8X8 INC /DE/
Form 10-Q
August 01, 2008

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

FORM 10-Q

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from ________to _________

Commission file number 000-21783

8X8, INC.

(Exact name of Registrant as Specified in its Charter)

Delaware	**77-0142404**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

3151 Jay Street
Santa Clara, CA 95054

(Address of Principal Executive Offices including Zip Code)

(408) 727-1885

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The number of shares of the Registrant's Common Stock outstanding as of July 24, 2008 was 62,175,269.

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Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	June 30, 2008	March 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,034	$ 11,185
Short-term investments	1,799	3,382
Accounts receivable, net	1,558	1,807
Inventory	1,717	1,539
Deferred cost of goods sold	1,038	943
Other current assets	473	549
Total current assets	19,619	19,405
Property and equipment, net	1,856	2,010
Other assets	127	136
Total assets	$ 21,602	$ 21,551
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 5,652	$ 4,885
Accrued compensation	1,379	1,048
Accrued warranty	316	314
Accrued taxes	1,484	2,896
Deferred revenue	2,481	3,139
Other accrued liabilities	503	976
Total current liabilities	11,815	13,258
Other liabilities	86	109
Fair value of warrant liability	266	335
Total liabilities	12,167	13,702
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock	62	62
Additional paid-in capital	208,404	208,001
Accumulated other comprehensive income	-	5
Accumulated deficit	(199,031)	(200,219)
Total stockholders' equity	9,435	7,849
Total liabilities and stockholders' equity	$ 21,602	$ 21,551

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

8X8, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts; unaudited)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007
Service revenues	$ 15,019	$ 13,411
Product revenues	1,262	1,331
Total revenues	16,281	14,742
Operating expenses:		
Cost of service revenues	3,814	3,986
Cost of product revenues	1,432	1,383
Research and development	1,192	1,057
Selling, general and administrative	8,751	8,919
Total operating expenses	15,189	15,345
Income (loss) from operations	1,092	(603)
Other income, net	85	132
Income on change in fair value of warrant liability	69	979
Income before provision for income taxes	1,246	508
Provision for income taxes	58	-
Net income	$ 1,188	$ 508
Net income per share:		
Basic	$ 0.02	$ 0.01
Diluted	$ 0.02	$ 0.01
Weighted average number of shares:		
Basic	62,096	61,772
Diluted	62,192	62,080

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)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007
Cash flows from operating activities:		
Net income	$ 1,188	$ 508
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	339	391
Stock compensation	328	205
Change in fair value of warrant liability	(69)	(979)
Other	23	24
Changes in assets and liabilities		
Accounts receivable, net	232	(74)
Inventory	(192)	7
Other current and noncurrent assets	85	(87)
Deferred cost of goods sold	(95)	113
Accounts payable	751	178
Accrued compensation	331	161
Accrued warranty	2	19
Accrued taxes & fees	(1,412)	(108)
Deferred revenue	(658)	(23)
Other current and noncurrent liabilities	(487)	(122)
Net cash provided by operating activities	366	213
Cash flows from investing activities:		
Purchases of property and equipment	(168)	(91)
Purchase of investments	-	(1,351)
Maturities of short-term investments	1,585	-
Net cash provided by (used in) investing activities	1,417	(1,442)
Cash flows from financing activities:		
Capital lease payments	(9)	(7)
Proceeds from issuance of common stock under employee stock plans	75	19
Net cash provided by financing activities	66	12
Net increase (decrease) in cash and cash equivalents	1,849	(1,217)
Cash and cash equivalents at the beginning of the period	11,185	6,735
Cash and cash equivalents at the end of the period	$ 13,034	$ 5,518

