- (6) The convertible subordinated debentures, which had a face value of \$7.5 million, are presented net of the related debt discount, which was amortized over the initial three-year term of the debentures. The debentures were redeemed in December 2001.
- (7) Net loss and net loss per share include restructuring and other charges of \$3.4 million
- (8) Beginning 8x8's fiscal year 2003, Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," was adopted, and 8x8 ceased to amortize approximately \$1.5 million of goodwill, net of amortization, including intangibles that were classified as goodwill upon adoption of SFAS No. 142. The 2000 to 2002 consolidated financial data includes amortization of goodwill and intangibles totaling \$0.7 million for 2002, \$11 million for 2001 and \$0.6 million for 2000.

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

### ***FORWARD-LOOKING STATEMENTS***

This 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, including our statements regarding anticipated cost savings arising from the restructuring activities implemented during fiscal 2003; our assumptions underlying our critical accounting determinations concerning revenue, allowances for doubtful accounts, valuation of goodwill, tax allowances and reserves for legal issues; factors that could impact our gross margins; our cost estimates under contracts accounted for using the percentage of completion method; efforts to raise additional financing; commitment of resources, and reduction in operating costs including the possible sale or cessation of certain business segments and the possible further reduction of personnel and suspension of salary increases and capital expenditures. You should not place undue reliance on these forward-looking statements. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including our good faith assumptions being incorrect, our business expenses being greater than anticipated due to competitive factors or unanticipated development or sales costs; revenues not resulting in the manner anticipated due to a continued slow down in technology spending, particularly in the telecommunications market; our failure to generate investor interest or to sell certain of our assets or business segments. The forward-looking statements may also be impacted by the additional risks faced by us as described in this Report, including those set forth under the section entitled "Factors that May Affect Future Results." All forward-looking statements included in this Report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements.

### ***OVERVIEW***

8x8, Inc., or 8x8, and its subsidiaries (collectively, the Company) develop and market telecommunication technology for IP telephony and video applications. The Company has three product lines: internet protocol telephone devices, videophones, and internet communication services; voice and video semiconductors and related software; and software that implements the functionality of a private branch exchange, or PBX, over data networks.

8x8's first product line includes consumer telephones, videophones, and communication software and services that work over broadband networks. 8x8 sells internet protocol telephony software and services that enable customers to provision and use IP dial-tone services with IP telephones and videophones. The service is marketed under the brand name Packet8. 8x8 also sells videophones that work over normal phone lines.

The Company has two primary subsidiaries, Netergy Microelectronics, Inc. (Netergy) and Centile, Inc. (Centile). Netergy provides voice and video semiconductors and related communication software to original equipment manufacturers, or OEMs, of telephones, terminal adapters, and other endpoint communication devices and to other semiconductor companies. Netergy's technologies are used to make IP telephones and to voice-enable cable and digital subscriber line, or DSL, modems, wireless devices, and other broadband technologies. Centile develops and markets hosted iPBX solutions that allow service providers to offer to small and medium-sized businesses over broadband networks the features and functions that are commonly found in a typical business phone system. A hosted iPBX solution is a software application that implements the functionality of a business phone system over the same data connection that a business uses for connection to the internet. The phone system software runs on servers that are located at a central data center so that the only phone system equipment that is required at the customer site are telephones. The phone system can also be accessed and controlled from any web browser on the internet.

### *CRITICAL ACCOUNTING POLICIES*

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States. Note 1 to the consolidated financial statements in Part II, Item 8 of this Report describes the significant accounting policies and methods used in the preparation of our consolidated financial statements.

We have identified the policies below as some of the more critical to our business and the understanding of our results of operations. These policies may involve a higher degree of judgment and complexity in their application and represent the critical accounting policies used in the preparation of our financial statements. Although we believe our judgments and estimates are appropriate and correct, actual future results may differ from our estimates. If different assumptions or conditions were to prevail, the results could be materially different from our reported results. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results.

#### **Use of estimates**

The preparation of our consolidated financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and equity and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates, particularly estimates relating to litigation and other contingencies, have a material impact on our financial statements, and are discussed in detail throughout our analysis of the results of operations.

In addition to evaluating estimates relating to the items discussed above, we also consider other estimates, including, but not limited to, those related to bad debts, the valuation of inventories, goodwill, income taxes, and financing operations. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets, liabilities and equity that are not readily apparent from other sources. Actual results could differ from those estimates under different assumptions or conditions. Additional information regarding risk factors that may impact our estimates is included below under "Factors that May Affect Future Results."

#### **Revenue recognition**

Our revenue recognition policies are described in Note 1 to the consolidated financial statements in Part II, Item 8 of this Report. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

At the time of each revenue transaction we assess whether the revenue amount is fixed and determinable and whether or not collection is reasonably assured. We assess whether the fee is fixed and determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are thirty to ninety days from invoice date, we account for the fee as not being fixed and determinable. In these cases, we recognize revenue as the fees become due. We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We generally do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the



fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of payment.

For arrangements with multiple obligations (for example, undelivered maintenance and support), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to the Company. This means that we defer revenue from the arranged fee that is equivalent to the fair value of the undelivered elements. Fair values for the ongoing maintenance and support obligations for our technology licenses are based upon separate sales of renewals to other customers or upon renewal rates quoted in the contracts. We base the fair value of services, such as training or consulting, on separate sales of these services to other customers. We recognize revenue for maintenance services ratably over the contract term. Our training and consulting services are billed based on hourly rates and we generally recognize revenue as these services are performed.

For sales generated from long-term contracts, we use the percentage of completion method of accounting. In doing so, management makes important judgments in costs and in measuring progress towards completion. These judgments underlie our determinations regarding overall contract value, contract profitability and timing of revenue recognition. Revenue and cost estimates are revised quarterly based on changes in circumstances, and any losses on contracts are recognized immediately.

If an arrangement includes acceptance criteria, revenue is not recognized until we can objectively demonstrate that the software or service can meet the acceptance criteria or when the customer has signed formal acceptance documentation. If a software license arrangement obligates us to deliver unspecified future products, revenue is recognized on a subscription basis, ratably over the term of the contract.

For all sales, except those completed via the internet, we use either a binding purchase order or other signed agreement as evidence of an arrangement. For sales over the internet, we use a credit card authorization as evidence of an arrangement.

Our ability to enter into revenue generating transactions and recognize revenue in the future is subject to a number of business and economic risks discussed below under "Factors that May Affect Future Results."

### **Collectibility of accounts receivable**

We must make estimates of the collectibility of our accounts receivable. Management specifically analyzes accounts receivable, including historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. The accounts receivable balance was \$1.4 million, net of an allowance for doubtful accounts of \$141,000 as of March 31, 2003, and one customer represented 30% of our gross accounts receivable. Based upon this customer's past payment history, discussions with the customer and our review of their financial condition, the outstanding balance was considered collectible and therefore no portion of this balance was specifically reserved for at March 31, 2003.

### **Valuation of inventories**

We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual future demand or market conditions are less favorable than those projected by us, additional inventory write-downs may be required.

### **Valuation of goodwill**

We assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include the following:

- significant underperformance relative to projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- our market capitalization relative to net book value.

Goodwill is included in our Centile reporting unit, which is the same as our Centile operating segment. During our impairment assessment, we compare the carrying value of our Centile reporting unit to its fair value. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the fair value of the goodwill within the reporting unit is less than the carrying value. The fair value for goodwill is determined based on discounted cash flows, market multiples or appraised values, as appropriate.

In the fourth quarter of fiscal 2003, the Company recorded an impairment charge of \$1.5 million to write-off its remaining goodwill. The impairment assessment resulted from our plan implemented in the fourth quarter of fiscal 2003 to reduce the workforce of Centile's France office by seventy percent.

### **Income taxes**

As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. In the event that we determine that we would be able to realize deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

Significant management judgment is required in determining the valuation allowance recorded against our net deferred tax assets, which primarily consist of net operating loss and tax credit carryforwards. We have recorded a valuation allowance of \$51 million as of March 31, 2003, due to uncertainties related to our ability to utilize most of our deferred tax assets before they expire. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable.

### **Litigation**

Management's current estimated range of liability related to pending litigation involving the Company is based on claims for which our management can estimate the amount and range of loss. We have recorded the minimum estimated liability related to those claims, where there is a range of loss. At March 31, 2003, liabilities related to litigation matters were not significant. Because of the uncertainties related to both the amount and range of loss on pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability, if any, related to our pending litigation and revise our estimates. Such revisions in our estimates of the potential liability could materially impact our results of operation and financial position.

## RESULTS OF OPERATIONS

The following table sets forth consolidated statement of operations data for each of the years ended March 31, 2003, 2002, and 2001, expressed as the percentage of our total revenues represented by each item. Cost of product revenues is presented as a percentage of product revenues and cost of license and other revenues is presented as a percentage of license and other revenues. You should read this information in conjunction with our Consolidated Financial Statements and related notes included elsewhere in this Report.

	<u>Year Ended March 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Product revenues.....	52 %	41 %	70 %
License and other revenues.....	48 %	59 %	30 %
Total revenues.....	<u>100 %</u>	<u>100 %</u>	<u>100 %</u>
Cost of product revenues.....	48 %	43 %	41 %
Cost of license and other revenues.....	29 %	2 %	32 %
Total cost of revenues.....	<u>39 %</u>	<u>19 %</u>	<u>38 %</u>
Gross profit.....	<u>61 %</u>	<u>81 %</u>	<u>62 %</u>
Operating expenses:			
Research and development.....	71 %	85 %	109 %
Selling, general and administrative.....	68 %	59 %	93 %
In-process research and development.....	-- %	-- %	25 %
Amortization of intangibles.....	-- %	5 %	60 %
Restructuring and other charges.....	31 %	-- %	183 %
Total operating expenses.....	<u>170 %</u>	<u>149 %</u>	<u>470 %</u>
Loss from operations.....	(109)%	(68)%	(408)%
Other income, net.....	5 %	7 %	14 %
Interest expense.....	-- %	(6)%	(8)%
Loss before provision for income taxes.....	(104)%	(67)%	(402)%
Provision for income taxes.....	-- %	-- %	-- %
Net loss before extraordinary gain and cumulative effect of change in accounting principle .....	(104)%	(67)%	(402)%
Extraordinary gain on extinguishment of debt, net....	-- %	5 %	-- %
Cumulative effect of change in accounting principle .....	-- %	-- %	(6)%
Net loss.....	<u>(104)%</u>	<u>(62)%</u>	<u>(408)%</u>

## REVENUES

**Product revenues** were \$5.7 million in fiscal 2003, a decrease of \$300,000 from the \$6 million reported in fiscal 2002. The decrease in fiscal 2003 was due to a \$1.1 million decrease in videoconferencing semiconductor sales, offset by a \$300,000 increase in voice over internet protocol (VoIP) semiconductor sales and a \$500,000 increase in sales of videophones and media hub systems. The significant decrease in videoconferencing semiconductor revenues was due primarily to a slight decrease in unit shipments, combined with decreases in average selling prices, or ASPs. The decrease in unit shipments of our videoconferencing semiconductors as compared to the prior year, is primarily attributable to our announcement during fiscal 2003 of the end of life of our existing videoconferencing semiconductors, as well as the factors set forth below explaining the decline for fiscal 2002 versus fiscal 2001. Our remaining videoconferencing semiconductor customers have been designing out our products in anticipation of the end of life. The increase in VoIP semiconductor sales was attributable to a significant increase in unit shipments, offset by decreases in ASPs. The increase in videophone system sales was attributable to our commencement of sales of these products in the fourth quarter of fiscal 2002, and as a result, fiscal 2003 includes four quarters of sales versus only one quarter of sales in fiscal 2002. The increase in media hub system revenues was attributable to the increase in licenses of our hosted iPBX product.

Product revenues were \$6.0 million in fiscal 2002, a decrease of \$6.8 million from the \$12.8 million reported in fiscal 2001. The decrease in product revenues in fiscal 2002 was due to decreases in sales of video monitoring and

consumer videophone systems approximating \$1 million, resulting from our decision to terminate further development and sales of these product lines in prior years, a slight decrease in IP telephony semiconductor sales, a \$300,000 decrease in media hub system revenues, and a \$5.4 million decrease in revenue derived from our videoconferencing semiconductor products. The decrease in media hub system revenues as compared to the prior year period was due primarily to a decline in sales to a significant customer. The significant decrease in videoconferencing semiconductor revenues was due primarily to a significant decrease in unit shipments, offset partially by increases in average selling prices, or ASPs. Factors that contributed to the significant decrease in unit shipments of our videoconferencing semiconductors as compared to the prior year include:

- Increased competition from other developers of semiconductors used in videoconferencing applications;
- The acquisition of two of our customers by a company that appears to have standardized its product development efforts around technology supplied by one or more of our competitors;
- Increased competition from evolving PC-based videoconferencing applications which has resulted in reduced demand for products marketed and sold by our customers that incorporate our videoconferencing semiconductors; and
- Decreased corporate and consumer spending.

**License and other revenues** were \$5.3 million in fiscal 2003, a decrease of \$3.3 million from the \$8.6 million recorded in fiscal 2002. License and other revenues, the majority of which are considered to be non-recurring in nature, consisted primarily of technology licenses and related maintenance revenues, as well as royalties earned under such licenses. License and other revenues for both fiscal 2003 and 2002 included approximately \$1.6 million of non-cash revenue recognition associated with the license of our video monitoring technology to Interlogix in fiscal 2001. The decrease in fiscal 2003 was primarily attributable to:

- A \$1.2 million decrease in royalties earned by Netergy under a license agreement for certain of our video compression technology. Royalty revenue recognized under this agreement totaled \$750,000 for fiscal 2003 as compared to approximately \$2 million for fiscal 2002. The licensee's obligations to pay royalties on shipments of products that incorporate our technology terminated in the first quarter of fiscal 2003 upon payment of the \$750,000;
- A decrease of approximately \$1 million in revenues associated with our license of service creation environment (SCE) technology to Lucent and unified messaging technology to Milinx;
- A \$1.1 million decrease in license revenue associated with our embedded IP telephony firmware technology, e.g., Veracity VoIP software and Audacity-T2 based reference design kits marketed by Netergy; and
- A decrease of approximately \$1.5 million in non-recurring license and maintenance revenues associated with Netergy's videoconferencing technology.

These decreases were partially offset by:

- A \$380,000 increase in license and maintenance revenues associated with Centile's hosted iPBX product; and
- Approximately \$1.1 million of revenues recognized by Netergy under a contract to develop our next-generation video compression semiconductor product that is accounted for using the percentage of completion method. Profit estimates on this contract are revised periodically based on changes in facts; any loss is required to be recognized immediately. Based on our cost estimates as of March 31, 2003, we recognized a loss approximating \$300,000 on this development contract in the quarter ended March 31, 2003, which has been recorded in the Cost of License and Other Revenues line in the consolidated statements of operations. Subsequent changes in our cost estimates could require us to recognize additional losses in a future period as the revenues under this contract are fixed.

License revenues were \$8.6 million in fiscal 2002, an increase of \$3.2 million from the \$5.4 million recognized in fiscal 2001. License and other revenues recognized in fiscal 2002 consisted primarily of technology licenses and related maintenance revenues, as well as royalties earned under such licenses. License and other revenues for fiscal 2001 also included \$1.2 million of professional service revenues associated with our Canadian operations. No professional service revenues were recognized in fiscal 2002 due to the elimination of the professional services organization as part of the restructuring of our Canadian operations in the fourth quarter of fiscal 2001. The negative

impact of eliminating professional service revenues in fiscal 2002 was more than offset by the following:

- An increase in royalties earned by Netergy under a license agreement for certain of our video compression technology. Royalty revenue recognized under this agreement approximated \$2.0 million for fiscal 2002 as compared to \$768,000 for fiscal 2001;
- A \$1.3 million increase in license revenue associated with Netergy's embedded IP telephony firmware technology;
- The recognition of \$309,000 of previously deferred revenue associated with our license of unified messaging technology to Milinx. Also, license revenues in fiscal 2002 included \$680,000 of non-recurring revenue associated with the license of our SCE technology to Lucent;
- A \$1.6 million increase in revenue in fiscal 2002 associated with the license of our video monitoring technology to Interlogix in fiscal 2001. Recognition of the approximately \$3.9 million of revenue ascribed to the license of video monitoring technology to Interlogix had been deferred until we satisfied certain remaining obligations in the quarter ended March 31, 2001. Revenue associated with the license is being recognized ratably over the license term, which expires in May 2003. All cash receipts associated with this license were received in fiscal 2001; and
- A decrease of approximately \$700,000 in non-recurring license and maintenance revenues associated with Netergy's videoconferencing technology.

Revenues from our ten largest customers in the fiscal years ended March 31, 2003, 2002, and 2001 accounted for approximately 63%, 73%, and 48%, respectively, of our total revenues. Two customers represented more than 10% of our total revenues in fiscal 2003. These customers, GE Interlogix, Inc. and Leadtek Research, Inc. represented 17% and 11% of our total revenues, respectively. Three customers represented more than 10% of our total revenues in fiscal 2002. These customers, ESS Technology, Inc., Leadtek Research, Inc. and GE Interlogix, Inc. represented 13%, 13% and 12% of our total revenues, respectively. During the fiscal year ended March 31, 2001 no customer accounted for 10% or more of total revenues.

Sales to customers outside the United States represented 62%, 61%, and 69%, and of total revenues in the fiscal years ended March 31, 2003, 2002, and 2001, respectively. The following table illustrates our net revenues by geographic area. Revenues are attributed to countries based on the destination of shipment (in thousands):

	Year Ended March 31,		
	2003	2002	2001
United States.....	\$ 4,218	\$ 5,777	\$ 5,632
Europe.....	2,657	4,126	5,862
Taiwan.....	1,569	2,026	2,739
Japan.....	919	1,119	1,188
Other.....	1,640	1,643	2,807
	<u>\$ 11,003</u>	<u>\$ 14,691</u>	<u>\$ 18,228</u>

#### *COST OF REVENUES AND GROSS PROFIT*

The cost of product revenues consists of costs associated with system manufacturing, components, semiconductor wafer fabrication, system and semiconductor assembly and testing performed by third-party vendors, and direct and indirect costs associated with purchasing, scheduling, and quality assurance. Gross profit from product revenues was \$3 million, \$3.4 million, and \$7.6 million, for the fiscal years ended March 31, 2003, 2002, and 2001, respectively. Product gross margin was 52%, 57%, and 59% for the fiscal years ended March 31, 2003, 2002, and 2001, respectively.

The \$400,000 decrease in gross profit from product revenues was primarily due to a decrease in product revenues

primarily attributable to lower ASPs, and a charge of approximately \$270,000 for non-cancelable purchase orders for IP telephony semiconductors recorded in the quarter ended March 31, 2003. The decreases in gross profit were partially mitigated by lower costs for our IP telephony semiconductors resulting from a change in suppliers during fiscal 2003.

The \$4.1 million decrease in gross profit from fiscal 2001 to fiscal 2002 was due primarily to a significant decrease in sales of our videoconferencing semiconductors and video monitoring systems. Gross profit in fiscal 2002 was also impacted by a decrease in product gross margins due to lower average selling prices realized on sales of our IP telephony semiconductors, and to a lesser extent, an increase in inventory reserves associated with our media hub products in the first quarter of fiscal 2002. The decrease in margins was mitigated to some extent by an increase in average selling prices realized on the sale of our videoconferencing semiconductors and the reversal of \$143,000 of reserves associated with our semiconductor products in the fourth quarter of fiscal 2002 due to the sale of inventory that had been specifically reserved for in fiscal 2001.

Gross profit from license and other revenues, which were largely nonrecurring, was \$3.8 million, \$8.4 million, and \$3.7 million, in fiscal 2003, 2002, and 2001, respectively. Associated gross margins were 71%, 98%, and 68% in fiscal 2003, 2002, and 2001. The decrease in gross margin from fiscal 2002 to fiscal 2003 was due primarily to the reduction in license and other revenues, and costs incurred to perform development services under revenue generating contracts in fiscal 2003, which included a loss approximating \$300,000 in the quarter ended March 31, 2003. The significant increase in gross margin from fiscal 2001 to fiscal 2002 was due to the elimination of our professional service organization as part of the restructuring of our Canadian operations in the fourth quarter of fiscal 2001.

Our gross margin is affected by a number of factors including product mix, product pricing, the percentage of direct sales and sales to resellers, and manufacturing and component costs. The markets for our products are characterized by falling average selling prices. Average selling prices realized to date for our IP telephony semiconductors have been lower than those historically attained for our videoconferencing semiconductor products, resulting in lower gross margins. We have encountered significant price competition in the markets for our products, and are at a significant disadvantage compared to our competitors, many of whom have substantially greater resources, and therefore may be better able to withstand an extended period of downward pricing pressure. To respond to competitive pricing pressures, we will be required to introduce differentiated products and continue to reduce costs as a means of maintaining or improving our margins. We may not be successful in our development efforts or product cost reduction measures and may face continued erosion of margins.

#### *RESEARCH AND DEVELOPMENT EXPENSES*

Research and development expenses consist primarily of personnel, system prototype design and fabrication, mask, prototype wafer, and equipment costs necessary for us to conduct our development efforts. Research and development costs, including software development costs, are expensed as incurred. Research and development expenses were \$7.8 million, \$12.6 million, and \$20 million for fiscal 2003, 2002, and 2001, respectively. The \$4.8 million decrease in research and development expenses in fiscal 2003 as compared to fiscal 2002 was due to the following:

- The shift in engineering resources from research and development functions to revenue generating contracts; these costs approximated \$1.3 million for fiscal 2003 and were included in cost of license and other revenue;
- Lower compensation costs due to a reduction in research and development personnel as compared to the comparable prior year period;
- Reduced purchases of software and related maintenance contracts;
- Reduced consulting expenses related to our SCE technology;
- Lower depreciation expense due to the retirement of assets; and
- Our overall efforts to reduce discretionary operating costs.

