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

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FORM 10-Q

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

**For the quarterly period ended September 30, 2004**

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**

(Address of Principal Executive Offices)

**(408) 727-1885**

(Registrant's Telephone Number, including Area Code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES ☐ NO ☒

The number of shares of the Registrant's Common Stock outstanding as of October 15, 2004 was 46,655,830.

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## PART I -- FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

**8x8, Inc.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(In thousands, unaudited)**

	September 30, 2004	March 31, 2004
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 27,969	\$ 13,249
Restricted cash .....	550	800
Short-term investments .....	160	--
Accounts receivable, net .....	411	608
Inventory .....	2,415	98
Other current assets .....	1,040	645
Total current assets .....	32,545	15,400
Property and equipment, net .....	608	158
Other assets .....	12	13
	<u>\$ 33,165</u>	<u>\$ 15,571</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable .....	\$ 1,581	\$ 854
Accrued compensation .....	417	415
Accrued warranty .....	171	194
Deferred revenue .....	655	547
Financing proceeds advance .....	11,980	--
Other accrued liabilities .....	727	559
Total current liabilities .....	15,531	2,569
Other liabilities .....	217	216
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock .....	43	38
Additional paid-in capital .....	175,410	164,469
Deferred compensation .....	--	(3)
Accumulated deficit .....	(158,036)	(151,718)
Total stockholders' equity .....	17,417	12,786
	<u>\$ 33,165</u>	<u>\$ 15,571</u>

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

**8x8, Inc.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share amounts; unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Product revenues .....	\$ 690	\$ 750	\$ 1,287	\$ 1,611
License and service revenues .....	1,843	1,676	3,314	2,438
Total revenues .....	<u>2,533</u>	<u>2,426</u>	<u>4,601</u>	<u>4,049</u>
Operating expenses:				
Cost of product revenues .....	876	544	1,788	907
Cost of license and service revenues .....	1,171	108	2,050	499
Research and development .....	684	656	1,261	1,700
Selling, general and administrative .....	<u>3,622</u>	<u>1,229</u>	<u>6,135</u>	<u>2,495</u>
Total operating expenses .....	<u>6,353</u>	<u>2,537</u>	<u>11,234</u>	<u>5,601</u>
Loss from operations .....	(3,820)	(111)	(6,633)	(1,552)
Other income, net .....	71	858	295	799
Benefit for income taxes .....	--	--	20	--
Net income (loss) .....	<u>\$ (3,749)</u>	<u>\$ 747</u>	<u>\$ (6,318)</u>	<u>\$ (753)</u>
Basic net income (loss) per share.....	<u>\$ (0.09)</u>	<u>\$ 0.02</u>	<u>\$ (0.15)</u>	<u>\$ (0.03)</u>
Diluted net income (loss) per share.....	<u>\$ (0.09)</u>	<u>\$ 0.02</u>	<u>\$ (0.15)</u>	<u>\$ (0.03)</u>
Shares used in basic share computation.....	43,134	30,069	40,935	30,054
Shares used in diluted share computation.....	43,134	31,213	40,935	30,054

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

**8x8, Inc.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands, unaudited)

	Six Months Ended September 30,	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net loss .....	\$ (6,318)	\$ (753)
Adjustments to reconcile net loss to net cash used in operating activities:		
Gain on sale of business .....	--	(790)
Depreciation and amortization .....	58	469
Other .....	--	(45)
Changes in assets and liabilities, net of business sold.....	(1,630)	(55)
Net cash used in operating activities .....	(7,890)	(1,174)
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment .....	(511)	(13)
Proceeds from sale of equipment .....	--	20
Restricted cash decrease.....	250	--
Purchase of short term investments .....	(160)	--
Short term investments -- trading activity, net.....	--	(802)
Net cash used in investing activities .....	(421)	(795)
<b>Cash flows from financing activities:</b>		
Financing proceeds advance .....	11,980	--
Proceeds from issuance of common stock .....	11,051	978
Net cash provided by financing activities .....	23,031	978
Net increase (decrease) in cash and cash equivalents .....	14,720	(991)
Cash and cash equivalents at the beginning of the period .....	13,249	3,371
Cash and cash equivalents at the end of the period .....	\$ 27,969	\$ 2,380

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

**8x8, Inc.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED**  
**FINANCIAL STATEMENTS**

**1. DESCRIPTION OF THE BUSINESS**

***THE COMPANY***

8x8, Inc., or 8x8, and its subsidiaries (collectively, the Company) develop and market communication technology and services for Internet protocol or, IP, telephony and video applications. The Company was incorporated in California in February 1987, and in December 1996 was reincorporated in Delaware. 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.

The Company offers the Packet8 broadband voice over Internet protocol, or VoIP, and video communications service, Packet8 Virtual Office service and videophone equipment and services. The Packet8 voice and video communications service (Packet8) enables broadband Internet users to add digital voice and video communications services to their high-speed Internet connection. Customers can choose a direct-dial phone number from any of the rate centers offered by the service, and then use an 8x8-supplied terminal adapter to connect any telephone to a broadband Internet connection and make or receive calls from a regular telephone number. All Packet8 telephone accounts come with voice mail, caller ID, call waiting, call waiting caller ID, call forwarding, hold, line-alternate, 3-way conferencing, web access to account controls, and real-time online billing. In addition, 8x8 offers a videophone for use with the Packet8 service.

Substantially all of the Company's revenues are generated from the sale, license and provision of VoIP products, services and technology. Prior to fiscal 2004, the Company was focused on its VoIP semiconductor business (through its subsidiary Netergy Microelectronics, Inc.) and hosted iPBX solutions business (through its subsidiary Centile, Inc.). In late fiscal 2003, the Company began to devote more of its resources to the promotion, distribution and development of the Packet8 service than to its existing semiconductor business or hosted iPBX solutions business. The Company completed several transactions during fiscal 2004 to license and sell technology and assets of these former businesses, including the sale of its hosted iPBX research and development center in France, the sale and license of its next generation video semiconductor development effort, and the license of technology and manufacturing rights for its VoIP semiconductor products to other semiconductor companies. In addition, during January 2004, the Company announced the end of life of its VoIP semiconductor products, and began accepting last time buy orders from customers. The Company continues to own the voice and video technology related to the semiconductor and iPBX businesses, and utilizes this technology in the Packet8 service offering, and continues to sell or license this technology to third parties.

The Company's fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in these notes to the consolidated financial statements refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2005 refers to the fiscal year ending March 31, 2005).

***LIQUIDITY***

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 believes that current cash and cash equivalents will be sufficient to finance the Company's operations through at least the next twelve months. However, the Company continually evaluates its cash needs and may pursue additional equity or debt financing in order to achieve the Company's overall business objectives. There can be no assurance that such financing will be available, or, if available, at a price that is acceptable to the Company. Failure to generate sufficient revenues, raise additional capital or reduce certain discretionary spending could have an adverse impact on the Company's ability to achieve its longer term business objectives.

**2. BASIS OF PRESENTATION**

The accompanying interim condensed consolidated financial statements are unaudited and have been prepared on substantially the same basis as our annual financial statements for the fiscal year ended March 31, 2004. In the opinion of management, these financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of our financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported

amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

These financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended March 31, 2004 and notes thereto included in the Company's fiscal 2004 Annual Report on Form 10-K. Certain prior period balances have been reclassified to conform to the current period presentation.

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

#### *Restricted Cash*

Restricted cash represents amounts held in certificates of deposit to support stand-by letters of credit used as security for third party vendors.

#### *Short-term Investments*

The Company's short-term investments consist of investments in mutual funds. All short-term investments are classified as available-for-sale and carried at fair value.