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

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

1. DESCRIPTION OF THE BUSINESS

THE COMPANY

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

The Company offers the Packet8 broadband Voice over Internet Protocol, or VoIP, and video communications service, Packet8 Virtual Office service, Packet8 Virtual Trunking service, Packet8 Hosted Key System service, videophone equipment and services, and Packet8 MobileTalk service. The Packet8 voice and video communications service ("Packet8") enables broadband Internet users to add digital voice and video communications services to their high-speed Internet connection. Customers can choose a direct-dial phone number from any of the rate centers offered by the service, and then use an 8x8-supplied terminal adapter to connect any telephone to a broadband Internet connection to make or receive calls from a regular telephone number. All Packet8 telephone accounts come with voice mail, caller ID, call waiting, call waiting caller ID, call forwarding, hold, line-alternate, 3-way conferencing, web access to account controls, and online billing. In addition, 8x8 offers videophones for use with the Packet8 service. 8x8 has developed a suite of business services called Packet8 Virtual Office that offer feature-rich communications services to small and medium-sized business, eliminating the need for traditional telecommunications services and business phone systems. 8x8's primary product focus is on replacing private branch exchange, or PBX, telephone systems in the small business marketplace with a hosted business VoIP solution. Packet8 Virtual Office can completely replace a company's PBX infrastructure and deliver all telecom services over a managed or unmanaged Internet connection. In June 2008, the Company launched Packet8 Virtual Trunking, which allows the customers to utilize their existing PBX and purchase inbound and outbound service from the Company. In July 2008, the Company introduced the Packet8 Hosted Key System service which replaces traditional premise-based telephone "key systems" typically used by companies whose size or structure dictates the sharing of multiple, common phone lines among employees. The Company also sells pre-programmed IP and analog telephones with speakerphones and a display screen, in conjunction with its Virtual Office service plans, which enable its business customers to access additional features of Virtual Office through on-screen phone menus. The Company's Packet8 MobileTalk service enables mobile phone users to make international phone calls from their mobile phones over the Packet8 international network.

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 2009 refers to the fiscal year ending March 31, 2009).

LIQUIDITY

Although the Company achieved positive cash flows from operations in the fiscal year ended March 31, 2008, and the quarter ended June 30, 2008, historical net losses and negative cash flows have been funded primarily through the issuance of equity securities and borrowings. Management believes that current cash, cash equivalents and investments will be sufficient to finance the Company's operations for at least the next twelve months. However, the Company continually evaluates its cash needs and may pursue additional equity or debt financing in order to achieve the Company's overall business objectives. There can be no assurance that such financing will be available, or, if available, at a price that is acceptable to the Company. Failure to generate sufficient revenues, raise additional capital or reduce certain discretionary spending could have an adverse impact on the Company's ability to achieve its longer term business objectives.

2. BASIS OF PRESENTATION

The accompanying interim condensed consolidated financial statements are unaudited and have been prepared on substantially the same basis as our annual financial statements for the fiscal year ended March 31, 2008. In the opinion of management, these financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of our financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

The March 31, 2008 year-end condensed consolidated balance sheet data was derived from audited consolidated financial statements and does not include all of the disclosures required by U.S. generally accepted accounting principles. These financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended March 31, 2008 and notes thereto included in the Company's fiscal 2008 Annual Report on Form 10-K.

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

Investments

The Company's investments are comprised of corporate debt, federal agency securities and money market funds. All short-term investments are classified as available-for-sale.

Packet8 Service Revenue

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

Emerging Issues Task Force (EITF) consensus No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if the deliverables in the arrangement meet specific criteria. In addition, arrangement consideration must be allocated among the separate units of accounting based on their relative fair values, with certain limitations. The provisioning of the Packet8 service with the accompanying desktop terminal or videophone adapter constitutes a revenue arrangement with multiple deliverables. In accordance with the guidance of EITF No. 00-21, the Company allocates Packet8 revenues, including activation fees, among the desktop terminal adapter or videophone and subscriber services. Revenues allocated to the desktop terminal adapter or videophone 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 when the related services are provided.