The \$7.4 million decrease in research and development expenses during fiscal 2002 as compared to fiscal 2001 was due to the following:

- The elimination of our Canadian operations in the fourth quarter of fiscal 2001. Research and development expenses incurred by our Canadian operations in fiscal 2001 approximated \$2.5 million;

- Reductions in research and development personnel staffing levels in the first and second quarters of fiscal 2002;
- Lower tooling and other project related expenses associated with semiconductor and system-level reference design projects in fiscal 2002;
- Lower third-party consulting expenses associated with development of the graphical user interface for Centile's hosted iPBX product;
- A decrease in stock compensation charges of approximately \$435,000; and
- Our overall efforts to reduce discretionary operating costs.

#### *SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES*

Selling, general, and administrative expenses consist primarily of personnel and related overhead costs for sales, marketing, finance, human resources, and general management. Such costs also include advertising, sales commissions, trade show, and other marketing and promotional expenses. Selling, general, and administrative expenses were \$7.4 million, \$8.6 million, and \$16.9 million in fiscal 2003, 2002, and 2001, respectively. The \$1.2 million decrease in selling, general, and administrative expenses in fiscal 2003 as compared to fiscal 2002 was due to the following:

- Reductions in sales, marketing and administrative personnel staffing levels; and
- Lower legal, financial reporting, corporate function, telephone, travel, corporate marketing, public relations and trade show expenditures resulting from our efforts to reduce discretionary operating costs.

The decrease in selling, general, and administrative expenses during fiscal 2002 as compared to fiscal 2001 was due primarily to the reasons set forth above, as well as:

- a \$3.7 million decrease due to the elimination of our Canadian operations in the fourth quarter of fiscal 2001; and
- a \$325,000 decrease in stock compensation expense.

#### *IN-PROCESS RESEARCH AND DEVELOPMENT AND AMORTIZATION OF INTANGIBLES*

We incurred in-process research and development charges of \$4.6 million in the second quarter of fiscal 2001 related to the acquisition of U|Force, Inc. (U|Force). Our consolidated financial statements reflect the acquisition of all of the outstanding stock of U|Force, Inc. on June 30, 2000 for a total purchase price of \$46.8 million. U|Force, based in Montreal, Canada, was a developer of IP-based software applications and a provider of professional services. U|Force was also developing a Java-based service creation environment (SCE) designed to allow telecommunication service providers to develop, deploy, and manage telephony applications and services to their customers. The purchase price was comprised of 8x8 common stock with a fair value of approximately \$38.0 million comprised of: (i) 1,447,523 shares issued at closing of the acquisition, and (ii) 2,107,780 shares to be issued upon the exchange or redemption of the exchangeable shares (the Exchangeable Shares) of Canadian entities held by former employee shareholders or indirect owners of U|Force stock. The Exchangeable Shares held by U|Force employees were subject to certain restrictions, including our right to repurchase the Exchangeable Shares if an employee departed prior to vesting. In addition, we also agreed to issue one share of preferred stock (the Special Voting Share) that provides holders of Exchangeable Shares with voting rights equivalent to the shares of common stock into which their shares are convertible. We also assumed outstanding stock options to purchase shares of U|Force common stock for which the Black-Scholes pricing model value of approximately \$6.5 million was included in the purchase price. Direct transaction costs related to the merger were approximately \$747,000. Additionally, the Company advanced \$1.5 million to U|Force upon signing the acquisition agreement, but prior to the close of the transaction. This amount was accounted for as part of the purchase price. The following table summarizes the composition of the purchase price (in thousands):

Value of common stock and Exchangeable Shares issued.....	\$	38,042
Value of stock options assumed.....		6,546
Cash advanced to U Force prior to closing.....		1,500
Direct transaction costs.....		747
	\$	<u>46,835</u>

The purchase price was allocated to tangible assets acquired and liabilities assumed based on the book value of U|Force's assets and liabilities, which we believe approximated their fair value. Intangible assets acquired included amounts allocated to U|Force's in-process research and development. The in-process research and development related to U|Force's initial products, the SCE and a unified messaging application, for which technological feasibility had not been established and the technology had no alternative future use. The estimated percentage complete for the unified messaging and SCE products was approximately 44% and 34%, respectively, at June 30, 2000. The fair value of the in-process technology was based on a discounted cash flow model, similar to the traditional "Income Approach," which discounts expected future cash flows to present value, net of tax. In developing cash flow projections, revenues were forecasted based on relevant factors, including estimated aggregate revenue growth rates for the business as a whole, characteristics of the potential market for the technology, and the anticipated life of the technology. Projected annual revenues for the in-process research and development projects were assumed to ramp up initially and decline significantly at the end of the in-process technology's economic life. Operating expenses and resulting profit margins were forecasted based on the characteristics and cash flow generating potential of the acquired in-process technologies. Risks that were considered as part of the analysis included the scope of the efforts necessary to achieve technological feasibility, rapidly changing customer markets, and significant competitive threats from numerous companies. We also considered the risk that if we failed to bring the products to market in a timely manner, it could adversely affect sales and profitability of the combined company in the future. The resulting estimated net cash flows were discounted at a rate of 25%. This discount rate was based on the estimated cost of capital plus an additional discount for the increased risk associated with in-process technology. The value of the acquired U|Force in-process research and development, which was expensed in the second quarter of fiscal 2001, approximated \$4.6 million. The excess of the purchase price over the net tangible and intangible assets acquired and liabilities assumed was allocated to goodwill. Amounts allocated to goodwill, the value of an assumed distribution agreement, and workforce were being amortized on a straight-line basis over three, three, and two years, respectively. The allocation of the purchase price was as follows (in thousands):

In-process research and development.....	\$	4,563
Distribution agreement.....		1,053
Workforce.....		1,182
U Force net tangible assets.....		1,801
Goodwill.....		38,236
	\$	<u>46,835</u>

Amortization of goodwill and intangible assets charged to operations was \$763,000 and \$11 million for the fiscal years ended March 31, 2002 and 2001, respectively. Amortization expense included amounts related to the amortization of goodwill and intangible assets arising from the acquisitions of U|Force in fiscal 2001 and Odisei S.A. in fiscal 2000. Beginning our fiscal year 2003, Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," was adopted, and we ceased to amortize approximately \$1.5 million of goodwill, net of amortization, including intangibles related to the acquisition of Odisei S.A. that were classified as goodwill upon the adoption of SFAS No. 142.

#### *RESTRUCTURING AND OTHER CHARGES*

##### **2003 Restructuring Actions**

During the third and fourth quarters of fiscal 2003, we continued our cost reduction activities to better align expense levels with current revenue levels and ensure conservative spending during the current economic downturn. As a result of these activities, we recorded restructuring and other asset impairment charges of approximately \$3.4 million. These charges included severance and benefits of approximately \$1.2 million, as we reduced our workforce, under voluntary and involuntary separation plans, by thirty-two employees or thirty percent. The majority of the affected employees were Netergy employees based in Santa Clara, California and Marlow, United Kingdom and included employees from sales and marketing and research and development, as well as four executives of Netergy. Severance of approximately \$325,000 attributable to involuntary terminations was paid



during the year ended March 31, 2003.

We closed Netergy's facility in Marlow, United Kingdom, and recorded \$434,000 of charges related to the termination of the operating leases for the facility and related services. In addition, we recorded asset impairment charges of \$212,000 related to assets in the United Kingdom that were abandoned or disposed of.

We also recorded a charge of approximately \$74,000 for its remaining lease liability for office space in Tempe, Arizona that was vacated as a result of the restructuring actions during the fourth quarter.

In the fourth quarter of fiscal 2003, we also implemented a plan to reduce the workforce at Centile's Sophia Antipolis, France office by ten employees or seventy percent. This downsizing and its potential impact on Centile's iPBX business prompted an assessment of the key assumptions underlying our goodwill valuation judgments. As a result of the analysis, we determined that an impairment charge of \$1.5 million was required because the estimated fair value of the goodwill was less than the book value of the goodwill that arose from the acquisition of Odisei S.A. in fiscal 2000.

The following table illustrates the charges, credits and balances of the restructuring reserves as of March 31, 2003 and summarizes asset impairment charges (in thousands):

	<b>Total Charges</b>	<b>Cash Payments</b>	<b>Non-Cash Charges</b>	<b>Liability at March 31, 2003</b>
Restructuring Charges:				
Severance.....	\$ 1,177	\$ (1,002)	\$ --	\$ 175
Facility related.....	508	(161)	(273)	74
Total restructuring charges.....	1,685	(1,163)	(273)	249
Asset Impairments:				
Fixed Assets.....	212	--	(212)	--
Goodwill.....	1,539	--	(1,539)	--
Total impairment charges.....	1,751	--	(1,751)	--
Total restructuring and impairment charges.....	<u>\$ 3,436</u>	<u>\$ (1,163)</u>	<u>\$ (2,024)</u>	<u>\$ 249</u>

We expect annual savings of approximately \$3 million related to voluntary and involuntary employee terminations. Future expected cost reductions will be reflected in the Cost of Sales, Selling, General and Administrative, and Research and Development line items in the consolidated statements of operations.

## 2001 Restructuring Actions

During the fourth quarter of fiscal 2001, after a significant number of employees had resigned, we discontinued our Canadian operations acquired in conjunction with the acquisition of U|Force in June 2000. We closed our offices in Montreal and Hull, Quebec and laid-off all remaining employees resulting in the cessation of the research and development efforts and the sales and marketing and professional services activities associated with the U|Force business. As a result of the restructuring, we recorded a one-time charge of \$33.3 million in the quarter ended March 31, 2001. The restructuring and other charges consisted of the following (in thousands):

Employee separation.....	\$ 765
Fixed asset losses and impairments.....	2,084
Intangible asset impairments.....	30,247
Lease obligation and termination.....	220
	<u>\$ 33,316</u>

Employee separation costs represent severance payments related to the 96 employees in the Montreal and Hull offices who were laid-off.

The impairment charges for fixed assets of approximately \$2.1 million included write-offs of abandoned and unusable assets of approximately \$1.4 million, a loss on sale of assets of \$567,000, and a charge for assets to be disposed of \$172,000. The loss on sale of assets of \$567,000 was attributable to the sale of office, computer, and other equipment of the Montreal facility. We received common stock of the purchaser valued at approximately \$412,000 as of the date of sale. Fair value of assets to be disposed of was measured based on expected salvage value, less costs to sell. Assets to be disposed of consist of computer equipment with a fair value of \$57,000 at March 31, 2001. Substantially all of these assets were liquidated during fiscal 2002.

The impairment charges for intangible assets represented the write-off of the unamortized intangible assets recorded in connection with the acquisition of U|Force. The charges of approximately \$30.2 million included: \$28.7 million for the goodwill related to the acquisition, \$739,000 for the assembled workforce, and \$789,000 related to a distribution agreement. The impairments were directly attributable to the cessation of operations in Canada. We performed an evaluation of the recoverability of the intangible assets related to these operations in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The lack of estimated future net cash flows related to the acquired products necessitated an impairment charge to write-off the remaining unamortized goodwill. The distribution agreement asset was written off because we will no longer provide products and services to customers under that agreement.

We terminated the lease for our primary facility in Montreal in March 2001, but we were required to pay rent on the facility through May 31, 2001. We terminated the lease for our facility in Hull, Quebec in fiscal 2002. Accrued obligations related to remaining lease commitments on the Montreal and Hull facilities totaled \$212,000 at March 31, 2001. Payments made in fiscal 2002 related to the terminations of the Montreal and Hull facility leases totaled \$225,000.

Cash payments related to the restructuring during the quarter ended March 31, 2001, which included all employee separation costs and certain lease termination costs, approximated \$920,000.

#### *OTHER INCOME, NET*

In fiscal 2003, 2002, and 2001, other income, net, was approximately \$600,000, \$1.0 million, and \$2.6 million, respectively. The decrease in other income, net, in fiscal 2003 compared to fiscal 2002 was due primarily to an approximately \$440,000 decrease in interest income resulting from lower average cash and cash equivalent balances and lower interest rates, a \$131,000 non-recurring gain realized on the sale of an investment in fiscal 2002, and a \$100,000 increase in foreign exchange losses. These decreases were offset by an increase in other income from our former Canadian operations of approximately \$175,000. The increase in Canadian other income was primarily attributable to the collection of Canadian research and development and other tax credits in fiscal 2003, which was partially offset by a write off of \$92,000, which represented the balance of the cumulative translation adjustment generated from the translation of the financial statements of our Canadian subsidiary. Our Canadian subsidiary has been substantially liquidated. We collected \$560,000 of Canadian tax credits in fiscal 2003, but no further refundable tax credits are expected from Canada. Apart from the tax credit receipt in fiscal 2003 and investment gain in 2002 described above, other income, net, consists primarily of interest income earned on our cash and cash equivalents and foreign exchange gains and losses. Interest income has continued to decrease due to significantly lower average cash and cash equivalent balances combined with lower interest rates. See "Item 3. Quantitative And Qualitative Disclosures About Market Risk" elsewhere in this Report for further discussion of our exposure to currency risk.

The decrease in other income, net, in fiscal 2002 compared to fiscal 2001 was due primarily to a significant decrease in interest income resulting from lower average cash and cash equivalent balances and lower interest rates. Gains realized on the sale of investments also decreased by approximately \$94,000 in fiscal 2002 as compared to fiscal 2001.

#### *INTEREST EXPENSE*

Interest expense in each of the two years ended March 31, 2002 consisted mainly of charges associated with the 4% convertible subordinated debentures, or the Debentures, that we issued in December 1999, including the amortization of the related debt discount and debt issuance costs. We redeemed the Debentures in December 2001. Interest expense for the year ended March 31, 2001 also included approximately \$128,000 associated with lease

lines of credit and a bank loan assumed as part of the U|Force acquisition. All of the U|Force debt obligations were repaid in the quarter ended March 31, 2001.

#### *PROVISION FOR INCOME TAXES*

The provisions of \$15,000 and \$17,000 for the years ended March 31, 2002 and 2001, respectively, were comprised primarily of certain foreign taxes. We had no provision for the fiscal year ended March 31, 2003. The provision for the year ended March 31, 2002 also reflected a \$10,000 refund of U.S. federal income taxes received in fiscal 2002.

At March 31, 2003, we had net operating loss carryforwards for federal and state income tax purposes of approximately \$115 million and \$42 million, respectively, which expire at various dates beginning in 2005. In addition, at March 31, 2002, we had research and development credit carryforwards for federal and state tax reporting purposes of approximately \$3 million and \$2.3 million, respectively. The federal credit carryforwards will begin expiring in 2010 while the California credit will carryforward indefinitely. Under the ownership change limitations of the Internal Revenue Code of 1986, as amended, the amount and benefit from the net operating losses and credit carryforwards may be impaired or limited in certain circumstances.

At March 31, 2003 and 2002, we had gross deferred tax assets of approximately \$51 million and \$47 million. We believe that, based on a number of factors, the weight of objective available evidence indicates that it is more likely than not that we will not be able to realize our deferred tax assets, and a full valuation allowance was recorded at March 31, 2003 and March 31, 2002.

#### *EXTRAORDINARY GAIN*

We realized an extraordinary gain of \$779,000 in the third quarter of fiscal 2002 resulting from the early extinguishment of our convertible subordinated debentures. See Note 5 to the consolidated financial statements in Part II, Item 8 of this Report for further discussion of this transaction.

#### *CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE*

In November 2000, the Emerging Issues Task Force of the Financial Accounting Standards Board reached several conclusions regarding the accounting for debt and equity securities with beneficial conversion features, including a consensus requiring the application of the "accounting conversion price" method, versus the use of the stated conversion price, to calculate the beneficial conversion feature for such securities. The Securities and Exchange Commission (SEC) required companies to record a cumulative catch-up adjustment in the fourth quarter of calendar 2000 related to the application of the "accounting conversion price" method to securities issued after May 21, 1999. Accordingly, we recorded a \$1.1 million non-cash expense during the quarter ended December 31, 2000 to account for a beneficial conversion feature associated with Debentures and related warrants issued in December 1999, and we presented it as a cumulative effect of a change in accounting principle as required by the SEC.

#### *LIQUIDITY AND CAPITAL RESOURCES*

As of March 31, 2003, we had cash and cash equivalents totaling \$3.4 million, representing a decrease of \$9 million from March 31, 2002. We currently have no borrowing arrangements.

Cash used in operations of \$8.8 million in fiscal 2003 primarily resulted from the net loss of \$11.4 million, a \$249,000 decrease in accrued compensation, a \$1.9 million decrease in deferred revenue, and a \$71,000 increase in accounts receivable. Cash used in operations was partially offset by a \$298,000 decrease in inventory and non-cash items, including depreciation and amortization of \$1.8 million, \$2.3 million for the non-cash portion of restructuring and asset impairment charges, and \$83,000 related to the provision for inventory. Cash used in investing activities in fiscal 2003 was attributable to purchases of short-term investments of \$208,000 and capital expenditures of \$137,000, partially offset by proceeds from the sale of equipment of \$42,000. Cash provided by financing activities during fiscal 2003 consisted of proceeds of \$89,000 resulting from the sale of our common stock to employees through our employee stock purchase and stock option plans.

Cash used in operations of \$7.9 million in fiscal 2002 reflected a net loss of \$9.1 million, a decrease in accounts payable of \$839,000, a decrease in accrued compensation of \$610,000, a decrease of \$579,000 in other accrued liabilities, a \$3.5 million decrease in deferred revenue and a non-cash extraordinary gain of \$779,000 due to

redemption of the convertible subordinated debentures. Cash used in operations was partially offset by a decrease in accounts receivable of \$1.7 million, a \$501,000 decrease in inventory, a \$1.6 million decrease in other current assets, and non-cash items including depreciation and amortization of \$3.9 million. Cash provided by investing activities in fiscal 2002 was attributable to proceeds from the sale of an investment in marketable equity securities of \$543,000 and proceeds from the sale of equipment of \$116,000, partially offset by capital expenditures of \$172,000. Cash used in financing activities during fiscal 2002 consisted of the \$4.6 million payment associated with the redemption of the convertible subordinated debentures and certain costs incurred in connection with the redemption, offset partially by proceeds of \$335,000 resulting from the sale of our common stock to employees through our employee stock purchase and stock option plans.

Cash used in operations of \$24.6 million in fiscal 2001 reflected a net loss of \$74.4 million, decreases in accounts payable and accrued compensation of \$2.2 million and \$623,000, an increase in other current and non-current assets of \$1.3 million, and a non-cash adjustment for a gain on sale of investments of \$225,000. Cash used in operations was partially offset by cash provided by a decrease in accounts receivable of \$851,000, an increase in other accrued liabilities of \$378,000, and non-cash items, including restructuring charges of \$32.3 million, depreciation and amortization of \$14.4 million, in-process research and development of \$4.6 million, the cumulative effect of a change in accounting principle of \$1.1 million, and stock compensation charges of \$753,000. Cash provided by investing activities in fiscal 2001 is primarily attributable to net proceeds from the sale of assets and the license of technology associated with our video monitoring product line of \$5.2 million, offset by acquisitions of property and equipment of \$6.1 million and cash paid for acquisitions, net, of \$558,000. Cash flows from financing activities in fiscal 2000 consisted primarily of proceeds from sales of the Company's common stock totaling \$2.8 million, offset by debt repayments of \$891,000 and repurchases of common stock and Exchangeable Shares of \$514,000. For the year, cash and cash equivalents decreased \$24.5 million.

As of March 31, 2003, our principal commitments consisted of obligations outstanding under non-cancelable operating leases. At March 31, 2003, future minimum annual lease payments under noncancelable operating leases, net of sublease income, were as follows (in thousands):

<u>YEAR ENDING MARCH 31,</u>	
2004.....	\$ 544
2005.....	280
2006.....	37
Total minimum payments.....	<u>\$ 861</u>

As noted previously, we redeemed our convertible subordinated debentures in December 2001. The consideration included issuing 1,000,000 shares of our common stock to the lenders. We have committed to maintaining the effectiveness of the registration statement filed with the SEC covering the resale of these shares. Should we fail to maintain the effectiveness of the registration statement we may be required to pay cash penalties and redeem all or a portion of the shares at the higher of \$0.898 or the market price of our common stock at the time of the redemption which could have a material adverse effect on our cash flows. The value of the shares still held by the lenders of \$669,000 at March 31, 2003, based upon the \$0.898 per share minimum potential redemption price, is reflected as contingently redeemable common stock in the consolidated balance sheet.

The consolidated financial statements presented in Part II, Item 8 of this Report have been prepared assuming that 8x8 will continue as a going concern, and do not include any adjustments that might result from the outcome of this uncertainty. 8x8 has incurred recurring losses from operations, had recurring negative cash flows, and has a significant accumulated deficit. These conditions raise substantial doubt about our ability to continue as a going concern. We are currently seeking additional financing in order to meet our cash requirements for fiscal 2004. We may not be able to obtain additional financing as needed on acceptable terms, or at all, which may require us to reduce our operating costs and other expenditures, including reductions of personnel, salaries and capital expenditures. Alternatively, or in addition to such potential measures, we may elect to implement other cost reduction actions as we may determine are necessary and in our best interests, including the possible sale or cessation of certain of our business segments. Any such actions undertaken might limit our opportunities to realize

plans for revenue growth and we might not be able to reduce our costs in amounts sufficient to achieve break-even or profitable operations. If we issue additional equity or convertible debt securities to raise funds, the ownership percentage of our existing stockholders would be reduced. New investors may demand rights, preferences or privileges senior to those of existing holders of our common stock.

