8X8 INC /DE/
Form 10-Q/A
June 29, 2007

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

FORM 10-Q/A

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

For the quarterly period ended June 30, 2006

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 August 1, 2006 was 61,284,431.

Explanatory Note

Overview.

This amendment to the Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 is being filed to reflect the restatement of our condensed consolidated financial statements to correct an error related to our accounting for common stock warrants and other errors previously identified and determined not to be material as discussed in Note 3 to our quarterly financial statements included in Part I Item 1 of this Form 10-Q/A. This amendment includes changes to Items 1, 2 and 4 of Part I, and Item 6 of Part II of the Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 of 8x8, Inc. ("8x8"), which was originally filed on August 9, 2006.

No attempt has been made in this Form 10-Q/A to reflect events occurring after the filing of the previously filed Form 10-Q. Among other things, forward-looking statements and risk disclosures made in the previously filed Form 10-Q have not been revised to reflect events that occurred or facts that became known to us after the filing of the previously filed Form 10-Q (other than the restatement), and such forward-looking statements and risk disclosures should be read in their historical context.

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Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

8X8, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, unaudited)

	June 30, 2006 (Restated)	March 31, 2006 (Restated)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,090	$ 6,259
Short-term investments	9,730	14,705
Accounts receivable, net	792	776
Inventory	2,685	1,738
Deferred cost of goods sold	740	1,542
Other current assets	737	774
Total current assets	20,774	25,794
Long-term investments	1,986	1,993
Property and equipment, net	3,230	3,071
Other assets	260	262
Total assets	$ 26,250	$ 31,120
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,933	$ 4,907
Accrued compensation	922	937
Accrued warranty	329	301
Deferred revenue	2,139	2,493
Other accrued liabilities	2,714	2,319
Total current liabilities	11,037	10,957
Other liabilities	195	70
Fair value of warrant liability	3,225	7,123
Total liabilities	14,457	18,150
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock	61	61
Additional paid-in capital	203,887	203,263
Accumulated other comprehensive loss	(32)	(35)
Accumulated deficit	(192,123)	(190,319)
Total stockholders' equity	11,793	12,970
Total liabilities and stockholders' equity	$ 26,250	$ 31,120

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, 2006 (Restated)	Three Months Ended June 30, 2005 (Restated)
Service revenues	$ 9,877	$ 4,996
Product revenues	2,394	1,009
Total revenues	12,271	6,005
Operating expenses:		
Cost of service revenues	4,762	2,069
Cost of product revenues	2,928	2,105
Research and development	1,321	1,324
Selling, general and administrative	9,205	5,865
Total operating expenses	18,216	11,363
Loss from operations	(5,945)	(5,358)
Other income, net	243	222
Income on change in fair value of warrant liability	3,898	225
Net loss	$ (1,804)	$ (4,911)
Net loss per share:		
Basic and diluted	$ (0.03)	$ (0.09)
Weighted average number of shares:		
Basic and diluted	61,138	53,823

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, 2006 (Restated)	Three Months Ended June 30, 2005 (Restated)
Cash flows from operating activities:		
Net loss	$ (1,804)	$ (4,911)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	290	138
Stock compensation	624	25
Income on change in fair value of warrant liability	(3,898)	(225)
Other	87	18
Changes in assets and liabilities	351	(1,519)
Net cash used in operating activities	(4,350)	(6,474)
Cash flows from investing activities:		
Purchases of property and equipment	(624)	(441)
Purchase of short-term investments	--	(3,489)
Sale of short-term investments	--	350
Maturities of short-term investments	4,950	1,000
Sale of property and equipment	13	--
Net cash provided by (used in) investing activities	4,339	(2,580)
Cash flows from financing activities:		
Bank overdraft	(153)	--
Capital lease payments	(5)	(3)
Proceeds from common stock offerings, net	--	(16)
Net cash used in financing activities	(158)	(19)
Net decrease in cash and cash equivalents	(169)	(9,073)
Cash and cash equivalents at the beginning of the period	6,259	22,515
Cash and cash equivalents at the end of the period	$ 6,090	$ 13,442
Supplemental disclosure:		
Assets acquired under capital lease	$ 10	$ 100

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

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

The Company's fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in these notes to the consolidated financial statements refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2007 refers to the fiscal year ending March 31, 2007).

LIQUIDITY

The Company has sustained net losses and negative cash flows from operations since fiscal 1999 that have been funded primarily through the issuance of equity securities and borrowings. Management believes that current cash and cash equivalents will be sufficient to finance the Company's operations through at least the next twelve months.

However, the Company continually evaluates its cash needs and anticipates seeking 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, 2006. 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 Condensed Consolidated Balance Sheet dated as of March 31, 2006 was derived from audited consolidated financial statements, see "NOTE 3. RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS", and does not include all 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, 2006 and notes thereto included in the Company's fiscal 2006 Annual Report on Form 10-K. Certain prior period balances have been reclassified to conform to the current period presentation.

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

Investments

The Company's investments are comprised of U.S. obligations, U.S. government debt agencies, corporate debt, auction rate securities and bank issues. All short-term investments are classified as available-for-sale.

Packet8 Service Revenue

Historically, the Company had deferred revenue recognition of new subscriber revenue from its Packet8 service offerings for up to thirty days to ensure that the customer's thirty day trial period had expired

and the customer did not cancel the service. In June 2006, the Company established it had sufficient history to make reasonable estimates of cancellations and began recognizing new subscriber revenue in the month the new order was shipped, net of an allowance for expected cancellations. The allowance for returns is based on the Company's historical experience as it has been providing the Packet8 service for more than two years. As a result of the change, the Company recognized an additional $68,000 of new order service revenue, $280,000 of new order product revenue and $466,000 of new order cost of product during the first quarter of fiscal 2007.

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. Subsequent to the subscriber's initial purchase of the service, 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 thirty 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 distributor 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 three 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 No. 123 "Accounting for Stock-Based Compensation" (SFAS 123) and superseded Accounting Principles Board Opinion No. 25 ("APB25"), "Accounting for Stock Issued to Employees," and related interpretations. Under the provisions of SFAS No. 123(R), share-based compensation cost is measured at the grant date, based on the calculated 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 No. 123(R) and, accordingly, financial statement amounts for the prior periods presented in this Form 10-Q/A have not been restated to reflect the fair value method of expensing share-based compensation.

Prior to April 1, 2006, the Company accounted for stock-based awards in accordance with APB25, whereby the difference between the exercise price and the fair market value on the date of grant is recognized as compensation expense. Under the intrinsic value method of accounting, no compensation expense was generally recognized in the Company's Condensed Consolidated Statements of Operations since the exercise price of the Company's employee stock option grant generally equaled the fair market value of the underlying common stock on the date of grant. However, to the extent awards were granted either below fair market value or were modified which required a re-measurement of compensation costs, the Company recorded compensation expense.

Stock-based compensation expense recognized in the Company's Condensed Consolidated Statements of Operations for the first quarter of fiscal 2007 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 No. 123 criteria, whereas stock options granted subsequent to April 1, 2006 were measured based on SFAS No. 123(R) criteria. In conjunction with the adoption of SFAS No. 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 included in the first quarter of fiscal 2007 includes the impact of estimated forfeitures. SFAS No. 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. The cumulative effect of changing from using the impact of estimated forfeitures to actual forfeitures was not material. For the periods prior to fiscal 2007, the Company accounted for forfeitures as they occurred.

Stock Option Plans

The Company has several stock-based compensation plans (the "Plans") that are described in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2006. The Company, under the various equity plans, grants stock options for shares of common stock to employees and directors. As of June 30, 2006, 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 the Plans. Options which generally vest over four years are granted at fair market value on the date of the grant and generally expire ten years from that date.

Option activity since March 31, 2006 is summarized as follows:

	Shares Available for Grant	Shares Subject to Options Outstanding	Weighted Average Exercise Price Per Share
Balance at March 31, 2006..............	4,059,405	8,870,718	$ 2.31
Changes in options available for grant..	1,000,000	--	--
Granted................................	(1,825,200)	1,825,200	1.44
Exercised..............................	--	--	--
Return to plan.........................	535,134	(535,134)	2.00
Termination of plan....................	(3,769,339)	--	--
Balance at June 30, 2006...............	--	10,160,784	$ 2.17

The 1996 Plan also provides for an annual increase in the number of shares reserved for issuance under the 1996 Plan on the first day of the Company's fiscal year in an amount equal to 5% of the Company's common stock issued and outstanding at the end of the immediately preceding fiscal year, subject to a maximum annual increase of 1,000,000 shares. The annual increase on the first day of the Company's fiscal year 2007 was 1,000,000 shares.

During the period ended June 30, 2006, stock options to purchase 3,769,339 shares were cancelled, but did not become available for future stock option grants due to the expiration of these shares under the 1996 Stock Plan and the 1996 Director Option Plan.

The following table summarizes the stock options outstanding and exercisable at June 30, 2006:

Options Outstanding				Options Exercisable	
Weighted Average Exercise	Weighted Average Remaining	Aggregate		Weighted Average Exercise	Aggreg

	Shares	Price Per Share	Contractual Life (Years)	Intrinsic Value	Shares	Price Per Share	Intrin Valu
$0.01 - $1.48....	3,210,341	$ 1.24	8.15	$ 144,788	1,364,377	$ 1.04	$ 137,
$1.54 - $1.73....	2,093,314	$ 1.68	8.10	--	974,865	$ 1.70	
$1.78 - $1.87....	2,193,180	$ 1.84	6.55	--	1,466,094	$ 1.87	
$1.88 - $3.67....	2,067,973	$ 2.84	6.79	--	1,238,498	$ 3.02	
$4.00 - $18.00...	595,976	$ 7.83	4.64	--	528,891	$ 8.24	
	10,160,784			$ 144,788	5,572,725		$ 137,

As of June 30, 2006, there were $4.0 million of total unrecognized compensation costs related to stock options. These costs are expected to be recognized over a weighted average period of 1.56 years.

When the measurement date is certain, the fair value of each option grant is estimated on the date of grant using the Black-Scholes valuation model. 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 months ended June 30, 2005, we used historical volatility of our stock over a period equal to the expected life of the options to estimate their fair value. In light of Staff Accounting Bulletin (SAB) No. 107 ("SAB 107"), the Company estimated the fair value of options granted during the three months ended June 30, 2006 using the historical volatility of our stock. 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 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:

	Three Months Ended June 30,	
	2006	**2005 ***
Expected volatility......................................	92%	136%
Expected dividend yield..................................	--	--
Risk-free interest rate..................................	4.98%	3.87%
Weighted average expected option term....................	3.33 years	3.49 years
Weighted average fair value of options granted.............	$ 0.90	$ 1.25

* The weighted average assumptions for the three months ended June 30, 2005 were determined in accordance with SFAS No. 123.