Deferred Cost of Goods Sold

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

Warrant Liability

The Company accounts for its warrants in accordance with Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock" ("EITF 00-19") which requires warrants to be classified as permanent equity, temporary equity or as assets or liabilities. In general, warrants that either require net-cash settlement or are presumed to require net-cash settlement are recorded as assets and liabilities at fair value and warrants that require settlement in shares are recorded as equity instruments. Certain of the Company's warrants require settlement in shares and are accounted for as permanent equity. The Company has two investor warrants that are classified as liabilities because they include a provision that specifies that the Company must deliver freely tradable shares upon exercise by the warrant holder. Because there are circumstances, irrespective of likelihood, that may not be within the control of the Company that could prevent delivery of registered shares, EITF 00-19 requires the warrants be recorded as a liability at fair value, with subsequent changes in fair value recorded as income (loss) in change in fair value of warrant liability. The fair value of the warrant is determined using a

Black-Scholes option pricing model, and is affected by changes in inputs to that model including our stock price, expected stock price volatility and contractual term.

Accounting for Stock-Based Compensation

Effective April 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("SFAS 123(R)"), which establishes standards for the accounting for equity instruments exchanged for employee services. SFAS 123(R) revised SFAS 123 "Accounting for Stock-Based Compensation" ("SFAS 123") and superseded Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees," and related interpretations. Under the provisions of SFAS 123(R), share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant), net of estimated forfeitures. The Company elected to adopt the modified prospective transition method as provided by SFAS 123(R).

Stock-based compensation expense recognized in the Company's Condensed Consolidated Statements of Operations for the first quarter of fiscal 2009 included both the unvested portion of stock-based awards granted prior to April 1, 2006 and stock-based awards granted subsequent to April 1, 2006. Stock options granted in periods prior to fiscal 2007 were measured based on SFAS 123 criteria, whereas stock options granted subsequent to April 1, 2006 were measured based on SFAS 123(R) criteria. In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation to expense from the accelerated multiple-option approach to the straight-line single option method. Compensation expense for all share-based payment awards granted subsequent to April 1, 2006 is recognized using the straight-line single-option method. Stock-based compensation expense includes the impact of estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Stock Option Plans

The Company has several stock-based compensation plans (the "Plans") that are described in Note 5 "Stockholders' Equity" of the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2008. The Company, under its various equity plans, grants stock options for shares of common stock to employees, non-employees, directors and consultants.

As of June 30, 2008, the 1992 Stock Plan, 1996 Stock Plan and 1996 Director Option Plan had expired and the 1999 Nonstatutory Stock Option Plan was cancelled by the Board, but there are still options outstanding under these plans. Options generally vest over four years, are granted at fair market value on the date of the grant and expire ten years from that date.

The Company's 2006 Stock Plan (the "2006 Plan") has 7,000,000 shares of common stock reserved for issuance. The 2006 Plan provides for granting incentive stock options to employees and nonstatutory stock options to employees, directors or consultants. The stock option price of incentive stock options granted may not be less than the fair market value on the effective date of the grant. Other types of options and awards under the 2006 Plan may be granted at any price approved by the administrator, which generally will be the compensation committee of the board of directors. Options generally vest over four years and expire ten years after grant. The 2006 Plan expires in May 2016.

Option Activity

Option activity since March 31, 2008 is summarized as follows:

	Shares Available for Grant	Shares Subject to Options Outstanding		Weighted Average Exercise Price Per Share
Balance at March 31, 2008	3,935,125	10,301,064	$	2.00
Granted	(281,000)	281,000		1.16
Exercised	-	(3,000)		0.69
Canceled/forfeited	169,595	(169,595)		1.68
Termination of plans	(98,845)	-		-
Balance at June 30, 2008	3,724,875	10,409,469	$	1.98

The following table summarizes the stock options outstanding and exercisable at June 30, 2008:

	Options Outstanding						Options Exercisable				
	Shares		Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (Years)		Aggregate Intrinsic Value	Shares		Weighted Average Exercise Price Per Share		Aggregate Intrinsic Value
\$0.01 - \$1.26	3,192,348	$	1.17	7.97	$	135,688	1,161,587	$	1.09	$	116,597
\$1.27 - \$1.54	2,194,000	$	1.40	7.63		-	1,261,708	$	1.41		-
\$1.55 - \$1.87	2,993,891	$	1.78	5.21		-	2,555,908	$	1.79		-
\$1.88 - \$14.50	2,024,230	$	4.18	3.95		-	1,897,079	$	4.30		-
\$14.51 - \$14.94	5,000	$	14.94	1.84		-	5,000	$	14.94		-
	10,409,469				$	135,688	6,881,282			$	116,597

Stock-based Compensation Expense

As of June 30, 2008, there were $2.1 million of total unrecognized compensation costs related to stock options. These costs are expected to be recognized over a weighted average period of 2.54 years.