#### *RELATED PARTY TRANSACTIONS*

During the fourth quarter of fiscal 2000, the Company sold 3.7 million shares of its common stock to STMicroelectronics NV (STM) at a purchase price of \$7.50 per share and received net proceeds of \$27.7 million. During fiscal 2003, we purchased semiconductors from a subsidiary of STM. Such purchases approximated \$550,000. In addition, during fiscal 2003 we contracted with a subsidiary of STM for non-recurring engineering services related to the development of our new semiconductor product. As of March 31, 2003, we had recorded liabilities to STM of \$392,000 for semiconductor purchases and purchase commitments and engineering services.

In March 2002 the Board authorized us to open securities trading accounts and make investments of up to \$1.0 million on behalf of 8x8, Inc. as directed by our Chairman, Joe Parkinson, Chief Executive Officer, or Chief Financial Officer. Mr. Parkinson has agreed to personally reimburse 8x8 on a quarterly basis for any losses resulting from his trading activities in order to maintain a minimum investment account balance of \$1.0 million. The Board has been assured of Mr. Parkinson's ability to cover any such losses; however, should he be unable to do so it could have a material impact on our cash flows and results of operations. As part of the arrangement, our Board has expressed its intent, but not obligation, to pay Mr. Parkinson a quarterly bonus in an amount equal to 25% of the profits attributable to investments made on our behalf by Mr. Parkinson to the extent such a bonus exceeds his salary for the corresponding period. The Company or Mr. Parkinson can terminate this arrangement at any time, subject to the terms of an agreement between 8x8 and Mr. Parkinson. Under the arrangement, we are required to return to Mr. Parkinson the amount representing the increase in value of the investment account over \$1.0 million to the extent required to restore replenishment payments made by Mr. Parkinson in prior quarters. Through March 31, 2003, Mr. Parkinson had made cumulative replenishment payments of approximately \$137,000 to offset losses incurred. As of March 31, 2003, the investment account balance approximated \$1,018,000. Accordingly, we had a payable of approximately \$18,000 to Mr. Parkinson at March 31, 2003. As of March 31, 2003, approximately \$200,000 of the \$1.0 million allocated for such investment activities was invested in marketable equity securities. The remaining \$800,000 was invested in money market funds.

#### *RECENT ACCOUNTING PRONOUNCEMENTS*

On October 3, 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supercedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30. SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (i) can be distinguished from the rest of the entity, and (ii) will be eliminated from the ongoing operations of the entity in a disposal transaction. We adopted SFAS No. 144 in the first quarter of fiscal 2003, and its adoption did not have a material impact on our results of operations or financial position.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No. 146 supercedes previous accounting guidance, principally Emerging Issues Task Force Issue (EITF) No. 94-3. SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date of the entity's commitment to an exit plan. SFAS No. 146 also requires that the liability be initially measured and recorded at fair value. SFAS No. 146 will be effective for exit or disposal activities that are initiated after December 31, 2002. We adopted SFAS No. 146 in the fourth quarter of fiscal 2003, and its adoption did not have a material impact on our results of operations or financial position.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," which expands

previously issued accounting guidance and disclosure requirements for certain guarantees. FIN45 requires an entity to recognize an initial liability for the fair value of an obligation assumed by issuing a guarantee. The provision for initial recognition and measurement of the liability will be applied on a prospective basis to guarantees issued or modified after December 31, 2002. We do not expect FIN 45 to have a material impact on our consolidated results of operations or financial position. We have included additional disclosures in accordance with FIN 45 in the footnotes to the consolidated financial statements presented in Part II, Item 8 of this Report.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation, Transition and Disclosure." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The additional disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. We will continue to account for stock-based compensation in accordance with Accounting Principles Board Opinion No. 25. We have included additional disclosures in accordance with SFAS No. 148 in the footnotes to the consolidated financial statements presented in Part II, Item 8 of this Report.

## **FACTORS THAT MAY AFFECT FUTURE RESULTS**

### **We will need to raise additional capital to support our operations, and failure to do so in a timely manner may cause us to implement additional cost reduction strategies**

As of March 31, 2003, we had approximately \$3.6 million in cash and cash equivalents and short-term investments. The possibility that we will not be able to meet our obligations as and when they become due over the next twelve months raises substantial doubt about our ability to continue as a going concern. Accordingly, we have been pursuing, and will continue to pursue, the implementation of certain cost reduction strategies. Additionally, we are seeking additional financing and evaluating financing alternatives in order to meet our cash requirements for fiscal 2004. We may not be able to obtain additional financing as needed on acceptable terms, or at all, which may require us to further reduce our operating costs and other expenditures, including additional reductions of personnel and capital expenditures. Alternatively, or in addition to such potential measures, we may elect to implement other cost reduction actions as we may determine are necessary and in our best interests, including the possible sale or cessation of certain of our business segments. Any such actions undertaken might limit our opportunities to realize plans for revenue growth and we might not be able to reduce our costs in amounts sufficient to achieve break-even or profitable operations. If we issue additional equity or convertible debt securities to raise funds, the ownership percentage of our existing stockholders would be reduced and they may experience significant dilution. New investors may demand rights, preferences or privileges senior to those of existing holders of our common stock. If we are not successful in these actions, we may be forced to cease operations.

### **We have a history of losses and we are uncertain as to our future profitability**

We recorded an operating loss of approximately \$4 million in the quarter ended March 31, 2003 and we ended the period with an accumulated deficit of \$149 million. In addition, we recorded operating losses of \$12 million, \$10.0 million and \$74.5 million for the fiscal years ended March 31, 2003, 2002 and 2001, respectively. We expect that we will continue to incur operating losses for the foreseeable future, and such losses may be substantial. We will need to generate significant revenue growth to achieve an operating profit. Given our history of fluctuating revenues and operating losses, we cannot be certain that we will be able to achieve profitability on either a quarterly or annual basis in the future.

### **We may not be able to maintain our listing on the Nasdaq SmallCap Market**

In April 2002, we were notified by the Nasdaq staff that the bid price for our common stock must close at \$1.00 per share or more for a minimum of ten consecutive trading days during the ninety calendar day period ending July 9, 2002 or we might be delisted. As we were not in compliance under the Nasdaq National Market minimum bid price listing standard by July 9, 2002, we transferred to and began trading on the Nasdaq SmallCap Market on July 26, 2002. As a result of our transfer to the Nasdaq SmallCap Market, our delisting determination was extended an additional ninety days until October 7, 2002. Although our common stock did not achieve a closing bid price of

\$1.00 for at least ten consecutive trading days before October 7, 2002, we met the initial listing criteria for the Nasdaq SmallCap Market as of October 7, 2002. As a result, we remained eligible to be quoted on the Nasdaq SmallCap Market for an additional 180-calendar day grace period, which expired on April 7, 2003, subject to our compliance with the continued listing requirements during the extended grace period. On April 8, 2003, the Nasdaq staff notified us that we have been granted an additional ninety days, or until July 7, 2003 to regain compliance with the minimum bid price listing standard. However, there is no assurance that we will be able to maintain the continued listing requirements, and, as a result, may be delisted from trading on that system. 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 a listing on a major stock market may:

- 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.

### **Our stock price has been highly volatile**

The market price of the shares of our common stock has been and is likely to be highly volatile. It may be significantly affected by factors such as:

- actual or anticipated fluctuations in our operating results;
- announcements of technical innovations;
- loss of key personnel;
- new products or new contracts by us, our competitors or their customers;
- developments with respect to patents or proprietary rights, general market conditions, changes in financial estimates by securities analysts, and other factors which could be unrelated to, or outside our control; and
- the potential delisting of our common stock.

The stock market has from time to time experienced significant price and volume fluctuations that have particularly affected the market prices for the common stocks of technology companies and that have often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the market price of our common stock. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been initiated against the issuing company. If our stock price is volatile, we may also be subject to such litigation. Such litigation could result in substantial costs and a diversion of management's attention and resources, which would disrupt business and could cause a decline in our operating results. Any settlement or adverse determination in such litigation would also subject us to significant liability.

### **If we fail to maintain effectiveness of a registration statement for the resale of shares of our common stock issued in connection with the redemption of our previously outstanding convertible debt, we may be forced to pay a cash penalty or redeem all or a portion of the shares, causing our business to suffer**

Under the terms of a registration rights agreement we entered into in connection with the redemption of our outstanding convertible debt, we agreed to register the 1,000,000 shares of our common stock issued to the former note holders for resale. If we fail to maintain the effectiveness of the registration statement, we may be required to pay cash penalties and may be required to redeem all or a portion of the shares of common stock held by the former note holders. Under the agreement, the redemption price would be the higher of \$0.898 or the market price of our common stock at the time of the redemption. If we are required to pay a cash penalty or to redeem any of the shares, this will deplete our cash reserves, which may cause significant harm to our business, results of operations and financial condition.

### **The growth of our business and future profitability depends on future IP telephony revenue**

We believe that our business and future profitability will be largely dependent on widespread market acceptance of our IP telephony technology and products. Our videoconferencing semiconductor business has not provided

sufficient revenues to profitably operate our business, and we have announced the end of life of these products and expect to make our final shipments in the first quarter of fiscal 2004. To date, we have not generated significant revenue from the sale of our IP telephony products and services. If we are not able to generate significant revenues selling into the IP telephony market, our business and operating results would be seriously harmed.

Success of our IP telephony strategy assumes that there will be future demand for IP telephony systems and services. In order for the IP telephony market to continue to grow, several things need to occur. Telephone service providers must continue to invest in the deployment of high speed broadband networks to residential and commercial customers. IP networks must improve quality of service for real-time communications, managing effects such as packet jitter, packet loss, and unreliable bandwidth, so that toll-quality service can be provided. IP telephony equipment must achieve the 99.999% reliability that users of the public switched telephone network have come to expect from their telephone service. IP telephony service providers must offer cost and feature benefits to their customers that are sufficient to cause the customers to switch away from traditional telephony service providers. If any or all of these factors fail to occur, our business may not grow.

**Our business has been adversely affected by the downturn in the telecommunications industry and these developments will continue to impact our revenues and operating results**

Through the end of 2000, the telecommunications market was experiencing rapid growth spurred by a number of factors including deregulation in the industry, entry of a large number of new emerging service providers, growth in data traffic and the availability of significant capital from the financial markets. In 2001, the telecommunications industry began a reversal of some of these trends, marked by a dramatic reduction in current and projected future capital expenditures by service providers, financial difficulties and, in some cases, bankruptcies experienced by emerging service providers, as well as a sharp contraction in the availability of capital. These conditions caused a substantial reduction in demand for telecommunications equipment and related software, which has had a resulting impact on demand for Netergy's IP telephony semiconductor and software products and for Centile's hosted iPBX solution. If our current or potential customers are forced to defer or further curtail their capital spending programs, sales of our hosted iPBX product and Packet8 IP telephone service to telecommunication service providers and sales of our IP telephony semiconductors to manufacturers of telecommunication equipment may continue to be adversely affected, which would negatively impact our business, financial condition, and results of operations. In addition, many of the industries in which telecommunication service providers operate have experienced consolidation. The loss of one or more of our current or potential telecommunication service provider or telecommunication equipment OEM customers, through industry consolidation or otherwise, could reduce or eliminate our sales to such a customer and consequently harm our business, financial condition, and results of operations.

We expect the developments described above to continue to affect our business for at least the next several quarters in the following manner:

- our ability to accurately forecast revenue will be diminished;
- our revenues could be reduced; and
- our losses may increase because operating expenses are largely based on anticipated revenue trends and a high percentage of our expenses are and will continue to be fixed in the short-term.

Our business, operating results and financial condition could be materially and adversely impacted by any one or a combination of the above.

**Our future operating results may not follow past or expected trends due to many factors and any of these could cause our stock price to fall**

Our historical operating results have fluctuated significantly and will likely continue to fluctuate in the future, and a decline in our operating results could cause our stock price to fall. On an annual and a quarterly basis, there are a number of factors that may affect our operating results, many of which are outside our control. These include, but are not limited to:

- changes in market demand;
- the timing of customer orders;
- competitive market conditions;



- lengthy sales cycles and/or regulatory approval cycles;
- new product introductions by us or our competitors;
- market acceptance of new or existing products;
- the cost and availability of components;
- the mix of our customer base and sales channels;
- the mix of products sold;
- the management of inventory;
- the level of international sales;
- continued compliance with industry standards; and
- general economic conditions.

Our gross margin is affected by a number of factors including product mix, the recognition of license and other revenues for which there may be little or no corresponding cost of revenues, product pricing, the allocation between international and domestic sales, the percentages of direct sales and sales to resellers, and manufacturing and component costs. The markets for our products are characterized by falling average selling prices. We expect that, as a result of competitive pressures, our product end of life announcement, and other factors, gross profit as a percentage of revenue for our videoconferencing semiconductor products will continue to decrease. Average selling prices realized to date for our IP telephony semiconductors have been lower than those historically attained for our videoconferencing semiconductor products, resulting in lower gross margins. In the likely event that we encounter significant price competition in the markets for our products, we could be at a significant disadvantage compared to our competitors, many of whom have substantially greater resources, and therefore may be better able to withstand an extended period of downward pricing pressure.

Variations in timing of sales may cause significant fluctuations in future operating results. Because a significant portion of our business may be derived from orders placed by a limited number of large customers, including original equipment manufacturers, the timing of such orders can cause significant fluctuations in our operating results. Anticipated orders from customers may fail to materialize. Delivery schedules may be deferred or canceled for a number of reasons, including changes in specific customer requirements or economic conditions. The adverse impact of a shortfall in our revenues may be magnified by our inability to adjust spending to compensate for such shortfall. Announcements by our competitors or us of new products and technologies could cause customers to defer purchases of our existing products, which would also have a material adverse effect on our business and operating results. As a result of these and other factors, it is likely that in some or all future periods our operating results will be below the expectations of investors, which would likely result in a significant reduction in the market price of our common stock.

**We depend on purchase orders from key customers and failure to receive significant purchase orders in the future would cause a decline in our operating results**

Historically, a significant portion of our sales has been to relatively few customers, although the composition of these customers has varied. Revenues from our ten largest customers for the fiscal years ended March 31, 2003, 2002 and 2001, accounted for approximately 62%, 73% and 48%, respectively, of total revenues. Substantially all of our product sales have been made, and are expected to continue to be made, on a purchase order basis. None of our customers has entered into a long-term agreement requiring it to purchase our products. In the future, we will need to gain purchase orders for our products to earn additional revenue. Further, substantially all of our license and other revenues are nonrecurring.

**The IP telephony market is subject to rapid technological change and we depend on new product introduction in order to maintain and grow our business**

IP telephony is an emerging market that is characterized by rapid changes in customer requirements, frequent introductions of new and enhanced products, and continuing and rapid technological advancement. To compete successfully in this emerging market, we must continue to design, develop, manufacture, and sell new and enhanced semiconductor and IP telephony software products and services that provide increasingly higher levels of performance and reliability at lower cost. These new and enhanced products must take advantage of technological

advancements and changes, and respond to new customer requirements. Our success in designing, developing, manufacturing, and selling such products and services will depend on a variety of factors, including:

- the identification of market demand for new products;
- the scalability of our IP telephony software products;
- product and feature selection;
- timely implementation of product design and development;
- product performance;
- cost-effectiveness of products under development;
- effective manufacturing processes; and
- success of promotional efforts.

Additionally, we may also be required to collaborate with third parties to develop our products and may not be able to do so on a timely and cost-effective basis, if at all. We have in the past experienced delays in the development of new products and the enhancement of existing products, and such delays will likely occur in the future. If we are unable, due to resource constraints or technological or other reasons, to develop and introduce new or enhanced products in a timely manner, if such new or enhanced products do not achieve sufficient market acceptance, or if such new product introductions decrease demand for existing products, our operating results would decline and our business would not grow.

**The long and variable sales and deployment cycles for our IP telephony products may cause our revenue and operating results to vary**

Our IP telephony software and semiconductor products, including our hosted iPBX, Packet8 telephone service and our Audacity family of semiconductors, have lengthy sales cycles, and we may incur substantial sales and marketing expenses and expend significant management effort without making a sale. A customer's decision to purchase our products often involves a significant commitment of its resources and a lengthy product evaluation and qualification process. We do not possess the capital infrastructure required to invest in extensive marketing or advertising campaigns that may be required in order to sell these products. In addition, the length of our sales cycles will vary depending on the type of customer to whom we are selling and the product being sold. Even after making the decision to purchase our products, our customers may deploy our products slowly. Timing of deployment can vary widely and will depend on various factors, including:

- the size of the network deployment;
- the complexity of our customers' network environments;
- our customers' skill sets;
- the hardware and software configuration and customization necessary to deploy our products; and
- our customers' ability to finance their purchase of our products.

As a result, it is difficult for us to predict the quarter in which our customers may purchase our IP telephony products, and our revenue and operating results may vary significantly from quarter to quarter.

**We need to retain key personnel to support our products and ongoing operations**

The development and marketing of our IP telephony products will continue to place a significant strain on our limited personnel, management, and other resources. While the pace of economic growth in the San Francisco Bay Area (where our corporate headquarters are located) has slowed, competition for highly-skilled engineering, sales, marketing, and support personnel has remained strong. Our future success depends upon the continued services of our executive officers and other key employees who have critical industry experience and relationships that we rely on to implement our business plan. None of our officers or key employees are bound by employment agreements for any specific term. The loss of the services of any of our officers or key employees could delay the development and introduction of, and negatively impact our ability to sell our products which could adversely affect our financial results and impair our growth. We currently do not maintain key person life insurance policies on any of our employees.

**We depend on contract manufacturers to manufacture substantially all of our products, and any delay or interruption in manufacturing by these contract manufacturers would result in delayed or reduced shipments to our customers and may harm our business**

We outsource the manufacturing of our semiconductor products to independent foundries and as such do not have internal manufacturing capabilities to meet our customers' demands. We have shifted the manufacture of our voice over IP semiconductors to an affiliate of STMicroelectronics NV, or STM, from Taiwan Semiconductor Manufacturing Corporation, or TSMC. STM or its contract manufacturer, TSMC, will be the sole manufacturer of our semiconductor products. Furthermore, to the extent TSMC is utilized, Taiwan is always subject to geological or geopolitical disturbances that could instantly cut off such supply. We also rely on other third party manufacturers for packaging and testing of our semiconductors.

We do not have long-term purchase agreements with our contract manufacturers or our component suppliers. There can be no assurance that our subcontract manufacturers will be able or willing to reliably manufacture our products, in volumes, on a cost-effective basis or in a timely manner. For our semiconductor products, the time to port our technology to another foundry, the time to qualify the new versions of product, and the cost of this effort as well as the tooling associated with wafer production would have a material adverse effect on our business, operating results, and financial condition. For our consumer videophones, IP telephones and media hub devices that are used with our hosted iPBX and Packet8 voice and video IP telephone service, we rely on the availability of these semiconductor products. These devices are also sourced solely from certain overseas contract manufacturers and partners, and are not available from any other manufacturer.

**We may not be able to manage our inventory levels effectively, which may lead to inventory obsolescence that would force us to lower our prices**

Our products have lead times of up to several months, and are built to forecasts that are necessarily imprecise. Because of our practice of building our products to necessarily imprecise forecasts, it is likely that, from time to time, we will have either excess or insufficient product inventory. Excess inventory levels would subject us to the risk of inventory obsolescence and the risk that our selling prices may drop below our inventory costs, while insufficient levels of inventory may negatively affect relations with customers. For instance, our customers rely upon our ability to meet committed delivery dates, and any disruption in the supply of our products could result in legal action from our customers, loss of customers or harm to our ability to attract new customers. Any of these factors could have a material adverse effect on our business, operating results, and financial condition.

**If our products do not interoperate with our customers' networks, orders for our products will be delayed or canceled and substantial product returns could occur, which could harm our business**

Many of the potential customers for our hosted iPBX product and Packet8 voice and video IP telephone service have requested that our products and services be designed to interoperate with their existing networks, each of which may have different specifications and use multiple standards. Our customers' networks may contain multiple generations of products from different vendors that have been added over time as their networks have grown and evolved. Our products must interoperate with these products as well as with future products in order to meet our customers' requirements. In some cases, we may be required to modify our product designs to achieve a sale, which may result in a longer sales cycle, increased research and development expense, and reduced operating margins. If our products do not interoperate with existing equipment or software in our customers' networks, installations could be delayed, orders for our products could be canceled or our products could be returned. This could harm our business, financial condition, and results of operations. Our Packet8 telephone service depends on the availability of third party network service providers that provide telephone numbers and PSTN call termination and origination services for our customers. Many of these network service providers are financially affected by the downturn in the telecommunications industry and may be forced to terminate the services that we depend on. The time to interface our technology to another network service provider, if available, and qualify this new service could have a material adverse effect on our business, operating results, and financial condition.

**We may have difficulty identifying the source of the problem when there is a problem in a network**

Our hosted iPBX and Packet8 IP telephone service must successfully integrate with products from other vendors, such as gateways to traditional telephone systems. As a result, when problems occur in a network, it may be

difficult to identify the source of the problem. The occurrence of hardware and software errors, whether caused by our hosted iPBX solution, Packet8 service or another vendor's products, may result in the delay or loss of market acceptance of our products and any necessary revisions may force us to incur significant expenses. The occurrence of some of these types of problems may seriously harm our business, financial condition and results of operations.

**Intense competition in the markets in which we compete could prevent us from increasing or sustaining our revenue and prevent us from achieving profitability**

We expect our competitors to continue to improve the performance of their current products and introduce new products or new technologies. If our competitors successfully introduce new products or enhance their existing products, this could reduce the sales or market acceptance of our products and services, increase price competition or make our products obsolete. To be competitive, we must continue to invest significant resources in research and development, sales and marketing, and customer support. We may not have sufficient resources to make these investments or to make the technological advances necessary to be competitive, which in turn will cause our business to suffer.