The Company recorded $593,000 of compensation expense relative to stock options for the quarter ended June 30, 2006 in accordance with FAS 123(R).

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 $31,000 for the quarter ended June 30, 2006 in accordance with SFAS 123(R).

The adoption of SFAS No. 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,	
	2006	**2005**
Expected volatility	135%	141%
Expected dividend yield	--	--
Risk-free interest rate	3.95%	1.79%
Weighted average expected option term	0.72 years	0.5 years
Weighted average fair value of options granted	$ 1.14	$ 0.33

As of June 30, 2006, there was $21,000 of total unrecognized compensation costs related to employee stock purchases. These costs are expected to be recognized over a weighted average period of 0.2 years.

Impact of adoption of SFAS No. 123(R)

The components of the Company's actual and pro forma stock-based compensation expense and the impact to the net loss per share are summarized below (in thousands, except per share amounts):

	Three Months Ended June 30,	
	Actual 2006	**Pro Forma 2005(1)**
	(Restated)	(Restated)
Employee stock options	$ 593	$ 561
Employee stock purchase	31	17
	$ 624	$ 578
Impact to basic and diluted net loss per share	$ 0.01	$ 0.01

1. Stock-based compensation for the three months ended June 30, 2005 was calculated based on the pro forma application of SFAS No. 123, and was not included in the Condensed Consolidated Statements of Operations.

SFAS No. 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, 2006 as the Company believes that it is more likely than not that it will not realize the benefit from tax deductions related to equity compensation.

The following table summarizes the distribution of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS No. 123(R) for the three months ended June 30, 2006 which was recorded as follows (in thousands):

	Three Months Ended June 30, 2006
	(Restated)
Cost of service revenues	$ 42
Cost of product revenues	6
Research and development	136
Selling, general and administrative	440
Total stock-based compensation expense related to employee stock options and employee stock purchases, pre-tax	624
Tax benefit	--
Stock based compensation expense related to employee stock options and employee stock purchases, net of tax	$ 624

Prior to April 1, 2006, the Company accounted for share-based compensation to employees in accordance with APB 25. The Company also followed the disclosure requirements of SFAS No. 123. The following table reflects the pro forma net loss and net loss per share for the three months ended June 30, 2005 (in thousands, except per share amounts):

	Three Months Ended June 30, 2005
	(Restated)
Net loss, as reported (1)	$ (4,911)
Deduct: Total employee stock-based compensation expense determined pursuant to SFAS No.123 (2)	(578)
Pro forma net loss (3)	$ (5,489)
Basic and diluted net loss per share:	
As reported	$ (0.09)
Pro forma (3)	$ (0.10)

1. Net loss and net loss per share for the period ended June 30, 2005 did not include stock-based compensation for employee stock options and employee stock purchases under SFAS No. 123 because the Company did not adopt the recognition provisions of SFAS No. 123.

2. Stock-based compensation for the period ended June 30, 2005 is calculated based on the pro forma application of SFAS No. 123.
3. Net loss and net loss per share for the period ended June 30, 2005 represents the pro forma information based on SFAS No. 123.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 154, "Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board Opinion No. 20 and FASB Statement No. 3" ("SFAS No. 154"). SFAS No. 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so or another methodology is required by the standard. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS No. 154's retrospective application requirement replaces APB No. 20's ("Accounting Changes") requirement to recognize most voluntary changes in accounting principle by including in net income (loss) of the period of the change the cumulative effect of changing to the new accounting principle. This statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. The requirements are effective for accounting changes made in fiscal years beginning after December 15, 2005 and will only impact the consolidated financial statements in periods in which a change in accounting principle is made. The Company adopted this standard in the quarter ended June 30, 2006 and the adoption will only impact the Consolidated Financial Statements in period in which a change in accounting principle is made.

In March 2006, the Emerging Issues Task Force reached a consensus on Issue No. 06-03 "How Taxes Collected from Customers and Remitted to Government Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)" ("EITF No. 06-03"). The Company is required to adopt the provisions of EITF No. 06-03 in the first quarter of fiscal 2008. The Company currently reports revenue net of taxes collected and remitted to governmental authorities. The Company does not expect the adoption of the provisions of EITF No. 06-03 in the first quarter of fiscal 2008 to have a material impact on its results of operations and financial condition.

In July 2006, FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: an Interpretation of FASB Statement No. 109" (FIN 48), which clarifies the accounting 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 expects to adopt FIN 48 in the first quarter of fiscal 2008, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its condensed consolidated financial statements.

3. RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

The Company has restated its condensed consolidated financial statements to correct certain, principally related to the application of 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") with respect to the accounting for warrants issued to three investors in three different equity financings that were consummated in fiscal 2005 and 2006 ("Equity Financings"). In fiscal years 2005 and 2006, the Company's financial statements accounted for these warrants as equity. The warrants include a provision that specifies that the Company is to deliver freely tradable shares upon exercise by the warrant holder. Because there are circumstances 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 in income. The Company's restated financial statements reflect a liability in the condensed consolidated balance sheets for the warrants and reflect income or loss in the condensed consolidated statement of operations for the change in their fair value from period-to-period. In connection with the restatement, the Company also has corrected certain errors that were previously identified and determined not to be material with respect to the condensed consolidated financial statements for the affected periods and that relate to (1) the reclassification of $2.0 million from long-term investments to short-term investments for the period ended March 31, 2006, (2) the reduction of $39,000 of stock compensation expense for the three months ended June 30, 2006, due to excess expense incorrectly recorded related to the termination of an employee, and (3) a $153,000 reduction in net cash used in operations due to a bank overdraft at the end of the period ended March 31, 2006. In addition, as part of the Company's review of the outstanding warrants, the Company determined that an immaterial number of warrants were not included in our outstanding warrants in the table presented under "NET LOSS PER SHARE", below.

Summary of Restatement Adjustments

The following summarizes the effects of the restatement on the condensed consolidated balance sheets as of June 30, 2006 and March 31, 2006, condensed consolidated statements of operations and cash flows for the three month periods ended June 30, 2006 and 2005 (in thousands, except shares or per share amounts):

	As of June 30,	
	As Previously Reported	Restatemen Adjustment
Condensed Consolidated Balance Sheet		
Fair value of warrant liability..	$ --	$ 3,22
Total liabilities	$ 11,232	$ 3,22
Additional paid-in capital	$ 215,735	$ (11,84
Accumulated deficit	$ (200,746)	$ 8,62
Total stockholders' equity	$ 15,018	$ (3,22

1. To reflect warrant liability due to changing the classification of certain warrants from equity to liability.
2. To reflect a reduction of additional paid-in capital for the fair value of warrants at issuance due to changing the classification of certain warrants from equity to liability.
3. To reflect change in fair value of the warrants classified as a liability and reduction of stock compensation expense.

	As of March 31	
	As Previously Reported	Restatemen Adjustment
Condensed Consolidated Balance Sheet		
Short-term investments	$ 12,726	$ 1,97
Total current assets	$ 23,815	$ 1,97
Long-term investments	$ 3,972	$ (1,97
Fair value of warrant liability..	$ --	$ 7,12
Additional paid-in capital	$ 215,072	$ (11,80
Accumulated deficit	$ (195,005)	$ 4,68
Total stockholders' equity	$ 20,093	$ (7,12

1. To reflect a reclassification of $1,979,000 from long-term to short-term investments.
2. To reflect warrant liability due to changing the classification of certain warrants from equity to liability.
3. To reflect a reduction of additional paid-in capital for the fair value of warrants at issuance due to changing the classification of certain warrants from equity to liability.
4. To reflect change in fair value of the warrants classified as a liability.

For the Three Months En

		As Previously Reported		Restatemen Adjustment
Condensed Consolidated Statement of Operations				
Research and development	$	1,360	$	(3
Total operating expenses	$	18,255	$	(3
Loss from operations	$	(5,984)	$	3
Income on change in fair value of warrant liability	$	--	$	3,89
Net loss	$	(5,741)	$	3,93
Net loss per share:				
Basic and diluted..	$	(0.09)	$	0.0

1. To reflect a $39,000 reduction in stock compensation expense in the first fiscal quarter of 2007.
2. To reflect change in fair value of the warrants classified as a liability.

		For the Three Months En		
		As Previously Reported		Restatemen Adjustment
Condensed Consolidated Statement of Operations				
Fair value of warrant liability.....................................		--		22
Net loss	$	(5,136)	$	22
Net loss per share:				
Basic and diluted..	$	(0.10)	$	0.0

1. To reflect change in fair value of the warrants classified as a liability.

		For the Three Months En		
		As Previously Reported		Restatemen Adjustment
Condensed Consolidated Statement of Cash Flows				
Net loss	$	(5,741)	$	3,93
Stock compensation		663		(3
Income on change in fair value of warrant liability		--		3,89
Changes in assets and liabilities....................................		198		15
Net cash used in operating activities		(4,503)		15
Bank overdraft		--		(15
Net cash used in financing activities		(5)		(15

1. To reflect a $39,000 reduction in stock compensation expense and $3,898,000 in income due to the change in the fair value of the warrants classified as a liability.
2. To reflect a $39,000 reduction in stock compensation expense.
3. To reflect change in fair value of the warrants classified as a liability.
4. To reflect a $153,000 increase due to the repayment of the bank overdraft.
5. To reflect the repayment of the bank overdraft in the correct period.

		For the Three Months En		
		As Previously Reported		Restatemen Adjustment
Condensed Consolidated Statement of Cash Flows				
Cash flows from operating activities:				

Net loss	$ (5,136)	$ 22
Income on change in fair value of warrant liability	--	(22

1. To reflect change in fair value of the warrants classified as a liability.

4. BALANCE SHEET DETAIL

	June 30, 2006	March 31, 2006
Inventory (in thousands):		
Work-in-process	$ 1,667	$ 1,192
Finished goods	1,018	546
	$ 2,685	$ 1,738

5. NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss available to common stockholders (numerator) by the weighted average number of vested, unrestricted common shares outstanding during the period (denominator). Due to net losses incurred for the three months ended June 30, 2006 and 2005, basic and diluted shares outstanding for each of the respective periods are the same. The following options and warrants were not included in the computations of net loss per share because the effect on the calculations would be anti-dilutive (in thousands):

	Three Months Ended June 30,	
	2006	2005
	(Restated)	(Restated)
Common stock options	10,161	7,912
Warrants	8,663	6,537
	18,824	14,449

6. COMPREHENSIVE LOSS

Comprehensive loss, as defined, includes all changes in equity (net assets) during a period from non-owner sources. The difference between the Company's net loss and comprehensive loss is due primarily to unrealized gains and losses on investments classified as available-for-sale. Comprehensive loss for the three months ended June 30, 2006 and 2005, was as follows (in thousands):

	Three Months Ended June 30,	
	2006	2005
	(Restated)	(Restated)
Net loss, as reported.............................	$ (1,804)	$ (4,911)
Unrealized gain (loss) on investments in securities..	3	3
Less: reclassification adjustment for gain		

(loss) included in net loss	--	(6)
Comprehensive loss	$ (1,801)	$ (4,914)

7. SEGMENT REPORTING

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

	Three Months Ended June 30,	
	2006	**2005**
Packet8 and videophones/equipment	$ 12,208	$ 5,666
Semiconductors and related software	52	335
Hosted iPBX solutions	11	4
Total revenues	$ 12,271	$ 6,005

No customer represented greater than 10% of the Company's total revenues for the three months ended June 30, 2006 or 2005. The Company's revenue distribution by geographic region (based upon the destination of shipments) was as follows:

	Three Months Ended June 30,	
	2006	**2005**
Americas	99%	96%
Europe	1%	4%
	100%	100%

8. COMMITMENTS AND CONTINGENCIES

Guarantees

Indemnifications

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

The Company has agreed to hold the other party harmless against losses arising from: i) a breach of representations or covenants or ii) out of 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.