To value option grants and other awards for actual and pro forma stock-based compensation, the Company has used the Black-Scholes option valuation model. When the measurement date is certain, the fair value of each option grant is estimated on the date of grant. Fair value determined using Black-Scholes varies based on assumptions used for the expected stock price volatility, expected life, risk-free interest rates and future dividend payments. During the three month periods ended June 30, 2008 and 2007, the Company used historical volatility of the common stock over a period equal to the expected life of the options to estimate their fair value. The expected life assumption represents the weighted-average period stock-based awards are expected to remain outstanding. These expected life assumptions are established through the review of historical exercise behavior of stock-based award grants with similar vesting periods. The risk-free interest rate is based on the closing market bid yields on actively traded U.S. treasury securities in the over-the-counter market for the expected term equal to the expected term of the option. The dividend yield assumption is based on the Company's history and expectation of future dividend payouts.

The following table summarizes the assumptions used to compute reported and pro forma stock-based compensation to employees and directors for the three months ended June 30, 2008 and 2007:

	Three Months Ended June 30,	
	2008	2007
Expected volatility	75%	83%
Expected dividend yield	-	-
Risk-free interest rate	2.91%	4.76%
Weighted average expected option term	4.00 years	3.95 years
Weighted average fair value of options granted	$ 0.66	$ 0.85

In accordance with SFAS 123(R), the Company recorded $295,000 and $186,000 in compensation expense relative to stock options for the three months ended June 30, 2008 and 2007, respectively.

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan, eligible employees can participate and purchase common stock semi-annually through payroll deductions at a price equal to 85% of the fair market value of the common stock at the beginning of each one year offering period or the end of a six month purchase period, whichever is lower. The contribution amount may not exceed ten percent of an employee's base compensation, including commissions but not including bonuses and overtime. The Company accounts for the Employee Stock Purchase Plan as a compensatory plan and recorded compensation expense of $33,000 and $19,000 for the three months ended June 30, 2008 and 2007, respectively in accordance with SFAS 123(R).

The adoption of SFAS 123(R) did not impact the Company's methodology to estimate the fair value of share-based payment awards under the Company's Employee Stock Purchase Plan. The estimated fair value of stock purchase rights granted under the Employee Stock Purchase Plan were estimated at the date of grant using the Black-Scholes pricing model with the following weighted-average assumptions:

	Three Months Ended June 30,	
	2008	2007
Expected volatility	54%	84%
Expected dividend yield	-	-
Risk-free interest rate	3.83%	5.13%
Weighted average expected option term	0.75 years	0.75 years
Weighted average fair value of options granted	$ 0.44	$ 0.36

As of June 30, 2008, there was $25,000 of total unrecognized compensation cost related to employee stock purchases. These costs are expected to be recognized over a weighted average period of 0.2 years.

SFAS 123(R) requires the benefits of tax deductions in excess of recognized compensation costs to be reported as a financing cash flow, rather than as an operating cash flow. The future realizability of tax benefits related to stock compensation is dependent upon the timing of employee exercises and future taxable income, among other factors. The Company did not realize any tax benefit from the stock compensation charge incurred during the three months ended June 30, 2008 and 2007 as the Company believes that it is more likely than not that it will not realize the benefit from tax deductions related to equity compensation.