In addition, our focus on developing a range of technology products, including semiconductors and related embedded software, hosted iPBX solutions, and the Packet8 telephone service products, places a significant strain on our research and development resources. Competitors that focus on one aspect of technology, such as software or semiconductors, may have a considerable advantage over us. In addition, many of our current and potential competitors have longer operating histories, are substantially larger, and have greater financial, manufacturing, marketing, technical, and other resources. For example, certain competitors in the market for our semiconductor products maintain their own semiconductor foundries and may therefore benefit from certain capacity, cost and technical advantages. Many also have greater name recognition and a larger installed base of products than we have. Competition in our markets may result in significant price reductions. As a result of their greater resources, many current and potential competitors may be better able than us to initiate and withstand significant price competition or downturns in the economy. There can be no assurance that we will be able to continue to compete effectively, and any failure to do so would harm our business, operating results, and financial condition.

**If we do not develop and maintain successful partnerships for IP telephony products, we may not be able to successfully market our solutions**

We are entering into new market areas and our success is partly dependent on our ability to forge new marketing and engineering partnerships. IP telephony communication systems are extremely complex and few, if any, companies possess all the required technology components needed to build a complete end to end solution. We will likely need to enter into partnerships to augment our development programs and to assist us in marketing complete solutions to our targeted customers. We may not be able to develop such partnerships in the course of our product development. Even if we do establish the necessary partnerships, we may not be able to adequately capitalize on these partnerships to aid in the success of our business.

**Inability to protect our proprietary technology or our infringement of a third party's proprietary technology would disrupt our business**

We rely in part on trademark, copyright, and trade secret law to protect our intellectual property in the United States and abroad. We seek to protect our software, documentation, and other written materials under trade secret and copyright law, which afford only limited protection. We also rely in part on patent law to protect our intellectual property in the United States and internationally. We hold fifty-four United States patents and have a number of United States and foreign patent applications pending. We cannot predict whether such pending patent applications will result in issued patents. We may not be able to protect our proprietary rights in the United States or internationally (where effective intellectual property protection may be unavailable or limited), and competitors may independently develop technologies that are similar or superior to our technology, duplicate our technology or design around any patent of ours. We have in the past licensed and in the future expect to continue licensing our technology to others; many of who are located or may be located abroad. There are no assurances that such licensees will protect our technology from misappropriation. Moreover, litigation may be necessary in the future to enforce our intellectual property rights, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of management time and resources and could have a material adverse effect on our business, financial condition, and

operating results. Any settlement or adverse determination in such litigation would also subject us to significant liability.

There has been substantial litigation in the semiconductor, electronics, and related industries regarding intellectual property rights, and from time to time third parties may claim infringement by us of their intellectual property rights. Our broad range of technology, including systems, digital and analog circuits, software, and semiconductors, increases the likelihood that third parties may claim infringement by us of their intellectual property rights. If we were found to be infringing on the intellectual property rights of any third party, we could be subject to liabilities for such infringement, which could be material. We could also be required to refrain from using, manufacturing or selling certain products or using certain processes, either of which could have a material adverse effect on our business and operating results. From time to time, we have received, and may continue to receive in the future, notices of claims of infringement, misappropriation or misuse of other parties' proprietary rights. There can be no assurance that we will prevail in these discussions and actions or that other actions alleging infringement by us of third party patents will not be asserted or prosecuted against the Company.

We rely upon certain technology, including hardware and software, licensed from third parties. There can be no assurance that the technology licensed by us will continue to provide competitive features and functionality or that licenses for technology currently utilized by us or other technology which we may seek to license in the future will be available to us on commercially reasonable terms or at all. The loss of, or inability to maintain existing licenses could result in shipment delays or reductions until equivalent technology or suitable alternative products could be developed, identified, licensed and integrated, and could harm our business. These licenses are on standard commercial terms made generally available by the companies providing the licenses. The cost and terms of these licenses individually are not material to our business.

**The failure of IP networks to meet the reliability and quality standards required for voice and video communications could render our products obsolete**

Circuit-switched telephony networks feature very high reliability, with a guaranteed quality of service. In addition, such networks have imperceptible delay and consistently satisfactory audio quality. Emerging broadband IP networks, such as LANs, WANs, and the internet, or emerging last mile technologies such as cable, digital subscriber lines, and wireless local loop, may not be suitable for telephony unless such networks and technologies can provide reliability and quality consistent with these standards.

**Our products must comply with industry standards, FCC regulations, state, country-specific and international regulations, and changes may require us to modify existing products**

In addition to reliability and quality standards, the market acceptance of telephony over broadband IP networks is dependent upon the adoption of industry standards so that products from multiple manufacturers are able to communicate with each other. Our IP telephony products rely heavily on standards such as SIP, H.323, MGCP and Megaco to interoperate with other vendors' equipment. There is currently a lack of agreement among industry leaders about which standard should be used for a particular application, and about the definition of the standards themselves. These standards, as well as audio and video compression standards, continue to evolve. We also must comply with certain rules and regulations of the Federal Communications Commission (FCC) regarding electromagnetic radiation and safety standards established by Underwriters Laboratories, as well as similar regulations and standards applicable in other countries. Standards are continuously being modified and replaced. As standards evolve, we may be required to modify our existing products or develop and support new versions of our products. The failure of our products to comply, or delays in compliance, with various existing and evolving industry standards could delay or interrupt volume production of our IP telephony products, which would have a material adverse effect on our business, financial condition and operating results.

**Future legislation or regulation of the internet and/or voice and video over IP services could restrict our business or increase our cost of doing business**

At present there are few laws, regulations or rulings that specifically address access to or commerce on the internet, including IP telephony. We are unable to predict the impact, if any, that future legislation, legal decisions or regulations concerning the internet may have on our business, financial condition, and results of operations. Regulation may be targeted towards, among other things, assessing access or settlement charges, imposing taxes

related to internet communications, imposing tariffs or regulations based on encryption concerns or the characteristics and quality of products and services, imposing regulations and requirements related to the handling of emergency 911 services, any of which could restrict our business or increase our cost of doing business. The increasing growth of the broadband IP telephony market and popularity of broadband IP telephony products and services heighten the risk that governments or other legislative bodies will seek to regulate broadband IP telephony and the internet. In addition, large, established telecommunication companies may devote substantial lobbying efforts to influence the regulation of the broadband IP telephony market, which may be contrary to our interests. Recent federal legislation provides for a significant deregulation of the U.S. telecommunications industry, including the local exchange, long distance and cable television industries. This legislation remains subject to judicial review and additional Federal Communications Commission, or FCC, rulemaking. As a result, we cannot predict the legislation's effect on our future operations. Many regulatory actions are under way or are being contemplated by federal and state authorities regarding important items. These actions could have a material adverse effect on our business, financial condition and operating results.

**Potential regulation of internet service providers could adversely affect our operations**

To date, the FCC has treated internet service providers as data service providers. Data service providers are currently exempt from federal and state regulations governing common carriers, including the obligation to pay access charges and contribute to the universal service fund. The FCC is currently examining the status of internet service providers and the services they provide. If the FCC were to determine that internet service providers, or the services they provide, are subject to FCC regulation, including the payment of access charges and contribution to the universal service funds, it could have a material adverse effect on our business, financial condition and operating results.

**The Company may lose customers if it experiences system failures that significantly disrupt the availability and quality of the services that it provides**

The operation of our Packet8 voice and video service depends on our ability to avoid and mitigate any interruptions in service or reduced capacity for customers. Interruptions in service or performance problems, for whatever reason, could undermine confidence in our services and cause us to lose customers or make it more difficult to attract new ones. In addition, because our services may be critical to the businesses of our customers, any significant interruption in service could result in lost profits or other loss to our customers. Although we attempt to disclaim liability in our service agreements, a court might not enforce a limitation on liability, which could expose us to financial loss. In addition, we may provide our customers with guaranteed service level commitments. If we are unable to meet these guaranteed service level commitments as a result of service interruptions, we may be obligated to provide credits, generally in the form of free service for a short period of time, to our customers, which could negatively affect our operating results.

The failure of any equipment or facility on our network, or those of our partners or customers, could result in the interruption of customer service until necessary repairs are made or replacement equipment is installed. Network failures, delays and errors could also result from natural disasters, terrorist acts, power losses, security breaches and computer viruses. These failures, faults or errors could cause delays, service interruptions, expose us to customer liability or require expensive modifications that could have a material adverse effect on our business, financial condition and operating results.

**Intellectual property and proprietary rights of others could prevent us from using necessary technology to provide IP voice and video services**

While we do not know of any technologies that are patented by others that we believe are necessary for us to provide our services, this necessary technology may in fact be patented by other parties either now or in the future. If this technology were held under patent by another person, we would have to negotiate a license for the use of that technology. We may not be able to negotiate such a license at a price that is acceptable. The existence of such a patent, or our inability to negotiate a license for any such technology on acceptable terms, could force us to cease using the technology and offering products and services incorporating the technology.

**We may transition to smaller geometry process technologies and higher levels of design integration, which could disrupt our business**

We continuously evaluate the benefits, on an integrated circuit, product-by-product basis, of migrating to smaller geometry process technologies in order to reduce costs related to the development and production of our semiconductors or to improve their performance. We believe that the transition of our products to increasingly smaller geometries will be important for us to remain competitive. We have in the past experienced difficulty in migrating to new manufacturing processes - which has resulted and could continue to result in reduced yields, delays in product deliveries, and increased expense levels. Moreover, we are dependent on relationships with our foundry and their partners to migrate to smaller geometry processes successfully. If any such transition is substantially delayed or inefficiently implemented, we may experience delays in product introductions and incur increased expenses. As smaller geometry processes become more prevalent, we expect to integrate greater levels of functionality, as well as customer and third party intellectual property, into our products. We cannot predict whether higher levels of design integration or the use of third party intellectual property will adversely affect our ability to deliver new integrated products on a timely basis, or at all.

**If we discover product defects, we may have product-related liabilities which may cause us to lose revenues or delay market acceptance of our products**

Products as complex as those we offer frequently contain errors, defects, and functional limitations when first introduced or as new versions are released. We have in the past experienced such errors, defects or functional limitations. We sell products into markets that are extremely demanding of robust, reliable, fully functional products. Therefore, delivery of products with production defects or reliability, quality or compatibility problems could significantly delay or hinder market acceptance of such products, which could damage our credibility with our customers and adversely affect our ability to retain our existing customers and to attract new customers. Moreover, such errors, defects or functional limitations could cause problems, interruptions, delays or a cessation of sales to our customers. Alleviating such problems may require significant expenditures of capital and resources by us. Despite our testing, our suppliers or our customers may find errors, defects or functional limitations in new products after commencement of commercial production. This could result in additional development costs, loss of, or delays in, market acceptance, diversion of technical and other resources from our other development efforts, product repair or replacement costs, claims by our customers or others against us, or the loss of credibility with our current and prospective customers.

**We have significant international operations, which subject us to risks that could cause our operating results to decline**

Sales to customers outside of the United States during the years ended March 31, 2003, 2002 and 2001 were 62%, 61% and 69% of total revenues, respectively. The following table illustrates our net revenues by geographic area expressed as a percentage of total revenues for the corresponding period. Revenues are attributed to countries based on the destination of shipment (in thousands):

	Year Ended March 31,		
	2003	2002	2001
United States.....	\$ 4,218	\$ 5,777	\$ 5,632
Europe.....	2,657	4,126	5,862
Taiwan.....	1,569	2,026	2,739
Japan.....	919	1,119	1,188
Other.....	1,640	1,643	2,807
	<u>\$ 11,003</u>	<u>\$ 14,691</u>	<u>\$ 18,228</u>

Substantially all of our current semiconductor and system-level products are, and substantially all of our future products will be, manufactured, assembled, and tested by independent third parties in foreign countries. International sales and manufacturing are subject to a number of risks, including general economic conditions in regions such as Asia, changes in foreign government regulations and telecommunication standards, export license requirements, tariffs and other trade barriers, potentially adverse tax consequences, fluctuations in currency exchange rates, greater difficulty in collecting accounts receivable and longer collection periods, the impact of recessions in economies outside of the United States, and difficulty in staffing and managing foreign operations. We

are also subject to geopolitical risks, such as political, social, and economic instability, potential hostilities, and changes in diplomatic and trade relationships, in connection with our international operations. Taiwan in particular is subject to a high rate of natural disasters, such as earthquakes or typhoons, which could have significant impact on our suppliers and customers due to a delay in operations within that country. In addition, Taiwan's tenuous relationship with mainland China is a source of continuing concern due to potential hostilities. A significant decline in demand from foreign markets could have a material adverse effect on our business, operating results, and financial condition.

**The location of our headquarters facility subjects us to the risk of earthquakes**

Our corporate headquarters is located in the San Francisco Bay area of Northern California, a region known for seismic activity. A significant natural disaster, such as an earthquake, could have a material adverse impact on our business, operating results, and financial condition.

**We may face interruption of production and services due to increased security measures in response to recent and potential future terrorist activities**

Our business depends on the free flow of products and services through the channels of commerce. Recently, in response to terrorists' activities and threats aimed at the United States, transportation, mail, financial and other services have been slowed or stopped altogether. Further delays or stoppages in transportation, mail, financial or other services, particularly any such delays or stoppages which harm our ability to obtain an adequate supply of products from our independent suppliers, could harm our business, results of operations and financial condition. Furthermore, we may experience an increase in operating costs, such as costs for transportation, insurance and security as a result of the terrorist activities and potential activities. We may also experience delays in receiving payments from customers that have been affected by the terrorist activities and potential activities. The United States economy in general is being adversely affected by terrorist activities and potential terrorist activities. Any economic downturn could adversely impact our results of operations, impair our ability to raise capital or otherwise adversely affect our ability to grow our business. Moreover, we cannot determine whether other attacks may occur in the future and the effects of such attacks on our business.

**These risk factors could cause actual results to differ materially from the results anticipated in forward-looking statements**

The reports that we file with the SEC and our other communications may contain forward-looking statements that involve risks and uncertainties. We consider forward-looking statements to be those statements that describe intentions, beliefs, and current expectations with respect to future operating performance. Our actual results could differ materially from those anticipated in our forward-looking statements as a result of certain factors.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our financial market risk consists primarily of risks associated with international operations and related foreign currencies. We derive a significant portion of our revenues from customers in Europe and Asia. In order to reduce the risk from fluctuation in foreign exchange rates, the vast majority of our sales are denominated in U.S. dollars. In addition, almost all of our arrangements with our semiconductor and system vendors are denominated in U.S. dollars. We have foreign subsidiaries 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.

We invest the majority of our surplus cash and cash equivalents in money market funds that bear variable interest rates, and, accordingly, fluctuations in interest rates do not have an impact on the fair values of such investments. However, given the currently low yields on such money market funds and other low-risk governmental and corporate debt securities, in March 2002 the Company's Board of Directors authorized us to open securities trading accounts and make investments in other classes of securities that may generate higher returns. The amount allocated for such investments was \$1.0 million to be invested on behalf of 8x8, Inc. at the direction of the Company's Chairman, Joe Parkinson, Chief Executive Officer, or Chief Financial Officer. Mr. Parkinson has agreed to personally reimburse 8x8 on a quarterly basis for any losses resulting from his trading activities in order to maintain a minimum investment account balance of \$1.0 million. The Board has been assured of Mr. Parkinson's ability to cover any such losses; however, should he be unable to do so, it could have a material impact on our cash flows,



results of operations, and financial condition. As part of the arrangement, our Board of Directors has expressed its intent, but not obligation, to pay Mr. Parkinson a quarterly bonus in an amount equal to 25% of the profits attributable to investments made on our behalf by Mr. Parkinson to the extent such a bonus exceeds his salary for the corresponding period. The Company or Mr. Parkinson can terminate this arrangement at any time, subject to the terms of an agreement that was filed with our fiscal 2002 report. As of March 31, 2003, approximately \$800,000 of the \$1.0 million was invested in money market funds.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

### INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULE

	<b>Page</b>
FINANCIAL STATEMENTS:	
Report of Independent Accountants	<a href="#"><u>40</u></a>
Consolidated Balance Sheets at March 31, 2003 and 2002	<a href="#"><u>41</u></a>
Consolidated Statements of Operations for each of the three years in the period ended March 31, 2003	<a href="#"><u>42</u></a>
Consolidated Statements of Stockholders' Equity for each of the three years in the period ended March 31, 2003	<a href="#"><u>43</u></a>
Consolidated Statements of Cash Flows for each of the three years in the period ended March 31, 2003	<a href="#"><u>44</u></a>
Notes to Consolidated Financial Statements	<a href="#"><u>45</u></a>
FINANCIAL STATEMENT SCHEDULE:	
Schedule II -- Valuation and Qualifying Accounts	<a href="#"><u>67</u></a>
Consolidated Quarterly Financial Data	<a href="#"><u>68</u></a>
Schedules other than the one listed above have been omitted because they are inapplicable, because the required information has been included in the financial statements or notes thereto, or the amounts are immaterial.	

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## **Report of Independent Accountants**

To the Board of Directors and Stockholders of 8x8, Inc.

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of 8x8, Inc. and its subsidiaries, at March 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2003, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and the financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered significant operating losses and has negative cash flows and a significant accumulated deficit. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 3 to the consolidated financial statements, as of April 1, 2002, the Company ceased amortization of goodwill to conform with the provisions of Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets."

PRICEWATERHOUSECOOPERS LLP

San Jose, California  
May 2, 2003

**8X8, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)**

	<b>March 31,</b>	
	<b>2003</b>	<b>2002</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents.....	\$ 3,371	\$ 12,422
Short term investments.....	208	--
Accounts receivable, net of allowance of \$141 and \$286, respectively.....	1,290	1,239
Inventory.....	352	733
Other current assets.....	595	612
Total current assets.....	5,816	15,006
Property and equipment, net.....	841	2,740
Intangibles and other assets.....	48	1,907
	<u>\$ 6,705</u>	<u>\$ 19,653</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable.....	\$ 652	\$ 548
Accrued compensation.....	847	921
Accrued warranty.....	477	478
Deferred revenue.....	545	2,421
Other accrued liabilities.....	1,125	958
Income taxes payable.....	226	280
Total current liabilities.....	3,872	5,606
Contingently redeemable common stock.....	669	813
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, \$0.001 par value:		
Authorized: 5,000,000 shares;		
Issued and outstanding: 1 share at March 31, 2003 and March 31, 2002.....	--	--
Common stock, \$0.001 par value:		
Authorized: 100,000,000 shares at March 31, 2003 and March 31, 2002;		
Issued and outstanding: 28,470,987 shares at March 31, 2003 and 28,228,215 shares at March 31, 2002.....	28	27
Additional paid-in capital.....	150,827	150,612
Deferred compensation.....	(12)	(30)
Accumulated other comprehensive loss.....	--	(99)
Accumulated deficit.....	(148,679)	(137,276)
Total stockholders' equity.....	2,164	13,234
	<u>\$ 6,705</u>	<u>\$ 19,653</u>

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

8X8, INC.

