

8X8 INC /DE/  
Form 10-Q  
October 26, 2012

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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, 2012

OR

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

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

Commission file number 000-21783

[8X8, INC.](#)

(Exact name of Registrant as Specified in its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**77-0142404**

(I.R.S. Employer Identification Number)

2125 O'Nel Drive  
San Jose, CA 95131

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

☒ NO    ☐

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

|                         |                          |                   |                                     |                                               |                          |                           |                          |
|-------------------------|--------------------------|-------------------|-------------------------------------|-----------------------------------------------|--------------------------|---------------------------|--------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer | <input checked="" type="checkbox"/> | Non-accelerated filer                         | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/> |
|                         |                          |                   |                                     | (Do not check if a smaller reporting company) |                          |                           |                          |

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

The number of shares of the Registrant's Common Stock outstanding as of October 22, 2012 was 71,470,617.

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FORM 10-Q PDF as a courtesy  
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## Part I -- FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

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

|                                               | September 30,<br>2012 | March 31,<br>2012 |
|-----------------------------------------------|-----------------------|-------------------|
| <b>ASSETS</b>                                 |                       |                   |
| Current assets:                               |                       |                   |
| Cash and cash equivalents                     | \$ 38,108             | \$ 22,426         |
| Short-term investments                        | 2,009                 | 1,942             |
| Accounts receivable, net                      | 4,153                 | 2,279             |
| Inventory                                     | 571                   | 581               |
| Deferred cost of goods sold                   | 125                   | 122               |
| Deferred tax asset                            | 1,151                 | 7,730             |
| Other current assets                          | 933                   | 806               |
| Total current assets                          | 47,050                | 35,886            |
| Property and equipment, net                   | 7,225                 | 3,820             |
| Intangible assets, net                        | 10,908                | 11,622            |
| Goodwill                                      | 25,150                | 25,150            |
| Non-current deferred tax asset                | 53,977                | 53,977            |
| Other assets                                  | 409                   | 278               |
| Total assets                                  | \$ 144,719            | \$ 130,733        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                   |
| Current liabilities:                          |                       |                   |
| Accounts payable                              | \$ 5,065              | \$ 5,476          |
| Accrued compensation                          | 3,047                 | 3,105             |
| Accrued warranty                              | 376                   | 387               |
| Accrued taxes                                 | 1,677                 | 1,472             |
| Deferred revenue                              | 985                   | 891               |
| Other accrued liabilities                     | 761                   | 884               |
| Total current liabilities                     | 11,911                | 12,215            |
| Non-current liabilities                       | 1,820                 | 68                |
| Total liabilities                             | 13,731                | 12,283            |
| Commitments and contingencies (Note 7)        |                       |                   |
| Stockholders' equity:                         |                       |                   |
| Common stock                                  | 72                    | 71                |
| Additional paid-in capital                    | 243,667               | 241,555           |
| Accumulated other comprehensive income (loss) | 9                     | (58)              |
| Accumulated deficit                           | (112,760)             | (123,118)         |
| Total stockholders' equity                    | 130,988               | 118,450           |
| Total liabilities and stockholders' equity    | \$ 144,719            | \$ 130,733        |

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

8X8, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts; unaudited)

|                                                    | Three Months Ended<br>September 30, |           | Six Months Ended<br>September 30, |           |
|----------------------------------------------------|-------------------------------------|-----------|-----------------------------------|-----------|
|                                                    | 2012                                | 2011      | 2012                              | 2011      |
| Service revenue                                    | \$ 24,177                           | \$ 18,013 | \$ 47,349                         | \$ 35,034 |
| Product revenue                                    | 2,194                               | 1,806     | 4,274                             | 3,292     |
| Total revenue                                      | 26,371                              | 19,819    | 51,623                            | 38,326    |
| Operating expenses:                                |                                     |           |                                   |           |
| Cost of service revenue                            | 5,825                               | 4,059     | 11,511                            | 7,874     |
| Cost of product revenue                            | 2,672                               | 2,613     | 5,382                             | 4,883     |
| Research and development                           | 2,030                               | 1,540     | 3,856                             | 2,947     |
| Sales and marketing                                | 11,010                              | 9,076     | 21,551                            | 17,260    |
| General and administrative                         | 2,070                               | 1,666     | 4,134                             | 2,891     |
| Gain on patent sale                                | -                                   | -         | (11,965)                          | -         |
| Total operating expenses                           | 23,607                              | 18,954    | 34,469                            | 35,855    |
| Income from operations                             | 2,764                               | 865       | 17,154                            | 2,471     |
| Other income (expense), net                        | 9                                   | (11)      | 17                                | 9         |
| Income before provision (benefit) for income taxes | 2,773                               | 854       | 17,171                            | 2,480     |
| Provision (benefit) for income taxes               | 1,032                               | 22        | 6,813                             | (299)     |
| Net income                                         | \$ 1,741                            | \$ 832    | \$ 10,358                         | \$ 2,779  |
| Net income per share:                              |                                     |           |                                   |           |
| Basic                                              | \$ 0.02                             | \$ 0.01   | \$ 0.15                           | \$ 0.04   |
| Diluted                                            | \$ 0.02                             | \$ 0.01   | \$ 0.14                           | \$ 0.04   |
| Weighted average number of shares:                 |                                     |           |                                   |           |
| Basic                                              | 71,261                              | 63,710    | 70,989                            | 62,989    |
| Diluted                                            | 74,558                              | 67,759    | 74,210                            | 66,833    |

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

8X8, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands, unaudited)

|                                                     | Three Months Ended<br>September 30, |        | Six Months Ended<br>September 30, |          |
|-----------------------------------------------------|-------------------------------------|--------|-----------------------------------|----------|
|                                                     | 2012                                | 2011   | 2012                              | 2011     |
| Net income                                          | \$ 1,741                            | \$ 832 | \$ 10,358                         | \$ 2,779 |
| Other comprehensive income (loss), net of tax       |                                     |        |                                   |          |
| Unrealized gain (loss) on investments in securities | 41                                  | (38)   | 67                                | (23)     |
| Comprehensive income                                | \$ 1,782                            | \$ 794 | \$ 10,425                         | \$ 2,756 |