#### *VoIP Service Revenue*

The Company defers revenue recognition of new subscriber revenue from its Packet8 service offerings until the acceptance period has expired. New customers may terminate their service within thirty days of order placement and receive a full refund of fees previously paid. As the Company has been providing its Packet8 service for a limited period of time, it has not developed sufficient history to apply a return rate and reserve against new order revenue. Accordingly, the Company defers new subscriber revenue for up to thirty days to ensure that the thirty day activation period has expired.

In November 2002, the Emerging Issues Task Force (EITF) reached consensus on EITF No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." This consensus requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if the deliverables in the arrangement meet specific criteria. In addition, arrangement consideration must be allocated among the separate units of accounting based on their relative fair values, with certain limitations. The provisioning of the Packet8 service with the accompanying desktop terminal adapter constitutes a revenue arrangement with multiple deliverables. In accordance with the guidance of EITF No. 00-21, the Company allocates Packet8 revenues, including activation fees, among the desktop terminal adapter and subscriber services. Revenues allocated to the desktop terminal adapter are recognized as product revenues at the end of thirty days after order placement, provided the customer does not cancel their Packet8 service. All other revenues are recognized as license and service revenues when the related services are provided.

#### *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," the Company provides pro forma disclosure of net loss and loss 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 (loss) and related per share amounts would have been as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Net income (loss), as reported.....	\$ (3,749)	\$ 747	\$ (6,318)	\$ (753)
Add: Stock-based compensation expense included in reported net income (loss).....	1	2	3	4
Deduct: Total stock-based compensation (expense) benefit determined pursuant to SFAS No.123.....	(339)	286	(879)	(254)
Pro forma net loss.....	<u>\$ (4,087)</u>	<u>\$ 1,035</u>	<u>\$ (7,194)</u>	<u>\$ (1,003)</u>
Basic net income (loss) per share:				
As reported.....	\$ (0.09)	\$ 0.02	\$ (0.15)	\$ (0.03)
Pro forma.....	\$ (0.09)	\$ 0.03	\$ (0.18)	\$ (0.03)
Diluted net income (loss) per share:				
As reported.....	\$ (0.09)	\$ 0.02	\$ (0.15)	\$ (0.03)
Pro forma.....	\$ (0.09)	\$ 0.03	\$ (0.18)	\$ (0.03)

### 3. BALANCE SHEET DETAIL

	September 30, 2004	March 31, 2004
Inventory (in thousands):		
Raw materials and work-in-process .....	\$ 1,286	\$ 57
Finished goods .....	1,129	41
	<u>\$ 2,415</u>	<u>\$ 98</u>

### 4. COMMON STOCK OFFERINGS

In June 2004, the Company sold 4,800,000 shares of its common stock at \$2.50 per share for aggregate proceeds of approximately \$12,000,000, before placement fees and other offering expenses. The purchaser also received a five year warrant to purchase 1,920,000 shares of 8x8 common stock at an exercise price of \$3.00 per share. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission relating to up to \$50,000,000 of 8x8 securities. The Company paid total cash fees of six percent of the gross proceeds to the placement agents, and issued three year warrants to purchase 240,000 common shares at \$2.50 per share and 96,000 common shares at \$3.00 per share.

On October 1, 2004, the Company sold 3,508,772 shares of its common stock at \$3.42 per share for aggregate proceeds of approximately \$12,000,000, before placement fees and other offering expenses. The purchaser also received a five year warrant to purchase 1,403,509 shares of 8x8 common stock at an exercise price of \$4.10 per share. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission. The Company paid total cash fees of six percent of the gross proceeds to the placement agents, and issued three year warrants to purchase 175,438 common shares at \$3.42 per share and 70,175 common shares at \$4.10 per share. Proceeds of \$11,980,000, which are net of the investor's legal fees to be paid by the Company, were received on September 30, 2004, and recorded as a liability on the condensed consolidated balance sheet as the sale did not legally close until October 1, 2004.

### 5. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) available to common stockholders (numerator) by the weighted average number of vested, unrestricted common shares outstanding during the period (denominator). Net income (loss) per share was as follows (in thousands, except per share amounts):



	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Numerator:				
Net income (loss).....	\$ (3,749)	\$ 747	\$ (6,318)	\$ (753)
Denominator:				
Common Shares.....	43,134	30,069	40,935	30,054
Denominator for basic calculation.....	43,134	30,069	40,935	30,054
Employee stock options.....	--	404	--	--
Warrants.....	--	740	--	--
Denominator for diluted calculation	<u>43,134</u>	<u>31,213</u>	<u>40,935</u>	<u>30,054</u>
Net income (loss) per share:				
Basic.....	\$ (0.09)	\$ 0.02	\$ (0.15)	\$ (0.03)
Diluted.....	\$ (0.09)	\$ 0.02	\$ (0.15)	\$ (0.03)

Due to net losses incurred for the three and six month periods ended September 30, 2004, and six month period ended September 30, 2003, basic and diluted shares outstanding for each of 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):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Common stock options .....	6,090	6,634	6,090	7,889
Warrants .....	4,575	--	4,575	3,390
	<u>10,665</u>	<u>6,634</u>	<u>10,665</u>	<u>11,279</u>

## 6. 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 gains and losses on short-term investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three and six months ended September 30, 2004 and 2003, approximated net loss for those periods.

## 7. SEGMENT REPORTING

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," establishes annual and interim reporting standards for an enterprise's business segments and related disclosures about its products, services, geographic areas and major customers. Under SFAS No. 131, the method for determining what information to report is based upon the way management organizes the operating segments within the Company for making operating decisions and assessing financial performance. The Company has determined that it has only one reportable segment. The following net revenues are presented by groupings of similar products (in thousands). The product lines described are consistent with the segments previously reported by the Company.

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Packet8 and videophones/equipment.....	\$ 2,067	\$ 214	\$ 3,493	\$ 271
Semiconductors and related software.....	447	2,158	1,030	3,565
Hosted iPBX solutions.....	19	54	78	213
Total revenues .....	<u>\$ 2,533</u>	<u>\$ 2,426</u>	<u>\$ 4,601</u>	<u>\$ 4,049</u>

No customer represented greater than 10% of the Company's total revenues for the three or six months ended September 30, 2004. For the quarter ended September 30, 2003, three customers represented greater than 10% of total

revenues. These customers represented 55%, 11% and 11% of total revenues, respectively. For the six months ended September 30, 2003, three customers represented greater than 10% of total revenues, and those percentages were 33%, 12% and 11%, respectively. The Company's revenue distribution by geographic region (based upon the destination of shipments) was as follows:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Americas.....	89%	12%	86%	22%
Europe.....	8%	74%	4%	59%
Asia Pacific.....	3%	14%	10%	19%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

## 8. COMMITMENTS AND CONTINGENCIES

### *Guaranties*

#### *Indemnifications*

In the normal course of business, the Company indemnifies other parties, including customers, lessors and parties to other transactions with the Company, with respect to certain matters.

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

#### *Product Warranties*

The Company accrues for the estimated costs that may be incurred under its product warranties upon revenue recognition. Changes in the Company's product warranty liability during the three and six months ended September 30, 2004, were as follows (in thousands):

	Three Months Ended September 30, 2004	Six Months Ended September 30, 2004
Balance at beginning of period.....	\$ 186	\$ 194
Accruals for warranties.....	14	37
Settlements.....	(29)	(37)
Changes in estimates.....	--	(23)
Balance at end of period.....	<u>\$ 171</u>	<u>\$ 171</u>

#### *Standby letters of credit.*

The Company has standby letters of credit totaling \$550,000, which were issued to guarantee certain contractual obligations and outstanding purchase orders and are collateralized by cash deposits at the Company's primary bank.