**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)**

	Years Ended March 31,		
	2003	2002	2001
Product revenues.....	\$ 5,739	\$ 6,044	\$ 12,808
License and other revenues.....	5,264	8,647	5,420
Total revenues.....	11,003	14,691	18,228
Cost of product revenues.....	2,781	2,626	5,225
Cost of license and other revenues.....	1,509	197	1,761
Total cost of revenues.....	4,290	2,823	6,986
Gross profit.....	6,713	11,868	11,242
Operating expenses:			
Research and development.....	7,835	12,559	19,950
Selling, general and administrative.....	7,441	8,560	16,899
In-process research and development.....	--	--	4,563
Amortization of intangibles.....	--	763	10,987
Restructuring and other charges.....	3,437	--	33,316
Total operating expenses.....	18,713	21,882	85,715
Loss from operations.....	(12,000)	(10,014)	(74,473)
Other income, net.....	597	1,029	2,628
Interest expense.....	--	(884)	(1,456)
Loss before provision for income taxes.....	(11,403)	(9,869)	(73,301)
Provision for income taxes.....	--	15	17
Net loss before extraordinary gain and cumulative effect of change in accounting principle .....	(11,403)	(9,884)	(73,318)
Extraordinary gain on extinguishment of debt, net.....	--	779	--
Cumulative effect of change in accounting principle.....	--	--	(1,081)
Net loss.....	<u>\$ (11,403)</u>	<u>\$ (9,105)</u>	<u>\$ (74,399)</u>
Basic and diluted per share amounts:			
Net loss before extraordinary gain and cumulative effect of change in accounting principle .....	\$ (0.40)	\$ (0.36)	\$ (2.95)
Extraordinary gain on extinguishment of debt, net.....	--	0.03	--
Cumulative effect of change in accounting principle.....	--	--	(0.04)
Net loss.....	<u>\$ (0.40)</u>	<u>\$ (0.33)</u>	<u>\$ (2.99)</u>
Basic and diluted shares outstanding.....	<u>28,386</u>	<u>27,271</u>	<u>24,846</u>

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

8X8, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(IN THOUSANDS, EXCEPT SHARES)

	Preferred Stock		Common Stock		Additional	Notes	Deferred	Accumulated	Accumulated	Total
	Shares	Amount	Shares	Amount	Paid-in	Receivable	Compensa-	other	Deficit	
					Capital	from	tion	Comprehen-		
						Stock-		sive		
						holders		Loss		
Balance at March 31, 2000.....	--	\$ --	22,958,921	\$ 23	\$ 101,559	\$ (69)	\$ (376)	\$ --	\$ (53,747)	\$ 47,390
Acquisition of UForce, Inc. ....	1	--	3,555,303	4	44,584	--	--	--	--	44,588
Issuance of common stock under	--	--	--	--	--	--	--	--	--	--
stock plans.....	--	--	1,206,591	1	2,761	--	--	--	--	2,762
Repayment of notes receivable										
from stockholders.....	--	--	--	--	--	60	--	--	--	60
Repurchase of common stock and	--	--	--	--	--	--	--	--	--	--
Exchangeable Shares.....	--	--	(1,040,089)	(1)	(521)	8	--	--	--	(514)
Deferred compensation related										
to stock options.....	--	--	--	--	551	--	202	--	--	753
Value of beneficial conversion										
feature associated with the										
convertible subordinated										
debentures.....	--	--	--	--	1,081	--	--	--	--	1,081
Change in unrealized loss on										
investments.....	--	--	--	--	--	--	--	(24)	--	--
Cumulative translation										
adjustment.....	--	--	--	--	--	--	--	(65)	--	--
Net loss.....	--	--	--	--	--	--	--	--	(74,399)	--
Total comprehensive loss.....	--	--	--	--	--	--	--	--	--	(74,488)
Balance at March 31, 2001.....	1	\$ --	26,680,726	\$ 27	\$ 150,015	\$ (1)	\$ (174)	\$ (89)	\$ (128,146)	\$ 21,632
Redemption of convertible										
subordinated debentures.....	--	--	1,000,000	--	321	--	--	--	(25)	296
Issuance of common stock under										
stock plans.....	--	--	457,346	--	335	--	--	--	--	335
Issuance of common stock to debt										
holders to satisfy interest	--	--	--	--	--	--	--	--	--	--
obligations.....	--	--	95,699	--	97	--	--	--	--	97
Forgiveness of note receivable.....	--	--	(5,556)	--	(1)	1	--	--	--	--
Deferred compensation related										
to stock options.....	--	--	--	--	(155)	--	144	--	--	(11)
Cumulative translation										
adjustment.....	--	--	--	--	--	--	--	(10)	--	--
Net loss.....	--	--	--	--	--	--	--	--	(9,105)	--
Total comprehensive loss.....	--	--	--	--	--	--	--	--	--	(9,115)
Balance at March 31, 2002.....	1	\$ --	28,228,215	\$ 27	\$ 150,612	\$ --	\$ (30)	\$ (99)	\$ (137,276)	\$ 13,234
Issuance of common stock under										
stock plans.....	--	--	242,772	1	88	--	--	--	--	89
Common stock no longer										
contingently redeemable.....	--	--	--	--	144	--	--	--	--	144
Deferred compensation related										
to stock options.....	--	--	--	--	(17)	--	18	--	--	1
Cumulative translation										
adjustment.....	--	--	--	--	--	--	--	99	--	--
Net loss.....	--	--	--	--	--	--	--	--	(11,403)	--
Total comprehensive loss.....	--	--	--	--	--	--	--	--	--	(11,304)
Balance at March 31, 2003.....	1	\$ --	28,470,987	\$ 28	\$ 150,827	\$ --	\$ (12)	\$ --	\$ (148,679)	\$ 2,164

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

8X8, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)

	Years Ended March 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net loss.....	\$ (11,403)	\$ (9,105)	\$ (74,399)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization.....	1,780	3,862	14,355
Extraordinary gain due to debt redemption .....	--	(779)	--
Stock compensation expense.....	1	(11)	753
Cumulative effect of change in accounting principle.....	--	--	1,081
In-process research and development.....	--	--	4,563
Gain on sale of investments, net.....	--	(131)	(225)
Non-cash portion of restructuring and other charges.....	2,273	--	32,331
Other.....	204	26	(20)
Changes in assets and liabilities, net of effects of businesses acquired and sold:			
Accounts receivable.....	(71)	1,668	851
Inventory.....	298	501	(85)
Other current and noncurrent assets.....	64	1,607	(1,281)
Accounts payable.....	104	(839)	(2,197)
Accrued compensation.....	(249)	(610)	(623)
Accrued warranty.....	(1)	(47)	(169)
Deferred revenue.....	(1,876)	(3,482)	197
Other accrued liabilities.....	93	(579)	378
Income taxes payable.....	(54)	(26)	(78)
Net cash used in operating activities.....	<u>(8,837)</u>	<u>(7,945)</u>	<u>(24,568)</u>
Cash flows from investing activities:			
Acquisitions of property and equipment.....	(137)	(172)	(6,127)
Cash paid for acquisitions, net.....	--	--	(558)
Proceeds from sale of investments.....	--	543	225
Proceeds from the sale of video monitoring assets, net.....	--	--	5,160
Proceeds from the sale of equipment.....	42	116	--
Purchases of short-term investments.....	(208)	--	--
Net cash (used in) provided by investing activities.....	<u>(303)</u>	<u>487</u>	<u>(1,300)</u>
Cash flows from financing activities:			
Debt repayments.....	--	(4,581)	(891)
Proceeds from issuance of common stock, net.....	89	335	2,763
Repayment of notes receivable from stockholders.....	--	--	60
Repurchase of common stock and Exchangeable Shares.....	--	--	(514)
Net cash provided by (used in) financing activities.....	<u>89</u>	<u>(4,246)</u>	<u>1,418</u>
Net decrease in cash and cash equivalents.....	<u>(9,051)</u>	<u>(11,704)</u>	<u>(24,450)</u>
Cash and cash equivalents, beginning of year.....	12,422	24,126	48,576
Cash and cash equivalents, end of year.....	<u>\$ 3,371</u>	<u>\$ 12,422</u>	<u>\$ 24,126</u>
Supplemental and non-cash disclosures:			
Income taxes paid.....	<u>\$ 36</u>	<u>\$ 12</u>	<u>\$ 25</u>
Interest paid.....	<u>\$ --</u>	<u>\$ 204</u>	<u>\$ 308</u>
Common stock issued to satisfy interest obligations.....	<u>\$ --</u>	<u>\$ 97</u>	<u>\$ --</u>
Issuance of shares and repricing of warrants in connection with the debt extinguishment.....	<u>\$ --</u>	<u>\$ 1,109</u>	<u>\$ --</u>
Issuance of shares and assumption of options in connection with the acquisition of U Force.....	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 44,586</u>
Marketable securities received in exchange for furniture and equipment.....	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 412</u>

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

## **8X8, INC.**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **1. THE COMPANY AND ITS SIGNIFICANT ACCOUNTING POLICIES**

##### ***THE COMPANY***

8x8, Inc., or 8x8, and its subsidiaries (collectively, the Company) develop and market communication technology 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. In August 2000, the Company changed its name from 8x8, Inc. to Netergy Networks, Inc. The Company changed its name back to 8x8, Inc. in July 2001. During the fiscal year ended March 31, 2001, 8x8 formed two subsidiaries, Netergy Microelectronics, Inc. (Netergy) and Centile, Inc. (Centile) and reorganized its operations more clearly along its three product lines.

- Within the parent company, 8x8 offers the Packet8 service that enables broadband internet users to add digital telephone service to their high-speed internet connection. In addition, 8x8 offers videophones for use on both traditional telephony networks and in conjunction with the Packet8 service;
- Netergy provides voice and video semiconductors and related communication software to original equipment manufacturers (OEMs) of telephones, terminal adapters, and other edge devices and to other semiconductor companies. Netergy's technologies are used to make IP telephones and to voice-enable cable and digital subscriber line modems, wireless devices, and other broadband technologies; and
- Centile develops and markets hosted iPBX solutions that allow service providers to offer to small and medium-sized businesses over broadband networks the features and functions that a user commonly expects to find in a typical business phone system. A hosted iPBX solution is a software application that implements the functionality of a business phone system over the same data connection that a business uses for connection to the internet. The phone system software runs on servers that are located at a central data center so that the only phone system equipment that is required at the customer site are telephones. The phone system can also be accessed and controlled from any web browser on the internet.

##### ***LIQUIDITY***

The possibility that the Company will not be able to meet its obligations as and when they become due over the next twelve months raises substantial doubt about the Company's ability to continue as a going concern. Accordingly, the Company has been pursuing, and will continue to pursue, the implementation of certain cost reduction strategies. Additionally, the Company plans to seek additional financing and evaluate financing alternatives during the next twelve months in order to meet its cash requirements for fiscal 2004. The Company has sustained net losses and negative cash flows from operations since fiscal 1999 that have been funded primarily through the issuance of equity securities and borrowings. Management expects to experience negative cash flows for the foreseeable future and such losses may be substantial. There is no assurance that the Company will be able to obtain financing on terms favorable to the Company, or at all. Failure to increase revenues, to manage net operating expenses and to raise additional financing through public or private equity financing or other sources of financing may result in the Company not achieving its longer term business objectives. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

##### ***FISCAL YEAR***

Effective beginning in fiscal 2001, the Company changed its fiscal year from a year ending on the Thursday closest to March 31 to a year ending on March 31. Fiscal 2001 was 52 weeks and 2 days, while fiscal 2002 and fiscal 2003 were each 52 weeks.

##### ***PRINCIPLES OF CONSOLIDATION***

The consolidated financial statements include the accounts of 8x8 and its subsidiaries. All material intercompany accounts and transactions have been eliminated.



## ***USE OF ESTIMATES***

The preparation of the consolidated financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and equity and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including, but not limited to, those related to bad debts, investments, goodwill and intangible assets, income taxes, restructuring and impairment charges, and other contingencies. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates under different assumptions or conditions.

## ***REVENUE RECOGNITION***

**Product revenue** -- The Company recognizes revenue from product sales upon shipment to OEMs 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. Reserves for returns and allowances for OEM and end user sales are recorded at the time of shipment. The Company defers recognition of revenue on sales to distributors and resellers where the right of return exists until products are resold to the end user.

**License and other revenue** -- The Company recognizes revenue from license contracts when a non-cancelable, non-contingent license agreement has been signed, the software product has been delivered, no uncertainties exist surrounding product acceptance, fees from the agreement are fixed and determinable, and collection is probable. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date if evidence of the fair value of all undelivered elements exists. If evidence of the fair value of the undelivered elements does not exist, revenue is deferred and recognized when delivery occurs. When the Company enters into a license agreement requiring that the Company provide significant customization of the software products, the license and consulting revenue is recognized using contract accounting. Revenue from maintenance agreements is recognized ratably over the term of the maintenance agreement, which in most instances is one year. The Company recognizes royalties upon notification of sale by its licensees. Revenue from consulting, training, and development services is recognized as the services are performed. For sales generated from long-term contracts, the Company uses the percentage of completion method of accounting. In doing so, management makes important judgments in estimating costs and in measuring progress towards completion. These judgments underlie the Company's determinations regarding overall contract value, contract profitability and timing of revenue recognition. Revenue and cost estimates are revised periodically based on changes in circumstances, and any losses on contracts are recognized immediately.

## ***CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS***

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. Management determines the appropriate classification of debt and equity securities at the time of purchase and reevaluates the classification at each reporting date. The cost of the Company's investments is determined based upon specific identification.

Investments classified as available-for-sale are reported at fair value, based upon quoted market prices, with unrealized gains and losses, net of related tax, if any, included in Accumulated Other Comprehensive Loss in the Consolidated Balance Sheet. At March 31, 2002 and 2003, there were no investments classified as available-for-sale.

Investments classified as trading securities are carried at fair value, with unrealized holding gains and losses included in earnings. Realized gains and losses are determined using the specific identification method based on the trade date of a transaction. The Company had \$208,000 of investments classified as trading securities at March 31, 2003, and no investments classified as trading securities at March 31, 2002.

In March 2002 8x8's board of directors (the Board) authorized the Company to open securities trading accounts and make investments of up to \$1.0 million, as directed by the Company's Chairman, Joe Parkinson, the Chief Executive

Officer, or the Chief Financial Officer. Mr. Parkinson has agreed to personally reimburse 8x8 on a quarterly basis for any losses resulting from his trading activities in order to maintain a minimum investment account balance of \$1.0 million. The Board has been assured of Mr. Parkinson's ability to cover any such losses; however, should he be unable to do so, it could have a material impact on the Company's cash flows and results of operations. As part of the arrangement, the Board has expressed its intent, but not obligation, to pay Mr. Parkinson a quarterly bonus in an amount equal to 25% of the profits attributable to investments made on the Company's behalf by Mr. Parkinson to the extent such a bonus exceeds his salary for the corresponding period. The Company or Mr. Parkinson can terminate this arrangement at any time. Under the arrangement, the Company is required to return to Mr. Parkinson the amount representing the increase in value of the investment account over \$1.0 million to the extent required to restore replenishment payments made by Mr. Parkinson in prior quarters. Through March 31, 2003, Mr. Parkinson had made cumulative replenishment payments of approximately \$137,000 to offset losses incurred. As of March 31, 2003, the investment account balance approximated \$1,018,000. Accordingly, the Company had a payable of approximately \$18,000 to Mr. Parkinson at March 31, 2003. As of March 31, 2003, \$208,000 of the \$1.0 million allocated for such investment activities was invested in marketable equity securities, and the remainder was invested in money market funds.

### ***INVENTORY***

Inventory is stated at the lower of standard cost, which approximates actual cost using the first-in, first-out method, or market. Inventory reserves are established when conditions indicate that the selling price could be less than cost due to physical deterioration, obsolescence, changes in price levels, or other causes. Reserves are established for excess inventory generally based on inventory levels in excess of demand, as determined by management, for each specific product. If actual product demand or selling prices are less favorable than the Company's estimate, the Company may be required to take additional inventory write-downs. Conversely, if the Company sells more inventory or at higher prices than the Company's forecast, future margins may be higher.

Inventory at March 31, 2003 and 2002 was comprised of the following:

	<b>March 31,</b>	
	<b>2003</b>	<b>2002</b>
	(in thousands)	
Raw materials and work-in-process.....	\$ 147	\$ 528
Finished goods.....	205	205
	<u>\$ 352</u>	<u>\$ 733</u>

### ***PROPERTY AND EQUIPMENT***

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method. Estimated useful lives of three years are used for equipment and software and five years for furniture and fixtures. Amortization of leasehold improvements is computed using the shorter of the remaining facility lease term or the estimated useful life of the improvements. Property and equipment at March 31, 2003 and 2002, was comprised of the following components:

	<b>March 31,</b>	
	<b>2003</b>	<b>2002</b>
	(in thousands)	
Machinery and computer equipment.....	\$ 7,378	\$ 8,076
Furniture and fixtures.....	847	1,084
Licensed software.....	4,142	4,105
Leasehold improvements.....	914	991
	<u>13,281</u>	<u>14,256</u>
Less: accumulated depreciation and amortization.....	<u>(12,440)</u>	<u>(11,516)</u>
	<u>\$ 841</u>	<u>\$ 2,740</u>

Maintenance, repairs and ordinary replacements are charged to expense. Expenditures for improvements that extend the physical or economic life of the property are capitalized. Gains or losses on the disposition of property and equipment are reflected in Other Income, net.

### ***IMPAIRMENT OF LONG-LIVED ASSETS***

8x8 reviews the recoverability of its long-lived assets, such as plant and equipment when events or changes in circumstances occur that indicate that the carrying value of the asset or asset group may not be recoverable. The assessment of possible impairment is based on the Company's ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows (undiscounted and without interest charges) of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-lived assets.

### ***WARRANTY EXPENSE***

The Company accrues for the estimated cost that may be incurred under its product warranties upon revenue recognition. Changes in the Company's product warranty liability during the year ended March 31, 2003 were not material.

### ***RESEARCH AND SOFTWARE DEVELOPMENT COSTS***

Research and development costs are charged to operations as incurred. Software development costs incurred prior to the establishment of technological feasibility are included in research and development and are expensed as incurred. The Company defines establishment of technological feasibility as the completion of a working model. Software development costs incurred subsequent to the establishment of technological feasibility through the period of general market availability of the product are capitalized, if material. To date, all software development costs have been expensed as incurred.

### ***FOREIGN CURRENCY TRANSLATION***

Assets and liabilities of the Company's foreign subsidiaries are translated from their respective functional currencies at exchange rates in effect at the balance sheet date, and revenues and expenses are translated at average exchange rates prevailing during the year. If the functional currency is the local currency, resulting translation adjustments are reflected as a separate component of stockholders' equity. If the functional currency is the U.S. dollar, resulting conversion adjustments are included in the results of operations. Foreign currency transaction gains and losses, which have been immaterial, are also included in results of operations. Total assets of the Company's foreign subsidiaries were \$508,000, \$1.6 million and \$3.8 million as of March 31, 2003, 2002, and 2001, respectively. During the year ended 2003, the Company substantially completed the liquidation of its investment in its Canadian operations acquired in conjunction with the acquisition of U|Force, Inc. in June 2000. As a result, the \$92,000 attributable to that entity and accumulated in the translation adjustment component of equity was removed and reported in other income. At March 31, 2003, the U.S. dollar was the functional currency for all foreign subsidiaries. The Company does not undertake any foreign currency hedging activities.

### ***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, based on available evidence, are not expected to be realized.

### ***TAX CREDITS***

Research and development and other refundable tax credits are accounted for using the cost reduction method. Under this method, tax credits relating to eligible expenditures are accounted for as a reduction of related expenses in the period during which the expenditures are incurred, provided there is reasonable assurance of realization.

## **CONCENTRATIONS**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents and trade accounts receivable. At March 31, 2003, approximately 55% of the Company's cash equivalents were placed in an institutional money market fund of a reputable, U.S. based financial institution. The Company has not experienced any material losses relating to any investment instruments.

The Company sells its products to OEMs and distributors throughout the world. The Company performs ongoing credit evaluations of its customers' financial condition, and for certain transactions requires collateral from its customers. For each of the three years ended March 31, 2003, the Company experienced minimal write-offs for bad debts and doubtful accounts. At March 31, 2003, three customers accounted for 30%, 18% and 15% of gross accounts receivable. At March 31, 2002, one customer accounted for 45% of accounts receivable.

The Company outsources the manufacturing of its semiconductor and system products to independent contract manufacturers. The inability of any contract manufacturer to fulfill supply requirements of the Company could materially impact future operating results, financial position and cash flows.

## **FAIR VALUE OF FINANCIAL INSTRUMENTS**

The estimated fair value of financial instruments is determined by the Company using available market information and valuation methodologies considered to be appropriate. The carrying amounts of the Company's cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair values due to their short maturities.

## **ACCOUNTING FOR STOCK-BASED COMPENSATION**

The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB Opinion No. 25) and related interpretations thereof. As required under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), the Company provides pro forma disclosure of net income and earnings per share. If the Company had elected to recognize compensation costs based on the fair value at the date of grant of the awards, consistent with the provisions of SFAS No. 123, net income and earnings per share amounts would have been as follows (in thousands, except per share amounts):

	<b>Year Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net loss:	\$ (11,403)	\$ (9,105)	\$ (74,399)
Add: Stock-based compensation expense			
included in reported net income.....	1	(11)	753
Deduct: Total stock-based compensation			
determined pursuant to SFAS No.123*.....	(4,446)	(9,483)	(10,486)
Pro forma net loss (basic and diluted)	<u>\$ (15,848)</u>	<u>\$ (18,599)</u>	<u>\$ (84,132)</u>
As reported net loss per share.....	\$ (0.40)	\$ (0.33)	\$ (2.99)
Pro forma net loss per share.....	\$ (0.56)	\$ (0.68)	\$ (3.39)

\*These amounts have been adjusted to reflect a correction to the forfeiture rate, which resulted in reductions in the pro forma net losses for 2002 and 2001 of \$6.5 million and \$3.1 million, respectively.

## **COMPREHENSIVE LOSS**

Comprehensive loss, as defined, includes all changes in equity (net assets) during a period from non-owner sources. The difference between net loss and comprehensive loss is due primarily to unrealized losses on short-term investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss is

reflected in the Consolidated Statements of Stockholders' Equity.

## **RECLASSIFICATIONS**

Certain prior year balances have been reclassified to conform with the current year presentation.

## **NET LOSS PER SHARE**

Basic net loss per share is computed by dividing net loss available to common stockholders (numerator) by the weighted average number of vested, unrestricted common and Exchangeable Shares (see Note 2) outstanding during the period (denominator). Net loss available to common stockholders was as follows (in thousands):

	<b>Years Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net loss.....	\$ (11,403)	\$ (9,105)	\$ (74,399)
Accretion of dividends on contingently redeemable common stock.....	--	(25)	--
Net loss available to common stockholders.....	<u>\$ (11,403)</u>	<u>\$ (9,130)</u>	<u>\$ (74,399)</u>

Due to net losses incurred for all periods presented, weighted average basic and diluted shares outstanding for the respective periods are the same. The following equity instruments were not included in the computations of net loss per share because the effect on the calculations would be anti-dilutive (in thousands):

	<b>Years Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Common stock options.....	7,615	9,900	7,732
Warrants.....	--	701	701
Convertible subordinated debentures.....	--	--	638
Unvested restricted common stock.....	--	--	30
	<u>7,615</u>	<u>10,601</u>	<u>9,101</u>

## **RECENT ACCOUNTING PRONOUNCEMENTS**

On October 3, 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supercedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30. SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (i) can be distinguished from the rest of the entity, and (ii) will be eliminated from the ongoing operations of the entity in a disposal transaction. The Company adopted SFAS No. 144 in the first quarter of fiscal 2003, and its adoption did not have a material impact on the Company's results of operations and financial condition.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No. 146 supercedes previous accounting guidance, principally Emerging Issues Task Force Issue (EITF) No. 94-3. SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date of the entity's commitment to an exit plan. SFAS No. 146 also requires that the liability be initially measured and recorded at fair value. SFAS No. 146 was effective for exit or disposal activities that are initiated after December 31, 2002. The Company adopted SFAS No. 146 in the fourth quarter of fiscal 2003, and its adoption did not have a material impact on its results of operations and financial

condition.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," which expands previously issued accounting guidance and disclosure requirements for certain guarantees. FIN 45 requires an entity to recognize an initial liability for the fair value of an obligation assumed by issuing a guarantee. The provision for initial recognition and measurement of the liability will be applied on a prospective basis to guarantees issued or modified after December 31, 2002. The Company does not expect this interpretation to have a material impact on its consolidated results of operations or financial position. The Company has included additional disclosures in accordance with FIN 45 in the footnotes to these consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation, Transition and Disclosure." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The additional disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. 8x8 will continue to account for stock-based compensation in accordance with Accounting Principles Board Opinion No. 25. The Company has included additional disclosures in accordance with SFAS No. 148 in the footnotes to these consolidated financial statements.