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<br>September 30, |           |
|-----------------------------------------------------------------------------------|-----------------------------------|-----------|
|                                                                                   | 2012                              | 2011      |
| <b>Cash flows from operating activities:</b>                                      |                                   |           |
| Net income                                                                        | \$ 10,358                         | \$ 2,779  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |           |
| Depreciation                                                                      | 1,132                             | 716       |
| Amortization                                                                      | 714                               | 74        |
| Stock-based compensation                                                          | 1,062                             | 595       |
| Deferred income tax provision (benefit)                                           | 6,579                             | (336)     |
| Other                                                                             | 207                               | 37        |
| Changes in assets and liabilities                                                 |                                   |           |
| Accounts receivable, net                                                          | (2,050)                           | (438)     |
| Inventory                                                                         | (19)                              | 1,491     |
| Other current and noncurrent assets                                               | (258)                             | 153       |
| Deferred cost of goods sold                                                       | (3)                               | (14)      |
| Accounts payable                                                                  | (277)                             | (1,737)   |
| Accrued compensation                                                              | (58)                              | (366)     |
| Accrued warranty                                                                  | (11)                              | 29        |
| Accrued taxes and fees                                                            | 205                               | (127)     |
| Deferred revenue                                                                  | 94                                | 235       |
| Other current and noncurrent liabilities                                          | 1,688                             | 151       |
| Net cash provided by operating activities                                         | 19,363                            | 3,242     |
| <b>Cash flows from investing activities:</b>                                      |                                   |           |
| Purchases of property and equipment                                               | (4,730)                           | (1,211)   |
| Acquisition of businesses, net of cash acquired                                   | -                                 | (713)     |
| Net cash used in investing activities                                             | (4,730)                           | (1,924)   |
| <b>Cash flows from financing activities:</b>                                      |                                   |           |
| Capital lease payments                                                            | (59)                              | (247)     |
| Repurchase of common stock                                                        | (147)                             | (1,038)   |
| Proceeds from issuance of common stock under employee stock plans                 | 1,255                             | 693       |
| Net cash provided by (used in) financing activities                               | 1,049                             | (592)     |
| Net increase in cash and cash equivalents                                         | 15,682                            | 726       |
| Cash and cash equivalents at the beginning of the period                          | 22,426                            | 16,474    |
| Cash and cash equivalents at the end of the period                                | \$ 38,108                         | \$ 17,200 |
| <b>Supplemental cash flow information</b>                                         |                                   |           |
| Issuance of common stock in connection with acquisitions                          | \$ -                              | \$ 29,125 |
| Acquisition of net assets in connection with acquisitions                         | -                                 | 372       |
| Transfer of net assets in purchase of strategic investment                        | -                                 | 297       |

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

8X8, Inc.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED  
FINANCIAL STATEMENTS

1. DESCRIPTION OF THE BUSINESS

THE COMPANY

8x8, Inc. ("8x8" or the "Company") develops and markets cloud-based business communications services encompassing internally developed Voice over Internet Protocol ("VoIP") technologies. These services enable telephony and video applications as well as web-based conferencing and unified communications capabilities. The Company also provides managed hosting and cloud-based computing services. As of September 30, 2012, the Company had approximately 30,500 business customers.

The Company was incorporated in California in February 1987 and was reincorporated in Delaware in December 1996. 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 2013 refers to the fiscal year ending March 31, 2013).

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, 2012. In the opinion of the Company's management, these financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of our financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from these estimates.

The March 31, 2012 year-end condensed consolidated balance sheet data in this document were derived from audited consolidated financial statements and do not include all of the disclosures required by U.S. generally accepted accounting principles. These financial statements should be read in conjunction with the Company's audited consolidated financial statements as of and for the fiscal year ended March 31, 2012 and notes thereto included in the Company's fiscal 2012 Annual Report on Form 10-K.

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

VoIP Service and Product Revenue

The Company's VoIP service and product revenue is derived from the sale of IP business telephones and VoIP service.

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 605-25 requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if the deliverables in the arrangement meet specific criteria. In addition, arrangement consideration must be allocated among the separate units of accounting based on their relative fair values, with certain limitations. The provisioning of the 8x8 service with the accompanying 8x8 IP telephone constitutes a revenue arrangement with multiple deliverables. In accordance with the guidance of ASC 605-25, the Company allocates 8x8 revenues, including activation fees, among the 8x8 IP telephones and subscriber services. Revenues allocated to these devices are recognized as product revenues during the

period of the sale less the allowance for estimated returns during the 30-day trial period. All other revenues are recognized as license and service revenues when the related services are provided. The Company records revenue net of any sales-related taxes that are billed to its customers. The Company believes this approach results in financial statements that are more easily understood by users.

Under the terms of the Company's typical subscription agreement, new customers can terminate their service within 30 days of order placement and receive a full refund of fees previously paid. The Company has determined that it has sufficient history of subscriber conduct to make a reasonable estimate of cancellations within the 30-day trial period. Therefore, the Company recognizes new subscriber revenue in the month in which the new order was shipped, net of an allowance for expected cancellations.

### Product Revenue

The Company recognizes revenue from product sales for which there are no related services to be rendered upon shipment to partners and end users provided that persuasive evidence of an arrangement exists, the price is fixed, title has transferred, collection of resulting receivables is reasonably assured, there are no customer acceptance requirements, and there are no remaining significant obligations. Gross outbound shipping and handling charges are recorded as revenue, and the related costs are included in cost of goods sold. Reserves for returns and allowances for partner and end user sales are recorded at the time of shipment.

### Deferred Cost of Goods Sold

Deferred cost of goods sold represents the cost of products sold for which the end customer or distributor has a right of return. The cost of the products sold is recognized contemporaneously with the recognition of revenue, when the subscriber has accepted the service.

### Goodwill and Other Intangible Assets

Amortization expense for the customer relationship intangible asset is included in sales and marketing expenses. Amortization expense for technology is included in cost of service revenue. The carrying values of intangible assets were as follows (in thousands):

|                                               | September 30, 2012    |                          |                     | March 31, 2012        |                          |                     |
|-----------------------------------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                                               | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Technology                                    | \$ 8,242              | \$ (844)                 | \$ 7,398            | \$ 8,242              | \$ (432)                 | \$ 7,810            |
| Customer relationships                        | 3,305                 | (752)                    | 2,553               | 3,305                 | (450)                    | 2,855               |
| Trade names/domains                           | 957                   | -                        | 957                 | 957                   | -                        | 957                 |
| Total acquired identifiable intangible assets | \$ 12,504             | \$ (1,596)               | \$ 10,908           | \$ 12,504             | \$ (882)                 | \$ 11,622           |

At September 30, 2012, annual amortization of intangible assets, based upon our existing intangible assets and current useful lives, is estimated to be the following (in thousands):

|                | Amount   |
|----------------|----------|
| Remaining 2013 | \$ 714   |
| 2014           | 1,334    |
| 2015           | 1,325    |
| 2016           | 1,325    |
| 2017           | 1,318    |
| Thereafter     | 3,935    |
| Total          | \$ 9,951 |

## Deferred Rent

In April 2012, the Company entered into an 87-month lease agreement. Under the terms of the lease agreement:

- the Company received a three month rent holiday from rental payments before;
- base rent is \$130,821 for the 15 months after the rent holiday; and
- rent expense increases 3% each year thereafter.

The Company also received a \$1.7 million allowance for tenant improvements. In accordance with the guidance in ASC 840-20, Leases, the Company accounts for its headquarters facility operating lease as follows:

### Rent Holidays.

The Company recognizes the related rent expense on a straight-line basis at the earlier of the first rent payment or the date of possession of the leased property. The difference between the amounts charged to expense and the rent paid is recorded as deferred lease incentives and amortized over the lease term.

### Rent Escalations.

The Company recognizes escalating rent provisions on a straight-line basis over the lease term. The difference between the amounts charged to expense and the rent paid is recorded as deferred lease incentives and amortized over the lease term.

### Tenant Improvement Allowance

. The tenant improvement allowance is deferred and amortized on a straight-line basis over the life of the lease as a reduction to rent expense.

In the second quarter of fiscal 2013, the Company received a \$1.7 million reimbursement for the cost of tenant improvements included within cash flows from operating activities. At September 30, 2012, total deferred rent included in Other accrued liabilities and Non-current liabilities was \$0.1 million and \$1.8 million, respectively.