As prescribed in SFAS 123(R), the following table summarizes the distribution of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) among the Company's operating functions for the three months ended June 30, 2008 and 2007 which was recorded as follows (in thousands):

	Three Months Ended June 30,	
	2008	2007
Cost of service revenues	$ 4	$ -
Cost of product revenues	4	1
Research and development	69	41
Selling, general and administrative	251	163
Total stock-based compensation expense related to employee stock options and employee stock purchases, pre-tax	328	205
Tax benefit	-	-
Stock based compensation expense related to employeee stock options and employee stock purchases, net of tax	$ 328	$ 205

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. The adoption of SFAS No. 157 did not have a material effect on the Company's condensed consolidated results of operations and financial condition.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159") which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The adoption of SFAS No. 159 did not have a material effect on the Company's condensed consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 141(Revised 2007), "Business Combinations" ("SFAS No. 141(R)"). SFAS No. 141(R) significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, acquired contingencies, transaction costs, in-process research and development and restructuring costs. In addition, under SFAS No. 141(R), changes in an acquired entity's deferred tax assets and uncertain tax positions after the measurement period will impact income tax expense. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company will adopt this pronouncement in the first quarter of fiscal 2010 and does not expect the adoption of SFAS No. 141(R) will have a material impact on its consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements an Amendment of ARB no. 51" ("SFAS No. 160"), which establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary, changes in a parent's ownership interest in a subsidiary and the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company will adopt this pronouncement in the first quarter of fiscal 2010 and does not expect the adoption of SFAS No. 160 to have a material impact on its consolidated results of operations and financial condition.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("SFAS No. 162"). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS No. 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." The Company does not expect the adoption of SFAS No. 162 to have a material impact on its consolidated results of operations and financial condition.

3. BALANCE SHEET DETAIL

		June 30, 2008		March 31, 2008
Inventory (in thousands):				
Work-in-process	$	1,014	$	1,095
Finished goods		703		444
	$	1,717	$	1,539

4. NET INCOME PER SHARE

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

	Three Months Ended June 30,			
		2008		2007
Numerator:				
Net income available to common stockholders	$	1,188	$	508
Denominator:				
Common shares		62,096		61,772
Denominator for basic calculation		62,096		61,772
Employee stock options		96		207
Employee stock purchase plan		-		48
Warrants		-		53
Denominator for diluted calculation		62,192		62,080
Net income per share				
Basic	$	0.02	$	0.01
Diluted	$	0.02	$	0.01

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

	Three Months Ended June 30,	
	2008	2007
Common stock options	10,126	8,150
Warrants	7,838	8,222
	17,964	16,372

5. COMPREHENSIVE INCOME

Comprehensive income, as defined, includes all changes in equity (net assets) during a period from non-owner sources. The difference between the Company's net income and comprehensive income is due primarily to unrealized losses on investments classified as available-for-sale. Comprehensive income for the three months ended June 30, 2008 and 2007 was as follows (in thousands):

	Three Months Ended June 30,	
	2008	**2007**
Net income, as reported	$ 1,188	$ 508
Unrealized loss on investments in securities	(5)	(1)
Comprehensive income	$ 1,183	$ 507

6. SEGMENT REPORTING

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

	Three Months Ended June 30,	
	2008	**2007**
Packet8 and videophones/equipment	$ 16,269	$ 14,625
Technology licensing and related software	12	117
Total revenues	$ 16,281	$ 14,742

No customer represented greater than 10% of the Company's total revenues for the three months ended June 30, 2008 or 2007. Revenues from customers outside the United States were not material for the three months ended June 30, 2008 or 2007.

7. INCOME TAXES

Income taxes are accounted for using the asset and liability approach. Under the asset and liability approach, a current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year. A deferred tax liability or asset is recognized for the estimated future tax effects attributed to temporary differences and carryforwards. If necessary, the deferred tax assets are reduced by the amount of benefits that, based on available evidence, it is more likely than not expected to be realized. Other than a $58,000 foreign withholding tax on royalty revenue from a customer in Spain, the Company made no provision for income taxes in any periods presented in the accompanying condensed consolidated financial statements because of net losses incurred, or it expects to utilize net operating loss carryforwards for which there is a valuation allowance.

On April 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: an Interpretation of FASB Statement No. 109" (FIN 48), which clarifies the accounting and disclosure for uncertainty in income taxes recognized in an enterprise's financial statements. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The Company believes that any income tax filing positions and deductions not sustained on audit will not result in a material change to its financial position or results of operations.