#### *Leases*

At September 30, 2004, future minimum annual lease payments under noncancelable operating leases, net of estimated sublease income, were as follows (in thousands):

Year ending March 31:

Remaining 2005.....	\$	54
2006.....		403
2007.....		482
2008.....		490
2009.....		493
2010.....		206
Total minimum payments.....	\$	<u>2,128</u>

### *Legal Proceedings*

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

### *Regulatory*

To date VoIP communication services have been largely unregulated in the United States. Many regulatory actions are underway or are being contemplated by federal and state authorities, including the Federal Communications Commission, or FCC, and state regulatory agencies. To date, the FCC has treated Internet service providers as information service providers. Information 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. The FCC initiated a notice of public rule-making in early 2004 to gather public comment on the appropriate regulatory environment for IP telephony. 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 the Company's business and operating results.

Several state regulatory authorities have contacted the Company regarding its Packet8 service. These inquiries have ranged from notification that the Packet8 service should be subject to local regulation, certification and fees to broad inquiries into the nature of the Packet8 services provided. The Company responds to the various state authorities as inquiries are received. Based on advice of counsel, the Company disputes the assertion, among others, that the Packet8 service should be subject to state regulation. While the Company does not believe that exposure to material amounts of fees or penalties exists, if the Company is subject to an enforcement action, the Company may become subject to liabilities and may incur expenses that adversely affect its results of operations. The California Public Utilities Commission (CPUC) instituted its own investigation in early 2004 to determine how it will classify and treat VoIP service providers like Packet8. In November 2004, the Company received notices from multiple municipalities in California that the Packet8 service is subject to utility user taxes, as defined in the respective municipal codes. The notices require that the Company begin collecting and remitting utility user taxes no later than January 1, 2005. On November 9, 2004, the FCC ruled that the VoIP service of a competitor and "similar" services are jurisdictionally interstate and not subject to state certification, tariffing and other common carrier regulations.

The effect of potential future VoIP telephony laws and regulations on the Company's operations, including, but not limited to, Packet8, cannot be determined.

## **ITEM 2. 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. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends," and similar expressions are intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results 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 or our failure to generate investor interest. 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.

## ***BUSINESS OVERVIEW***

We develop and market telecommunication technology for Internet protocol, or IP, telephony and video applications. We offer the Packet8 broadband voice over Internet protocol, or VoIP, and video communications service, Packet8 Virtual Office service and videophone equipment and services. We shipped our first VoIP product in 1998, launched our Packet8 service in November 2002, and launched the Packet8 Virtual Office business service offering in March 2004. As of September 30, 2004, we had approximately 26,000 activated Packet8 lines in service. Substantially all of the Company's revenues are generated from the sale, license and provision of VoIP products, services and technology.

In late fiscal 2003, we began to devote more of our resources to the promotion, distribution and development of the Packet8 voice and video communications service than to our existing semiconductor business or hosted iPBX solutions business. We completed several transactions during fiscal 2004 to license and sell technology and assets of these businesses, including the sale of our iPBX research and development center in France, the sale of our next generation video semiconductor development effort, and the license of technology and manufacturing rights for our VoIP semiconductor products to other semiconductor companies. In addition, during January 2004, we announced the end of life of our VoIP semiconductor products, and began accepting last time buy orders from customers. This change in our business has resulted in a reduction of revenues, but has enabled us to reduce costs and generate cash from the related license and sale transactions related to the semiconductor and iPBX businesses. We continue to own the voice and video technology related to the semiconductor and iPBX businesses, and utilize this technology in the Packet8 service offering and continue to sell or license this technology when the opportunity is in our best interest.

Our fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in this Report refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2005 refers to the fiscal year ended March 31, 2005).

On October 1, 2004, we sold 3,508,772 shares of our common stock at \$3.42 per share for aggregate proceeds of approximately \$12,000,000, before placement fees and other offering expenses. The purchaser also received a five year warrant to purchase 1,403,509 shares of 8x8 common stock at an exercise price of \$4.10 per share. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission relating to up to \$50,000,000 of our securities. We paid total cash fees of six percent of the gross proceeds to the placement agents, and issued three year warrants to purchase 175,438 common shares at \$3.42 per share and 70,175 common shares at \$4.10 per share. Proceeds of \$11,980,000, which are net of the investor's legal fees to be paid by us, were received on September 30, 2004, and recorded as a liability on the condensed consolidated balance sheet as the sale did not legally close until October 1, 2004.

## ***RESULTS OF OPERATIONS***

The following table sets forth condensed consolidated statements of operations data for the three and six month periods ended September 30, 2004 and 2003, respectively, expressed as a percentage of our total revenues represented by each item.

	Three Months Ended		Six Months Ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Product revenues .....	27%	31%	28%	40%
License and service revenues .....	73%	69%	72%	60%
Total revenues .....	100%	100%	100%	100%
Operating expenses:				
Cost of product revenues .....	35%	23%	39%	22%
Cost of license and service revenues .....	46%	4%	45%	12%
Research and development .....	27%	27%	27%	42%
Selling, general and administrative .....	143%	51%	133%	62%
Total operating expenses .....	251%	105%	244%	138%
Loss from operations .....	-151%	-5%	-144%	-38%
Other income, net .....	3%	35%	6%	20%
Benefit for income taxes .....	--	--	--	--
Net income (loss) .....	-148%	30%	-138%	-18%

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

### **Revenues**

Product revenues consist of revenues from sales of VoIP semiconductors, sales of our system products such as hosted iPBX media hub systems and VoIP terminal adapters and videophone systems, primarily attributable to our Packet8 service. Product revenues were \$690,000 in the second quarter of fiscal 2005, a decrease of approximately \$60,000 from the \$750,000 reported in the second quarter of fiscal 2004. The decrease for the second quarter of fiscal 2005 was primarily attributable to a \$480,000 decrease in revenues from sales of semiconductors, partially offset by an increase of approximately \$450,000 for product revenues attributable to the Packet8 service due to the increase in the subscriber base.

Product revenues were \$1.3 million for the six months ended September 30, 2004, a decrease of approximately \$300,000 from the \$1.6 million for the six months ended September 30, 2003. The decrease for the six month period ended September 30, 2004, as compared to the corresponding period in the prior year was due primarily to a \$900,000 decline in sales of our semiconductors due to the end of life of those products. The decrease in semiconductor revenue was partially offset by a \$600,000 increase in product revenues attributable to the Packet8 segment due to the increase in the subscriber base compared to the prior year.

License and service revenues consist primarily of technology licenses and related maintenance revenues, as well as the royalties earned under such licenses, and revenues attributable to our Packet8 service. License and service revenues were \$1.8 million in the second quarter of fiscal 2005, an increase of approximately \$100,000 as compared to the \$1.7 million recorded for the second quarter of fiscal 2004. We expect that Packet8 service revenues will continue to comprise the majority of license and service revenues on a going forward basis. The quarter over quarter increase was primarily due to a \$1.4 million increase in revenues attributable to our Packet8 service due to the increase in our subscriber base. The Packet8 service revenue increase was partially offset by a \$1.3 million decrease in license and maintenance revenues associated with our hosted iPBX product and IP semiconductor telephony technology. We defer revenue recognition of new Packet8 subscriber revenue until we deem that the customer has accepted the service. During the first quarter of fiscal 2005, we changed our terms of service such that customers may terminate their service and receive a full refund of fees previously paid within thirty days of order placement rather than within thirty days of service activation. As the Company has been providing its Packet8 service for a limited period of time, it has not developed sufficient history to apply a return rate and reserve against new order revenue. Accordingly, the Company defers new subscriber revenue for up to thirty days to ensure that the trial period has expired. As a result of the change in terms of service, the Company recognized an additional \$100,000 of new order revenue during the quarter ended June 30, 2004.