## Option and Stock Purchase Right/Restricted Stock Unit Activity

Stock purchase right/restricted stock unit activity since March 31, 2012 is summarized as follows:

|                               | Number of<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Market<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in Years) |
|-------------------------------|---------------------|-----------------------------------------------------------|--------------------------------------------------------------------|
| Balance at March 31, 2012     | 966,400             | \$ 2.50                                                   | 2.61                                                               |
| Granted                       | 369,436             | 5.56                                                      |                                                                    |
| Released                      | (182,733)           | 2.07                                                      |                                                                    |
| Forfeited                     | (80,244)            | 2.72                                                      |                                                                    |
| Balance at September 30, 2012 | 1,072,859           | \$ 3.61                                                   | 2.74                                                               |

Option activity since March 31, 2012 is summarized as follows:

|                                              | <b>Shares<br/>Available<br/>for Grant</b> | <b>Shares<br/>Subject to<br/>Options<br/>Outstanding</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>Per Share</b> |
|----------------------------------------------|-------------------------------------------|----------------------------------------------------------|------------------------------------------------------------------|
| Balance at March 31, 2012                    | 375,546                                   | 6,034,335                                                | \$ 1.90                                                          |
| Change in options available for grant        | 4,100,000                                 | -                                                        | -                                                                |
| Granted - options                            | (890,000)                                 | 890,000                                                  | 5.80                                                             |
| Stock purchase rights/restricted stock units | (369,436)                                 | -                                                        | -                                                                |
| Exercised                                    | -                                         | (476,719)                                                | 1.40                                                             |
| Canceled/forfeited                           | 68,511                                    | (68,511)                                                 | 4.42                                                             |
| Termination of plans                         | (41,051)                                  | -                                                        | -                                                                |
| Balance at September 30, 2012                | 3,243,570                                 | 6,379,105                                                | \$ 2.46                                                          |

The following table summarizes the stock options outstanding and exercisable at September 30, 2012:

| <b>Options Outstanding</b> |               |                                                                  |                                                                            | <b>Options Exercisable</b>               |           |                                                                  |                                          |
|----------------------------|---------------|------------------------------------------------------------------|----------------------------------------------------------------------------|------------------------------------------|-----------|------------------------------------------------------------------|------------------------------------------|
|                            | <b>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>Per Share</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life (Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |           | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>Per Share</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
| \$0.55 - \$1.26            | 1,887,000     | \$ 1.04                                                          | 5.2                                                                        | \$ 10,421,645                            | 1,887,000 | \$ 1.04                                                          | \$ 10,421,645                            |
| \$1.27 - \$1.72            | 1,554,919     | \$ 1.53                                                          | 2.8                                                                        | 7,828,087                                | 1,554,919 | \$ 1.53                                                          | 7,828,087                                |
| \$1.73 - \$3.17            | 1,319,894     | \$ 2.41                                                          | 5.9                                                                        | 5,476,782                                | 841,505   | \$ 2.19                                                          | 3,674,501                                |
| \$3.18 - \$4.95            | 765,292       | \$ 4.13                                                          | 6.9                                                                        | 1,859,600                                | 276,581   | \$ 3.93                                                          | 727,527                                  |
| \$4.96 - \$5.87            | 852,000       | \$ 5.87                                                          | 9.9                                                                        | 587,880                                  | 17,743    | \$ 5.87                                                          | 12,242                                   |
|                            | 6,379,105     |                                                                  |                                                                            | \$ 26,173,994                            | 4,577,748 |                                                                  | \$ 22,664,002                            |

## Stock-based Compensation Expense

The following table summarizes the classification of stock-based compensation expense for the three and six months ended September 30, 2012 and 2011 (in thousands):

|                                                                                                                   | Three Months Ended<br>September 30, |        | Six Months Ended<br>September 30, |        |
|-------------------------------------------------------------------------------------------------------------------|-------------------------------------|--------|-----------------------------------|--------|
|                                                                                                                   | 2012                                | 2011   | 2012                              | 2011   |
| Cost of service revenues                                                                                          | \$ 43                               | \$ 26  | \$ 86                             | \$ 46  |
| Cost of product revenues                                                                                          | -                                   | -      | 1                                 | -      |
| Research and development                                                                                          | 75                                  | 56     | 170                               | 104    |
| Sales and marketing                                                                                               | 308                                 | 199    | 624                               | 355    |
| General and administrative                                                                                        | 80                                  | 48     | 181                               | 90     |
| Total stock-based compensation expense related to<br>employee stock options and employee stock purchases, pre-tax | 506                                 | 329    | 1,062                             | 595    |
| Tax benefit                                                                                                       | -                                   | -      | -                                 | -      |
| Stock based compensation expense related to employee<br>stock options and employee stock purchases, net of tax    | \$ 506                              | \$ 329 | \$ 1,062                          | \$ 595 |

As of September 30, 2012, there was \$7.7 million of unamortized stock-based compensation expense related to unvested options and stock awards which is expected to be recognized over a weighted average period of 3.36 years.

To value option grants and stock purchase rights/restricted stock units for stock-based compensation, the Company used the Black-Scholes option valuation model. Fair value determined using the Black-Scholes option valuation model varies based on assumptions used for the expected stock price volatility, expected life, risk-free interest rates and future dividend payments. During the three and six month periods ended September 30, 2012 and 2011, the Company used the historical volatility of the Company's stock over a period equal to the expected life of the options. The expected life assumptions represent the weighted-average period the stock-based awards are expected to remain outstanding. These expected life assumptions are established through the review of historical exercise behavior of stock-based award grants with similar vesting periods. The risk-free interest rate is based on the closing market bid yields on actively traded U.S. treasury securities in the over-the-counter market for the expected term equal to the expected term of the option. The dividend yield assumption is based on the Company's history and expectation of future dividend payouts.

The following table summarizes the assumptions used to estimate the fair value of stock options to employees and directors for the three and six months ended September 30, 2012 and 2011:

|                                                | Three Months Ended<br>September 30, |            | Six Months Ended<br>September 30, |            |
|------------------------------------------------|-------------------------------------|------------|-----------------------------------|------------|
|                                                | 2012                                | 2011       | 2012                              | 2011       |
| Expected volatility                            | 68%                                 | 76%        | 68%                               | 76%        |
| Expected dividend yield                        | -                                   | -          | -                                 | -          |
| Risk-free interest rate                        | 0.71%                               | 0.31%      | 0.71%                             | 0.33%      |
| Weighted average expected option term          | 5.40 years                          | 3.00 years | 5.30 years                        | 3.00 years |
| Weighted average fair value of options granted | \$ 3.38                             | \$ 2.27    | \$ 3.33                           | \$ 2.25    |

## Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan, eligible employees can participate and purchase common stock semi-annually through payroll deductions at a price equal to 85% of the fair market value of the common stock at the beginning of each one year offering period or the end of the applicable six month purchase period within that offering period, whichever is lower. The contribution amount may not exceed 10% of an employee's base compensation, including commissions but not including bonuses and overtime, subject to a calendar year maximum total purchase price per employee of \$25,000. The Company accounts for the Employee Stock Purchase Plan as a compensatory plan and recorded compensation expense of \$68,000 and \$115,000 for the three months ended September 30, 2012 and 2011 and \$242,000 and \$195,000 for the six months ended September 30, 2012 and 2011, respectively, in accordance with ASC 718.