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, 2006 were as follows (in thousands):

	Three Months Ended June 30, 2006
Balance at beginning of period	$ 301
Accruals for warranties	117
Settlements	(89)
Changes in estimates	--
Balance at end of period	$ 329

Standby letters of credit.

The Company has a standby letter of credit totaling $250,000, which was issued to guarantee certain contractual obligations and is collateralized by cash deposits at the Company's primary bank. This letter of credit is recorded in the other assets line items in the condensed consolidated balance sheets.

Leases

At June 30, 2006, future minimum annual lease payments under noncancelable operating leases were as follows (in thousands):

Year ending March 31:	
Remaining 2007	$ 361
2008	490
2009	493
2010	206
Total minimum payments	$ 1,550

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

Year ending March 31:		
Remaining 2007	$	21
2008		28
2009		28
2010		28
2011		2
Total minimum payments		107
Less: Amount representing interest		(12)
		95
Less: Short-term portion of capital lease obligations		(23)
Long-term portion of capital lease obligations	$	72

Capital leases included in office equipment were $118,000 at June 30, 2006. Total accumulated depreciation was $25,000 at June 30, 2006. Amortization expense for assets recorded under capital leases is included in depreciation expense.

Minimum Third Party Network Service Provider Commitments

In July 2006, the Company entered into a minimum monthly commitment effective June 1, 2006 for twenty four months with one of its third party network service provider vendors. The monthly minimum payment under the contract is $400,000 for twenty four months.

Legal Proceedings

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

State and Municipal Taxes

Currently, the Company does not collect or remit state or municipal taxes (such as sales and use, excise and ad valorem taxes), fees or surcharges ("Taxes") on the charges to the Company's customers for its services, except that the Company collects and remits California sales tax. The Company has received inquiries or demands from a few states and municipal taxing and 911 agencies, and is currently under audit by one state, seeking payment of Taxes that are applied to or collected from the customers of providers of traditional public switched telephone network services. 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. In addition, a few states address how VoIP providers should contribute to support public safety agencies, and in those states the Company will begin to remit fees to appropriate state agencies in fiscal 2007. The Company had recorded an expense of $189,000 and $109,000 for three months ended June 30, 2006 and 2005, respectively as its best estimate of the probable tax exposure for such assessments. The Company believes the cuulative exposure for assessments is $919,000 as of June 30, 2006, which is recorded in the other accrued liabilities line item in the consolidated balance sheets.

Regulatory

To date VoIP communication services have been largely unregulated in the United States. Many regulatory actions are underway or are being contemplated by federal and state authorities, including the Federal Communications Commission, or FCC, and state regulatory agencies. To date, the FCC has treated VoIP service providers as information service providers, though the FCC has avoided specifically ruling on this categorization. Information service providers are currently exempt from federal and state regulations governing common carriers, including the obligation to pay access charges and contribute to the universal service fund. The FCC is currently examining the status of VoIP service providers and the services they provide. The FCC initiated a notice of proposed rule-making (NPRM) in early 2004 to gather public comment on the appropriate regulatory environment for IP telephony. In November 2004, the FCC ruled that the VoIP service of a competitor and "similar" services are jurisdictionally interstate and not subject to state certification, tariffing and other legacy telecommunication carrier regulations. The FCC ruling has been appealed by several states and the outcome of these appeals cannot be determined at this time. If the FCC or an appeals court were to determine that VoIP service providers, or the services they provide, are subject to FCC regulation, including the payment of access charges and contribution to the universal service funds, it could have a material adverse effect on the Company's business and operating results.

On June 21, 2006, the FCC expanded the base of Universal Service Fund (USF) contributions to interconnected VoIP providers. The FCC established a safe harbor percentage of interstate revenue of 64.9% of total VoIP service revenue. The Company may calculate its contribution based on the safe harbor or by submitting a traffic study that is subsequently approved by the FCC. The Company submitted a traffic study to the FCC on July 18, 2006. The FCC has not responded to the Company. The Company is required to begin contributions on October 1, 2006. For a period of at least two quarters beginning October 1, 2006, the Company will be required to contribute to the USF for its subscribers' retail revenues as well as through its underlying carriers' wholesale charges. The Company currently plans to charge its subscribers a USF fee equal to the USF contribution amounts it must contribute beginning October 1, 2006 based upon its subscribers' retail revenues. The impact of this price increase on our customers or the Company's inability to recoup its costs or liabilities in remitting USF contributions or other factors could have a material adverse effect on the Company's financial position, results of operations and cash flows.

On May 19, 2005, the FCC unanimously adopted an Order and Notice of Proposed Rulemaking ("NPRM") that requires VoIP providers that interconnect with the public switched telephone network ("PSTN"), or interconnected VoIP providers, to provide emergency 911 ("E911") service. On June 3, 2005, the FCC released the text of the First Report and Order and Notice of Proposed Rulemaking in the VoIP E911 proceeding (the "VoIP E911 Order"). As a result of the VoIP E911 Order, interconnected VoIP providers are required to offer the E911 emergency calling capabilities present on traditional switched and cellular phone lines. All interconnected VoIP providers must deliver 911 calls to the appropriate local public safety answering point, or PSAP, through the PSTN's legacy wireline selective router, which is used to deliver E911 calls, along with call back number and location, where the PSAP is able to receive that information. E911 must be included in the basic service offering; it cannot be an optional or extra feature. The PSAP delivery obligation, along with call back number and location information must be provided regardless of whether the VoIP service is "fixed" or "nomadic." User registration of location is permissible initially, although the FCC is committed to an advanced form of E911 that will determine user location without user intervention, one of the topics of the further NPRM. The VoIP E911 Order mandates that existing and prospective customers must be notified, prominently and in plain language, of the capabilities and limitations of VoIP service with respect to emergency calling, and interconnected VoIP providers must obtain and maintain affirmative acknowledgement from each customer that the customer has read and understood the notice of limitations and distribute warning labels or stickers alerting consumers and other potential users of the limitations of VoIP E911 service to each new subscriber prior to the initiation of service. In addition, an interconnected VoIP provider must make it possible for customers to update their address (i.e., change their registered location) via at least one option that requires no equipment other than that needed to access the VoIP service. On July 26, 2005 the FCC issued guidance to all interconnected VoIP providers regarding the July 29, 2005 notification deadline. In this guidance, the FCC determined that it would not initiate enforcement action until August 30, 2005, against any provider of interconnected

VoIP service regarding the requirement that it obtain affirmative acknowledgement by every existing subscriber on the condition that the provider file a detailed report with the Commission by August 10, 2005, containing a variety of detailed descriptions. The FCC's notice further stated that it expected interconnected VoIP providers who had not received subscriber acknowledgements from one hundred percent of existing subscribers by August 29, 2005 to disconnect, no later than August 30, 2005, all subscribers from whom it had not received such acknowledgement. To date, the Company has filed the status reports requested by the FCC, and suspended service of an insignificant number of subscribers on August 30, 2005. The Company also filed a VoIP E911 compliance report, as required by the FCC, on November 28, 2005. As was detailed in the compliance report, the Company currently cannot offer E911 services that route directly to a local PSAP to all of its customers, as the direct interconnection to local PSAPs is not available in certain rate centers from which telephone numbers are provisioned for the Packet8 service. The Company is addressing this issue with its telecommunication interconnection partners. On November 28, 2005, the Company began routing certain nomadic 911 calls and 911 calls that cannot be directly connected to a local PSAP, along with location information, to a national emergency call center. The emergency dispatchers in this national call center utilize the location information provided to route the call to the correct PSAP or first responder, The FCC may determine that the Company's nomadic E911 solution does not satisfy the requirements of the VoIP E911 order because, in some instances, the Company will not be able to connect Packet8 subscribers directly to a PSAP. In this case, the FCC could require the Company to disconnect a significant number of subscribers. The effect of such disconnections or any enforcement action initiated by the FCC or other state agency or task force against the Company could have a material adverse effect on the Company's financial position, results of operations and cash flows. On January 1, 2006, the Company began charging its customers a monthly fee of $1.99 for E911 services on all Packet8 phone numbers capable of placing outbound calls in order to recoup some of the expenses associated with providing nationwide, nomadic E911 service. The impact of this price increase on our customers or the Company's inability to recoup its costs or liabilities in providing E911 services or other factors could have a material adverse effect on the Company's financial position, results of operations and cash flows.

On August 5, 2005, the FCC unanimously adopted an order responsive to a joint petition filed by the Department of Justice, the Federal Bureau of Investigation, and the Drug Enforcement Administration asking the FCC to declare that broadband Internet access services and VoIP services be covered by the Communications Assistance for Law Enforcement Act, or CALEA. The Order concludes that CALEA applies to facilities-based broadband Internet access providers and providers of interconnected VoIP service and requires these providers to be in full compliance within eighteen months of September 23, 2005. The FCC also stated that, in the coming months, it will release another order that will address separate questions regarding the assistance capabilities required of the providers covered by the August 5, 2005 order. On May 3, 2006, the FCC adopted a second order, which clarifies that the FCC will not establish standards for VoIP providers to comply with CALEA. Instead, the FCC directs law enforcement agencies, experts and the industry to develop the standards. The FCC's order clarifies that VoIP providers may use third party vendors to comply with the requirements of CALEA. On July 6, 2006, the FCC established August 4, 2006 as the effective date for its order requiring interconnected VoIP providers to comply with CALEA. The FCC stated, however, that the effective date of those rules that established reporting requirements will be delayed until the FCC receives approval from the Office of Management and Budget to collect such paperwork. Our failure to achieve compliance with any future CALEA orders, rules, filings or standards, or any enforcement action initiated by the FCC or other agency, state or task force against us could have a material adverse effect on our financial position, results of operations or cash flows.