License and service revenues were \$3.3 million for the six months ended September 30, 2004, an increase of approximately \$900,000 as compared to the \$2.4 million recorded for the six months ended September 30, 2003. The increase was primarily attributable to a \$2.6 million increase in Packet8 service revenues. The Packet8 service revenue increase was offset by a decrease of \$1.7 million in license and maintenance revenues associated with our hosted iPBX product and IP semiconductor telephony technology.

No customer represented greater than 10% of our total revenues for the three or six months ended September 30, 2004. For the quarter ended September 30, 2003, three customers represented greater than 10% of total revenues. These customers represented 55%, 11% and 11% of our total revenues, respectively. For the six months ended September 30, 2003, three customers represented greater than 10% of total revenues. Those percentages were 33%, 12% and 11%, respectively. Our revenue distribution by geographic region (based upon the destination of shipments) was as follows:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2004	2003	2004	2003
Americas.....	89%	12%	86%	22%
Europe.....	8%	74%	4%	59%
Asia Pacific.....	3%	14%	10%	19%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

### ***Cost of Product Revenues***

The cost of product revenues consists of costs associated with systems, components, semiconductor wafer fabrication, system and semiconductor assembly and testing performed by third-party vendors, estimated warranty obligations and direct and indirect costs associated with product purchasing, scheduling, quality assurance, shipping and handling. The cost of product revenues were \$876,000 for the three months ended September 30, 2004 as compared to \$544,000 for the three months ended September 30, 2003. The cost of product revenues increased by approximately \$330,000, for the second quarter of fiscal 2005 as compared to the prior year quarter primarily due to an approximately \$600,000 increase for equipment provided to Packet8 subscribers upon activation of their service and related manufacturing, handling, overhead and shipping costs. The increase in Packet8 expenses was partially offset by a \$288,000 decrease in cost of revenues for semiconductor products due to the decrease in sales of such products during the second quarter of fiscal 2005 due to the end of life of these products initiated in fiscal 2004.

The cost of product revenues was approximately \$1.8 million for the six months ended September 30, 2004, an increase of approximately \$900,000 from the \$900,000 recorded for the six months ended September 30, 2003. The \$900,000 increase in the cost of product revenues was primarily attributable to an approximately \$1.2 million increase for equipment provided to Packet8 subscribers upon activation of their service and related manufacturing, handling, overhead and shipping costs. The increase in Packet8 expenses was partially offset by a \$445,000 decrease in cost of revenues for semiconductor products due to the decrease in sales of such products during the second quarter of fiscal 2005 due to the end of life of VoIP semiconductors initiated in fiscal 2004 and end of life of video semiconductors completed in the first quarter of fiscal 2004.

We generally do not charge Packet8 subscribers for the DTA 310s when they subscribe on our web site. We have also offered incentives to customers who purchase DTA 310s in our retail channels to offset the cost of the equipment purchased from a retailer. In accordance with Emerging Issues Task Force Issue No. 00-21, a portion of Packet8 revenues is allocated to product revenues, but these revenues are less than the cost of the DTA 310s. Accordingly, cost of product revenues exceed product revenues.

### ***Cost of License and Service Revenues***

The cost of license and service revenues consists of costs primarily associated with network operations and related personnel, telephony origination and termination services provided by third party carriers, and royalty expenses. The cost of license and service revenues was \$1.2 million for the second quarter of fiscal 2005, an increase of \$1.1 million as compared to the \$100,000 recorded in the second quarter of fiscal 2004. The increase for fiscal 2005 was primarily attributable to a \$1.1 million increase in Packet8 network operations and third party carrier service charges due to the year over year growth in the Packet8 subscriber base.

The cost of license and service revenues was \$2.1 million, an increase of \$1.6 million for the six months ended September 30, 2004, as compared to the \$500,000 recorded for the six months ended September 30, 2003. The increase of \$1.6 million for the six months ended September 30, 2004, was primarily due to a \$1.9 million increase in Packet8 network operations and third party carrier service charges due to the year over year growth in the Packet8 subscriber base. This increase was offset by a \$364,000 decrease in costs related to the development of a next generation video semiconductor product; as these costs related to a revenue generating contract they were included in cost of license and service revenue in fiscal 2004. In the third quarter of fiscal 2004, we terminated the next generation video

semiconductor development effort in connection with the license and sale of the technology to Leadtek Research, Inc.

### ***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 expenses were \$684,000 for the second quarter of fiscal 2005, an increase of approximately \$28,000 for the second quarter of fiscal 2005 as compared to the second quarter of fiscal 2004. The increase in research and development expenses for the three month period ended September 30, 2004, as compared to the comparable period in the prior year was primarily due to an increase in compensation costs due to additional headcount and costs associated with 8x8 Europe SARL, our French subsidiary, which was formed in the third quarter of fiscal 2004. These increases were offset by a decrease in depreciation and software maintenance expenses.

Research and development expenses were \$1.3 million and \$1.7 million for the six months ended September 30, 2004 and 2003, respectively. The \$400,000 decrease for fiscal 2005 was primarily attributable to a \$233,000 reduction in depreciation and amortization expense due to the end of life of certain assets, a \$119,000 reduction in semiconductor tooling expenses, and a \$130,000 reduction in expenditures attributable to our research and development operation in France. We sold Centile Europe SA at the beginning of the second quarter of fiscal 2004, and formed a new French subsidiary, 8x8 Europe SARL, in the third quarter of fiscal 2004. We expect research and development expenditures related to our Packet8 service to continue to increase.

### ***Selling, General and Administrative Expenses***

Selling, general and administrative expenses consist primarily of personnel and related overhead costs for sales, marketing, customer support, finance, human resources and general management. Such costs also include sales commissions, trade show, advertising and other marketing and promotional expenses. Selling, general and administrative expenses were \$3.6 million and \$1.2 million for the quarters ended September 30, 2004 and 2003, respectively. The \$2.4 million increase in selling, general and administrative expenses for the three month period ended September 30, 2004, as compared to the comparable period in the prior year was primarily attributable to a \$286,000 increase in compensation expense for personnel due to headcount additions, a \$1 million increase in advertising, public relations and other marketing and promotional expenses, a \$730,000 increase in contractor expenses related to the increase in staffing of our customer service organization and a \$130,000 increase in sales representative commissions.

Selling, general and administrative expenses were \$6.1 million and \$2.5 million for the six months ended September 30, 2004 and 2003, respectively. The \$3.6 million increase in selling, general and administrative expenses for the six months ended September 30, 2004, as compared to the comparable period in the prior year was primarily attributable to a \$546,000 increase in compensation expense for personnel due to headcount additions, a \$1.4 million increase in advertising, public relations and other marketing and promotional expenses, a \$1.1 million increase in contractor expenses related to the increase in staffing of our customer support organization and a \$293,000 increase in legal and accounting fees. We expect sales and marketing expenditures related to our Packet8 service to continue to increase.

### ***Other Income, Net***

Other income, net was \$71,000 and \$858,000 for the three month periods ended September 30, 2004 and 2003, respectively. The decrease of \$787,000 in other income for the second quarter of fiscal 2005 as compared to the prior year was primarily attributable to a gain of \$790,000 recognized in the second quarter of fiscal 2004 for the sale of our subsidiary, Centile Europe SA, in July 2003.

For the six months ended September 30, 2004 and 2003, other income (expense) net was \$295,000 and \$799,000, respectively. The decrease of \$504,000 in other income for the six months ended September 30, 2004 as compared to the comparable period in the prior year was primarily attributable to the \$790,000 gain on the sale of Centile Europe SA recorded in the second quarter of fiscal 2004. The decrease was partially offset by the fiscal 2005 receipt of escrow funds related to a cost-basis common stock investment in an entity that was acquired in 1999 by a third party and an increase in interest income due to higher average cash balances in fiscal 2005.