The Company had unrecognized tax benefits of approximately $2.1 million as of March 31, 2008. The Company does not believe that there has been any change in the unrecognized tax benefits in the period ended June 30, 2008 and does not believe it is reasonably possible that the unrecognized tax benefit will materially change in the next 12 months. The application of FIN 48 would have resulted in a decrease in the accumulated deficit of $2.1 million, except that the decrease was fully offset by the application of a valuation allowance. To the extent that the unrecognized tax benefits are ultimately recognized they may have an impact on the effective tax rate in future periods; however, such impact on the effective tax rate would only occur if the recognition of such unrecognized tax benefits occurs in a future period when the Company has already determined it is more likely than not that its deferred tax assets are realizable.

The Company is subject to taxation in the U.S., California and various states and foreign jurisdictions in which we have or had a subsidiary or branch operations or we are collecting sales tax. All tax returns from fiscal 1995 to fiscal 2008 may be subject to examination by the Internal Revenue Service, California and various states. The Company extended the filing date of the 2008 federal tax return and all state income tax returns. As of June 30, 2008, these returns had not yet been filed. In addition, as of June 30, 2008, there were no active federal, state or local income tax audits. The foreign tax jurisdictions may be subject to examination for the fiscal years 2005 to 2008.

The Company's policy for recording interest and penalties associated with audits is to record such items as a component of operating expense income before taxes. During the three months ended June 30, 2008 and 2007, the Company did not recognize any interest or penalties related to unrecognized tax benefits.

8. COMMITMENTS AND CONTINGENCIES

Guarantees

Indemnifications

In the normal course of business, the Company enters into contracts under which the Company has agreed to hold harmless other parties, including customers, lessors and parties to other transactions with the Company, with respect to certain matters such as losses arising from a breach of representations or covenants or 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 prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material impact on the Company's operating results, financial position or cash flows. Under some of these agreements, however, the Company's potential indemnification liability might not have a contractual limit.

Product Warranties

The Company accrues for the estimated costs that may be incurred under its product warranties upon revenue recognition. Changes in the Company's product warranty liability, which is included in cost of product revenues in the condensed consolidated statements of operations, during the three months ended June 30, 2008 were as follows (in thousands):

	Three Months Ended June 30,	
	2008	**2007**

Balance at beginning of period	$ 314	$ 323
Accruals for warranties	65	104
Settlements	(63)	(85)
Balance at end of period	$ 316	$ 342

Standby letters of credit

The Company has a standby letter of credit totaling $100,000, which was issued to guarantee certain contractual obligations and is collateralized by cash deposits at the Company's primary bank. The collateral related to this letter of credit is recorded in the other assets line items in the condensed consolidated balance sheets.

Leases

At June 30, 2008, future minimum annual lease payments under noncancelable operating leases were as follows (in thousands):

Year ending March 31:		
Remaining 2009	$	370
2010		206
Total minimum payments	$	576

In April 2005, June 2006 and March 2007, the Company entered into a series of noncancelable capital lease agreements, respectively, for office equipment bearing interest at various rates. At June 30, 2008, future minimum annual lease payments were as follows (in thousands):

Year ending March 31:		
Remaining 2009	$	32
2010		42
2011		26
2012		22
Total minimum payments		122
Less: Amount representing interest		(9)
		113
Less: Short-term portion of capital lease obligations		(37)
Long-term portion of capital lease obligations	$	76

Capital leases included in office equipment were $182,000 at June 30, 2008. Total accumulated depreciation was $74,000 at June 30, 2008. Amortization expense for assets recorded under capital leases is included in depreciation expense.

Minimum Third Party Customer Support Commitments

In January 2008, the Company entered into a contract with one of its third party customer support vendors containing a minimum monthly commitment of approximately $436,000 effective January 1, 2008 through March 31, 2009. At June 30, 2008, the total remaining obligation under the contract was $3.9 million.