Several state regulatory authorities have contacted the Company regarding its Packet8 service. These inquiries have ranged from notification that the Packet8 service should be subject to local regulation, certification and fees to broad inquiries into the nature of the Packet8 services provided. The Company responds to the various state authorities as inquiries are received. Based on advice of counsel, the Company disputes the assertion, among others, that the Packet8 service should be subject to state regulation. While the Company does not believe that exposure to material amounts of fees or penalties exists, if 8x8 is subject to an enforcement action, the Company may become subject to liabilities and may incur expenses that adversely affect its financial position, results of operations and cash flows.

On March 7, 2006, the Attorney General of Missouri sent us an investigative demand for information related to our provisioning and marketing of E911 services since January 1, 2005. We submitted our response on March 31, 2006 and, to date, have received no response from the Attorney General.

In May 2005, we received a notice from the City of Chicago that we were being investigated for non-compliance with Chicago tax laws, as we are not collecting and remitting Chicago's Telecommunications Tax. In addition, the notice requested that we complete a questionnaire. We completed the questionnaire received and disputed the applicability of this tax to Packet8 services.

On April 7, 2005, the California Public Utilities Commission (CPUC) instituted a rulemaking to assess and revise the regulation of all telecommunications utilities in California except for small incumbent local exchange carriers (ILECs). The primary goal of this proceeding is to develop a uniform regulatory framework for all telecommunications utilities, except small ILECs, to the extent that it is feasible and in the public interest to do so. While not specifically directed at VoIP, it is unclear at this time what impact this new rulemaking will have on the CPUCs classification or treatment of VoIP services. In late 2004 and early 2005, the Company received notices from multiple municipalities in California that the Packet8 service is subject to utility user taxes, as defined in the respective municipal codes. The notices require that the Company begin collecting and remitting utility user taxes no later than January 1, 2005. The Company has responded to and disputed the municipalities' assertions.

In January 2005, we received a letter from the Municipal Association of South Carolina, or MASC, an association representing multiple municipalities in South Carolina. The MASC asserts that we are subject to a business license tax applied to telecommunications companies doing business within the participating municipalities' corporate limits. We have responded to the MASC regarding their assertion.

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

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

We have restated our condensed consolidated financial statements to correct certain errors, principally related to our application of 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") with respect to the accounting of warrants issued to three investors in three different equity financings that were consummated in fiscal 2005 and 2006 ("Equity Financings"). In fiscal years 2005 and 2006, our financial statements accounted for these warrants as equity. The warrants include a provision that specifies that the Company must deliver freely tradable shares upon exercise by the warrant holder. Because there are circumstances 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 in income. Our restated financial statements reflect a liability on the condensed consolidated balance sheets for the warrants and reflect income or loss in the condensed consolidated statement of operations for the change in their fair value from period-to-period. In connection with the restatement, we also have corrected certain errors that we had previously identified and determined not to be material with respect to our condensed consolidated financial statements for the affected periods and that relate to (1) our reclassification of $2.0 million from long-term investments to short-term investments for the period ended March 31, 2006, (2) the reduction of $39,000 of stock compensation expense for the three months ended June 30, 2006, due to excess expense incorrectly recorded related to the termination of an employee and (3) a $153,000 reduction in net cash used in operations due to a bank overdraft at the end of the period ended March 31, 2006.

FORWARD-LOOKING STATEMENTS

This Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends," and similar expressions are intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including our good faith assumptions being incorrect, our business expenses being greater than anticipated due to competitive factors or unanticipated development or sales costs; revenues not resulting in the manner anticipated or our failure to generate customer or investor interest. The forward-looking statements may also be impacted by the additional risks faced by us as described in this Report, including those set forth under the section entitled "Factors that May Affect Future Results." All forward-looking statements included in this Report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements.

BUSINESS OVERVIEW

We develop and market telecommunication technology for Internet protocol, or IP, telephony and video applications. We offer the Packet8 broadband voice over Internet protocol, or VoIP, and video communications service, Packet8 Virtual Office service and videophone equipment and services (collectively, Packet8). We shipped our first VoIP product in 1998, launched our Packet8 service in November 2002, and launched the Packet8 Virtual Office business service offering in March 2004. As of June 30, 2006, we had approximately 151,000 Packet8 subscriber lines in service as compared to 133,000 lines at March 31, 2006. 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 2006 refers to the fiscal year ending March 31, 2006).

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, 2006.

WARRANT LIABILITY

We account for our 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 our warrants require settlement in shares and are accounted for as permanent equity. We also have three investor warrants that are classified as liabilities because they include a provision that specifies that we must deliver freely tradable shares upon exercise by the warrant holder. Because there are circumstances, irrespective of likelihood, that may not be within our control 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.

RECENT ACCOUNTING PRONOUNCEMENTS

Stock-Based Compensation Expense

On April 1, 2006, we adopted SFAS No. 123(R), which establishes standards for the accounting for equity instruments exchanged for employee services, on a modified prospective basis. The following table summarizes the distribution of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS No. 123(R) for the three months ended June 30, 2006 which was recorded as follows (in thousands):

	Three Months Ended June 30, 2006 (Restated)
Cost of service revenues	$ 42
Cost of product revenues	6
Research and development	136
Selling, general and administrative	440
Total stock-based compensation expense related to employee stock options and employee stock purchases, pre-tax	624
Tax benefit	--
Stock based compensation expense related to employee stock options and employee stock purchases, net of tax	$ 624

Stock options granted in periods prior to fiscal 2007 were measured based on SFAS No. 123 criteria, whereas stock options granted subsequent to April 1, 2006 were measured based on SFAS No. 123(R) criteria. In conjunction with the adoption of SFAS No. 123(R), we changed our 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 included in the first quarter of fiscal 2007 includes the impact of estimated forfeitures. SFAS No. 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. For the periods prior to fiscal 2007, we accounted for forfeitures as they occurred.

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:

	Three Months Ended June 30,	
	2006	2005 *

Expected volatility..	92%	136%
Expected dividend yield....................................	--	--
Risk-free interest rate....................................	4.98%	3.87%
Weighted average expected option term......................	3.33 years	3.49 years
Weighted average fair value of options granted.............	$ 0.90	$ 1.25

* The weighted average assumptions for the three months ended June 30, 2005 were determined in accordance with SFAS No. 123.

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 154, "Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so or another methodology is required by the standard. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS No. 154's retrospective application requirement replaces APB No. 20's ("Accounting Changes") requirement to recognize most voluntary changes in accounting principle by including in net income (loss) of the period of the change the cumulative effect of changing to the new accounting principle. This Statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. The requirements are effective for accounting changes made in fiscal years beginning after December 15, 2005 and will only impact the consolidated financial statements in periods in which a change in accounting principle is made. We adopted SFAS No. 154 in the first quarter of fiscal 2007.

In March 2006, the Emerging Issues Task Force reached a consensus on Issue No. 06-03 "How Taxes Collected from Customers and Remitted to Government Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)" ("EITF No. 06-03"). We are required to adopt the provisions of EITF No. 06-03 in the first quarter of fiscal 2008. We currently report revenue net of taxes collected and remitted to governmental authorities. We do not expect the adoption of the provisions of EITF No. 06-03 in the first quarter of fiscal 2008 to have a material impact on our results of operations and financial condition.

In July 2006, FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: an Interpretation of FASB Statement No. 109" (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This Interpretation requires that we recognize in our 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. We expect to adopt FIN 48 in the first quarter of fiscal 2008, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to our opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our condensed consolidated financial statements.

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 thirty days after purchasing our service. Management reviews this metric to evaluate whether we are retaining our existing subscribers in accordance with our business plans.

Subscriber acquisition cost: Subscriber acquisition cost is defined as costs for advertising, marketing, promotions, commissions and equipment subsidies. Management reviews this metric to evaluate how effective our marketing programs are in acquiring new subscribers on an economical basis in the context of estimated subscriber lifetime value.

Average monthly revenue per line: Average monthly revenue per line for a particular period is calculated by dividing our total revenue for that period by the simple average number of subscriber lines for the period and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two.

Management believes it is useful to monitor these metrics together and not individually as it does not make business decisions based upon any single metric.

RESULTS OF OPERATIONS

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

Service revenues	June 30, 2006	June 30, 2005	Dollar Change	Percent Change
	(dollar amounts in thousands)			
Three months ended........................	$ 9,877	$ 4,996	$ 4,881	97.7%
Percentage of total revenues..............	80.5%	83.2%		

Revenues

Service revenues

consist primarily of revenues attributable to the provision of our Packet8 service and VoIP technology licenses and any royalties earned under such licenses. We expect that Packet8 service revenues will continue to comprise nearly all of our service revenues on a going forward basis. The increase for the first quarter of fiscal 2007 was primarily due to a $4.9 million increase in revenues attributable to our Packet8 service due to the growth in the subscriber base. In addition, we began charging a monthly regulatory recovery fee of $1.50 per line effective May 2005 and a monthly emergency 911 service cost recovery fee of $1.99 per line effective in January 2006. As of June 30, 2006, we had 151,000 Packet8 subscriber lines in service as compared to 73,000 lines at June 30, 2005.

Our average revenue per line, or ARPU, decreased to $28.76 for the first fiscal quarter of 2007 compared to $29.70 for the same period of fiscal 2006. The decrease was primarily attributed to a reduction in sales of videophones in the first fiscal quarter of 2007 compared to the same period of fiscal 2006.

Churn approximated 4.1% for the first fiscal quarter of 2007 and 2.6% for the same period of fiscal 2006. The increase in churn was due to a one-time change in our collection policies and procedures in the first fiscal quarter of 2007. We have reduced the number of months a subscriber may remain on our service without paying for the service. 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 subscribers and attracting new subscribers, our churn will likely increase and our business will be adversely affected.

Prior to the first fiscal quarter of 2007, we had deferred revenue recognition of new Packet8 subscriber revenue for up to thirty days to ensure that the thirty day trial period had expired and customer had not cancelled the service. In the first fiscal quarter of 2007, we determined that we had sufficient operating history to calculate an expected rate of return and accordingly have recorded an allowance for returns from new order revenue recognized. As a result of the change in our revenue recognition policy, we recognized an additional $68,000 of new order service revenue and $280,000 of new order product revenue during the first quarter of fiscal 2007.

Product revenues	June 30, 2006	June 30, 2005	Dollar Change	Percent Change
	(dollar amounts in thousands)			
Three months ended........................	$ 2,394	$ 1,009	$ 1,385	137.3%
Percentage of total revenues...............	19.5%	16.8%		

Product revenues

consist of revenues from sales of VoIP terminal adapters, telephones and videophones, primarily attributable to our Packet8 service. The increase for the first quarter of fiscal 2007 was primarily attributable to a $1.6 million increase for product revenues attributable to the Packet8 service due to the growth in the subscriber base. This increase is partially offset by a $214,000 decrease in sales of VoIP semiconductors. We completed our last shipment of VoIP semiconductors during the first fiscal quarter of fiscal 2006, and do not expect to record any future revenues from sales of semiconductor products.