## 2. ACQUISITION OF U|FORCE, INC.

The Company's consolidated financial statements reflect the purchase acquisition of all of the outstanding stock of U|Force, Inc. (U|Force) on June 30, 2000 for a total purchase price of \$46.8 million. U|Force, based in Montreal, Canada, was a developer of IP-based software applications and a provider of professional services. U|Force was also developing a Java-based service creation environment (SCE) designed to allow telecommunication service providers to develop, deploy, and manage telephony applications and services to their customers. The purchase price was comprised of 8x8 common stock with a fair value of approximately \$38.0 million comprised of: (i) 1,447,523 shares issued at closing of the acquisition, and (ii) 2,107,780 shares to be issued upon the exchange or redemption of the exchangeable shares (the Exchangeable Shares) of Canadian entities held by former employee shareholders or indirect owners of U|Force stock. See Note 10 regarding further discussion of the Exchangeable Shares. 8x8 also assumed outstanding stock options to purchase shares of U|Force common stock for which the Black-Scholes option-pricing model value of approximately \$6.5 million was included in the purchase price. Direct transaction costs related to the merger were approximately \$747,000. Additionally, the Company advanced \$1.5 million to U|Force upon signing the acquisition agreement, but prior to the close of the transaction. This amount was accounted for as part of the purchase price. The following table summarizes the composition of the purchase price (in thousands):

Value of common stock and Exchangeable Shares issued.....	\$	38,042
Value of stock options assumed.....		6,546
Cash advanced to U Force prior to closing.....		1,500
Direct transaction costs.....		747
	\$	<u>46,835</u>

The purchase price was allocated to tangible assets acquired and liabilities assumed based on the book value of U|Force's assets and liabilities, which approximated their fair value. Intangible assets acquired included amounts allocated to U|Force's in-process research and development. The in-process research and development related to U|Force's initial products, the SCE and a unified messaging application, for which technological feasibility had not been established and the technology had no alternative future use. The estimated percentage complete for the unified messaging and SCE products was approximately 44% and 34%, respectively, at June 30, 2000. The fair value of the in-process technology was based on a discounted cash flow model, similar to the traditional "Income Approach," which discounts expected future cash flows to present value, net of tax. In developing cash flow projections, revenues were forecasted based on relevant factors, including aggregate revenue growth rates for the business as a whole, characteristics of the potential market for the technology, and the anticipated life of the technology. Projected

annual revenues for the in-process research and development projects were assumed to ramp up initially and decline significantly at the end of the in-process technology's economic life. Operating expenses and resulting profit margins were forecasted based on the characteristics and cash flow generating potential of the acquired in-process technologies. Risks that were considered as part of the analysis included the scope of the efforts necessary to achieve technological feasibility, rapidly changing customer markets, and significant competitive threats from numerous companies. The Company also considered the risk that if the products were not brought to market in a timely manner, it could adversely affect sales and profitability of the combined company in the future. The resulting estimated net cash flows were discounted at a rate of 25%. This discount rate was based on the estimated cost of capital plus an additional discount for the increased risk associated with in-process technology. The value of the acquired U|Force in-process research and development, which was expensed in the second quarter of fiscal 2001, approximated \$4.6 million. The excess of the purchase price over the net tangible and intangible assets acquired and liabilities assumed was allocated to goodwill. Amounts allocated to goodwill, the value of an assumed distribution agreement, and workforce were being amortized on a straight-line basis over three, three, and two years, respectively, prior to the write-off of the unamortized balances in the fourth quarter of fiscal 2001 as discussed in Note 4. The allocation of the purchase price was as follows (in thousands):

In-process research and development.....	\$	4,563
Distribution agreement.....		1,053
Workforce.....		1,182
U Force net tangible assets.....		1,801
Goodwill.....		38,236
	\$	<u>46,835</u>

### 3. ADOPTION OF SFAS NO. 142, GOODWILL AND OTHER INTANGIBLE ASSETS

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Furthermore, SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. In accordance with SFAS No. 142, the effect of this accounting change was reflected prospectively. Supplemental comparative disclosure as if the change had been retroactively applied to the prior year period is as follows (in thousands, except per share amounts):

	Year Ended March 31,		
	2003	2002	2001
Reported net loss .....	\$ (11,403)	\$ (9,105)	\$ (74,399)
Add back: Goodwill and intangibles amortization.....	--	763	10,987
Adjusted net loss.....	<u>\$ (11,403)</u>	<u>\$ (8,342)</u>	<u>\$ (63,412)</u>
Basic and diluted earnings per share:			
Reported net loss per share.....	\$ (0.40)	\$ (0.33)	\$ (2.99)
Goodwill and intangibles amortization.....	--	0.03	0.44
Adjusted net loss per share.....	<u>\$ (0.40)</u>	<u>\$ (0.30)</u>	<u>\$ (2.55)</u>

In accordance with SFAS No. 142, 8x8 is required to perform an annual impairment test for goodwill. Goodwill has been allocated to 8x8's Centile segment and reporting unit. SFAS No. 142 requires 8x8 to compare the fair value of the reporting unit to its carrying amount on an annual basis to determine if there is potential impairment. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the fair value of the goodwill within the reporting unit is less than the carrying value. The fair value for goodwill is determined based on discounted cash flows, market multiples or appraised values as appropriate. As described in Note 4 below, the Company recorded a \$1.5 million goodwill impairment charge in the fourth quarter of fiscal 2003.

#### 4. RESTRUCTURING AND OTHER CHARGES

##### 2003 Restructuring Actions

During the third and fourth quarters of fiscal 2003, the Company continued its cost reduction activities to better align expense levels with current revenue levels and ensure conservative spending during the current economic downturn. As a result of these activities, the Company recorded restructuring and other asset impairment charges of approximately \$3.4 million. These charges included severance and benefits of approximately \$1.2 million, as the Company reduced its workforce, under voluntary and involuntary separation plans, by thirty-two employees or thirty percent. The majority of the affected employees were Netergy employees based in Santa Clara, California and Marlow, United Kingdom and included employees from sales and marketing and research and development, as well as four executives of Netergy. Severance of approximately \$325,000 attributable to involuntary terminations was paid during the year ended March 31, 2003.

The Company closed its facility in Marlow, United Kingdom, and recorded charges of \$434,000 related to the termination of the operating leases for the facility and related services. In addition, the Company recorded asset impairment charges of \$212,000 related to assets in the United Kingdom that were abandoned or disposed of.

The Company also recorded a charge of approximately \$74,000 for its remaining lease liability for office space in Tempe, Arizona that was vacated as a result of the restructuring actions during the fourth quarter.

In the fourth quarter of fiscal 2003, the Company also implemented a plan to reduce the workforce at Centile's Sophia Antipolis, France office by ten employees or seventy percent. This downsizing and its potential impact on Centile's iPBX business prompted an assessment of the key assumptions underlying our goodwill valuation judgments. As a result of the analysis, the Company determined that an impairment charge of \$1.5 million was required because the estimated fair value of the goodwill was less than the book value of the goodwill that arose from the acquisition of Odisei S.A. in fiscal 2000.

The following table illustrates the charges, credits and balances of the restructuring reserves as of March 31, 2003 and summarizes impairment charges (in thousands):

	<u>Total Charges</u>	<u>Cash Payments</u>	<u>Non-Cash Charges</u>	<u>Liability at March 31, 2003</u>
Restructuring Charges:				
Severance.....	\$ 1,177	\$ (1,002)	\$ --	\$ 175
Facility related.....	508	(161)	(273)	74
Total restructuring charges.....	1,685	(1,163)	(273)	249
Asset Impairments:				
Fixed Assets.....	212	--	(212)	--
Goodwill.....	1,539	--	(1,539)	--
Total impairment charges.....	1,751	--	(1,751)	--
Total restructuring and impairment charges.....	<u>\$ 3,436</u>	<u>\$ (1,163)</u>	<u>\$ (2,024)</u>	<u>\$ 249</u>

##### 2001 Restructuring Actions

During the fourth quarter of fiscal 2001, after a significant number of employees had resigned, the Company discontinued its Canadian operations acquired in conjunction with the acquisition of U|Force in June 2000. The Company closed its offices in Montreal and Hull, Quebec and laid-off all remaining employees resulting in the cessation of most of the research and development efforts and all of the sales and marketing and professional services activities associated with the U|Force business. As a result of the restructuring, the Company recorded a one-time charge of \$33.3 million in the quarter ended March 31, 2001. The restructuring charge consisted of the following (in thousands):



Employee separation.....	\$	765
Fixed asset losses and impairments.....		2,084
Intangible asset impairments.....		30,247
Lease obligation and termination.....		220
	\$	<u>33,316</u>

Employee separation costs represent severance payments related to the 96 employees in the Montreal and Hull offices who were terminated.

The impairment charges for fixed assets approximated \$2.1 million which included write-offs of abandoned and unusable assets of approximately \$1.4 million, a loss on sale of assets of \$567,000, and a charge for assets to be disposed of \$172,000. The asset write-offs of \$1.4 million included approximately \$850,000 related to leasehold improvements and \$560,000 related to computer equipment, furniture, and software. The loss on sale of assets of \$567,000 was attributable to the sale of office, computer, and other equipment of the Montreal office. The Company received common stock of the purchaser valued at approximately \$412,000 at the date of sale. Fair value of assets to be disposed of was measured based on expected salvage value, less costs to sell. Assets to be disposed of consist of computer equipment with a fair value of \$57,000 at March 31, 2001. Substantially all of these assets were liquidated during fiscal 2002.

The impairment charges for intangible assets represented the write-off of the unamortized intangible assets recorded in connection with the acquisition of U|Force. The charges of approximately \$30.2 million included: \$28.7 million for the goodwill related to the acquisition, \$739,000 for the assembled workforce, and \$789,000 related to a distribution agreement. The impairments were directly attributable to the cessation of operations in Canada. The Company performed an evaluation of the recoverability of the intangible assets related to these operations in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The lack of estimated future net cash flows related to the acquired products necessitated an impairment charge to write-off the remaining unamortized goodwill. The distribution agreement asset was written off because the Company will no longer provide products and services to customers under that agreement.

Cash payments related to the restructuring during the quarter ended March 31, 2001, which included all employee separation costs and certain lease termination costs, approximated \$920,000. Accrued obligations related to remaining lease commitments on the Montreal and Hull facilities totaled \$212,000 at March 31, 2001. The Company terminated the lease for its primary facility in Montreal in March 2001, but was required to pay rent on the facility through May 31, 2001. The Company terminated the lease for the facility in Hull, Quebec, in fiscal 2002. The payments made in fiscal 2002 related to the terminations of the Montreal and Hull facility leases totaled \$225,000. There were no remaining restructuring related accruals at March 31, 2002.

## 5. DEBT

### Convertible Subordinated Debentures

#### *Issuance of the Debentures*

In December 1999, the Company issued \$7.5 million of 4% Series A and Series B convertible subordinated debentures (the Debentures) due in December 2002. In conjunction with the issuance of the Debentures, the lenders received warrants to purchase 531,915 8x8 common shares at \$7.05 per share and 105,634 shares at \$35.50 per share (the Lender Warrants). The Company also issued warrants to the placement agent to purchase 53,191 8x8 common shares at \$7.05 per share and 10,563 shares at \$35.50 per share. All of the warrants expired in December 2002 without being exercised.

Using the Black-Scholes pricing model, the Company determined that the debt discount associated with the fair value of the warrants issued to the lenders approximated \$2.2 million. The costs of issuing the Debentures totaled

\$864,000, including a non-cash charge for the value of warrants issued to the placement agent. The debt discount and debt issuance costs were amortized to interest expense on a straight-line basis over the term of the Debentures.

#### ***Cumulative Effect of Change in Accounting Principle – Beneficial Conversion Feature***

In November 2000, the Emerging Issues Task Force reached several conclusions regarding the accounting for debt and equity securities with beneficial conversion features, including a consensus requiring the application of the "accounting conversion price" method, versus the use of the stated conversion price, to calculate the beneficial conversion feature for such securities. The SEC required companies to record a cumulative catch-up adjustment in the fourth quarter of calendar 2000 related to the application of the "accounting conversion price" method to securities issued after May 21, 1999. Accordingly, the Company recorded a \$1.1 million non-cash expense during the quarter ended December 31, 2000 to account for a beneficial conversion feature associated with the Debentures and related warrants. The Company has presented the charge in the Consolidated Statements of Operations as a cumulative effect of a change in accounting principle.

#### ***Extraordinary Item – Early Extinguishment of Debentures***

In December 2001, the Company redeemed the Debentures for \$4.5 million in cash and 1,000,000 contingently redeemable shares of common stock. Additionally, the Company agreed to reduce the exercise price of the Lender Warrants to \$0.898 per share. This transaction resulted in an extraordinary gain of \$779,000, net of the incremental fair value of the repriced warrants, the write-off of unamortized debt discount and debt issue costs, and other costs associated with the early extinguishment of the Debentures.

#### ***Contingently Redeemable Common Stock***

Under the terms of the registration rights agreement that the Company and the lenders entered into in connection with the issuance of the 1,000,000 shares of common stock associated with the extinguishment described above, the Company agreed to register the shares for resale and maintain the effectiveness of the registration statement for specified periods of time until the shares are resold or can be resold without the registration statement (the Maintenance Requirements). The Company further agreed that if it does not comply with the Maintenance Requirements in the future, it may be required to pay cash penalties and redeem all or a portion of the shares held by the lenders at the higher of \$0.898 per share or the market price of the Company's stock at the time of the redemption. The remaining shares held by the lenders at March 31, 2003 and March 31, 2002 were recorded at their potential redemption values of \$669,000 and \$813,000, respectively, and classified as contingently redeemable common stock due to the redemption rights described above. The Company will not mark the contingently redeemable common stock to the higher of \$0.898 per share or market unless it becomes probable that the Company will not be able to comply with the Maintenance Requirements.

The approximately \$25,000 difference between the potential redemption value of the shares held by the lenders at March 31, 2002 and the value of those shares on the date of issuance has been treated as a deemed dividend and included as an adjustment to net income (loss) available to common stockholders for purposes of calculating the Company's net income (loss) per share for fiscal 2002.

## **6. DISPOSITION OF VIDEO MONITORING PRODUCT LINE**

On May 19, 2000, the Company entered into an Asset Purchase Agreement with Interlogix, Inc. (Interlogix) providing for the sale of certain assets comprising the Company's video monitoring business (the Business) to Interlogix. The assets sold included certain accounts receivable, inventories, technical information, machinery, equipment, contract rights, intangibles, records, and supplies. Concurrently with the execution of the Asset Purchase Agreement, the Company and Interlogix entered into a Technology License Agreement (the License Agreement) providing for the licensing of certain related intellectual property to Interlogix, a Development Agreement providing Interlogix continuing rights in certain products to be developed by the Company, a Transition Services Agreement providing for certain services to be rendered by the Company to Interlogix in respect of the Business, and a Supply Agreement providing for the continuing sale of certain products to Interlogix by the Company. The aggregate purchase price paid by Interlogix was approximately \$5.2 million in cash.

The Company's obligations under the Transition Services Agreement expired in fiscal 2001. The cost of services provided under the Transition Services Agreement was reimbursed by Interlogix. Pursuant to the Asset Purchase Agreement, the Company is responsible for reimbursing Interlogix for costs they incur associated with warranty

obligations related to video monitoring products manufactured prior to May 19, 2000. The Company's estimated remaining exposure to such warranty obligations is reflected in the warranty accrual at March 31, 2003.

At signing, the Company's continuing obligations under the License and Development Agreements included: (i) providing future updates and upgrades to the licensed technology, if any, over the initial three-year term of the License Agreement (the Maintenance Obligations) and (ii) certain potential obligations to assist Interlogix in the development of future products (the Development Obligations). The Company deferred the recognition of the approximately \$3.9 million of revenue ascribed to the license of video monitoring technology to Interlogix until the Development Obligations expired in the quarter ended March 31, 2001. Upon expiration of the Development Obligations, the Company commenced recognition of the previously deferred revenue and is recognizing the revenue ratably over the license term, which expires in May 2003, due to the remaining Maintenance Obligations. The remaining balance in deferred revenue at March 31, 2003 is approximately \$285,000.

## **7. TRANSACTIONS WITH RELATED PARTIES**

### ***Strategic Relationship with STMicroelectronics NV***

During the fourth quarter of fiscal 2000, the Company sold 3.7 million shares of its common stock to STMicroelectronics NV (STM) at a purchase price of \$7.50 per share and received net proceeds of \$27.7 million. In addition, the Company granted STM the right to a seat on the Company's Board of Directors as long as it holds at least 10% of the Company's outstanding shares. STM was also granted certain rights to maintain its percentage ownership interest of the Company's outstanding voting securities, including certain rights to participate in future securities offerings of the Company, or, in certain circumstances, the right to acquire additional shares through market purchases. The Company also granted to an STM subsidiary a non-exclusive, royalty-bearing license to certain technology and undertook certain joint development activities with a subsidiary of STM. Under the terms of the agreement, the STM subsidiary guaranteed certain minimum payments to the Company totaling \$1.0 million; \$500,000 for prepaid royalties and \$500,000 for certain non-recurring engineering services (the Minimum Payments). The Company received the Minimum Payments in fiscal 2001.

During fiscal 2003, the Company purchased semiconductors from a subsidiary of STM. Such purchases approximated \$550,000. In addition, during fiscal 2003 the Company contracted with a subsidiary of STM for non-recurring engineering services related to the development of a new semiconductor product by the Company. As of March 31, 2003, the Company had recorded liabilities to STM of \$392,000 for semiconductor purchases and purchase commitments and engineering services.

### ***Other Transactions***

In March 2002 the Board of Directors authorized the Company to open securities trading accounts and make investments in other classes of securities that may generate higher returns than the currently low yields on governmental and corporate debt securities and money market funds. The amount allocated for such investments was \$1.0 million to be invested on behalf of 8x8, Inc. as directed by the Company's Chairman, Joe Parkinson; Chief Executive Officer; or Chief Financial Officer. Mr. Parkinson has agreed to personally reimburse 8x8, Inc. on a quarterly basis for any losses resulting from his trading activities in order to maintain a minimum investment account balance of \$1.0 million. As part of the arrangement, the Company's Board of Directors has expressed its intent, but not obligation, to pay Mr. Parkinson a quarterly bonus in an amount equal to 25% of the profits attributable to investments made on the Company's behalf by Mr. Parkinson to the extent such a bonus exceeds his salary for the corresponding period. The Company or Mr. Parkinson can terminate this arrangement at any time, subject to the terms of an agreement between Mr. Parkinson and the Company. Under the arrangement, the Company is required to return to Mr. Parkinson the amount representing the increase in value of the investment account over \$1.0 million to the extent required to restore replenishment payments made by Mr. Parkinson in prior quarters. Through March 31, 2003, Mr. Parkinson had made cumulative replenishment payments of approximately \$137,000 to offset losses incurred. As of March 31, 2003, the investment account balance approximated \$1,018,000. Accordingly, the Company had a payable of approximately \$18,000 to Mr. Parkinson at March 31, 2003. As of March 31, 2003, approximately \$200,000 was invested in equity securities, and the remaining \$800,000 was invested in money market accounts.

During fiscal 2001, Dr. Bernd Girod, a director of 8x8 and its subsidiary, Netergy, received \$22,000 in consideration

for technical consulting services that he provided to the Company. In addition, the Company contributed \$150,000 during fiscal 2001 to a Stanford University research program managed by Dr. Girod.

## 8. INCOME TAXES

The Company's loss before income taxes included \$65,000, \$161,000 and \$162,000 of foreign subsidiary income for the fiscal years ended March 31, 2003, 2002, and 2001, respectively.

The components of the consolidated provision for income taxes consisted of the following (in thousands):

	Years Ended March 31,		
	2003	2002	2001
Current:			
Federal.....	\$ --	\$ (10)	\$ --
State.....	--	--	--
Foreign.....	--	25	17
	<u>\$ --</u>	<u>\$ 15</u>	<u>\$ 17</u>

Deferred tax assets were comprised of the following (in thousands):

	March 31,	
	2003	2002
Research and development credit carryforwards.....	\$ 5,459	\$ 4,809
Net operating loss carryforwards.....	41,543	23,954
Inventory valuation.....	419	569
Reserves and allowances.....	349	471
Goodwill.....	--	14,193
Other.....	2,806	3,335
	<u>50,576</u>	<u>47,331</u>
Valuation allowance.....	<u>(50,576)</u>	<u>(47,331)</u>
Total.....	<u>\$ --</u>	<u>\$ --</u>

Management believes that, based on a number of factors, the weight of objective available evidence indicates that it is more likely than not that the Company will not be able to realize its deferred tax assets, and thus a full valuation allowance was recorded at March 31, 2003 and March 31, 2002.