Legal Proceedings

From time to time, the Company may be involved in various legal claims and litigation that arise in the normal course of its operations. While the results of such claims and litigation cannot be predicted with certainty, the Company currently believes that it is not a party to any litigation the final outcome of which is likely to have a material adverse effect on the Company's financial position, results of operations or cash flows. However, should the Company not prevail in any such litigation; it could have a material adverse impact on the Company's operating results, cash flows or financial position.

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State and Municipal Taxes

For a period of time, the Company did not collect or remit state or municipal taxes (such as sales, excise, and ad valorem taxes), fees or surcharges ("Taxes") on the charges to the Company's customers for its services, except that the Company has historically complied with the California sales tax and financial contributions to the 9-1-1 system and universal service fund. We have received inquiries or demands from a number of state and municipal taxing agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although the Company has consistently maintained that these Taxes do not apply to its service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes as part of the streamlined sales tax initiatives and the Company has begun collecting and remitting Taxes in those states. Additionally, some of these Taxes could apply to the Company retroactively. As such, we have an accrued tax liability of $0.8 million at June 30, 2008 as our best estimate of the potential tax exposure for any retroactive assessment.

Regulatory Matters

Like many interconnected VoIP providers, the Company relies on a third party to route emergency calls originated by our customers. For certain customers, the third party solution provider may route 911 calls to a national emergency call center in the event of a system outage or other circumstances. The emergency dispatchers in this national call center may utilize the location information provided by the customer to route the call to the correct Public Safety Answering Point ("PSAP"), which is a local call center staffed by trained emergency operators, or first responder. The FCC could determine that calls routed in this manner do not satisfy its requirements should we be unable to connect our customers directly to a PSAP. The Company may be subject to enforcement actions including, but not limited to, fines, cease and desist orders, or other penalties for those customers, whose 911 calls are routed to a national emergency call center and not directly to a PSAP. As of June 30, 2008, the Company provided emergency calling services to 100% of its customers located in the United States.

On November 8, 2007, the FCC released a Report and Order concerning Local Number Portability ("LNP Order"). The obligations require interconnected VoIP providers to contribute to shared numbering administration costs on a competitively neutral basis. The assessment of local number portability fees to the Company's service will increase the Company's costs and reduce its profitability or cause the Company to increase the price of its retail service offerings. The LNP Order also requires that the Company process certain ports within a specified timeframe. The Company could be subject to fines, forfeitures and other penalties by state public utilities commissions or the FCC if it is not able to process certain ports in the relevant timeframe or we could face legal liability in state or federal court from customers or carriers.

The effect of any future laws, regulations and the orders on the Company's operations, including, but not limited to, the Packet8 service, cannot be determined. But as a general matter, increased regulation and the imposition of additional funding obligations increases the Company's costs of providing service that may or may not be recoverable from the Company's customers. This could result in making the Company's services less competitive with traditional telecommunications services if the Company increases its retail prices or decreases the Company's profit margins if it attempts to absorb such costs.

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

FORWARD-LOOKING STATEMENTS

This Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends," and similar expressions are intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results and trends may differ materially from historical results or those projected in any such forward-looking statements depending on a variety of factors. These factors include, but are not limited to, customer acceptance and demand for our VoIP products and services, the reliability of our services, the prices for our services, customer renewal rates, customer acquisition costs, actions by our competitors, including price reductions for their telephone services, potential federal and state regulatory actions, compliance costs, potential warranty claims and product defects, our needs for and the availability of adequate working capital, our ability to innovate technologically, the timely supply of products by our contract manufacturers, potential future intellectual property infringement claims that could adversely affect our business and operating results, and our ability to retain our listing on the NASDAQ Capital Market. The forward-looking statements may also be impacted by the additional risks faced by us as described in this Report, including those set forth under the section entitled "Factors that May Affect Future Results." All forward-looking statements included in this Report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In addition to those factors discussed elsewhere in this Form 10-Q, see the Risk Factors discussion in Item 1A of our 2008 Form 10-K and Part II, Item 1A of this Form 10-Q. The forward-looking statements included in this Form 10-Q are made only as of the date of this report, and we undertake no obligation to update the forward-looking statements to reflect subsequent events or circumstances.