Prior to the first fiscal quarter of 2007, we had deferred revenue recognition of new Packet8 subscriber revenue for up to thirty days to ensure that the thirty day trial period had expired and customer had not cancelled the service. In the first fiscal quarter of 2007, we determined that we had sufficient operating history to calculate an expected rate of return and accordingly have recorded an allowance for returns from new order revenue recognized. As a result of the change in our revenue recognition policy, we recognized an additional $68,000 of new order service revenue and $280,000 of new order product revenue during the first quarter of fiscal 2007.

No customer represented greater than 10% of our total revenues for the three months ended June 30, 2006 and 2005. Our revenue distribution by geographic region (based upon the destination of shipments) was as follows:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Americas..	99%	96%
Europe...	1%	4%
	100%	100%

Cost of Service Revenues

Cost of service revenues	June 30, 2006	June 30, 2005	Dollar Change	Percent Change
	(dollar amounts in thousands)			
Three months ended........................	$ 4,762	$ 2,069	$ 2,693	130.2%

Percentage of license and service revenues.	48.2%	41.4%

The cost of service revenues consists of costs primarily associated with network operations and related personnel, telephony origination and termination services provided by third party carriers and technology license and royalty expenses. The increase in cost of service revenues for the three months ended June 30, 2006 as compared to the comparable period in the prior year was attributable to a $2.7 million increase in Packet8 network operations and third party carrier service charges due to the year over year growth in the Packet8 subscriber base, respectively.

Cost of Product Revenues

	June 30,			
Cost of product revenues	**2006**	**2005**	**Dollar Change**	**Percent Change**
	(dollar amounts in thousands)			
Three months ended........................	$ 2,928	$ 2,105	$ 823	39.1%
Percentage of product revenues............	122.3%	208.6%		

The cost of product revenues consists of costs associated with systems, components, system and semiconductor 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 increase in the cost of product revenues for the first quarter of fiscal 2007 as compared to the prior year quarter was primarily due to a $0.9 million increase attributable to equipment provided to Packet8 subscribers upon activation of their service and related manufacturing, personnel, handling, overhead and shipping costs. The increase in Packet8 cost of product revenues was partially offset by a $65,000 decrease in cost of revenues for semiconductor products due to the decrease in sales of such products during the first quarter of fiscal 2006 due to the end of life of these products initiated in fiscal 2004.

Prior to the first fiscal quarter of 2007, we deferred the cost of product revenues of new Packet8 subscriber for up to thirty days to ensure that the thirty day trial period had expired and the customer had not cancelled the service. In June 2006, we determined that we had sufficient history to calculate an expected rate of return and accordingly have recorded an allowance for sales returns from new order revenue. As a result of the change in the revenue recognition policy, we recognized an additional $466,000 of new order cost of product revenue during the first quarter of fiscal 2007.

We generally do not separately charge Packet8 subscribers for the terminal adapters used to provide our service when they subscribe on our website. We have also offered incentives to customers who purchase terminal adapters in our retail channels to offset the cost of the equipment purchased from a retailer, and generally these incentives are recorded as reductions of revenue. In accordance with FASB Emerging Issues Task Force Issue No. 00-21, a portion of Packet8 services revenues is allocated to product revenues, but these revenues are less than the cost of the terminal adapters at the time of purchase. Accordingly, cost of product revenues exceeds product revenues, and we expect this trend to continue.

Research and Development Expenses

	June 30,			
Research and development	**2006**	**2005**	**Dollar Change**	**Percent Change**
	(dollar amounts in thousands)			

Three months ended	$ 1,321	$ 1,324	$ (3)	-0.2%
Percentage of total revenues	10.8%	22.0%		

Research and development expenses consist primarily of personnel, system prototype, software and equipment costs necessary for us to conduct our engineering and development efforts. The increase in research and development expenses for the first quarter of fiscal 2007 as compared to the comparable period in the prior year was primarily attributable to a $136,000 increase in SFAS 123(R) stock option expense charges.

Selling, General and Administrative Expenses

Selling, general and administrative	June 30, 2006	2005	Dollar Change	Percent Change
	(dollar amounts in thousands)			
Three months ended	$ 9,205	$ 5,865	$ 3,340	56.9%
Percentage of total revenues	75.0%	97.7%		

Selling, general and administrative expenses consist primarily of personnel and related overhead costs for sales, marketing, customer support, finance, human resources and general management. Such costs also include sales commissions, trade show, advertising and other marketing and promotional expenses. The increase in selling, general and administrative expenses for the first quarter of fiscal 2007 as compared to the comparable period in the prior year was primarily attributable to a $533,000 increase in personnel costs due to additional employee and contractor headcount to support the growth of our Packet8 service, primarily for the increase in staffing customer service positions, a $893,000 increase in sales agent and retailer commissions due to the expansion of our distribution channels for our Packet8 service, a $778,000 increase in advertising, and a $263,000 increase in credit card processing fees. The increase was also impacted by a $440,000 increase in SFAS 123(R) stock option expense charges.

Subscriber acquisition costs increased to $135 per customer for the first fiscal quarter of 2007 from $132 per customer for the comparable period in fiscal 2006. Subscriber acquisition costs increased for the first fiscal quarter of 2007 compared to the first fiscal quarter of fiscal 2006 due to an increase in overall marketing spending and higher one-time bounty payments to sales agents.

Other Income, Net

Other income, net	June 30, 2006	2005	Dollar Change	Percent Change
	(dollar amounts in thousands)			
Three months ended	$ 243	$ 222	$ 21	9.5%
Percentage of total revenues	2.0%	3.7%		

The increase in other income for the first quarter of fiscal 2007 as compared to the prior year was primarily due to higher interest rates on our cash balances as these funds were invested in marketable securities. In the first fiscal quarter of 2007, other income, net was primarily comprised of interest and investment income earned on our cash, cash equivalents and investment balances.

Income on change in Fair Value of Warrant Liability

Income on change in fair value of warrant liability	June 30, 2006 (Restated)	June 30, 2005 (Restated)	Dollar Change	Percent Change
	(dollar amounts in thousands)			
Three months ended	$ 3,898	$ 225	$ 3,673	1632.4%
Percentage of total revenues	31.8%	3.7%		

In connection with the sale of shares of our common stock in fiscal 2005 and 2006, we issued warrants in three different equity financings. The warrants included a provision that we must deliver freely tradable shares upon exercise of the warrant. Because there are circumstances that may not be within our control that could prevent delivery of registered shares, EITF 00-19 requires the warrants be recorded as a liability at fair value with subsequent changes in fair value recorded as a gain or loss. The fair value of the 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. To the extent that the fair value of the warrant liability increases or decreases, we record a loss or income in our statement of operations. The increase in the income from change in fair value of warrants in the first fiscal quarter of 2007 compared to the same in period fiscal 2006 is due to a reduction in the fair value of warrants resulting from a decline in our stock price, expected stock price volatility and contractual life of the warrants which are the primary assumptions applied to the Black-Scholes model which we have used to calculate the fair value of the warrants.

Provision for Income Taxes

There were no tax provisions recorded during the three month period ended June 30, 2006 and 2005, due to year to date net losses incurred. No tax provisions have been recorded for any period presented, as we believe that, based on the history of our operating losses and other factors, the weight of available evidence indicates that it is more likely than not that we will not be able to realize the benefit of our net operating losses. Accordingly, a full valuation reserve has been recorded against our net deferred tax assets.

Liquidity and Capital Resources

At June 30, 2006, we had $6.1 million of cash and cash equivalents and $11.7 million in investments in marketable securities for a combined total of $17.8 million. In comparison, at June 30, 2005, we had $13.4 million of cash and cash equivalents, $0.3 million in restricted cash, and $11.2 million in investments in marketable securities for a combined total of $24.9 million. Our cash and cash equivalents balance decreased by $0.2 million and the combined balance decreased by $5.2 million during the first three months of fiscal 2007. The decrease in the combined balance was used to fund operations, as discussed below.

Cash used in operations of approximately $4.4 million for the first three months of fiscal 2007 was primarily attributable to the net loss of $1.8 million, adjusted for $3.9 million of non-cash income due to the change in the fair value of warrants and $0.9 million of depreciation, amortization, and stock-based compensation expense. The favorable changes in operating assets and liabilities were primarily attributable to a $0.8 million decrease in deferred cost of goods sold and an increase in other accrued liabilities of $0.5 million. These favorable changes were offset by a $0.9 million increase in inventory and a $0.4 million decrease in deferred revenue. Cash used in operations of approximately $6.5 million for the first quarter of fiscal 2006 was primarily attributable to the net loss of $4.9 million and net cash used in changes in operating assets and liabilities of $1.5 million, adjusted for $138,000 of depreciation and amortization expense and $0.2 million of non-cash income due to the change in the fair value of warrants. The changes in operating assets and liabilities were primarily attributable to a $1.3 million decrease in accounts payable. Our negative operating cash flows primarily reflect our net losses resulting from the same factors affecting our revenues and expenses as described above.

Cash provided by investing activities of $4.3 million for the three months ended June 30, 2006 was primarily attributable to proceeds of $4.9 million received from the maturity of short term investments. The cash inflows were partially offset by $0.6 million of purchases of fixed assets. Cash used in investing activities of $2.6 million for three months ended June 30, 2005 was primarily attributable $0.4 million of purchase of fixed assets and purchases of short term investments of $3.5 million. The cash outflows were partially offset by proceeds of $1.3 million received from the maturity or sale of short-term investments.

Cash used in financing activities of approximately $5,000 for the first quarter of fiscal 2007 consisted of capital lease payments. Cash used in financing activities of approximately $19,000 for the first quarter of fiscal 2006 consisted primarily of $3,000 of capital lease payments and $16,000 of issuance costs related to our March 2005 financing.

At June 30, 2006, we had open purchase orders of approximately $3.7 million, primarily related to inventory purchases from our contract manufacturers. These purchase commitments are reflected in our consolidated financial statements once goods or services have been received or at such time when we are obligated to make payments related to these goods or services. At June 30, 2006, future minimum annual lease payments under noncancelable operating leases were as follows (in thousands):

Year ending March 31:		
Remaining 2007	$	361
2008		490
2009		493
2010		206
Total minimum payments	$	1,550

At June 30, 2006, future third party network service provider monthly minimums were $400,000 per month through May 31, 2008.

We had no off-balance sheet arrangements at June 30, 2006 as defined in Regulation S-K Item 303(a)(4).