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

|                                                | Three Months Ended<br>September 30, |            | Six Months Ended<br>September 30, |            |
|------------------------------------------------|-------------------------------------|------------|-----------------------------------|------------|
|                                                | 2012                                | 2011       | 2012                              | 2011       |
| Expected volatility                            | 34%                                 | 68%        | 34%                               | 68%        |
| Expected dividend yield                        | -                                   | -          | -                                 | -          |
| Risk-free interest rate                        | 0.16%                               | 0.10%      | 0.16%                             | 0.10%      |
| Weighted average expected option term          | 0.75 years                          | 0.75 years | 0.75 years                        | 0.75 years |
| Weighted average fair value of options granted | \$ 1.45                             | \$ 1.49    | \$ 1.45                           | \$ 1.49    |

As of September 30, 2012, there was \$199,000 of total unrecognized compensation cost related to employee stock purchases. These costs are expected to be recognized over a weighted average period of 0.5 years.

The future realization of tax benefits related to stock-based compensation is dependent upon the timing of employee exercises and future taxable income, among other factors. The Company did not realize any tax benefit from the stock-based compensation charges incurred during the three and six months ended September 30, 2012 and 2011.

## Segment Reporting

No customer represented greater than 10% of the Company's total revenue for the three and six months ended September 30, 2012 or 2011. Revenue from technology licensing and related software and customers outside the United States was not material for the three and six months ended September 30, 2012 or 2011.

## 3. FAIR VALUE MEASUREMENT

The following tables present the Company's fair value hierarchy for assets and liabilities measured at fair value on a recurring basis at September 30, 2012 and March 31, 2012 (in thousands):

|                         | <b>Quoted Prices<br/>in Active<br/>Markets<br/>for Identical<br/>Assets<br/>(Level 1)</b> | <b>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> | <b>Balance at<br/>September 30,<br/>2012</b> |
|-------------------------|-------------------------------------------------------------------------------------------|------------------------------------------------------|--------------------------------------------------------------|----------------------------------------------|
| Cash equivalents:       |                                                                                           |                                                      |                                                              |                                              |
| Money market funds      | \$ 14,370                                                                                 | \$ -                                                 | \$ -                                                         | \$ 14,370                                    |
| Short-term investments: |                                                                                           |                                                      |                                                              |                                              |
| Mutual funds (1)        | -                                                                                         | 2,009                                                | -                                                            | 2,009                                        |
| Total                   | \$ 14,370                                                                                 | \$ 2,009                                             | \$ -                                                         | \$ 16,379                                    |

|                         | <b>Quoted Prices<br/>in Active<br/>Markets<br/>for Identical<br/>Assets<br/>(Level 1)</b> | <b>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs<br/>(Level 3)</b> | <b>Balance at<br/>March 31,<br/>2012</b> |
|-------------------------|-------------------------------------------------------------------------------------------|------------------------------------------------------|--------------------------------------------------------------|------------------------------------------|
| Cash equivalents:       |                                                                                           |                                                      |                                                              |                                          |
| Money market funds      | \$ 14,366                                                                                 | \$ -                                                 | \$ -                                                         | \$ 14,366                                |
| Short-term investments: |                                                                                           |                                                      |                                                              |                                          |
| Mutual funds (1)        | -                                                                                         | 1,942                                                | -                                                            | 1,942                                    |
| Total                   | \$ 14,366                                                                                 | \$ 1,942                                             | \$ -                                                         | \$ 16,308                                |

(1) The fair value of mutual funds is determined based on published net asset values. The Company uses such pricing data as the primary input to make its assessments and determinations as to the ultimate valuation of its investment portfolio.

## 4. BALANCE SHEET DETAIL

|                           | September 30,<br>2012 | March 31,<br>2012 |
|---------------------------|-----------------------|-------------------|
| Inventory (in thousands): |                       |                   |
| Work-in-process           | \$ 26                 | \$ 55             |
| Finished goods            | 545                   | 526               |
|                           | \$ 571                | \$ 581            |

## 5. NET INCOME PER SHARE

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

|                                             | Three Months Ended<br>September 30,      |         | Six Months Ended<br>September 30,        |          |
|---------------------------------------------|------------------------------------------|---------|------------------------------------------|----------|
|                                             | 2012                                     | 2011    | 2012                                     | 2011     |
|                                             | (in thousands, except per share amounts) |         | (in thousands, except per share amounts) |          |
| Numerator:                                  |                                          |         |                                          |          |
| Net income available to common stockholders | \$ 1,741                                 | \$ 832  | \$ 10,358                                | \$ 2,779 |
| Denominator:                                |                                          |         |                                          |          |
| Common shares                               | 71,261                                   | 63,710  | 70,989                                   | 62,989   |
| Denominator for basic calculation           | 71,261                                   | 63,710  | 70,989                                   | 62,989   |
| Employee stock options                      | 2,975                                    | 3,622   | 2,896                                    | 3,443    |
| Stock purchase rights                       | 322                                      | 427     | 325                                      | 401      |
| Denominator for diluted calculation         | 74,558                                   | 67,759  | 74,210                                   | 66,833   |
| Net income per share                        |                                          |         |                                          |          |
| Basic                                       | \$ 0.02                                  | \$ 0.01 | \$ 0.15                                  | \$ 0.04  |
| Diluted                                     | \$ 0.02                                  | \$ 0.01 | \$ 0.14                                  | \$ 0.04  |

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

|                        | Three Months Ended<br>September 30, |      | Six Months Ended<br>September 30, |      |
|------------------------|-------------------------------------|------|-----------------------------------|------|
|                        | 2012                                | 2011 | 2012                              | 2011 |
| Employee stock options | 824                                 | 159  | 732                               | 542  |
| Stock purchase rights  | 127                                 | 15   | 64                                | 7    |
|                        | 951                                 | 174  | 796                               | 549  |

## 6. INCOME TAXES

For the three and six months ended September 30, 2012, the Company recorded a provision for income taxes of \$1.0 million and \$6.8 million, respectively, which was primarily attributable to net income from operations, including the gain on patent sale. For the three and six months ended September 30, 2011, the Company recorded accruals for state gross receipt and franchise taxes and released a portion of its valuation allowance against the deferred tax asset as the Company deemed it was more likely than not it would be used to offset the \$0.3 million deferred tax liability recorded in connection with the acquisition of Zerigo. During the period ended September 30, 2011 the provision for income taxes was not significant due to the valuation allowance.

At March 31, 2012, there was \$2.5 million of unrecognized tax benefits that, if recognized, would have affected the effective tax rate. The Company does not believe that there has been any significant change in the unrecognized tax benefits in the three and six month periods ended September 30, 2012 and does not believe it is reasonably possible that the unrecognized tax benefit will materially change in the next 12 months. To the extent that the unrecognized tax benefits are ultimately recognized they may have an impact on the effective tax rate in future periods.