### ***Provision for Income Taxes***

There were no tax provisions recorded during the three and six month periods ended September 30, 2004 and 2003, due to year to date net losses incurred. In the quarter ended June 30, 2004, we recorded approximately \$20,000 of income tax benefit attributable to an income tax refund received by one of our foreign subsidiaries. No additional tax benefits

have been recorded for any period presented, as we believe that, based on the history of our operating losses and other factors, the weight of available evidence indicates that it is more likely than not that we will not be able to realize the benefit of our net operating losses. Accordingly, a full valuation reserve has been recorded against our deferred tax assets.

### ***Liquidity and Capital Resources***

As of September 30, 2004, we had cash and cash equivalents approximating \$28 million, representing an increase of approximately \$15 million from March 31, 2004, the end of our last fiscal year. We currently have no bank borrowing arrangements.

Cash used in operations of approximately \$7.9 million for the first six months of fiscal 2005 was primarily attributable to the net loss of \$6.3 million and net cash used in changes in operating assets and liabilities of \$1.6 million primarily attributable to inventory purchases, adjusted for \$58,000 of depreciation and amortization expense. Cash used in operations of approximately \$1.2 million for the first six months of fiscal 2004 was primarily attributable to the net loss of \$753,000, adjusted for the \$790,000 gain on the sale of Centile Europe and \$469,000 of depreciation and amortization, and net cash used in changes in operating assets and liabilities of \$55,000. Our negative operating cash flows primarily reflect our net losses resulting from the same factors affecting our revenues and expenses as described above.

Cash used in investing activities of \$421,000 for the six months ended September 30, 2004 was primarily attributable to \$511,000 of purchases of fixed assets and purchases of investments of \$160,000, partially offset by a \$250,000 decrease in cash classified as restricted cash due to the termination of a letter of credit. Cash used in investing activities for the six months ended September 30, 2003 was primarily attributable to net purchases of marketable equity securities and mutual funds of \$802,000 and purchases of fixed assets of \$13,000, offset by \$20,000 of proceeds from the sale of fixed assets.

Cash provided by financing activities during the first six months of fiscal 2005 consisted primarily of \$11.1 million of net proceeds received from a common stock offering completed in June 2004, and approximately \$12 million of proceeds received on September 30, 2004, from an offering that subsequently closed on October 1, 2004. Cash provided by financing activities during the first six months of fiscal 2004 consisted primarily of \$978,000 of proceeds resulting from the sale of common stock in a private placement transaction and to employees through our employee stock plans.

At September 30, 2004, we had open purchase orders related to our contract manufacturers and other contractual obligations of approximately \$1.1 million primarily related to inventory purchases. These purchase commitments are reflected in our consolidated financial statements once goods or services have been received or at such time when we are obligated to make payments related to these goods or services. At September 30, 2004, future minimum annual lease payments under noncancelable operating leases, net of estimated sublease income, were as follows (in thousands):

Year ending March 31:

Remaining 2005.....	\$	54
2006.....		403
2007.....		482
2008.....		490
2009.....		493
2010.....		206
Total minimum payments.....	\$	<u>2,128</u>

Based upon our current expectations, we believe that our current cash and cash equivalents and short-term investments, together with cash generated from operations, are sufficient to satisfy our expected working capital and capital expenditure requirements for the next twelve months.

Although we believe that our current cash and cash equivalents will satisfy our expected working capital and capital expenditure requirements through at least the next twelve months, our business may change in ways we do not currently anticipate, which could require us to raise additional funds to support our operations earlier than otherwise expected. Unless we achieve and maintain profitability, we will need to raise additional capital to support our business. 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 by making reductions in 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. 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.

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

Our financial market risk consists primarily of risks associated with international operations and related foreign currencies. Historically, we have derived 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, substantially all of our arrangements with our 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.

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

This report contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. Our actual results could differ materially from those anticipated or projected in these forward-looking statements as a result of certain factors, including those set forth in the following cautionary statements and elsewhere in this report. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks were to occur, our business, financial condition or results of operations would likely suffer. In that event, the trading price of our common stock would decline. Any forward-looking statements should be considered in light of the factors discussed below.

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

We recorded an operating loss of approximately \$6.6 million for the six months ended September 30, 2004, and we ended the period with an accumulated deficit of \$158 million. In addition, we recorded operating losses of \$4 million, \$12 million and \$10 million for the fiscal years ended March 31, 2004, 2003 and 2002, 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.

#### **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;
- future legislation or regulation of the Internet and or voice over Internet protocol (VoIP);
- loss of key personnel;
- new products or new contracts by us, our competitors or their customers; and
- 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.

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.

**The growth of our business and our future profitability depends on the growth of the Packet8 revenue.**

We continue to devote substantially all of our resources to the promotion, distribution and development of our Packet8 service rather than to our semiconductor business. As such, our future growth and profitability will be dependent on revenue from our Packet8 service, as opposed to revenue from the semiconductor business, which has historically accounted for a substantial portion of the Company's consolidated revenues.

Semiconductor and related software revenues represented approximately 83% and 88%, respectively, of the Company's consolidated revenues for fiscal 2004 and 2003. However, these revenues have not been sufficient to profitably operate our semiconductor business. Therefore, we have reduced the scope of these operations. During the quarter ended June 30, 2003, we completed the end-of-life of our legacy videoconferencing semiconductor products. In November 2003, we sold the VIP1 video semiconductor development effort to Leadtek Research, Inc. (Leadtek). Under the terms of the transaction, Leadtek acquired the VIP1 development activities, key engineers, software tools and equipment. Revenues attributable to this development effort, prior to the aforementioned transaction, were \$0 and \$1.1 million during the fiscal years ended March 31, 2004 and 2003, respectively, representing approximately 0% and 12% of revenues of our semiconductor business and 0% and 10.5% of 8x8's consolidated revenues for such periods. As a result of the transfer of this development effort to Leadtek, this development revenue ceased. In January 2004, we initiated an end-of-life program for our VoIP telephony semiconductor products, including the Audacity T2 and T2U products. The semiconductor business remains a continuing operation and will continue to generate revenue in the future, although we expect the amounts to decrease, both on an absolute basis and as percentage of our consolidated revenues.

Revenues from the hosted iPBX solutions business represented approximately 3% and 8% of the Company's consolidated revenues for fiscal 2004 and 2003, respectively. In July 2003, we sold our European subsidiary, Centile Europe S.A., and licensed, on a non-exclusive basis, our iPBX technology to the purchaser. In March 2004, we announced the Packet8 Virtual Office service, which includes technologies previously offered as part of the hosted iPBX solutions business.

**We have only been selling our Packet8 service for a limited period and there is no guarantee that Packet8 will gain broad market acceptance.**

We have only been selling our Packet8 service since November 2002. Given our limited history with offering this service, there are many difficulties that we may encounter, including regulatory hurdles, discussed below, and other problems that we may not anticipate. To date, we have not generated significant revenue from the sale of our VoIP telephony products and services, including our Packet8 service, and there is no guarantee that we will be successful in generating significant revenues or achieving profitability. If we are not able to generate significant revenues selling into the VoIP telephony market, our business and operating results would be seriously harmed.