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

Year ending March 31:		
Remaining 2007	$	21
2008		28
2009		28
2010		28
2011		2
Total minimum payments		107
Less: Amount representing interest		(12)
		95
Less: Short-term portion of capital lease obligations		(23)
Long-term portion of capital lease obligations	$	72

At June 30, 2006, we have a $3.2 million liability related to warrants issued to three investors in three equity financing transactions in the fiscal years 2006 and 2005. We account for these warrants as liabilities, because the possibility, however likely or unlikely, that we would be unable to deliver registered shares upon a future exercise of these warrants. The required accounting for a warrant with an assumed "net cash settlement" provision under EITF 00-19 is to estimate the fair value on the date of issuance and to record a liability equal to that value with subsequent changes in the fair value recorded as income or expense at the end of each reporting period under EITF 00-19 . The amount we record as a liability under EITF 00-19 is not, nor do we intend for it to be an admission or stipulation of the amount that we would owe or be obligated to pay the warrant holder in the event that we are unable to deliver registered shares to the warrant holder. In fact, we have made no determination of the amount of liability, if any, that we would owe to the warrant holder in the event of such a breach.

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

Although we believe that our current cash and cash equivalents will satisfy our expected working capital and capital expenditure requirements through at least the next twelve months, our business may change in ways we do not currently anticipate, which could require us to raise additional funds to support our operations earlier than otherwise expected. Unless we achieve and maintain profitability, we will need to raise additional capital to support our business. We may not be able to obtain additional financing as needed on acceptable terms, or at all, which may require us to reduce our operating costs and other expenditures by making reductions in personnel and capital expenditures. Alternatively, or in addition to such potential measures, we may elect to implement other cost reduction actions as we may determine are necessary and in our best interests. Any such actions undertaken might limit our opportunities to realize plans for revenue growth and we might not be able to reduce our costs in amounts sufficient to achieve break-even or profitable operations.

FACTORS THAT MAY AFFECT FUTURE RESULTS

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

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

We recorded an operating loss of $5.9 million for the three months ended June 30, 2006, and we ended the period with an accumulated deficit of $192 million. In addition, we recorded operating losses of $25 million and $20 million for the fiscal years ended March 31, 2006 and 2005, respectively. We expect that we will continue to incur operating losses for the foreseeable future, and such losses may be substantial. We will need to generate significant revenue growth to achieve an operating profit. Given our history of fluctuating revenues and operating losses, we cannot be certain that we will be able to achieve profitability on either a quarterly or annual basis in the future.

Our stock price has been highly volatile.

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

- actual or anticipated fluctuations in our operating results;
- announcements of technical innovations;
- future legislation or regulation of the Internet and/or voice over Internet protocol (VoIP);
- loss of key personnel;
- new entrants into the VOIP service marketplace, including cable and incumbent telephone companies and other well-capitalized competitors;
- new products or new contracts by us, our competitors or their customers; and
- developments with respect to patents or proprietary rights, general market conditions, changes in financial estimates by securities analysts, and other factors which could be unrelated to, or outside of, our control.

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

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

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

Semiconductor and related software revenues represented approximately 83% and 88%, respectively, of the Company's consolidated revenues for fiscal 2004 and 2003. However, these revenues were not sufficient to profitably operate our semiconductor business. Therefore, we significantly reduced the scope of these operations. During the quarter ended June 30, 2003, we completed the end-of-life of our legacy videoconferencing semiconductor products. In November 2003, we sold the VIP1 video semiconductor development effort to Leadtek Research, Inc. (Leadtek). Under the terms of the transaction, Leadtek acquired the VIP1 development activities, key engineers, software tools and equipment. Revenues attributable to this development effort, prior to the aforementioned transaction, were $0 and $1.1 million during the fiscal years ended March 31, 2004 and 2003, respectively, representing approximately 0% and 12% of revenues of our semiconductor business and 0% and 10.5% of 8x8's consolidated revenues for such periods. As a result of the transfer of this development effort to Leadtek, this development revenue ceased. In January 2004, we initiated an end-of-life program for our VoIP telephony semiconductor products, including the Audacity T2 and T2U products. The semiconductor business no longer generates significant revenues.

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

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

We have been selling our Packet8 service since November 2002. To date, we have not generated adequate revenue from the sale of our voice over IP, or VoIP, telephony products and services, including our Packet8 service, to achieve profitability. If we are not able to generate higher revenues selling into the VoIP telephony market, our business and operating results would be seriously harmed. If we are not able to retain a significant percentage of our current and future Packet8 customers on an ongoing basis, our business and operating results would be seriously harmed.

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

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

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

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

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

Given the significant price competition in the markets for our products, we are at a significant disadvantage compared to our competitors, many of whom have substantially greater resources, and therefore may be better able to withstand an extended period of downward pricing pressure. The adverse impact of a shortfall in our revenues may be magnified by our inability to adjust spending to compensate for such shortfall. Announcements by our competitors or us of new products and technologies could cause customers to defer purchases of our existing products, which would also have a material adverse effect on our business and operating results.

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

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

VoIP telephony is an emerging market that is characterized by rapid changes in customer requirements, frequent introductions of new and enhanced products, and continuing and rapid technological advancement. To compete successfully in this emerging market, we must continue to design, develop, manufacture, and sell new and enhanced VoIP telephony software products and services that provide increasingly higher levels of performance and reliability at lower cost. These new and enhanced products must take advantage of technological advancements and changes, and respond to new customer requirements. Our success in designing, developing, manufacturing, and selling such products and services will depend on a variety of factors, including:

- the identification of market demand for new products;
- the scalability of our VoIP telephony software products;
- product and feature selection;
- timely implementation of product design and development;
- product performance;
- cost-effectiveness of current products and services and products under development;
- our ability to successfully implement service features mandated by federal and state law;
- effective manufacturing processes; and
- effectiveness of promotional efforts.

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

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

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

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

Most of our current and potential competitors have longer operating histories, significantly greater resources and name recognition and a larger base of customers than we have. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can to ours. Our competitors may also offer bundled service arrangements offering a more complete product despite the technical merits or advantages of our products. These competitors include traditional telephone service providers, such as at&t and Verizon, cable television companies, such as Cablevision, Cox and Time Warner, and other VoIP service providers such as EBay/Skype and Vonage. Competition could decrease our prices, reduce our sales, lower our gross profits or decrease our market share.

Our success depends on third parties in our distribution channels.

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

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

The development and marketing of our VoIP products will continue to place a significant strain on our limited personnel, management, and other resources. Our future success depends upon the continued services of our executive officers and other key employees who have critical industry experience and relationships that we rely on to implement our business plan. None of our officers or key employees are bound by employment agreements for any specific term. The loss of the services of any of our officers or key employees could delay the development and introduction of, and negatively impact our ability to sell our products which could adversely affect our financial results and impair our growth. We currently do not maintain key person life insurance policies on any of our employees.

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

We do not have long-term purchase agreements with our contract manufacturers. There can be no assurance that our contract manufacturers will be able or willing to reliably manufacture our products, in volumes, on a cost-effective basis or in a timely manner. For our videophones, cordless handsets and terminal adaptors that are used with our Packet8 service, we rely on the availability of certain semiconductor products. These devices are also sourced solely from certain overseas contract manufacturers and partners, and are currently not available from any other manufacturer. Any of these factors could have a material adverse effect on our business, financial condition or results of operations.

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

Our Packet8 service depends on the availability of third party network service providers that provide telephone numbers and public switched telephone network (PSTN) call termination and origination services for our customers. Many of these network service providers have been affected by the downturn in the telecommunications industry and may be forced to terminate the services that we depend on. The time to interface our technology to another network service provider, if available, and qualify this new service could have a material adverse effect on our business, operating results or financial condition.

While we believe that relations with our current service providers are good and we have contracts in place, there can be no assurance that these service providers will be able or willing to supply cost-effective services to us in the future or that we will be successful in signing up alternative or additional providers. While we believe that we could replace our current providers, if necessary, our ability to provide service to our subscribers would be impacted during this timeframe, and this could have an adverse effect on our business, financial condition or results of operations. The loss of access to, or requirement to change, the telephone numbers we provide to our customers could have a material adverse effect on our business.

We may not be able to manage our inventory levels effectively, which may lead to inventory obsolescence that would force us to incur inventory write-downs.

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

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

Many of the potential customers for our Packet8 service have requested that our products and services be designed to interoperate with their existing networks, each of which may have different specifications and use multiple standards. Our customers' networks may contain multiple generations of products from different vendors that have been added over time as their networks have grown and evolved. Our products must interoperate with these products as well as with future products in order to meet our customers' requirements. In some cases, we may be required to modify our product designs to achieve a sale, which may result in a longer sales cycle, increased research and development expense, and reduced operating margins. If our products do not interoperate with existing equipment or software in our customers' networks, installations could be delayed, orders for our products could be canceled or our products could be returned. In addition, contractual obligations may require us to continue to provide services that interoperate whether cost effective or in our interests. Any of these factors could harm our business, financial condition or results of operations.

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

Our Packet8 service must successfully integrate with products from other vendors, such as gateways to traditional telephone systems. As a result, when problems occur in a network, it may be difficult to identify the source of the problem. The occurrence of hardware and software errors, whether caused by our Packet8 service or another vendor's products, may result in the delay or loss of market acceptance of our products and any necessary revisions may force us to incur significant expenses. The occurrence of some of these types of problems may seriously harm our business, financial condition or results of operations.

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

We expect our competitors to continue to improve the performance of their current products and introduce new products or new technologies. If our competitors successfully introduce new products or enhance their existing products, this could reduce the sales or market acceptance of our products and services, increase price competition or make our products obsolete. For instance, our competitors, such as local exchange carriers and cable television providers, may be able to bundle services and products that we do not offer together with long distance or VoIP telephony services. These services could include wireless communications, voice and data services, Internet access and cable television. This form of bundling would put us at a competitive disadvantage if these providers can combine a variety of services offerings at a single attractive price. To be competitive, we must continue to invest significant resources in research and development, sales and marketing, and customer support. We may not have sufficient resources to make these investments or to make the technological advances necessary to be competitive, which in turn will cause our business to suffer.

Many of our current and potential competitors have longer operating histories, are substantially larger, and have greater financial, manufacturing, marketing, technical, and other resources. Many also have greater name recognition and a larger installed base of customers than we have. Competition in our markets may result in significant price reductions. As a result of their greater resources, many current and potential competitors may be better able than us to initiate and withstand significant price competition or downturns in the economy. There can be no assurance that we will be able to continue to compete effectively, and any failure to do so would harm our business, operating results or financial condition.

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

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

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

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

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

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

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

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

Our products must comply with industry standards, FCC regulations, state, local, country-specific and international regulations, and changes may require us to modify existing products and/or services.