The Company is subject to taxation in the U.S., California and various other states and foreign jurisdictions in which it has or had a subsidiary or branch operations or it is collecting sales tax. All tax returns from fiscal 1995 to fiscal 2012 may be subject to examination by the Internal Revenue Service, California and various other states. As of October 22, 2012, there were no active federal or state income tax audits. Returns filed in foreign jurisdictions may be subject to examination for the fiscal years 2009 to 2010.

## 7. COMMITMENTS AND CONTINGENCIES

### Guarantees

### Indemnifications

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

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

## Product Warranties

The Company accrues for the estimated costs that may be incurred under its product warranties upon revenue recognition. Changes in the Company's product warranty liability, which is included in cost of product revenue in the condensed consolidated statements of income were as follows (in thousands):

|                                | Three Months Ended<br>September 30, |        | Six Months Ended<br>September 30, |        |
|--------------------------------|-------------------------------------|--------|-----------------------------------|--------|
|                                | 2012                                | 2011   | 2012                              | 2011   |
| Balance at beginning of period | \$ 405                              | \$ 378 | \$ 387                            | \$ 362 |
| Accruals for warranties        | 105                                 | 130    | 276                               | 268    |
| Settlements                    | (134)                               | (117)  | (287)                             | (239)  |
| Balance at end of period       | \$ 376                              | \$ 391 | \$ 376                            | \$ 391 |

## Minimum Third Party Customer Support Commitments

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

## Minimum Third Party Network Service Provider Commitments

The Company entered into contracts with multiple vendors for third party network services that expire on various dates in fiscal 2012 and 2013. At September 30, 2012, future minimum annual payments under these third party network service contracts were as follows (in thousands):

Year ending March 31:

|                        |    |       |
|------------------------|----|-------|
| 2013                   | \$ | 433   |
| 2014                   |    | 382   |
| 2015                   |    | 319   |
| 2016                   |    | 52    |
| Total minimum payments | \$ | 1,186 |

## Legal Proceedings

From time to time, the Company may become involved in various legal claims and litigation that arise in the normal course of its operations. While the results of such claims and litigation cannot be predicted with certainty, the Company is not currently aware of any such matters that it believes would have a material adverse effect on its financial position, results of operations or cash flows.

On March 15, 2011, the Company was named as a defendant in a lawsuit, Bear Creek Technologies, Inc. v. 8x8, Inc. et al., along with more than 20 other defendants. On August 17, 2011, the suit against the Company was dismissed without prejudice under Rule 21 of the Federal Rules of Civil Procedure. On August 17, 2011, the Company was sued again by Bear Creek Technologies, Inc. in the United States District Court for the District of Delaware. The Company filed a motion to dismiss the complaint on October 11, 2011. On May 2, 2012, the Judicial Panel on Multidistrict Litigation ordered the suit against the Company and over a dozen related cases, to be coordinated or consolidated for pretrial proceedings. On August 27, 2012, the Court denied several defendants' motions to dismiss the complaint including the Company's. On October 11, 2012, the Company answered the complaint and alleged three counterclaims as well as affirmative defenses. The Company believes it has factual and legal defenses to these claims and intends to litigate the case vigorously. The Company cannot estimate potential liability or expense in this case at this early stage of litigation.

On October 25, 2011, the Company was named a defendant in a lawsuit, Klausner Technologies, Inc. v. Oracle Corporation et al., along with 30 other defendants. On November 1, 2011, Klausner dismissed the complaint voluntarily and filed new complaints separating the defendants, including a new complaint against the Company. The Company filed a motion to dismiss the complaint on February 23, 2012, which was granted in part by the Court on September 11, 2012. On September 25, 2012 the plaintiff filed an amended complaint to which the Company responded by filing another motion to dismiss on October 11, 2012. That motion as well as another motion for a change in venue filed by the Company on August 23, 2012 are pending. The Company has not answered the complaint and believes it has meritorious defenses to this lawsuit. The Company intends to defend the case vigorously. The Company cannot estimate potential liability or expense in this case at this early stage of litigation.

#### State and Municipal Taxes

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

#### 8. PATENT SALE

On June 22, 2012, the Company entered into a patent purchase agreement and sold a family of patents to a third party for \$12.0 million plus a future payment of up to a maximum of \$3.0 million based on future license agreements entered into by the third party purchaser. Under the terms and conditions of the patent purchase agreement, the Company has retained certain limited rights to continue to use the patents. The patent purchase agreement contains representations and warranties customary for transactions of this type.

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

### FORWARD-LOOKING STATEMENTS

This Management Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends," and similar expressions are intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results and trends may differ materially from historical results or those projected in any such forward-looking statements depending on a variety of factors. These factors include, but are not limited to, customer acceptance and demand for our voice over Internet protocol, or VoIP, telephony products and services, the reliability of our services, the prices for our services, customer renewal rates, customer acquisition costs, actions by our competitors, including price reductions for their telephone services, potential federal and state regulatory actions, compliance costs, potential warranty claims and product defects, our needs for and the availability of adequate working capital, our ability to innovate technologically, the timely supply of products by our contract manufacturers, potential future intellectual property infringement claims that could adversely affect our business and operating results, and our ability to retain our listing on the NASDAQ Capital Market. All forward-looking statements included in this report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In addition to those factors discussed elsewhere in this Form 10-Q, see the Risk Factors discussion in Item 1A of our 2012 Form 10-K. The forward-looking statements included in this Form 10-Q are made only as of the date of this report, and we undertake no obligation to update the forward-looking statements to reflect subsequent events or circumstances.

### BUSINESS OVERVIEW

We develop and markets cloud-based business communications services encompassing internally developed Voice over Internet Protocol ("VoIP") technologies. These services enable telephony and video applications as well as web-based conferencing and unified communications capabilities. We also provide managed hosting and cloud-based computing services. As of September 30, 2012, we had approximately 30,500 business customers. Since fiscal 2004, substantially all of our revenue has been generated from the sale, license and provision of VoIP products, services and technology. Prior to fiscal 2003, our focus was on our VoIP semiconductor business.

Our fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in this report refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2013 refers to the fiscal year ending March 31, 2013).

No customer represented greater than 10% of our total revenue for the three and six months ended September 30, 2012 and 2011. Revenue from customers outside the United States was not material for the three and six months ended September 30, 2012 or 2011.

### CRITICAL ACCOUNTING POLICIES & ESTIMATES

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

which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended March 31, 2012. As of September 30, 2012, there had been no material changes to our critical accounting policies and estimates.