**The success of our Packet8 service is dependent on the growth and public acceptance of VoIP telephony.**

The success of our Packet8 voice and video communications service is dependent upon future demand for VoIP telephony systems and services. In order for the IP telephony market to continue to grow, several things need to occur. Telephone and cable service providers must continue to invest in the deployment of high speed broadband networks to residential and commercial customers. VoIP 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. VoIP telephony equipment and services must achieve a similar level of reliability that users of the public switched telephone network have come to expect from their telephone service. VoIP 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. Furthermore, end users in markets serviced by recently deregulated telecommunications providers are not familiar with obtaining services from competitors of these providers and may be reluctant to use new providers, such as us. We will need to devote substantial resources to educate customers and end users about the benefits of VoIP telephony solutions in general and our services in particular. If any or all of these factors fail to occur, our business may not grow.

**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 royalty 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. 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. 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.

Due to these and other factors, we believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as indicators of our future performance. It is possible that in some future periods our results of operations may be below the expectations of public market analysts and investors. If this were to occur, the price of our common stock would likely decline significantly.

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

VoIP 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 VoIP 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 VoIP 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.

**Decreasing telecommunications rates may diminish or eliminate our competitive pricing advantage.**

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

**We are a small company with limited resources compared to some of our current and potential competitors and we may not be able to compete effectively and increase market share.**

Most of our current and potential competitors have longer operating histories, significantly greater resources and name recognition and a larger base of customers than we have. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can to ours. Our competitors may also offer bundled service arrangements offering a more complete product despite the technical merits or advantages of our products. These competitors include traditional telephone service providers, such as AT&T and Verizon, cable television companies, such as Cablevision, Comcast and Time Warner, and other VoIP service providers such as

Vonage. Competition could decrease our prices, reduce our sales, lower our gross profits or decrease our market share.

**Our success depends on third parties in our distribution channels.**

We currently sell our products direct to consumers and through resellers, and are focusing efforts on increasing our distribution channels. Our future revenue growth will depend in large part on sales of our products through reseller and other distribution relationships. We may not be successful in developing additional distribution relationships. Agreements with distribution partners generally provide for one-time and recurring commissions based on our list prices, and do not require minimum purchases or restrict development or distribution of competitive products. Therefore, entities that distribute our products may compete with us. In addition, distributors and resellers may not dedicate sufficient resources or give sufficient priority to selling our products. Our failure to develop new distribution channels, the loss of a distribution relationship or a decline in the efforts of a material reseller or distributor could have a material adverse effect on our business, financial condition or results of operations.

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

The development and marketing of our VoIP products will continue to place a significant strain on our limited personnel, management, and other resources. 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 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 videophones and VoIP terminal adaptors that are used with our Packet8 service, we rely on the availability of certain semiconductor products. These devices are also sourced solely from certain overseas contract manufacturers and partners, and are currently not available from any other manufacturer. Any of these factors could have a material adverse effect on our business, financial condition or results of operations.

**We rely on third party network service providers to originate and terminate substantially all of our public switched telephone network calls.**

Our Packet8 service depends on the availability of third party network service providers that provide telephone numbers and public switched telephone network (PSTN) call termination and origination services for our customers. Many of these network service providers have been 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 or financial condition.

While we believe that relations with our current service provider are good and we have a contract in place, there can be no assurance that this service provider will be able or willing to supply services to us in the future or that we will be successful in signing up alternative or additional providers. While we believe that we could replace our current provider, if necessary, our ability to provide service to our subscribers would be impacted during this timeframe, and this could have an adverse effect on our business, financial condition or results of operations.

**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 or 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 Packet8 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 or results of operations.

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

Our Packet8 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 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 or 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. For instance, our competitors, such as local exchange carriers and cable television providers, may be able to bundle services and products that we do not offer together with long distance or VoIP telephony services. These services could include wireless communications, voice and data services, Internet access and cable television. This form of bundling would put us at a competitive disadvantage if these providers can combine a variety of services offerings at a single attractive price. 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.

Many of our current and potential competitors have longer operating histories, are substantially larger, and have greater financial, manufacturing, marketing, technical, and other resources. Many also have greater name recognition and a larger installed base of customers 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 or financial condition.

**If we do not develop and maintain successful partnerships for VoIP 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. VoIP 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 communications, 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 us.

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 VoIP 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 VoIP telephony products, which would have a material adverse effect on our business, financial condition or operating results.

**Our ability to offer services outside the U.S. is subject to the local regulatory environment, which may be complicated and often uncertain.**

Regulatory treatment of VoIP telephony outside the United States varies from country to country. We currently distribute our products and services directly to consumers and through resellers that may be subject to telecommunications regulations in their home countries. The failure of these resellers to comply with these laws and regulations could reduce our revenue and profitability. Because of our relationship with the resellers, some countries may assert that we are required to register as a telecommunications carrier in that country. In such case, our failure to do so could subject us to fines or penalties. In addition, some countries are considering subjecting VoIP services to the regulations applied to traditional telephone companies. Regulatory developments such as these could have a material adverse effect on our international operation.

In many countries in which we operate or our services are sold, the status of the laws that may relate to our services is unclear. We cannot be certain that our customers, resellers, or other affiliates are currently in compliance with regulatory or other legal requirements in their respective countries, that they or we will be able to comply with existing or future requirements, and/or that they or we will continue to be in compliance with any requirements. Our failure or the failure of those with whom we transact business to comply with these requirements could have a material adverse effect on our business, operating results or financial condition.

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

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.

Many regulatory actions are underway or are being contemplated by federal and state authorities, including the FCC and other state regulatory agencies. On February 12, 2004, the FCC initiated a notice of public rule-making to update FCC policy and consider the appropriate regulatory classification for VoIP and other IP enabled services. On November 9, 2004, the FCC ruled that Vonage DigitalVoice and similar services are jurisdictionally interstate and not subject to state certification, tariffing and other common carrier regulations, including 911. On February 11, 2004, the California Public Utilities Commission (CPUC) initiated an investigation into voice over IP providers. As a tentative conclusion of law, the CPUC stated that they believe that VoIP providers are telecommunications providers and should be treated as such from a regulatory standpoint. There is risk that a regulatory agency requires us to conform to rules that are unsuitable for IP communications technologies or rules that cannot be complied with due to the nature and efficiencies of IP routing, or are unnecessary or unreasonable in light of the manner in which Packet8 offers service to its customers. It is not possible to separate the Internet, or any service offered over it, into intrastate and interstate components. While suitable alternatives may be developed in the future, the current IP network does not enable us to identify the geographic nature of the traffic traversing the Internet. There is also risk that specific E911 requirements imposed by a regulatory agency may impede our ability to offer service in a manner that conforms to these requirements. While we are developing technologies that seek to provide access to emergency services in conjunction with our IP communications offerings, the existing requirements, which are tethered to and dependent upon the legacy PSTN



network, neither work in an IP environment nor take advantage of the significantly enhanced capabilities of the IP network.

**The effects of federal or state regulatory actions could have a material adverse effect on our business, financial condition and operating results.**

Increasing interest by U.S. states in the regulation of voice over IP services could result in laws or regulatory actions that harm our business.

Several states have recently shown an interest in regulating voice over IP, or VoIP, services, as they do for providers of traditional telephone service. If this trend continues, and if state regulation is not preempted by action by the U.S. federal government, we may become subject to a "patchwork quilt" of state regulations and taxes, which would increase our costs of doing business, and adversely affect our operating results and future prospects.