In addition to reliability and quality standards, the market acceptance of telephony over broadband IP networks is dependent upon the adoption of industry standards so that products from multiple manufacturers are able to communicate with each other. Our VoIP telephony products rely heavily on communication standards such as SIP, H.323, MGCP and Megaco and network standards such as TCP/IP and UDP to interoperate with other vendors' equipment. There is currently a lack of agreement among industry leaders about which standard should be used for a particular application, and about the definition of the standards themselves. These standards, as well as audio and video compression standards, continue to evolve. We also must comply with certain rules and regulations of the Federal Communications Commission (FCC) regarding electromagnetic radiation and safety standards established by Underwriters Laboratories, as well as similar regulations and standards applicable in other countries. Standards are continuously being modified and replaced. As standards evolve, we may be required to modify our existing products or develop and support new versions of our products. We must comply with certain federal, state and local requirements regarding how we interact with our customers, including marketing practices, consumer protection, privacy and billing issues, the provision of 911 emergency service and the quality of service we provide to our customers. The failure of our products and services to comply, or delays in compliance, with various existing and evolving standards could delay or interrupt volume production of our VoIP telephony products, subject us to fines or other imposed penalties, or harm the perception and adoption rates of our service, any of which would have a material adverse effect on our business, financial condition or operating results.

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

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

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

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

At present there are few laws, regulations or rulings that specifically address access to commerce and communications services on the Internet, including IP telephony. We are unable to predict the impact, if any, that future legislation, legal decisions or regulations concerning the Internet may have on our business, financial condition, and results of operations. Regulation may be targeted towards, among other things, assessing access or settlement charges, imposing taxes related to internet communications and imposing tariffs or regulations based on encryption concerns or the characteristics and quality of products and services, any of which could restrict our business or increase our cost of doing business. The increasing growth of the broadband IP telephony market and popularity of broadband IP telephony products and services heighten the risk that governments or other legislative bodies will seek to regulate broadband IP telephony and the Internet. In addition, large, established telecommunication companies may devote substantial lobbying efforts to influence the regulation of the broadband IP telephony market, which may be contrary to our interests.

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

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

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

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

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

On September 22, 2003, the California Public Utilities Commission, or CPUC, sent us a letter that alleged that we are offering intrastate telecommunications services for profit in California without having received formal certification from the CPUC to provide such service. The CPUC also requested that we file an application with the CPUC for authority to conduct business as a telecommunications utility no later than October 22, 2003. After consultation with regulatory counsel, we responded to the CPUC, disputed its assertions and did not file the requested application. In our October 22, 2003 response to the CPUC, we disagreed with the CPUC's classification of us as a telephone corporation under the California Public Utilities Code. We asserted that we are an information services provider and not a telecommunications provider. The letter from the CPUC did not indicate, and we cannot predict, what any potential penalties or consequences in failing to obtain certification might be. If we are subjected to penalties, or if we are required to comply with CPUC regulations affecting telecommunications service providers, our business may be adversely affected. On November 13, 2003, the CPUC held a hearing in San Francisco to hear testimony from CPUC staff and industry representatives regarding what course of action the CPUC should take with respect to Internet telephony. A representative from 8x8 testified at the hearing. On February 11, 2004, the CPUC stated that, as a tentative conclusion of law, they believe that VoIP providers are telecommunications providers and should be treated as such from a regulatory standpoint. The CPUC initiated an investigation into appropriate regulation of VoIP providers under state law, and acknowledged that it has not enforced the same regulatory regime over VoIP as applies to telecommunications services. The CPUC is considering a number of potential regulatory requirements, including contribution to state universal service programs, provisioning of 911 services, payment of access charges to interconnect with the PSTN and compliance with NANP protocols and basic consumer protection laws, including California's telecommunications "bill of rights." The CPUC is also considering whether exempting VoIP providers from requirements applicable to traditional providers of voice telephony creates unfair competitive advantages that should be proactively addressed, if the regulatory framework governing the provision of VoIP should vary based on the market served and whether VoIP providers should be subject to the current system of intercompany compensation arrangements. The CPUC has indicated that this process could last up to 18 months, but there is no way for us to predict the timetable or outcome of this process. On April 7, 2005, the CPUC instituted a rulemaking to assess and revise the regulation of all telecommunications utilities in California except for small incumbent local exchange carriers, or ILECs. The primary goal of this proceeding is to develop a uniform regulatory framework for all telecommunications utilities, except small ILECs, to the extent that it is feasible and in the public interest to do so. While not specifically directed at VoIP, it is unclear at this time what impact this new rulemaking will have on the

CPUCs classification or treatment of VoIP services.

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

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

In late 2004 and early 2005, we received notices from multiple municipalities in California that the Packet8 service is subject to utility user taxes, as defined in the respective municipal codes. The notices require that we begin collecting and remitting utility user taxes no later than January 1, 2005. We have responded to these municipalities and disputed their assertions.

In January 2005, we received a letter from an association representing multiple municipalities in South Carolina asserting that we are subject to a business license tax applied to telecommunications companies. We have responded to this association and disputed their assertion.

In May 2005, we received a notice from the City of Chicago that we were being investigated for non-compliance with Chicago tax laws as we are not collecting and remitting Chicago's Telecommunications Tax. We completed the questionnaire received and disputed the applicability of this tax to the Packet8 service.

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

In accordance with current industry practice, we do not collect state and federal telecommunications taxes or other telecommunications surcharges with respect to our Packet8 service. Based upon a new ruling published by the Internal Revenue Service, or IRS, we ceased collecting Federal Excise Tax, or FET, on June 1, 2006. We do not collect Value Added Tax, or VAT, for services that we provide to customers in European Union, or EU, member countries. Future expansion of our Packet8 service, along with other aspects of our evolving business, may result in additional sales and other tax obligations. One or more states or foreign countries may seek to impose sales or other tax collection obligations on out-of-jurisdiction companies that provide telephone service. A successful assertion by one or more states or foreign countries that we should collect sales or other taxes on the sale of merchandise or services could result in substantial tax liabilities for past sales, decrease our ability to compete with traditional telephone companies, and could have a material adverse effect on our business, financial condition or operating results.

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

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

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

In May 2005, the FCC unanimously adopted an Order and Notice of Proposed Rulemaking, or NPRM, which requires VoIP providers that interconnect with the PSTN, or interconnected VoIP providers, to provide emergency 911, or E911, service. On June 3, 2005, the FCC released the text of the First Report and Order and Notice of Proposed Rulemaking in the VoIP E911 proceeding, or the VoIP E911 Order. As a result of the VoIP E911 Order, interconnected VoIP providers were required to implement the E911 emergency calling capabilities offered by traditional landline phone companies. All interconnected VoIP providers must deliver 911 calls to the appropriate local public safety answering point, or PSAP, through the PSTN's legacy wireline selective router, which is used to deliver E911 calls, along with call back number and location, where the PSAP is able to receive that information. E911 must be included in the basic service offering; it cannot be an optional or extra feature. The PSAP delivery obligation, along with call back number and location information must be provided regardless of whether the VoIP service is "fixed" or "nomadic." User registration of location is permissible initially, although the FCC is committed to an advanced form of E911 that will determine user location without user intervention, one of the topics of the further NPRM to be released eventually. The VoIP E911 Order mandates that existing and prospective customers must be notified of the capabilities and limitations of VoIP service with respect to emergency calling, and interconnected VoIP providers must obtain and maintain affirmative acknowledgement from each customer that the customer has read and understood the notice of limitations and distribute warning labels or stickers alerting consumers and other potential users of the limitations of VoIP E911 service to each new subscriber prior to the initiation of service. In addition, an interconnected VoIP provider must make it possible for customers to update their address (i.e., change their registered location) via at least one option that requires no equipment other than that needed to access the VoIP service. All interconnected VoIP providers must comply with the requirements of the VoIP E911 Order within one-hundred and twenty days of the publication of the VoIP E911 Order in the Federal Register, which was November 28, 2005, with the exception that the customer notification obligations must be complied with within thirty days of the publication.

Beginning in June 2004, we offered E911 service as an option to Packet8 subscribers who choose phone numbers in markets where E911 service is available (our E911 service was initially only available in a subset of the markets where we provided telephone numbers). Even with E911 provisioned, the IP dialtone service provided by Packet8 is only as reliable as a customer's underlying broadband data service and Internet service provider (neither service is provided by us), and may not be suitable for use in all emergency situations. For customers who chose not to or were unable to subscribe to our E911 service, we played a recorded message in response to customers who dialed 911 from these lines instructing them to hang up and either dial their local police/fire department directly from the phone on the Packet8 service, or to dial 911 from a phone connected to the traditional telephone network.

On July 26, 2005 the FCC issued guidance to all interconnected VoIP providers regarding the July 29, 2005 notification deadline. In this guidance, the FCC determined that it would not initiate enforcement action until August 30, 2005 against any provider of interconnected VoIP service regarding the requirement that it obtain affirmative acknowledgement by every existing subscriber, on the condition that the provider file a detailed report with the FCC by August 10, 2005 containing a variety of detailed descriptions. To date, we have filed the reports requested by the FCC, and we suspended service of an insignificant number of subscribers on August 30, 2005 who had not responded to our acknowledgement requests.

On November 7, 2005 the Enforcement Bureau of the FCC issued a notice to interconnected VoIP providers detailing the information required to be submitted to the FCC in E911 compliance letters due by November 28, 2005. In this notice, the Enforcement Bureau stated that, although it does not require providers that have not achieved full E911 compliance by November 28, 2005 to discontinue the provision of interconnected VoIP services to any existing customers, it does expect that such providers will discontinue marketing VoIP service, and accepting new customers for their service, in all areas where they are not transmitting 911 calls to the appropriate PSAP in full compliance with the Commission's rules. On November 28, 2005 we began offering nomadic E911 service to all of our customers with United States service addresses, and began charging those customers an additional $1.99 per month plus any applicable local 911 taxes and surcharges effective January 1, 2006. On November 28, 2005, we also modified the Packet8 account signup procedures to require service addresses to be entered and validated, at the time an order for service is placed, to ascertain whether Packet8's nomadic 911 service is available at that address. On November 28, 2005, we also filed our E911 compliance report which is available on the FCC's website under Wireline Competition Docket Number 05-196.

The FCC may determine that our nomadic E911 solution does not satisfy the requirements of the VoIP E911 order because, in some instances, our nomadic E911 solution requires that we route an E911 call to a national emergency call center instead of connecting Packet8 subscribers directly to a local PSAP. The FCC may issue further guidance on compliance requirements in the future that might require us to disconnect a significant number of subscribers. The effect of such disconnections or any enforcement action initiated by the FCC or other agency or task force against us could have a material adverse effect on our financial position, results of operations or cash flows.

The VoIP E911 Order has increased our cost of doing business and may adversely affect our ability to deliver the Packet8 service to new and existing customers in all geographic regions or to nomadic customers who move to a location where E911 services compliant with the FCC's mandates are unavailable. We cannot guarantee that E911 service will be available to all of our subscribers, especially those accessing our service from outside of the United States. The VoIP E911 Order or follow-on orders or clarifications or their impact on our customers due to service price increases or other factors could have a material adverse effect on our business, financial position and results of operations.

There may be risks associated with our ability to comply with the requirements of federal law enforcement agencies.