## RECENT ACCOUNTING PRONOUNCEMENTS

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

## SELECTED OPERATING STATISTICS

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

|                                                                                      | Sept. 30,<br>2012 | June 30,<br>2012 | Three Months Ended<br>March 31,<br>2012 | Dec 31,<br>2011 | Sept. 30,<br>2011 |
|--------------------------------------------------------------------------------------|-------------------|------------------|-----------------------------------------|-----------------|-------------------|
| Gross business customer additions (1)                                                | 2,915             | 2,943            | 2,892                                   | 2,836           | 3,176             |
| Gross business customer cancellations (less cancellations within 30 days of sign-up) | 2,149             | 1,458            | 1,697                                   | 1,642           | 1,620             |
| Business customer churn (less cancellations within 30 days of sign-up) (2)           | 2.4%              | 1.7%             | 2.0%                                    | 2.0%            | 2.1%              |
| Business service revenue churn                                                       | 1.0%              | 2.3%             | 1.6%                                    | 1.9%            | 1.9%              |
| Total business customers (3)                                                         | 30,498            | 29,913           | 28,671                                  | 27,677          | 26,727            |
| Business customer average monthly service revenue per customer (4)                   | \$ 256            | \$ 250           | \$ 244                                  | \$ 239          | \$ 207            |
| Overall service margin                                                               | 76%               | 75%              | 76%                                     | 77%             | 77%               |
| Overall product margin                                                               | -22%              | -30%             | -15%                                    | -24%            | -45%              |
| Overall gross margin                                                                 | 68%               | 67%              | 68%                                     | 68%             | 66%               |
| Business subscriber acquisition cost per service (5)                                 | \$ 89             | \$ 97            | \$ 99                                   | \$ 92           | \$ 101            |
| Average number of services subscribed to per business customer                       | 10.6              | 10.1             | 9.8                                     | 9.4             | 9.0               |
| Business customer subscriber acquisition cost (6)                                    | \$ 944            | \$ 980           | \$ 965                                  | \$ 867          | \$ 906            |

- (1) Includes 250 customers acquired directly from our acquisitions in the second quarter of fiscal 2012 from Contactual and does not include customers of Virtual Office Solo or Zerigo, Inc. ("Zerigo").
- (2) Business customer churn is calculated by dividing the number of business customers that terminated (after the expiration of the 30-day trial) during that period by the simple average number of business customers during the period and dividing the result by the number of months in the period. The simple average number of business customers during the period is the number of business customers on the first day of the period plus the number of business customers on the last day of the period divided by two. In the second quarter of fiscal 2013, an affiliate with 411 business customers representing approximately \$9,000 of monthly service revenue cancelled service. Excluding these 411 cancellations, business customer churn (less cancellations within 30 days of sign-up) was 1.9%.
- (3) Business customers are defined as customers paying for service. Customers that are currently in the 30-day trial period are considered to be customers that are paying for service. Customers subscribing to Virtual Office Solo or Zerigo services are not included as business customers.
- (4) Business customer average monthly service revenue per customer is service revenue from business customers in the period divided by the number of months in the period divided by the simple average number of business customers during the period.
- (5) Business subscriber acquisition cost per service is defined as the combined costs of advertising, marketing,

promotions, sales commissions and equipment subsidies for business services sold during the period divided by the number of gross business services added during the period.

- (6) Business customer subscriber acquisition cost is business subscriber acquisition cost per service times the average number of services subscribed to per business customer.

## RESULTS OF OPERATIONS

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

|                             | September 30,                 |           | Dollar    | Percent |
|-----------------------------|-------------------------------|-----------|-----------|---------|
| <u>Service revenue</u>      | 2012                          | 2011      | Change    | Change  |
|                             | (dollar amounts in thousands) |           |           |         |
| Three months ended          | \$ 24,177                     | \$ 18,013 | \$ 6,164  | 34.2%   |
| Percentage of total revenue | 91.7%                         | 90.9%     |           |         |
| Six months ended            | \$ 47,349                     | \$ 35,034 | \$ 12,315 | 35.2%   |
| Percentage of total revenue | 91.7%                         | 91.4%     |           |         |

Service revenue consists primarily of revenue attributable to the provision of our 8x8 VoIP services and royalties earned under our VoIP technology licenses. We expect that 8x8 service revenues will continue to comprise nearly all of our service revenues for the foreseeable future. 8x8 service revenue increased in the second quarter of fiscal 2013 primarily due to the increase in our business customer subscriber base. Our business subscriber base grew from 26,727 business customers on September 30, 2011, to 30,498 on September 30, 2012. The increase for the first six months of fiscal 2013 also was primarily attributable to the increase in our business customer base from approximately 24,000 businesses on April 1, 2011 to 30,498 on September 30, 2012. The increase was partially offset by a decrease in customers of our residential services. These changes were consistent with the redirection of our marketing efforts toward our business customer service. We expect the trends to continue in future periods.

|                             | September 30,                 |          | Dollar | Percent |
|-----------------------------|-------------------------------|----------|--------|---------|
| <u>Product revenue</u>      | 2012                          | 2011     | Change | Change  |
|                             | (dollar amounts in thousands) |          |        |         |
| Three months ended          | \$ 2,194                      | \$ 1,806 | \$ 388 | 21.5%   |
| Percentage of total revenue | 8.3%                          | 9.1%     |        |         |
| Six months ended            | \$ 4,274                      | \$ 3,292 | \$ 982 | 29.8%   |
| Percentage of total revenue | 8.3%                          | 8.6%     |        |         |

Product revenue consists primarily of revenue from sales of IP telephones attributable to our 8x8 service. Product revenue increased for the three and six months ended September 30, 2012 primarily due to an increase in equipment sales to business customers.

|                                | September 30,                 |          | Dollar   | Percent |
|--------------------------------|-------------------------------|----------|----------|---------|
| <u>Cost of service revenue</u> | 2012                          | 2011     | Change   | Change  |
|                                | (dollar amounts in thousands) |          |          |         |
| Three months ended             | \$ 5,825                      | \$ 4,059 | \$ 1,766 | 43.5%   |
| Percentage of service revenue  | 24.1%                         | 22.5%    |          |         |
| Six months ended               | \$ 11,511                     | \$ 7,874 | \$ 3,637 | 46.2%   |
| Percentage of service revenue  | 24.3%                         | 22.5%    |          |         |

The cost of service revenue primarily consists of costs associated with network operations and related personnel, telephony origination and termination services provided by third party carriers and technology license and royalty expenses. Cost of service revenue for the three months ended September 30, 2012 increased over the comparable period in the prior fiscal year primarily due to a \$1.2 million increase in third party network service expenses, a \$0.3 million increase in payroll and related costs, a \$0.2 million increase in amortization expenses due to intangibles acquired in acquisition of businesses, and a \$0.2 million increase in depreciation expense. The increase in expense was partially offset by a \$0.2 million reduction in expensed license and fees.

Cost of service revenue for the six months ended September 30, 2012 increased from the comparable period in the prior fiscal year primarily due to a \$2.2 million increase in third party network service fees, a \$0.6 million increase in payroll and related costs, a \$0.4 million increase in amortization expenses due to intangibles acquired in acquisition of businesses, a \$0.3 million increase in depreciation expense, and a \$0.2 million increase in consulting and outside service expenses. The increase in expense was partially offset by a \$0.2 million reduction in expensed license and fees.

| <b><u>Cost of product revenue</u></b> | <b>2012</b> | <b>September 30,<br/>2011</b> | <b>Dollar<br/>Change</b> | <b>Percent<br/>Change</b> |
|---------------------------------------|-------------|-------------------------------|--------------------------|---------------------------|
|                                       |             | (dollar amounts in thousands) |                          |                           |
| Three months ended                    | \$ 2,672    | \$ 2,613                      | \$ 59                    | 2.3%                      |
| Percentage of product revenue         | 121.8%      | 144.7%                        |                          |                           |
| Six months ended                      | \$ 5,382    | \$ 4,883                      | \$ 499                   | 10.2%                     |
| Percentage of product revenue         | 125.9%      | 148.3%                        |                          |                           |

The cost of product revenue consists of costs associated with systems, components, system manufacturing, assembly and testing performed by third-party vendors, estimated warranty obligations and direct and indirect costs associated with product purchasing, scheduling, quality assurance, shipping and handling. The amount of revenue allocated to product revenue based on the relative selling price is less than the cost of the IP phone equipment. The cost of product revenue for the three months ended September 30, 2012 increased over the comparable period in the prior fiscal year primarily due to an increase in the shipment of equipment to customers.