We have already been contacted by several state regulatory authorities regarding our Packet8 service. On September 11, 2003, we received a letter from the Public Service Commission of Wisconsin (the WPSC) notifying us that the WPSC believes that we, via our Packet8 voice and video communications service, are offering intrastate telecommunications services in the state of Wisconsin without certification of the WPSC. According to the WPSC's letter, it believes that we cannot legally provide Packet8-based resold intrastate services in Wisconsin without certification of the WPSC. In addition, the Commission believes that Packet8 bills for intrastate services to Wisconsin customers are void and not collectible. The letter also states that if we do not obtain certification to offer intrastate telecommunications services, the matter will be referred to the State of Wisconsin Attorney General for enforcement action. The letter also states that even if the Company were certified by the WPSC, the previous operation without certification may still subject the Company to referral to the State of Wisconsin Attorney General for enforcement action and possible forfeitures. We consulted with counsel and have responded to the WPSC and disputed their assertions. While we do not believe that the potential amounts of any forfeitures would be material to us, if we are subject to an enforcement action, we may become subject to liabilities and may incur expenses that adversely affect our results of operations.

On September 17, 2003, we were contacted by the Ohio Public Utilities Commission (OPUC) and asked to respond to a questionnaire on Voice over IP technologies that the OPUC is conducting. The OPUC inquired as to the nature of our service, how it is provided, and to what Ohio residents the service is made available. The questionnaire did not contain any assertions regarding the legality of the Packet8 service under Ohio law or any statements as to whether the OPUC believes we are subject to regulation by the state of Ohio. We responded to this questionnaire on October 20, 2003.

On September 22, 2003, the California Public Utilities Commission (CPUC) sent us a letter that alleged that we are offering intrastate telecommunications services for profit in California without having received formal certification from the CPUC to provide such service. The CPUC also requested that we file an application with the CPUC for authority to conduct business as a telecommunications utility no later than October 22, 2003. After consultation with regulatory counsel, we responded to the CPUC, disputed its assertions and did not file the requested application. In our October 22, 2003 response to the CPUC, we disagreed with the CPUC's classification of us as a telephone corporation under the California Public Utilities Code. We asserted that we are an information services provider and not a telecommunications provider. The letter from the CPUC did not indicate, and we cannot predict, what any potential penalties or consequences in failing to obtain certification might be. If we are subjected to penalties, or if we are required to comply with CPUC regulations affecting telecommunications service providers, our business may be adversely affected. On November 13, 2003, the CPUC held a hearing in San Francisco to hear testimony from CPUC staff and industry representatives regarding what course of action the CPUC should take with respect to Internet telephony. A representative from 8x8 testified at the hearing. On February 11, 2004, the CPUC stated that, as a tentative conclusion of law, they believe that VoIP providers are telecommunications providers and should be treated as such from a regulatory standpoint. The CPUC initiated an investigation into appropriate regulation of VoIP providers under state law, and acknowledged that it has not enforced the same regulatory regime over VoIP as applies to telecommunications services. The CPUC is considering a number of potential regulatory requirements, including contribution to state universal service programs, provision of 911 services, payment of access charges to interconnect with the PSTN and compliance with NANP protocols and basic consumer protection laws. The CPUC is also considering whether exempting VoIP providers from requirements applicable to traditional providers of voice telephony creates unfair competitive advantages, if the regulatory framework governing the provision of VoIP should vary based on the market served and whether VoIP providers should be subject to the current system of intercompany compensation arrangements. The CPUC has indicated that this process could last up to 18 months, but there is no way for us to predict the timetable or outcome of this process.

On May 19, 2004, in response to a 2003 complaint case brought by Frontier Telephone of Rochester against Vonage, the New York State Public Service Commission, or NYPSC concluded that Vonage is a telephone corporation as defined by New York law and must obtain a Certificate of Public Convenience and Necessity, which represents the authorization of the NYPSC to provide telephone service in New York. The NYPSC will allow a forty-five day period in which Vonage can identify and seek waivers of any rules that it believes should not apply. Vonage will be required to provide 911 service in some form, and will be required to file a schedule of its rates. Currently, this decision applies only to Vonage. On June 30, 2004, a federal judge issued a preliminary injunction until January 2005 enjoining the NYPSC from regulating Vonage as a telecommunications carrier. The federal judge will consider the merits of a permanent injunction in January 2005. While this ruling applies only to Vonage and not to us, if we are subject to regulation by the NYPSC, we may become subject to liabilities and may incur expenses that adversely affect our results of operations.

On July 27, 2004, we received a letter from the Arizona Corporation Commission (ACC) stating that it was conducting a competitive analysis of the various telecommunications markets in Arizona. The letter requested that we provide answers to a listing of questions as well as certain data. On August 26, 2004, after executing the ACC's standard protective agreement governing the submission of commercially sensitive information, we sent to the ACC answers to some of the questions posed in the initial letter, together with information responsive to certain of the data requests. Inasmuch as the ACC proceeding is a generic docket opened for the purpose of gathering information regarding VoIP, additional information requests are possible, but none has been received to date.

In November 2004, we received notices from multiple municipalities in California that the Packet8 service is subject to utility user taxes, as defined in the respective municipal codes. The notices require that we begin collecting and remitting utility user taxes no later than January 1, 2005.

**We may be subject to liabilities for past sales and our future sales may decrease.**

In accordance with current industry practice, we do not collect state and federal telecommunications taxes, other than federal excise tax, or other telecommunications surcharges with respect to our Packet8 service. We do not collect Value Added Tax, or VAT, for services that we provide to customers in European Union, or EU, member countries. Future expansion of our Packet8 service, along with other aspects of our evolving business, may result in additional sales and other tax obligations. One or more states or foreign countries may seek to impose sales or other tax collection obligations on out- of-jurisdiction companies that provide telephone service. A successful assertion by one or more states or foreign countries that we should collect sales or other taxes on the sale of merchandise or services could result in substantial tax liabilities for past sales, decrease our ability to compete with traditional telephone companies, and could have a material adverse effect on our business, financial condition or operating results.

**Potential regulation of Internet service providers could adversely affect our operations.**

To date, the FCC has treated Internet service providers as information service providers. Information 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.

**There may be risks associated with the lack of 911 emergency dialing or the limitations associated E911 emergency dialing with the Packet8 service.**

We offer E911 service as an option to Packet8 customers who choose phone numbers in markets where E911 service is available (our E911 service is only available in a subset of the markets where we provide telephone numbers). We primarily market the Packet8 service to our residential customers as a secondary line service, not a primary line service. We do not encourage our residential customers to use Packet8 as their only telephone service, unless they provision Packet8 E911 service on the telephone line. Even with E911 provisioned, the IP dialtone service provided by Packet8 is only as reliable as a customer's underlying broadband data service (which is not provided by us), and may not be suitable for use in all emergency situations. For customers who choose not to or are unable to subscribe to our E911 service, we play a recorded message in response to customers who dial 911 from these lines instructing them to hang up and either dial their local police/fire department directly from the phone on the Packet8 service, or to dial 911 from a phone connected to the traditional telephone network. However, there may be a risk of liability or future regulatory

action with respect to us offering E911 service as an optional service, or the inability of customers to access local 911 emergency services from a telephone connected to Packet8 service.

To date, the FCC has not classified any interstate VoIP telephony service provider as a "telecommunications carrier," preferring instead to permit the nascent industry to grow. Under current federal law, providers of "information services" do not incur obligations to participate in 911 and E911 emergency calling systems. However, there is no guarantee that the FCC's interpretations and the relevant federal law will not change in a manner that may increase our cost of doing business or otherwise adversely affect our ability to deliver the Packet8 service to consumers in all geographic regions.

We cannot guarantee that 911 service will be available to all of our subscribers, or to subscribers outside of the United States. We are also developing ways to directly connect IP calls to emergency services, but there is no guarantee that these new technologies will work or that regulatory authorities will find these new methods acceptable for emergency service provisioning or the handling of emergency call traffic.

**We may lose customers if we experience system failures that significantly disrupt the availability and quality of the services that we provide.**

The operation of our Packet8 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.