On August 5, 2005, the FCC unanimously adopted an order responsive to a joint petition filed by the Department of Justice, the Federal Bureau of Investigation, and the Drug Enforcement Administration asking the FCC to declare that broadband Internet access services and VoIP services be covered by the Communications Assistance for Law Enforcement Act, or CALEA. The Order concludes that CALEA applies to facilities-based broadband Internet access providers and providers of interconnected VoIP service and requires these providers to be in full compliance within 18 months of September 23, 2005. The FCC also stated that, in the coming months, it will release another order that will address separate questions regarding the assistance capabilities required of the providers covered by the August 5, 2005 order. On May 3, 2006, the FCC adopted a second order, which clarifies that the FCC will not establish standards for VoIP providers to comply with CALEA. Instead, the FCC directs law enforcement agencies, experts and the industry to develop the standards. The FCC's order clarifies that VoIP providers may use third party vendors to comply with the requirements of CALEA. On July 6, 2006, the FCC established August 4, 2006 as the effective date for its order requiring interconnected VoIP providers to comply with CALEA. The FCC stated, however, that the effective date of those rules that established reporting requirements will be delayed until the FCC receives approval from the Office of Management and Budget to collect such paperwork. Our failure to achieve compliance with any future CALEA orders, rules, filings or standards, or any enforcement action initiated by the FCC or other agency, state or task force against us could have a material adverse effect on our financial position, results of operations or cash flows.

There may be risks associated with our ability to comply with funding requirements of the Universal Service Fund, or USF, and similar state or federal funds, or that our customers will cancel service due to the impact of these price increases to their service.

On June 21, 2006, the FCC expanded the base of Universal Service Fund (USF) contributions to interconnected VoIP providers. The FCC established a safe harbor percentage of interstate revenue of 64.9% of total VoIP service revenue. The Company may calculate its contribution based on the safe harbor or by submitting a traffic study that is subsequently approved by the FCC. The Company submitted a traffic study to the FCC on July 18, 2006. The FCC has not responded to the Company. The Company is required to begin contributions on October 1, 2006. For a period of at least two quarters beginning October 1, 2006, the Company will be required to contribute to the USF for its subscribers' retail revenues as well as through its underlying carriers' wholesale charges. The Company currently plans to charge its subscribers a USF fee equal to the USF contribution amounts it must contribute beginning October 1, 2006 based upon its subscribers' retail revenues. The impact of this price increase on our customers or the Company's inability to recoup its costs or liabilities in remitting USF contributions or other factors could have a material adverse effect on the Company's financial position, results of operations and cash flows.

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

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

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

A fundamental requirement for operating an internet-based, worldwide voice and video communications service and electronically billing our Packet8 customers is the secure transmission of confidential information and media over public networks. Although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches may adversely affect our operating results. The law relating to the liability of providers of online payment services is currently unsettled. We rely on third party providers to process and guarantee payments made by Packet8 subscribers up to certain limits, and we may be unable to prevent our customers from fraudulently receiving goods and services. Our liability risk will increase if a larger fraction of our Packet8 transactions involve fraudulent or disputed credit card transactions. Any costs we incur as a result of fraudulent or disputed transactions could harm our business. In addition, the functionality of our current billing system relies on certain third-party vendors delivering services. If these vendors are unable or unwilling to provide services, we will not be able to charge for our Packet8 services in a timely or scalable fashion, which could significantly decrease our revenue and have a material adverse effect on our business, financial condition and operating results.

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

Subscribers have obtained access to the Packet8 service without paying for monthly service and international toll calls by unlawfully using our authorization codes and submitting fraudulent credit card information. To date, such losses from unauthorized credit card transactions and theft of service have not been significant. We have implemented anti-fraud procedures in order to control losses relating to these practices, but these procedures may not be adequate to effectively limit all of our exposure in the future from fraud. If our procedures are not effective, consumer fraud and theft of service could significantly decrease our revenue and have a material adverse effect on our business, financial condition and operating results.

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

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

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

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

We will likely need to raise additional capital to support our operations.

As of June 30, 2006, we had cash and cash equivalents and investments of approximately $17.8 million. Unless we achieve and maintain profitability, we will need to raise additional capital. We may not be able to obtain such additional financing as needed on acceptable terms, or at all, which may require us to reduce our operating costs and other expenditures, including reductions of personnel and capital expenditures. If we issue additional equity or convertible debt securities to raise funds, the ownership percentage of our existing stockholders would be reduced and they may experience significant dilution. New investors may demand rights, preferences or privileges senior to those of existing holders of our common stock. If we are not successful in these actions, we may be forced to cease operations.

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

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

If our minimum closing bid price per share falls below $1.00 for a period of 30 consecutive business days in the future, we may again be subject to delisting procedures. As of the close of business on July 31, 2006, our common stock had a closing bid price of approximately $0.71 per share and had closed below $1.00 for thirteen consecutive trading days. We must also meet additional continued listing requirements contained in Nasdaq Marketplace Rule 4310(c)(2)(b), which requires that we have a minimum of $2,500,000 in stockholders' equity or $35,000,000 market value of listed securities or $500,000 of net income from continuing operations for the most recently completed fiscal year (or two of the three most recently completed fiscal years). As of July 31, 2006, based on our closing price as of that day, the market value of our securities approximated $44 million and we were in compliance with Nasdaq Marketplace Rule 4310(c)(2)(b). There can be no assurance that we will continue to meet the continued listing requirements.

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

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

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

We have evaluated our internal controls systems in order to allow management to report on, and our independent auditors to attest to, the effectiveness of our internal controls over financial reporting, as required by this legislation. We are required to perform the system and process evaluation and testing (and any necessary remediation) required in an effort to allow our management to assess the effectiveness of our system of internal controls over financial reporting as of the end of each fiscal year. Our independent auditors must then attest to and report on that assessment by our management to comply with the management certification and auditor attestation requirements of Section 404 of the Sarbanes Oxley Act (Section 404). As a result, we have and expect to continue to incur significant additional expenses and diversion of management's time towards Section 404 compliance. In any fiscal year, we may fail to timely complete our evaluation, testing and remediation actions in order to allow for this assessment by our management or our independent auditors may not be able to timely attest to our management's assessment. If we are not able to comply with the requirements of Section 404 in a timely manner or with adequate compliance, we might be subject to sanctions or investigation by regulatory authorities, such as the Securities Exchange Commission or the Nasdaq Capital Market. Further, if our independent auditors are not satisfied with our internal control over financial reporting or with the level at which it is documented, designed, operated or reviewed, they may decline to attest to management's assessment or may issue a qualified report identifying a material weakness in our internal controls. Any such action could adversely affect our financial results and could cause our stock price to decline.

The fair value of certain warrant liabilities may increase or decrease, and as a result, we may be required pursuant to EITF 00-19 to reflect a corresponding increase or decrease in our net income or net loss, as the case may be, and the amount of our recorded liability for the warrants for the applicable quarter also may fluctuate materially.

Pursuant to 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"), warrants issued to three investors in three different equity financings we consummated in fiscal 2005 and 2006 are classified as liabilities because the possibility, however likely or unlikely, that the Company would be unable to deliver registered shares upon a future exercise of these warrants means that the warrants are deemed to include a "net cash settlement" provision within the meaning of EITF 00-19. The required accounting for a warrant with a "net cash settlement" provision under EITF 00-19 is to estimate the fair value on the date of issuance and to record a liability equal to that value to reflect the required assumption that the Company will breach its obligation to deliver registered shares in the future (which we refer to as a "presumed breach"). The warrants will continue to be recorded as liabilities until such time as the warrants are exercised, expire or we and the warrant holders amend the applicable warrant agreement in a manner that renders this accounting treatment unnecessary. In the event that at the end of any fiscal quarter the fair value of these warrants increases or decreases, we will be required to re-value the warrants and reflect such change for the applicable fiscal quarter in our financial statements in accordance with EITF 00-19. If the fair value at the end of any fiscal quarter increases, we will recognize a corresponding increase in expense for such fiscal quarter, as well as reflect a corresponding increase in our liabilities for such fiscal quarter, in accordance with EITF 00-19, resulting in a reduction of our stockholders' equity on our balance sheet for such fiscal quarter and a decrease in net income on our income statement for such fiscal quarter. If the fair value at the end of any fiscal quarter decreases, we will recognize a corresponding decrease in expense for such fiscal quarter, as well as reflect a corresponding decrease in our liabilities for such fiscal quarter, in accordance with EITF 00-19, resulting in an increase of our stockholders' equity on our balance sheet for such fiscal quarter and increase in net income on our income statement for such fiscal quarter. The amount we record as a liability under EITF 00-19 is not, nor do we intend for it to be an admission or stipulation of the amount that we would owe or be obligated to pay the warrant holder in the event of an actual breach by us of the warrant terms. In fact, we have made no determination of the amount of liability, if any, that we would owe to the warrant holder in the event of such a breach.

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 revenues from customers in Europe and Asia. In order to reduce the risk from fluctuation in foreign exchange rates, the vast majority of our sales are denominated in U.S. dollars. In addition, almost all of our arrangements with our contract manufacturers are denominated in U.S. dollars. We have a foreign subsidiary in France and are exposed to market risk from changes in exchange rates. We have not entered into any currency hedging activities. To date, our exposure to exchange rate volatility has not been significant; however, there can be no assurance that there will not be a material impact in the future.

Investments

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

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Effectiveness of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 ("Disclosure Controls") that are designed to ensure that information the Company is 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/A, 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 not effective as of the end of the period covered by this Quarterly Report on Form 10-Q/A due to the existence of the material weakness described below.

Material Weakness in Internal Control over Financial Reporting

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In connection with the restatement disclosed in Note 3 "Restatement of Previously Issued Financial Statements" to the Condensed Consolidated Financial Statements included in Part I Item 1 of this Form 10-Q/A, the Company identified the following material weakness existing as of June 30, 2006. The Company did not maintain effective controls over the accounting for warrants. Specifically, the Company's controls did not ensure the appropriate classification of warrants as a liability in accordance with generally accepted accounting principles. This control deficiency resulted in the misstatement of stockholders' equity and liabilities, the restatement of our 2005 and 2006 annual consolidated financial statements and the interim consolidated financial statements for the first three quarters of 2007 and all quarters for 2006. Further, this control deficiency could result in misstatements of the aforementioned accounts and disclosures that would result in a material misstatement of our annual or interim consolidated financial statements that would not be prevented or detected.

Limitations on the Effectiveness of Controls

The Company's management, including the Chief Executive Officer and Chief Financial Officer, does not expect that the Company's 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, within the Company have been detected.

Changes in Internal Control over Financial Reporting

During the period covered by this Quarterly Report on Form 10-Q/A, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS

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

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

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

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

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: June 29, 2007

8X8, INC.
(Registrant)
By: /s/ DANIEL WEIRICH
Daniel Weirich

Chief Financial Officer
(Principal Financial and Accounting Officer)