At March 31, 2003, the Company had net operating loss carryforwards for federal and state income tax purposes of approximately \$115 million and \$42 million, respectively, which expire at various dates beginning in 2005. The net operating loss carryforwards include approximately \$5 million resulting from employee exercises of non-qualified stock options or disqualifying dispositions, the tax benefits of which, when realized, will be accounted for as an addition to additional paid-in capital rather than as a reduction of the provision for income taxes. In addition, at March 31, 2003, the Company had research and development credit carryforwards for federal and state tax reporting purposes of approximately \$3 million and \$2.3 million, respectively. The federal credit carryforwards will begin expiring in 2010 while the California credit will carryforward indefinitely. Under applicable tax laws, the amount of and benefits from net operating losses and credits that can be carried forward may be impaired or limited in certain circumstances. Events which may cause limitations in the amount of net operating loss carryforwards that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50% over a three year period.

A reconciliation of the tax provision (benefit) to the amounts computed using the statutory U.S. federal income tax rate of 34% is as follows (in thousands):

	<b>Years Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Benefit at statutory rate.....	\$ (3,877)	\$ (3,090)	\$ (25,296)
State income taxes (benefit) before valuation allowance, net of federal effect.....	(684)	229	(3,909)
In-process research and development.....	--	--	1,551
Non-deductible goodwill.....	523	259	--
Discount on issuance of Common Stock.....	--	558	--
Research and development credits.....	--	(216)	(1,162)
Change in valuation allowance.....	4,030	2,302	29,027
Non-deductible compensation.....	--	(4)	256
Foreign rate differences.....	--	(30)	1
Other.....	8	7	(451)
	<u>\$ --</u>	<u>\$ 15</u>	<u>\$ 17</u>

## 9. COMMITMENTS AND CONTINGENCIES

### *Leases*

The Company leases its primary facility in Santa Clara, California under a non-cancelable operating lease agreement that expires in November 2004. The Company also has leased facilities in Arizona, France and Canada. The facility leases include rent escalation clauses, and require the Company to pay taxes, insurance, and normal maintenance costs. At March 31, 2003, future minimum annual lease payments under non-cancelable operating leases, net of sublease income, were as follows (in thousands):

#### YEAR ENDING MARCH 31,

2004.....	\$ 544
2005.....	280
2006.....	37
Total minimum payments.....	<u>\$ 861</u>

Rent expense for the years ended March 31, 2003, 2002 and 2001, was \$1.5 million, \$1.5 million and \$1.8 million, respectively.

The Company subleases office space under operating lease agreements expiring at various dates through 2005. The total future minimum rentals to be received under these noncancelable sublease agreements approximate \$18,000 in each of fiscal 2004, 2005 and 2006 and \$12,000 in fiscal 2007.

### *Legal Proceedings*

In November 2001, the Company settled a lawsuit that was filed against it in April 2001 in British Columbia, Canada by Milinx Business Services, Inc. and Milinx Business Group, Inc (collectively, Milinx). The Company was released of any further obligations to Milinx in exchange for returning a portion of the original license fee. As a result of the settlement agreement, in fiscal 2002 the Company recognized \$309,000 of previously deferred revenue stemming from a March 2000 license agreement with Milinx.

The Company is also involved in various other legal claims and litigation that have arisen in the normal course of the Company's operations. While the results of such claims and litigation cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a significant adverse effect on the

Company's financial position or results of operations. However, should the Company not prevail in any such litigation, its operating results and financial position could be adversely impacted.

## **10. STOCKHOLDERS' EQUITY**

### ***Common Stock***

In August 2000, the Company's stockholders authorized an amendment to the restated certificate of incorporation to increase the authorized number of shares of common stock to 100,000,000 shares from 40,000,000 shares.

### ***Exchangeable Shares and Preferred Stock***

In conjunction with the acquisition of U|Force (see Note 2), the Company agreed to issue up to 2,107,780 shares of 8x8 common stock upon the exchange or redemption of the exchangeable shares (the Exchangeable Shares) of Canadian entities held by employee shareholders of U|Force stock. The Exchangeable Shares held by U|Force employees were subject to certain restrictions, including the Company's right to repurchase the Exchangeable Shares if an employee departed the Company prior to vesting. Upon vesting, the Exchangeable Shares were convertible into 8x8 common stock on a 1-for-1 basis. The Company also issued one share of preferred stock (the Special Voting Share) that provides holders of Exchangeable Shares with voting rights that are equivalent to the shares of common stock into which their shares are convertible.

During the fourth quarter of fiscal 2001, the Company repurchased a total of 1,034,107 unvested Exchangeable Shares at an average price of \$0.49 per share when the beneficial holders of such shares resigned from the Company. In addition, 812,866 Exchangeable Shares were converted into an equivalent number of shares of the Company's common stock in the fourth quarter of fiscal 2001. The remaining 260,807 Exchangeable Shares were exchanged for shares of the Company's common stock during the year ended March 31, 2002.

### ***1992 Stock Option Plan***

The Board of Directors reserved 2,000,000 shares of the Company's common stock for issuance under the 1992 Stock Option Plan (the 1992 Plan). The 1992 Plan expired in fiscal 2003.

### ***Key Personnel Plan***

In July 1995, the Board of Directors adopted the Key Personnel Plan. The Board of Directors reserved 2,200,000 shares of the Company's common stock for issuance under this plan. The Key Personnel Plan provided for granting incentive and nonstatutory stock options to officers of the Company at prices equal to the fair market value of the stock at the grant dates. Options generally vest over four years. Shares issued under the Key Personnel Plan were subject to repurchase at the original issuance price of \$0.50 per share if the employee left the Company prior to vesting. During fiscal 2001, the Company repurchased 5,982 unvested shares. As of March 31, 2003, all shares were vested and no shares are available for grant under the Key Personnel Plan. The Company is no longer issuing options under this plan.

### ***1996 Stock Plan***

In June 1996, the Board of Directors adopted the 1996 Stock Plan (the 1996 Plan) and reserved 1,000,000 shares of the Company's common stock for issuance under this plan. The Company's stockholders subsequently authorized increases in the number of shares of the Company's common stock reserved for issuance under the 1996 Plan of 500,000 shares in June 1997 and 2,000,000 shares in August 2000. The 1996 Plan also provides for an annual increase in the number of shares reserved for issuance under the 1996 Plan on the first day of the Company's fiscal year in an amount equal to 5% of the Company's common stock issued and outstanding at the end of the immediately preceding fiscal year, subject to a maximum annual increase of 1,000,000 shares. The annual increase was 1,000,000 shares in each of fiscal 2003, 2002 and 2001. To date, this provision has resulted in increases in shares reserved for issuance under the 1996 Plan totaling 4,535,967. The 1996 Plan provides for granting incentive stock options to employees and nonstatutory stock options to employees, directors or consultants. The stock option price of incentive stock options granted may not be less than the determined fair market value at the date of grant. Options generally vest over four years and expire ten years after grant.

### ***1996 Director Option Plan***

The Company's 1996 Director Option Plan (the Director Plan) was adopted in June 1996 and became effective in July 1997. A total of 150,000 shares of common stock were initially reserved for issuance under the Director Plan. The Company's stockholders subsequently authorized an increase in the number of shares of common stock reserved for issuance under the Director Plan to 500,000 shares in August 2000, and 1,000,000 in July 2002. The Director Plan provides for both discretionary and periodic grants of nonstatutory stock options to non-employee directors of the Company (the Outside Directors). The exercise price per share of all options granted under the Director Plan will be equal to the fair market value of a share of the Company's common stock on the date of grant. Options generally vest over a period of four years. Options granted to Outside Directors under the Director Plan have a ten year term, or shorter upon termination of an Outside Director's status as a director. If not terminated earlier, the Director Plan will have a term of ten years.

### ***1999 Nonstatutory Stock Option Plan***

In fiscal 2000, the Company's Board of Directors approved the 1999 Nonstatutory Stock Option Plan (the 1999 Plan) with 600,000 shares initially reserved for issuance thereunder. In fiscal 2001, the number of shares reserved for issuance was increased to 3,600,000 shares by the Board of Directors. Under the terms of the 1999 Plan, options may not be issued to either officers or directors of the Company provided, however, that options may be granted to an officer in connection with the officer's initial employment by the Company. Options generally vest over four years and expire ten years after grant. The 1999 Plan has not been approved by the stockholders of the Company.

### ***UForce Company -- Societe UForce Amended and Restated 1999 Stock Option Plan***

In connection with the acquisition of U|Force (see Note 2), the Company assumed the UForce Company -- Societe UForce Amended and Restated 1999 Stock Option Plan (the U|Force Plan), and reserved 1,023,898 shares of the Company's common stock related to options issued thereunder. The U|Force Plan provided for the grant of nonstatutory stock options to employees and consultants of U|Force at prices equal to the fair market value of the stock at the grant dates. Due to the cessation of the Company's Canadian operations (see Note 4), 1,016,408 and 7,490 of the options previously granted under the U|Force Plan were forfeited and returned to the U|Force Plan in fiscal 2001 and fiscal 2002, respectively. In fiscal 2002, the Company's Board of Directors terminated the U|Force Plan.

Option activity under the Company's stock option plans since March 31, 2000, excluding the Netergy and Centile stock option plans, is summarized as follows:

	<b>Shares Available for Grant</b>	<b>Shares Subject to Options Outstanding</b>	<b>Weighted Average Exercise Price Per Share</b>
Balance at March 31, 2000.....	15,437	4,173,762	\$ 5.25
Change in options available for grant.....	7,373,898	--	--
Granted or assumed.....	(8,116,100)	8,116,100	6.26
Exercised.....	--	(925,008)	2.30
Returned to plan.....	3,632,963	(3,632,963)	8.29
Balance at March 31, 2001.....	2,906,198	7,731,891	5.24
Change in options available for grant.....	(23,898)	--	--
Granted.....	(4,901,073)	4,901,073	1.09
Exercised.....	--	(40,757)	0.01
Returned to plan.....	2,692,381	(2,692,381)	6.18
Balance at March 31, 2002.....	673,608	9,899,826	2.95
Change in options available for grant.....	1,370,187	--	--
Granted.....	(857,800)	857,800	0.48
Exercised.....	--	(53,040)	0.37
Returned to plan.....	3,089,997	(3,089,997)	3.05
Balance at March 31, 2003.....	<u>4,275,992</u>	<u>7,614,589</u>	\$ 2.65

Significant option groups outstanding at March 31, 2003 and related weighted average exercise price and contractual life information for 8x8, Inc.'s stock option plans are as follows:

<b>Range of Exercise Prices</b>	<b>Options Outstanding</b>			<b>Options Exercisable</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price Per Share</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Shares</b>	<b>Weighted Average Exercise Price Per Share</b>
\$ 0.01 to \$ 3.16.....	5,974,588	\$ 1.38	8.0	2,394,740	\$ 1.66
\$ 3.16 to \$ 6.32.....	811,511	\$ 3.84	6.8	791,165	\$ 3.82
\$ 6.32 to \$ 9.49.....	311,327	\$ 7.42	5.4	249,693	\$ 7.43
\$ 9.49 to \$12.65.....	445,268	\$ 11.72	6.7	318,470	\$ 11.72
\$12.65 to \$15.81.....	33,895	\$ 14.56	5.4	26,537	\$ 14.56
\$15.81 to \$28.46.....	38,000	\$ 21.25	6.9	28,852	\$ 21.20
	<u>7,614,589</u>	\$ 2.65	7.7	<u>3,809,457</u>	\$ 3.57

The Company recorded a deferred compensation charge of approximately \$7,267,000 with respect to options repriced and certain additional options granted in fiscal 1997. In addition, the Company recorded deferred compensation charges of approximately \$503,000 and \$406,000 in connection with certain options granted to non-officer employees in fiscal 2001 and 2000, respectively. The Company recognizes deferred compensation over the related vesting period of the options (which is generally forty-eight months). The Company recognized \$753,000 as compensation expense in the fiscal year ended March 31, 2001. Stock compensation expense in fiscal 2003 and 2002 was not significant. Deferred compensation is subject to reduction for any employee who terminates employment prior to the expiration of such employee's option vesting period.

#### ***Netergy Microelectronics, Inc. 2000 Stock Option Plan***

Netergy's 2000 Stock Option Plan (the Netergy Plan) was adopted in December 2000 by the Netergy Board of Directors. The Netergy Plan provides for granting incentive stock options (ISO) to employees and nonstatutory stock options (NSO) to employees, directors, and consultants of Netergy. Options granted under the Netergy Plan



may be granted for periods up to ten years and at prices no less than 85% of the estimated fair value of the shares on the date of grant as determined by the Netergy Board of Directors, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than 100% and 85% of the estimated fair value of the shares on the date of grant, respectively, and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively. To date, options granted vest over four years. However, in the event of a change in control (as defined in the Netergy Plan document) vesting for certain options will be accelerated. Option activity during each of the three years ended March 31, 2003 was as follows:

	<b>Shares Available for Grant</b>	<b>Shares Subject to Options Outstanding</b>	<b>Weighted Average Exercise Price Per Share</b>
Shares reserved at Netergy Plan's inception.....	5,000,000	--	\$ --
Granted.....	(3,572,000)	3,572,000	0.50
Returned to plan.....	400,000	(400,000)	0.50
Balance at March 31, 2001.....	1,828,000	3,172,000	0.50
Granted.....	(136,000)	136,000	0.50
Exercised.....	--	--	--
Returned to plan.....	264,834	(264,834)	0.50
Balance at March 31, 2002.....	1,956,834	3,043,166	0.50
Granted.....	(617,000)	617,000	0.50
Exercised.....	--	--	--
Returned to plan.....	1,945,490	(1,945,490)	0.50
Balance at March 31, 2003.....	<u>3,285,324</u>	<u>1,714,676</u>	\$ 0.50

As of March 31, 2003, 991,702 options were exercisable, the weighted average remaining contractual life was 5.9 years, and the weighted average exercise price was \$0.50 per share.

#### ***Centile, Inc. 2001 Stock Option Plan***

Centile's 2001 Stock Option Plan (the Centile Plan) was adopted in March 2001 by the Centile Board of Directors. The Centile Plan provides for granting ISOs to employees and NSOs to employees, directors, and consultants of Centile. Options granted under the Centile Plan may be granted for periods up to ten years and at prices no less than 85% of the estimated fair value of the shares on the date of grant as determined by the Centile Board of Directors, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than 100% and 85% of the estimated fair value of the shares on the date of grant, respectively, and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively. To date, options granted vest over four years. Option activity during each of the three years ended March 31, 2003 was as follows:

	<b>Shares Available for Grant</b>	<b>Shares Subject to Options Outstanding</b>	<b>Weighted Average Exercise Price Per Share</b>
Shares reserved at Centile Plan's inception.....	4,500,000	--	\$ --
Granted.....	(4,107,000)	4,107,000	0.43
Balance at March 31, 2001.....	393,000	4,107,000	0.43
Granted.....	(846,000)	846,000	0.43
Exercised.....	--	--	--
Returned to plan.....	2,688,000	(2,688,000)	0.43
Balance at March 31, 2002.....	2,235,000	2,265,000	0.43
Granted.....	(96,000)	96,000	0.43
Exercised.....	--	--	--
Returned to plan.....	459,128	(459,128)	0.43
Balance at March 31, 2003.....	<u>2,598,128</u>	<u>1,901,872</u>	\$ 0.43

As of March 31, 2003, 767,051 options were exercisable, the weighted average remaining contractual life was 7.5 years, and the weighted average exercise price was \$0.43 per share.

#### ***1996 Employee Stock Purchase Plan***

The Company's 1996 Stock Purchase Plan (the Purchase Plan) was adopted in June 1996 and became effective upon the closing of the Company's initial public offering in July 1997. Under the Purchase Plan, 500,000 shares of common stock were initially reserved for issuance. At the start of each fiscal year, the number of shares of common stock subject to the Purchase Plan increases so that 500,000 shares remain available for issuance. This provision resulted in increases of 416,589, 281,583 and 180,910 shares issuable under the Purchase Plan during the fiscal years ended March 31, 2003, 2002 and 2001, respectively. During fiscal 2003, 2002 and 2001, 189,575, 416,589 and 281,583 shares, respectively, were issued under the Purchase Plan.

The Purchase Plan permits eligible employees to purchase common stock through payroll deductions at a price equal to 85% of the fair market value of the common stock at the beginning of each two 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. In the event of a merger of the Company with or into another corporation or the sale of all or substantially all of the assets of the Company, the Purchase Plan provides that a new exercise date will be set for each option under the plan which exercise date will occur before the date of the merger or asset sale.

#### ***Certain pro forma disclosures***

The Company accounts for its stock plans in accordance with the provisions of APB Opinion No. 25. Had compensation cost for the Company's stock plans been determined based on the fair value of options at their grant dates, as prescribed in SFAS No. 123, the Company's net loss would have been as follows (in thousands, except per share amounts):

	<b>Year Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net loss:			
As reported.....	\$ (11,403)	\$ (9,105)	\$ (74,399)
Pro forma*.....	\$ (15,848)	\$ (18,599)	\$ (84,132)
Basic and diluted loss per share:			
As reported.....	\$ (0.40)	\$ (0.33)	\$ (2.99)
Pro forma.....	\$ (0.56)	\$ (0.68)	\$ (3.39)

\*These amounts have been adjusted to reflect a correction to the forfeiture rate, which resulted in reductions in the pro forma net losses for 2002 and 2001 of \$6.5 million and \$3.1 million, respectively.

For the purposes of the disclosure above, the fair value of each of the Company's option grants, excluding those options issued under the Netergy and Centile Plans, has been estimated on the date of grant using the Black-Scholes pricing model with the following assumptions:

	<b>Year Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Expected volatility.....	162%	135%	141%
Expected dividend yield.....	0.0%	0.0%	0.0%
Risk-free interest rate.....	2.8% to 4.7%	3.5% to 4.9%	4.7% to 6.8%
Weighted average expected option term.....	5.1 years	5.1 years	5 years
Weighted average fair value of options granted.....	\$ 0.45	\$ 0.96	\$ 5.17

The fair value of grants under the Netergy and Centile stock option plans, for purposes of the pro forma disclosure, have also been estimated on the date of grant using the Black-Scholes pricing model using the weighted average assumptions noted below. The expected volatility factors for the Netergy and Centile plans reflect the fact that the underlying shares of Netergy and Centile are not publicly traded and therefore the Company's overall volatility factor has been reduced by 50% for these plans. The various risk free interest rates used in the computations reflect the different rates in effect at the respective grant dates.

	<b>Year Ended March 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Expected volatility.....	81%	67%	70%
Expected dividend yield.....	0.0%	0.0%	0.0%
Risk-free interest rate.....	2.8% to 4.8%	4.1% to 4.8%	4.7% to 5.1%
Weighted average expected option term.....	5.16 years	5.25 years	5 years
Netergy weighted average fair value of options granted.....	\$ 0.34	\$ 0.31	\$ 31%
Centile weighted average fair value of options granted.....	\$ 0.29	\$ 0.26	\$ 0.26

For the purpose of providing pro forma disclosures, the estimated fair value of stock purchase rights granted under the Purchase Plan were estimated using the Black-Scholes pricing model with the following weighted-average assumptions:

	Year Ended March 31,		
	2003	2002	2001
Expected volatility.....	162%	135%	141%
Expected dividend yield.....	0.0%	0.0%	0.0%
Risk-free interest rate.....	1.53%	3.82%	4.92%
Weighted average expected rights term.....	1.25 years	1.25 years	1.25 years
Weighted average fair value of rights granted.....	\$ 0.30	\$ 1.16	\$ 3.00

## 11. EMPLOYEE BENEFIT PLANS

### *401(k) Savings Plan*

In April 1991, the Company adopted a 401(k) savings plan (the Savings Plan) covering substantially all of its U.S. employees. Eligible employees may contribute to the Savings Plan from their compensation up to the maximum allowed by the Internal Revenue Service. The Company made matching contributions of \$85,000 and \$125,000 to the Savings Plan during fiscal 2002 and 2001, respectively. The matching contributions vest over three years. The Savings Plan does not allow employee contributions to be invested in 8x8 common stock.

## 12. SEGMENT REPORTING

During the fourth quarter of fiscal year 2001, the Company changed its internal reporting processes and determined that it had three reportable segments: Netergy, Centile, and Corporate and Other. Intersegment revenues between the reportable segments were not significant during the periods presented. Shared support service functions such as human resources, facilities management, and other infrastructure support and overhead are allocated between the segments. Accounting policies are applied consistently to the segments, where applicable. The Company's reportable segments have been determined based on the nature of the operations and products offered to customers:

- The Netergy segment primarily reflects the activity associated with the sale and development of semiconductors and related software focused on the IP telephony and videoconferencing markets. In addition, the Netergy segment includes revenue derived from the license of video monitoring technology to Interlogix, Inc.
- The Centile segment reflects activity associated with the development and sale of its hosted iPBX solution. Centile also markets and sells media hub systems as part of its hosted iPBX solution.
- The Corporate and Other segment represents the business activities of the parent entity, 8x8, Inc. The results for the Corporate and Other segment principally reflect activities related to the development and deployment of the Packet8 telephony service, sales of consumer videophones, unallocated corporate overhead expenses, and revenues and certain costs associated with discontinued product lines.

The following table illustrates results by segment (in thousands):

Year Ended March 31,			
	2003	2002	2001
Revenues:			
Netergy.....	\$ 9,719	\$ 13,350	\$ 15,850
Centile.....	861	260	198
Corporate and Other.....	423	1,081	2,180
Total revenues.....	<u>\$ 11,003</u>	<u>\$ 14,691</u>	<u>\$ 18,228</u>
Gross profit:			
Netergy.....	\$ 5,928	\$ 10,656	\$ 10,792
Centile.....	667	205	71
Corporate and Other.....	118	1,007	379
Total gross profit.....	<u>\$ 6,713</u>	<u>\$ 11,868</u>	<u>\$ 11,242</u>
Operating loss:			
Netergy.....	\$ (4,169)	\$ (1,509)	\$ (5,668)
Centile.....	(4,081)	(5,721)	(13,024)
Corporate and Other.....	(3,750)	(2,784)	(55,781)
Total operating loss.....	<u>\$ (12,000)</u>	<u>\$ (10,014)</u>	<u>\$ (74,473)</u>
Net loss:			
Netergy.....	\$ (4,002)	\$ (1,318)	\$ (5,661)
Centile.....	(4,337)	(5,627)	(12,955)
Corporate and Other.....	(3,064)	(2,160)	(55,783)
Total net loss.....	<u>\$ (11,403)</u>	<u>\$ (9,105)</u>	<u>\$ (74,399)</u>

There were no reconciling items between the segments for the revenue, gross profit, operating loss and net loss amounts.