The cost of product revenue for the six months ended September 30, 2012 increased over the comparable period in the prior fiscal year due to a \$0.4 million increase in the shipment of equipment to customers and a \$0.1 million increase in freight expenses.

| <b><u>Research and development</u></b> | <b>2012</b> | <b>September 30,<br/>2011</b> | <b>Dollar<br/>Change</b> | <b>Percent<br/>Change</b> |
|----------------------------------------|-------------|-------------------------------|--------------------------|---------------------------|
|                                        |             | (dollar amounts in thousands) |                          |                           |
| Three months ended                     | \$ 2,030    | \$ 1,540                      | \$ 490                   | 31.8%                     |
| Percentage of total revenue            | 7.7%        | 7.8%                          |                          |                           |
| Six months ended                       | \$ 3,856    | \$ 2,947                      | \$ 909                   | 30.8%                     |
| Percentage of total revenue            | 7.5%        | 7.7%                          |                          |                           |

Historically, our research and development expenses have consisted primarily of personnel, system prototype design, and equipment costs necessary for us to conduct our development and engineering efforts. We expense research and development costs as they are incurred. The research and development expenses for the three months ended September 30, 2012 increased over the comparable period in the prior fiscal year primarily due to a \$0.3 million increase in payroll and related costs, a \$0.1 million increase in recruiting expenses and a \$0.1 million increase in other research and development expenses.

The research and development expenses for the six months ended September 30, 2012 increased over the comparable period in the prior fiscal year due to a \$0.8 million increase in payroll and related costs and a \$0.1 million increase in other research and development expenses.

| <b><u>Sales and marketing</u></b> | <b>2012</b> | <b>September 30,<br/>2011</b> | <b>Dollar<br/>Change</b> | <b>Percent<br/>Change</b> |
|-----------------------------------|-------------|-------------------------------|--------------------------|---------------------------|
|                                   |             | (dollar amounts in thousands) |                          |                           |
| Three months ended                | \$ 11,010   | \$ 9,076                      | \$ 1,934                 | 21.3%                     |
| Percentage of total revenue       | 41.8%       | 45.8%                         |                          |                           |
| Six months ended                  | \$ 21,551   | \$ 17,260                     | \$ 4,291                 | 24.9%                     |
| Percentage of total revenue       | 41.7%       | 45.0%                         |                          |                           |

Sales and marketing expenses consist primarily of personnel and related overhead costs for sales, marketing, and customer service. Such costs also include outsourced customer service call center operations, sales commissions, as well as trade show, advertising and other marketing and promotional expenses. Sales and marketing expenses for the three months ended September 30, 2012 increased over the same quarter in the prior fiscal year primarily because of a \$1.7 million increase in payroll and related costs, a \$0.1 million increase in third party sales commissions, a \$0.1 million increase in amortization of customer relationship intangibles, a \$0.1 million increase in bad debt expenses, and a \$0.2 million increase in other miscellaneous sales and marketing expenses. The increase in expense was partially offset by a \$0.3 million reduction in other advertising expenses.

Sales and marketing expenses for the first six months of fiscal 2013 increased over the same period in the prior fiscal year primarily because of a \$3.4 million increase in payroll and related costs, a \$0.2 million increase in third party sales commissions, a \$0.2 million increase in amortization of customer relationship intangibles, a \$0.1 million increase in bad debt expense, a \$0.1 million increase in sales promotion expenses, a \$0.1 million increase in telephone expenses, a \$0.1 million increase in travel and meal expenses and a \$0.3 million increase in other sales and marketing expenses. The increase in expenses was partially offset by a \$0.2 million reduction in temporary personnel, consulting and outside service expenses.

| <u>General and administrative</u> | September 30,                 |          | Dollar<br>Change | Percent<br>Change |
|-----------------------------------|-------------------------------|----------|------------------|-------------------|
|                                   | 2012                          | 2011     |                  |                   |
|                                   | (dollar amounts in thousands) |          |                  |                   |
| Three months ended                | \$ 2,070                      | \$ 1,666 | \$ 404           | 24.2%             |
| Percentage of total revenue       | 7.8%                          | 8.4%     |                  |                   |
| Six months ended                  | \$ 4,134                      | \$ 2,891 | \$ 1,243         | 43.0%             |
| Percentage of total revenue       | 8.0%                          | 7.5%     |                  |                   |

General and administrative expenses consist primarily of personnel and related overhead costs for finance, human resources and general management. General and administrative expenses for the three months ended September 30, 2012 increased over the same quarter in the prior fiscal year primarily because of a \$0.3 million increase in temporary personnel, consulting and outside service expenses, a \$0.2 million increase in payroll and related costs and a \$0.1 million increase in depreciation expense. The increase in expenses was partially offset by a \$0.2 million reduction in legal expenses.

General and administrative expenses for the first six months of fiscal 2013 increased over the same period in the prior fiscal year primarily because of a \$0.7 million increase in temporary personnel, consulting and outside service expenses, a \$0.4 million increase in payroll and related costs, a \$0.1 million increase in recruiting expenses, a \$0.1 million increase in sales and use tax expense and a \$0.1 million increase in accounting and tax expenses, although legal expenses declined in the recent period.

| <u>Gain on patent sale</u>  | September 30,                 |      | Dollar<br>Change | Percent<br>Change |
|-----------------------------|-------------------------------|------|------------------|-------------------|
|                             | 2012                          | 2011 |                  |                   |
|                             | (dollar amounts in thousands) |      |                  |                   |
| Three months ended          | \$ -                          | \$ - | \$ -             | 0.0%              |
| Percentage of total revenue | 0.0%                          | 0.0% |                  |                   |
| Six months ended            | \$ (11,965)                   | \$ - | \$ (11,965)      | 100.0%            |
| Percentage of total revenue | -23.2%                        | 0.0% |                  |                   |

In June 2012, we entered into a patent purchase agreement for the sale of a family of United States patents for \$12.0 million in cash. We recognized a gain of slightly less than \$12.0 million, net of transaction costs, which has been recorded as a reduction of operating expenses in the consolidated statements of operations.

|                             | September 30,                 |         | Dollar | Percent |
|-----------------------------|-------------------------------|---------|--------|---------|
| <u>Other income, net</u>    | 2012                          | 2011    | Change | Change  |
|                             | (dollar amounts in thousands) |         |        |         |
| Three months ended          | \$ 9                          | \$ (11) | \$ 20  | -181.8% |
| Percentage of total revenue | 0.0%                          | -0.1%   |        |         |
| Six months ended            | \$ 17                         | \$ 9    | \$ 8   | 88.9%   |
| Percentage of total revenue | 0.0%                          | 0.0%    |        |         |

In the six months ended September 30, 2012, other income, net consisted of interest expense, distribution of capital gains on investments and interest income earned on our cash, cash equivalents and investments. Other income, net was negative for the three months ended September 30, 2011 primarily because of the buyout, including interest expense, of capital leases acquired with the acquisition of Contactual in September 2011.