BUSINESS OVERVIEW

We develop and market telecommunication technology for Internet protocol, or IP, telephony and video applications. We offer the Packet8 broadband voice over Internet protocol, or VoIP, and video communications service, Packet8 Virtual Office service, Packet8 Trunking service, Packet8 Hosted Key System service, Packet8 MobileTalk and videophone equipment and services (collectively, Packet8). We shipped our first VoIP product in 1998, launched our Packet8 service in November 2002, launched the Packet8 Virtual Office business service offering in March 2004, and launched the Packet8 Virtual Trunking service offering in June 2008. Substantially all of our revenues are generated from the sale, license and provisioning of VoIP products, services and technologies.

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 2009 refers to the fiscal year ending March 31, 2009).

CRITICAL ACCOUNTING POLICIES & ESTIMATES

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of assets and liabilities. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended March 31, 2008.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, but does not require any new fair value measurements. The adoption of SFAS No. 157 did not have a material effect on our condensed consolidated results of operations and financial condition

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159") which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The adoption of SFAS No. 159 did not have a material effect on our condensed consolidated results of operations and financial condition

In December 2007, the FASB issued SFAS No. 141(Revised 2007), "Business Combinations" ("SFAS No. 141(R)"). SFAS No. 141(R) significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, acquired contingencies, transaction costs, in-process research and development and restructuring costs. In addition, under SFAS No. 141(R), changes in an acquired entity's deferred tax assets and uncertain tax positions after the measurement period will impact income tax expense. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. We will adopt this pronouncement in the first quarter of fiscal 2010 and do not expect the adoption of SFAS No. 141(R) will have a material impact on our consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements an Amendment of ARB no. 51" ("SFAS No. 160"), which establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary, changes in a parent's ownership interest in a subsidiary and the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. We will adopt this pronouncement in the first quarter of fiscal 2010 and do not expect the adoption of SFAS No. 160 will have a material impact on our consolidated results of operations and financial condition.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("SFAS No. 162"). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS No. 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." We do not expect the adoption of SFAS No. 162 to have a material impact on our consolidated results of operations and financial condition.

KEY BUSINESS METRICS

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 key business metrics include the following:

Churn:

Average monthly subscriber line churn for a particular period is calculated by dividing the number of lines that terminated during that period by the simple average number of lines during the period and dividing the result by the number of months in the period. The simple average number of lines during the period is the number of lines on the first day of the period, plus the number of lines on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first 30 days after purchasing our service. Management reviews this metric to evaluate whether we are retaining our existing customers in accordance with our business plans. Churn approximated 3.5% for the first fiscal quarter of 2009 and 4.6% for the same period of fiscal 2008. Churn decreased due to a greater percentage of business customers than residential customers in the first fiscal quarter of 2009 compared with the same period in fiscal 2008. Business customers typically have a lower churn rate than residential customers. If we are unable to compete effectively against our existing competitors as well as against potential new entrants into the VoIP telephone service business, in both retaining our existing customers and attracting new customers, or if an increasing percentage of our customers decide to drop our VoIP services for other reasons such as cost, lack of use, or our inability to meet their requirements for phone service, our churn will likely increase and our business will be adversely affected.

Subscriber acquisition cost:

Subscriber acquisition cost is defined as the combined costs of advertising, marketing, promotions, commissions and equipment subsidies. Management reviews this metric to evaluate how effective our marketing programs are in acquiring new customers on an economical basis in the context of estimated subscriber lifetime value. Subscriber acquisition costs increased to $162 per service for the first fiscal quarter of 2009 from $138 per service for the comparable period in fiscal 2008 due to our marketing focus on small businesses rather than residential customers. Historically, the subscriber cost of acquisition for a business customer is greater than the cost to acquire a residential subscriber.

RESULTS OF OPERATIONS

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

	June 30,		Dollar	Percent

Service revenues		2008		2007		Change	Change
			(dollar amounts in thousands)				
Three months ended	$	15,019	$	13,411	$	1,608	