The following table illustrates net revenues by geographic area. Revenues are attributed to countries based on the destination of shipment (in thousands):

Year Ended March 31,			
	2003	2002	2001
United States.....	\$ 4,218	\$ 5,777	\$ 5,632
Europe.....	2,657	4,126	5,862
Taiwan.....	1,569	2,026	2,739
Japan.....	919	1,119	1,188
Other.....	1,640	1,643	2,807
	<u>\$ 11,003</u>	<u>\$ 14,691</u>	<u>\$ 18,228</u>

The majority of the Company's long-lived assets were located in the United States. Long-lived assets consist primarily of property and equipment and deposits. The following table illustrates long-lived assets by country (in thousands):

March 31,		
	2003	2002
United States.....	\$ 645	\$ 2,051
United Kingdom.....	--	602
France.....	244	452
	<u>\$ 889</u>	<u>\$ 3,104</u>

Two customers represented more than 10% of our total revenues in fiscal 2003. These customers represented 17%, and 11% of our total revenues, respectively. During the fiscal year ended March 31, 2002, three customers represented more than 10% of our total revenues. These customers represented 13%, 13%, and 12% of our total revenues. During the fiscal year ended March 31, 2001, no customer accounted for 10% or more of total revenues.

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**8X8, INC.**

**SCHEDULE II -- VALUATION AND QUALIFYING ACCOUNTS  
(IN THOUSANDS)**

<b><u>Description</u></b>	<b><u>Balance at Beginning of Year</u></b>	<b><u>Additions Charged to Costs and Expenses</u></b>	<b><u>Deductions</u></b>	<b><u>Balance at End of Year</u></b>
Allowance for doubtful accounts:				
Year ended March 31, 2001.....	\$ 442	\$ 25	\$ 78	\$ 389
Year ended March 31, 2002.....	389	--	103	286
Year ended March 31, 2003.....	286	20	165	141

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**8X8, INC.**

**CONSOLIDATED QUARTERLY FINANCIAL DATA**

**(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)  
(UNAUDITED)**

	QUARTER ENDED							
	March 31, 2003	Dec. 31, 2002	Sept. 30, 2002	June 30, 2002	March 31, 2002	Dec. 31, 2001	Sept. 30, 2001	June 30, 2001
Total revenues.....	\$ 2,907	\$ 2,386	\$ 2,442	\$ 3,268	\$ 2,221	\$ 4,944	\$ 3,926	\$ 3,600
Cost of revenues.....	1,692	755	982	861	692	659	434	1,038
Gross profit.....	1,215	1,631	1,460	2,407	1,529	4,285	3,492	2,562
Operating expenses:								
Research and development.....	1,540	1,825	2,078	2,392	2,705	2,295	2,697	3,868
Selling, general, and administrative.....	1,383	2,023	1,852	2,183	1,956	2,269	2,367	2,962
Amortization of intangibles.....	--	--	--	--	191	190	191	191
Restructuring and other charges.....	2,097	1,340	--	--	--	--	--	--
Total operating expenses.....	5,020	5,188	3,930	4,575	4,852	4,754	5,255	7,021
Loss from operations.....	(3,805)	(3,557)	(2,470)	(2,168)	(3,323)	(469)	(1,763)	(4,459)
Other income (expense), net.....	27	16	511	43	218	135	(220)	12
Loss before income taxes.....	(3,778)	(3,541)	(1,959)	(2,125)	(3,105)	(334)	(1,983)	(4,447)
Provision for income taxes.....	--	--	--	--	15	--	--	--
Net loss before extraordinary gain	(3,778)	(3,541)	(1,959)	(2,125)	(3,120)	(334)	(1,983)	(4,447)
Extraordinary gain on extinguishment of debt, net.....	--	--	--	--	--	779	--	--
Net income (loss).....	\$ (3,778)	\$ (3,541)	\$ (1,959)	\$ (2,125)	\$ (3,120)	\$ 445	\$ (1,983)	\$ (4,447)
Net income (loss) per share:								
Basic.....	\$ (0.13)	\$ (0.12)	\$ (0.07)	\$ (0.08)	\$ (0.11)	\$ 0.02	\$ (0.07)	\$ (0.17)
Diluted.....	\$ (0.13)	\$ (0.12)	\$ (0.07)	\$ (0.08)	\$ (0.11)	\$ 0.02	\$ (0.07)	\$ (0.17)
Shares used in per share calculations:								
Basic.....	28,460	28,452	28,387	28,246	28,156	27,201	26,958	26,769
Diluted.....	28,460	28,452	28,387	28,246	28,156	27,438	26,958	26,769

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

None.

**PART III**

Certain information required by Part III is omitted from this Report on Form 10-K in that the Registrant will file its definitive Proxy Statement for its Annual Meeting of Stockholders (the 2003 Proxy Statement) pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of the fiscal year covered by this Report, and certain information included in the 2003 Proxy Statement is incorporated herein by reference.

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information required by this is included in the 2003 Proxy Statement under the captions "Election of Directors - Nominees," "Additional Information -- Executive Officers" and "Additional Information -- Section 16(a) Beneficial Ownership Reporting Compliance" and is incorporated herein by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item is included in the 2003 Proxy Statement under the captions "Election of Directors -- Compensation of Directors," "Additional Information -- Executive Compensation" and is incorporated herein by reference.

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

The information required by this Item is set forth in the 2003 Proxy Statement under the captions "Additional Information -- Security Ownership" and "Additional Information -- Equity Compensation Plan Information" and are incorporated herein by reference.

## **ITEM 13. CERTAIN RELATIONSHIPS AND TRANSACTIONS**

### ***Agreements with STMicroelectronics***

In the quarter ended March 31, 2000, the Company entered into a strategic relationship with STMicroelectronics NV, or STM. Under various agreements, STM purchased shares of 8x8 common stock and was granted certain related rights, licensed certain of the Company's intellectual property and engaged the Company to jointly develop products that enable voice and other multimedia services over internet protocol networks. In addition, STM and 8x8 entered into a cross license agreement in March 2002 that is more fully described below.

*Stock Purchase and Related Rights.* As part of the arrangement, STM purchased 3.7 million shares of 8x8's common stock for \$27.75 million. STM's share ownership currently represents 13.1% of our outstanding common stock making them the Company's largest shareholder. STM has been granted certain registration rights that expire upon the earlier of the date that STM can sell the remaining shares it holds in any three-month period under Rule 144, or February 2007. The registration rights allow STM to:

- require us to file a registration statement with the U.S. Securities and Exchange Commission covering the resale of some or all of the 3.7 million shares still held by STM, subject to certain conditions; and
- participate in future registration statements, including a registered public offering involving an underwriting, subject to certain conditions and limitations.

In addition, STM has preemptive rights that allow STM to purchase additional shares of common stock from the Company or receive rights to acquire shares of 8x8 common stock, in proportion to their ownership percentage, to the extent that shares of 8x8 common stock or rights to acquire 8x8 common stock are issued in connection with financing activities. STM's preemptive rights terminate on the later of the date that it owns less than 10% of 8x8's outstanding common stock or February 2003. Further, so long as STM holds at least 10% of 8x8's outstanding common stock, the Company is obligated to nominate one qualified nominee selected by STM for election to 8x8's board of directors. Christos Lagomichos, vice president and general manager of the Set-Top Box Division of STM's subsidiary, STMicroelectronics, Inc., was selected as a nominee by STM and currently serves on 8x8's board of directors.

*License and Development Agreements.* Under a non-exclusive, royalty-bearing license agreement entered into in the quarter ended March 31, 2000 in conjunction with the stock purchase and rights agreements discussed above, the Company provided a subsidiary of STM, STMicroelectronics, Inc., or STM Inc., with rights to use certain of its voice-over-internet-protocol semiconductor and embedded software technology. STM Inc. is required to pay royalties based on a percentage of the net sales price of products sold by STM Inc. that incorporate the licensed technology.

Under a separate development agreement that was also executed in the quarter ended March 31, 2000, 8x8 and STM Inc. established a framework for the joint development of semiconductor products and defined two initial projects. One project provides for the joint development of a voice-enabled chipset for cable modems and cable television set-top boxes. STM Inc. is not required to pay the Company any engineering fees associated with the development efforts necessary to support this project, which is still ongoing. STM Inc. is required to pay certain per-unit royalties based upon shipments of products that may eventually result from this development effort. The other project involves the integration of certain of our voice-over-internet protocol technology into products intended to be used in various internet telephony applications including digital subscriber line, or DSL, modems and internet protocol telephones. In May 2000 STM Inc. paid us \$1.0 million associated with this project; \$500,000 for engineering fees



associated with the development effort and \$500,000 of prepaid royalties. We have substantially completed our obligations under this project and STM Inc. is currently marketing and selling a product resulting from this joint development effort. STM Inc. is required to pay us additional per-unit royalties based upon shipments of this product only if cumulative royalties owed eventually exceed the balance of prepaid royalties. Should STM Inc. elect to have us provide extended product maintenance and support, they are required to pay us additional fees of which a portion will be considered prepaid royalties.

In March 2002, 8x8 licensed certain STM Very Long Instruction Word, or VLIW, microprocessor cores, related tools and MPEG4 video compression firmware from STM for use in the Company's Internet Protocol, or IP, video communication processor development initiatives. Additionally, 8x8 agreed to license STM certain of its existing and future H.263 and H.264 video compression/decompression firmware implementations for use with STM's semiconductor products. The licenses are non-exclusive, non-transferable and non-assignable and provide for the sharing of updates and enhancements to the licensed technology, subject to certain limitations. The agreement includes provisions that allow the Company to manufacturing semiconductor devices that contain the STVLIW core at STM or at other third-party fabrication facilities. The Company is required to pay STM per-unit royalties based upon shipments of products that incorporate the VLIW technology. In addition, STM is required to pay the Company certain per-unit royalties based upon shipments of STM semiconductor products that contain the Company's video technology.

During fiscal 2003, the Company began purchasing semiconductors from STM Inc. In addition, the Company and STM Inc. entered into an arrangement under which STM Inc. will provide the Company with non-recurring engineering services related to the development of a new semiconductor product by the Company.

Additional information required by this Item is set forth in the 2003 Proxy Statement under the captions "Additional Information -- Employment Contracts and Termination of Employment and Change in Control Arrangements," "Additional Information -- Compensation Committee Interlocks and Insider Participation," "Additional Information -- Report of the Compensation Committee of the Board of Directors" and "Additional Information -- Stock Performance Graph" and is incorporated herein by reference.

#### **ITEM 14. CONTROLS AND PROCEDURES**

Within the ninety day period prior to the date of the report, 8x8 carried out an evaluation, under the supervision and with the participation of the management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of 8x8's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that 8x8's disclosure controls and procedures are effective to timely alert them to material information related to 8x8 (including its consolidated subsidiaries) required to be included in 8x8's Exchange Act filings. Subsequent to the date of management's evaluation, there were no significant changes in our internal controls or in other factors that could significantly affect these controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

### **PART IV**

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

**(a)(1) Financial Statements.** The information required by this item is included in Item 8.

**(a)(2) Financial Statement Schedules.** The information required by this item is included in Item 8.

**(a)(3) Exhibits.** The documents listed on the Exhibit Index appearing at pages X-X of this Report are filed herewith. Copies of the exhibits listed in the Exhibit Index will be furnished, upon request, to holders or beneficial owners of the Company's common stock.

**(b) Reports on Form 8-K.** None.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant, 8x8, Inc., a Delaware corporation, has duly caused this Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Santa Clara, State of California, on May 29, 2003.

8X8, INC.

By: /s/ BRYAN R. MARTIN

Bryan R. Martin,  
President and Chief Executive Officer

## POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENT, that each person whose signature appears below constitutes and appoints Bryan R. Martin and James Sullivan, jointly and severally, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorney-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Report on Form 10-K has been signed by the following persons in the capacities and on the date indicated:

Signature

Title

Date \_\_\_\_\_

/s/ BRYAN R. MARTIN  
Bryan R. Martin

Director, President and Chief Executive Officer  
(Principal Executive Officer)

May 29, 2003

/s/ JAMES SULLIVAN  
James Sullivan

Chief Financial Officer, Vice President, Finance  
and Secretary  
(Principal Financial and Accounting Officer)

May 29, 2003

/s/ JOE PARKINSON  
Joe Parkinson

Chairman of the Board

May 29, 2003

/s/ BERND GIROD  
Bernd Girod

Director

May 29, 2003

/s/ GUY L. HECKER  
Guy L. Hecker, Jr.

Director

May 29, 2003

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Christos Lagomichos

Director

May 29, 2003

/s/ WILLIAM TAI  
William Tai

Director

May 29, 2003

Certifications of Principal Executive Officer and Principal Financial Officer Regarding Facts and Circumstances  
Relating to Annual Reports

I, Bryan R. Martin, certify that:

1. I have reviewed this annual report on Form 10-K of 8x8, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within ninety days prior to the filing date of this annual report (the "Evaluation Date"); and
  - (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: May 29, 2003      /s/ Bryan R. Martin

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Bryan R. Martin  
President and Chief Executive Officer

Certifications of Principal Executive Officer and Principal Financial Officer Regarding Facts and Circumstances Relating to Annual Reports

I, James Sullivan, certify that:

1. I have reviewed this annual report on Form 10-K of 8x8, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within ninety days prior to the filing date of this annual report (the "Evaluation Date"); and
  - (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: May 29, 2003      /s/ James Sullivan

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James Sullivan  
Vice President, Finance and Chief Financial Officer

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**8X8, INC.**

**EXHIBIT INDEX**

Exhibit Number	Exhibit Title
2.1 (c)	Stock Exchange Agreement, dated as of May 13, 1999, by and among 8x8, Inc. (the Registrant), Odisei S.A. and the Security Holders named therein and the agreements related thereto.
2.2 (g)	Share Exchange Agreement, dated as of May 19, 2000, by and among the Registrant, U Force, all of the shareholders of U Force and indirect owners of the shares of U Force.
3.1 (a)	Form of Amended and Restated Certificate of Incorporation of Registrant.
3.2 (a)	Bylaws of Registrant.
3.3 (l)	Certificate of Amendment of Amended and Restated Certificate of Incorporation of Registrant.
3.4 (n)	Certificate of Amendment of Amended and Restated Certificate of Incorporation of Registrant.
4.1 (d)	Securities Purchase Agreement by and among Wingate Capital Ltd. and Fisher Capital Ltd. (collectively the Buyers) and the Registrant dated December 15, 1999, with Schedule and Exhibits.
4.2 (d)	Registration Rights Agreement by and among the Registrant and the Buyers dated December 15, 1999.
4.3 (d)	Form of Series A Warrant by and among the Registrant and FleetBoston Robertson Stephens, Inc. dated December 16, 1999.
4.4 (d)	Form of Series B Warrant by and among the Registrant and FleetBoston Robertson Stephens Inc. dated December 16, 1999.
4.5 (d)	Registration Rights Agreement by and among the Registrant and FleetBoston Robertson Stephens Inc. dated December 16, 1999.
4.6 (f)	Common Stock Purchase Agreement by and among the Registrant and STMicroelectronics dated January 24, 2000.
4.7 (f)	Form of Investor Rights Agreement by and among the Registrant and STMicroelectronics dated January 24, 2000.
4.8 (o)	Form of Amendment No.1 to the Series A and Series B Warrants, dated as of December 17, 2001, by and among the Registrant, Fisher Capital Ltd. and Wingate Capital Ltd.
4.9 (o)	Registration Rights Agreement, dated as of December 13, 2001, by and among the Registrant, Fisher Capital Ltd. and Wingate Capital Ltd.
10.1 (a)	Form of Indemnification Agreement.
10.2 (a)	1992 Stock Option Plan, as amended, and form of Stock Option Agreement.
10.3 (a)	Key Personnel Plan, as amended, and form of Stock Option Agreement.
10.4 (i)	1996 Stock Plan, as amended, and form of Stock Option Agreement.

- 10.5 (a) 1996 Employee Stock Purchase Plan, as amended, and form of Subscription Agreement.
- 10.6 (j) 1996 Director Option Plan, as amended, and form of Director Option Agreement.
- 10.7 (a) Facility lease dated as of July 3, 1990 by and between Sobrato Interests, a California Limited Partnership, and the Registrant, as amended.
- 10.8 (b) Fifth Amendment to Lease dated January 26, 1998 between Sobrato Interests and the Registrant.
- 10.9 (b) Landlord's Consent to Sublease dated February 23, 1998 among Sobrato Interests, Bay Networks, Inc. and the Registrant.
- 10.10 (e) 1999 Nonstatutory Stock Option Plan, as amended, and form of Stock Option Agreement.
- 10.11 (h) Asset Purchase Agreement by and among the Registrant and Interlogix, Inc. dated May 19, 2000.
- 10.12 (h) Technology License Agreement by and among the Registrant and Interlogix, Inc. dated May 19, 2000.
- 10.13 (k) UForce Company -- Societe UForce Amended and Restated 1999 Stock Option Plan.
- 10.14 (l) Settlement Agreement and Release by and between the Registrant and Keith Barraclough dated July 10, 2000.
- 10.15 (l) Severance Agreement and Mutual Release by and between the Registrant, Netergy Networks Canada Corporation and Dominique Pitteloud dated October 13, 2000.
- 10.16 (m) Agreement by and between the Registrant and Dr. Paul Voois dated April 30, 2001.
- 10.17 (m) Agreement by and between the Registrant and Jonathan Foster dated April 30, 2001.
- 10.18 (p) Redemption and Exchange Agreement, dated as of December 13, 2001, by and among 8x8, Inc., Fisher Capital Ltd. and Wingate Capital Ltd.
- 10.19 (q) License Agreement dated as of January 24, 2000, by and between the Registrant and STMicroelectronics, Inc.
- 10.20 (q) Development Agreement dated as of January 24, 2000, by and between the Registrant and STMicroelectronics, Inc.
- 10.21 (r) LX Video Development and License Agreement dated as of March 19, 2002, by and between the Registrant and STMicroelectronics N.V.
- 10.22 (r) Netergy Microelectronics, Inc. 2000 Stock Option Plan, as amended, and form of Stock Option Agreement.
- 10.23 (r) Centile, Inc. 2001 Stock Option Plan, as amended, and form of Stock Option Agreement.
- 10.24 (r) Investment Agreement dated April 1, 2002 by and between the Registrant and Joe Parkinson.
- 21.1 Subsidiaries of Registrant.
- 23.1 Consent of Independent Accountants.
- 24.1 Power of Attorney.
- 99.1 Certification of Chief Executive Officer of the Registrant pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (a) Incorporated by reference to identically numbered exhibits filed in response to Item 16 (a), "Exhibits," of the registrant's Registration Statement on Form S-1 (File No. 333-15627), as amended, declared effective July 1, 1997.
- (b) Incorporated by reference to exhibits filed in response to Item 14 (a), "Exhibits," of the Registrant's Annual Report on Form 10-K for the fiscal year ended March 31, 1998.
- (c) Incorporated by reference to identically numbered exhibits filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K dated June 7, 1999 and 8-K/A dated August 9, 1999.
- (d) Incorporated by reference to exhibits filed in response to Item 6(a), "Exhibits," of the Registrant's Report on Form 10-Q for the fiscal quarter ended December 31, 1999.
- (e) Incorporated by reference to exhibit 4.1 filed in response to Item 8, "Exhibits," of the Registrant's Statement on Form S-8 dated July 17, 2000.
- (f) Incorporated by reference to exhibits filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K filed on February 16, 2000.
- (g) Incorporated by reference to an exhibit filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K filed on May 23, 2000.
- (h) Incorporated by reference to exhibits filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K filed on May 26, 2000.
- (i) Incorporated by reference to exhibit 4.1 filed in response to Item 8, "Exhibits," of the Registrant's Report on Form S-8 dated November 7, 2000.
- (j) Incorporated by reference to exhibit 4.2 filed in response to Item 8, "Exhibits," of the Registrant's Report on Form S-8 dated November 7, 2000.
- (k) Incorporated by reference to exhibit 4.2 filed in response to Item 8, "Exhibits," of the Registrant's Statement on Form S-8 dated July 17, 2000.
- (l) Incorporated by reference to exhibits filed in response to Item 14 (a), "Exhibits," of the Registrant's Annual Report on Form 10-K for the fiscal year ended March 31, 2001.
- (m) Incorporated by reference to exhibits filed in response to Item 6(a), "Exhibits," of the Registrant's Report on Form 10-Q for the fiscal quarter ended June 30, 2001.
- (n) Incorporated by reference to exhibit 3.1 filed in response to Item 6(a), "Exhibits," of the Registrant's Report on Form 10-Q for the fiscal quarter ended September 30, 2001.
- (o) Incorporated by reference to exhibits filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K filed on December 17, 2001.
- (p) Incorporated by reference to exhibit 10.1 filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K/A filed on January 30, 2002.
- (q) Incorporated by reference to exhibits filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 8-K/A filed on January 30, 2002.
- (r) Incorporated by reference to exhibits filed in response to Item 7, "Exhibits," of the Registrant's Report on Form 10-K filed on May 23, 2002.