|                                           | September 30,                 |          | Dollar   | Percent  |
|-------------------------------------------|-------------------------------|----------|----------|----------|
| <u>Provision (benefit) for income tax</u> | 2012                          | 2011     | Change   | Change   |
|                                           | (dollar amounts in thousands) |          |          |          |
| Three months ended                        | \$ 1,032                      | \$ 22    | \$ 1,010 | 4590.9%  |
| Percentage of income                      |                               |          |          |          |
| before provision for income taxes         | 37.2%                         | 2.6%     |          |          |
| Six months ended                          | \$ 6,813                      | \$ (299) | \$ 7,112 | -2378.6% |
| Percentage of income before               |                               |          |          |          |
| provision (benefit) for income taxes      | 39.7%                         | -12.1%   |          |          |

For the three and six months ended September 30, 2012, we recorded a provision for income taxes of \$1.0 million and \$6.8 million, respectively, which was primarily attributable to net income from operations, including the gain on patent sale. For the three and six months ended September 30, 2011, we released a portion of our valuation allowance against the deferred tax asset as we deemed it was more likely than not it would be used to offset the \$0.3 million deferred tax liability recorded in connection with the acquisition of Zerigo.

The increase in income tax expense for the three months ended September 30, 2012 was primarily attributable to net income from operations, including the gain on patent sale.

The increase in income tax expense for the six months ended September 30, 2012 compared with the same period in the prior fiscal year was due to the provision for income tax of \$6.8 million which was primarily attributable to net income from operations, including the gain on patent sale.

The effective tax rate is calculated by dividing the income tax provision by net income before income tax expense. We estimate our annual effective tax rate at the end of each quarter. The fiscal 2013 estimated annual effective tax rate is expected to be approximately 40%, but may fluctuate each quarter due to the timing of other discrete period transactions. In estimating the annual effective tax rate, we, in consultation with our tax advisors, consider, among other things, annual pre-tax income, permanent tax differences, changes to tax rates, state apportionment, and the application and interpretations of existing tax laws.

## Liquidity and Capital Resources

As of September 30, 2012, we had approximately \$40.1 million in cash, cash equivalents and short-term investments.

Net cash provided by operating activities for the six months ended September 30, 2012 was approximately \$19.4 million, compared with \$3.2 million for the six months ended September 30, 2011. The increase in cash flow resulted primarily from a \$12.0 million gain on the sale of a patent family in June 2012, a \$1.7 million reimbursement from landlord for tenant improvements, and an increase in service and product revenue in the first six months of fiscal 2012. Cash provided by operating activities has historically been affected by the amount of net income, sales of subscriptions, changes in working capital accounts particularly in deferred revenue due to timing of annual plan renewals, add-backs of non-cash expense items such as the use of deferred tax assets, depreciation and amortization and the expense associated with stock-based awards.

Net cash used in investing activities was \$4.7 million during the six months ended September 30, 2012, compared with \$1.9 million used in investing activities for the six months ended September 30, 2011. The increase in cash used in investing activities during the six months ended September 30, 2012 is primarily related to an increase in the purchase of additional equipment, furniture and fixtures and leasehold improvements (\$4.7 million). The increase in cash used for the purchase of furniture and fixtures and leasehold improvements is primarily due to the Company's move to its new headquarters facility in San Jose, California.

Our financing activities for the six months ended September 30, 2012 consisted primarily of cash from the issuance of shares due to exercise of employee stock options (\$1.3 million) offset by cash used to repurchase shares of our common stock (\$0.1 million).

## Contractual Obligations

We lease our headquarters facility in San Jose, California under an operating lease agreement that expires in October 2019. The lease is an industrial net lease with monthly base rent of \$130,821 for the first 15 months with a 3% increase each year thereafter, and requires us to pay property taxes, utilities and normal maintenance costs.

We entered into a series of noncancelable capital lease agreements for office equipment bearing interest at various rates. Assets under capital lease at September 30, 2012 totaled \$110,000 with accumulated amortization of \$60,000.

In the third quarter of 2010, we amended the contract with one of our third party customer support vendors containing a minimum monthly commitment of approximately \$430,000. The agreement requires a 150-day notice to terminate. At September 30, 2012, the total remaining obligation under the contract was \$2.2 million.

We have entered into contracts with multiple vendors for third party network services. At September 30, 2012, future minimum annual payments under these third party network service contracts were \$433,000 in 2013, \$382,000 in 2014, \$319,000 in 2015 and \$52,000 in 2016.

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

### Foreign Currency

Our financial market risk consists primarily of risks associated with international operations and related foreign currencies. We derive a portion of our revenue from customers in Europe and Asia. In order to reduce the risk from fluctuation in foreign exchange rates, the vast majority of our sales are denominated in U.S. dollars. In addition, almost all of our arrangements with our contract manufacturers are denominated in U.S. dollars. We have not entered into any currency hedging activities. To date, our exposure to exchange rate volatility has not been significant and was not material for the three and six months ended September 30, 2012 or 2011.



## Investments

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

## ITEM 4. CONTROLS AND PROCEDURES

### Evaluation of Effectiveness of Disclosure Controls and Procedures

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

As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our Disclosure Controls. Based on this evaluation our Chief Executive Officer and our Chief Financial Officer have concluded that our Disclosure Controls were effective as of September 30, 2012.

### Limitations on the Effectiveness of Controls

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

### Changes in Internal Control over Financial Reporting.

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II -- OTHER INFORMATION

### ITEM 1. Legal Proceedings

Descriptions of our legal proceedings are contained in Part I, Item 1, Financial Statements — Notes to Condensed Consolidated Financial Statements — "Note 7".

### ITEM 1A. Risk Factors

We face many significant risks in our business, some of which are unknown to us and not presently foreseen. These risks could have a material adverse impact on our business, financial condition and results of operations in the future. We have disclosed a number of material risks under Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended March 31, 2012, which we filed with the Securities and Exchange Commission on May 24, 2012 in

addition to the following updated risk factor disclosures.

## ITEM 6. EXHIBITS

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                                   |
|-------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1              | <u>Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u>                                                                                      |
| 31.2              | <u>Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u>                                                                                      |
| 32.1              | <u>Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u>                                                                                                                                 |
| 32.2              | <u>Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (PDF as a courtesy)</u>                                                                                                                                 |
| 101.INS*          | XBRL Instance Document                                                                                                                                                                                                                                                                                        |
| 101.SCH*          | XBRL Taxonomy Extension Schema                                                                                                                                                                                                                                                                                |
| 101.CAL*          | XBRL Taxonomy Extension Calculation Linkbase                                                                                                                                                                                                                                                                  |
| 101.DEF*          | XBRL Taxonomy Extension Definition Linkbase                                                                                                                                                                                                                                                                   |
| 101.LAB*          | XBRL Taxonomy Extension Label Linkbase                                                                                                                                                                                                                                                                        |
| 101.PRE*          | XBRL Taxonomy Extension Presentation Linkbase                                                                                                                                                                                                                                                                 |
| *                 | Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability. |

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: October 25, 2012

8X8, INC.  
(Registrant)

By: /s/ DANIEL WEIRICH  
Daniel Weirich

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