Consumer access to our websites directly affects our ability to sign new subscribers and the account management services we offer and thus affects our service revenues. We experience occasional system interruptions that make our websites unavailable or prevent us from efficiently fulfilling orders or providing services to consumers, which may reduce our service revenues and the attractiveness of our products and services. If we are unable to continually add additional software and hardware and upgrade our systems and network infrastructure in an effective manner, it could cause service interruption and adversely affect our ability to deliver the Packet8 service.

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.

**Our success depends on our ability to handle a large number of simultaneous calls, which our network may not be able to accommodate.**

We expect the volume of simultaneous calls to increase significantly as the Packet8 subscriber base grows. Our network hardware and software may not be able to accommodate this additional volume. If we fail to maintain an appropriate level of operating performance, or if our service is disrupted, our reputation could be hurt, we could lose customers and this could have a material adverse effect on our business, financial condition and results of operations.

**We could be liable for breaches of security on our web site, fraudulent activities of our users, or the failure of third-party vendors to deliver credit card transaction processing services.**

A fundamental requirement for operating an internet-based, worldwide voice and video communications service and electronically billing our Packet8 customers is the secure transmission of confidential information over public networks. Although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches may adversely affect our operating results. The law relating to the liability of providers of online payment services is currently unsettled. We rely on third party providers to process and guarantee payments made by Packet8 subscribers up to certain limits, and we may be unable to prevent our users from fraudulently receiving goods and services. Our liability

risk will increase if a larger fraction of our Packet8 transactions involve fraudulent or disputed credit card transactions. Any costs we incur as a result of fraudulent transactions could harm our business. In addition, the functionality of our current billing system relies on certain third-party vendors delivering services. If these vendors are unable or unwilling to provide services, we will not be able to charge for our Packet8 services in a timely or scalable fashion.

**We have experienced losses due to subscriber fraud and theft of service.**

Subscribers have obtained access to the Packet8 service without paying for monthly service and international toll calls by unlawfully using our authorization codes and submitting fraudulent credit card information. To date, such losses from unauthorized credit card transactions and theft of service have not been significant. We have implemented anti-fraud procedures in order to control losses relating to these practices, but these procedures may not be adequate to effectively limit all of our exposure in the future from fraud. If our procedures are not effective, consumer fraud and theft of service could significantly decrease our revenue and 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, certain necessary technology may in fact be patented by other parties either now or in the future. If such technology were held under patent by another person, we would have to negotiate a license for the use of that certain technology. We may not be able to negotiate such a license at a price that is acceptable. The existence of such a patent, or our inability to negotiate a license for any such technology on acceptable terms, could force us to cease using such technology and offering products and services incorporating such technology.

**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 that subject us to risks that could cause our operating results to decline.**

For the six months ended September 30, 2004, sales to customers outside of the United States represented approximately 14% of our total sales. Sales to customers outside of the United States during the years ended March 31, 2004, 2003 and 2002 were 71%, 62%, and 61%, respectively, of total revenues. Substantially all of our 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, potentially weaker protection of intellectual property rights, 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. In addition, language and cultural differences may result in uncertain market acceptance and difficulties in marketing efforts. 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 or financial condition.

**We may need to raise additional capital to support our operations.**

As of September 30, 2004, we had cash and cash equivalents, restricted cash and investments of approximately \$28.7 million. Unless we achieve and maintain profitability, we will need to raise additional capital. We may not be able to obtain such 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 and capital expenditures. 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 may not be able to maintain our listing on the Nasdaq SmallCap Market.**

Our common stock trades on the Nasdaq SmallCap Market, which has certain compliance requirements for continued listing of common stock.

If our minimum closing bid price per share falls below \$1.00 for a period of 30 consecutive business days in the future, we may again be subject to delisting procedures. As of the close of business on October 15, 2004, our common stock had a closing bid price of \$3.21 per share. We must also meet additional continued listing requirements contained in Nasdaq Marketplace Rule 4310(c)(2)(b), which requires that we have a minimum of \$2,500,000 in stockholders' equity or \$50,000,000 market value of listed securities or \$500,000 of net income from continuing operations for the most recently completed fiscal year (or two of the three most recently completed fiscal years). As of October 15, 2004, based on our closing price as of that day, the market value of our securities approximated \$148 million and we were in compliance with Nasdaq Marketplace Rule 4310(c)(2)(b). There can be no assurance that we will continue to meet the continued listing requirements.

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

**While we believe that we currently have adequate internal control procedures in place, we are still exposed to potential risks from recent legislation requiring companies to evaluate internal controls under Section 404 of the Sarbanes Oxley Act of 2002.**

We are evaluating our internal controls systems in order to allow management to report on, and our independent auditors to attest to, our internal controls, as required by this legislation. We will be performing the system and process evaluation and testing (and any necessary remediation) required in an effort to comply with the management certification and auditor attestation requirements of Section 404 of the Sarbanes Oxley Act. As a result, we expect to incur additional expenses and diversion of management's time. While we anticipate being able to fully implement the requirements relating to internal controls and all other aspects of Section 404 in a timely fashion, we cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations since there is no precedent available by which to measure compliance adequacy. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, we might be subject to sanctions or investigation by regulatory authorities, such as the Securities Exchange Commission or the Nasdaq SmallCap Market. Any such action could adversely affect our financial results and could cause our stock price to decline.

## **ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of our Chief Executive Officer (“CEO”) and our Chief Financial Officer (“CFO”), the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **CEO and CFO Certifications**

Attached, as Exhibits 31 and 32, are two separate forms of certifications of the CEO and the CFO. The certifications attached as Exhibits 31.1 and 31.2 are required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 (the “Section 302 Certifications”). The information contained in this Item 4 relates to the Controls Evaluation referred to in the Section 302 Certifications, and should be read with the Section 302 Certifications for a more complete understanding of the topics presented.

### **Disclosure Controls and Internal Controls**

Our management, including the CEO and CFO, has a responsibility for establishing and maintaining adequate disclosure and internal controls over our financial reporting. Disclosure Controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Internal controls are procedures that are designed with the objective of providing reasonable assurance that our transactions are properly authorized, our assets are safeguarded against unauthorized or improper use, and our transactions are properly recorded and reported, all to permit the preparation of our financial statements in conformity with generally accepted accounting principles.

### **Limitations on the Effectiveness of Controls**

Our management, including the CEO and CFO, does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. In addition, over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## **PART II – OTHER INFORMATION**

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

The Company’s 2004 Annual Meeting of Stockholders was held on August 10, 2004, at the Company’s principal executive offices in Santa Clara, California. At the meeting, shares of the Company’s common stock were present in person and by proxy. The number of votes present in person or by proxy represented approximately 92% of eligible votes associated with outstanding votable securities.

The voting results by proposal were:

PROPOSAL 1. Each person elected as a director will serve until the next annual meeting of stockholders or until such person's successor is elected and qualified. The following nominees for director were elected:

<u>Name of Nominee</u>	<u>Votes Cast For</u>	<u>Votes Withheld</u>
Barry Andrews	37,647,112	2,052,592
Guy L. Hecker, Jr.	39,265,169	434,535
Bryan R. Martin	37,654,112	2,045,592
Christopher McNiffe	37,588,548	2,111,156
Donn Wilson	39,260,538	439,166

PROPOSAL 2. The ratification and appointment of PricewaterhouseCoopers LLP as independent auditors of the Company for the fiscal year ending March 31, 2005, was approved by the stockholders with 39,439,592 voting in favor, 108,805 voting against and 151,307 abstaining.

#### **ITEM 6. EXHIBITS**

31.1 Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

#### **SIGNATURE**

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

Date: November 12, 2004

8X8, INC.

*(Registrant)*

By: /s/ James Sullivan /

James Sullivan

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