

8X8 INC /DE/
Form 10-Q
January 31, 2014

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

FORM 10-Q

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

For the quarterly period ended December 31, 2013

OR

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

For the transition period from _____ to _____

Commission file number 000-21783

[8X8, INC.](#)

(Exact name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

77-0142404

(I.R.S. Employer Identification Number)

2125 O'Nel Drive
San Jose, CA 95131

(Address of Principal Executive Offices)

(408) 727-1885

(Registrant's Telephone Number, including Area Code)

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

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

☒ NO ☐

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

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

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

The number of shares of the Registrant's Common Stock outstanding as of January 24, 2014 was 87,874,850.

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Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

| | December 31, 2013 | March 31, 2013 |
|---|----------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 172,114 | \$ 50,305 |
| Short-term investments | 1,901 | 1,964 |
| Accounts receivable, net | 5,169 | 3,880 |
| Inventory | 828 | 511 |
| Deferred cost of goods sold | 215 | 182 |
| Deferred tax asset | 4,532 | 6,096 |
| Other current assets | 1,999 | 732 |
| Total current assets | 186,758 | 63,670 |
| Property and equipment, net | 7,485 | 6,673 |
| Intangible assets, net | 15,606 | 10,194 |
| Goodwill | 38,235 | 25,150 |
| Non-current deferred tax asset | 47,366 | 46,352 |
| Other assets | 1,101 | 572 |
| Total assets | \$ 296,551 | \$ 152,611 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 6,497 | \$ 5,644 |
| Accrued compensation | 5,311 | 3,629 |
| Accrued warranty | 634 | 452 |
| Accrued taxes | 2,109 | 1,912 |
| Deferred revenue | 3,208 | 1,236 |
| Other accrued liabilities | 1,711 | 862 |
| Total current liabilities | 19,470 | 13,735 |
| Non-current liabilities | 1,672 | 1,817 |
| Other non-current liabilities | 12 | 26 |
| Total liabilities | 21,154 | 15,578 |
| Commitments and contingencies (Note 8) | | |
| Stockholders' equity: | | |
| Common stock | 88 | 72 |
| Additional paid-in capital | 379,802 | 246,176 |
| Accumulated other comprehensive income (loss) | 227 | (36) |
| Accumulated deficit | (104,720) | (109,179) |
| Total stockholders' equity | 275,397 | 137,033 |
| Total liabilities and stockholders' equity | \$ 296,551 | \$ 152,611 |

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

8X8, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts; unaudited)

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|-----------|-----------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Service revenue | \$ 29,737 | \$ 24,023 | \$ 84,062 | \$ 69,314 |
| Product revenue | 3,008 | 2,382 | 8,749 | 6,656 |
| Total revenue | 32,745 | 26,405 | 92,811 | 75,970 |
| Operating expenses: | | | | |
| Cost of service revenue | 5,584 | 4,890 | 15,579 | 15,184 |
| Cost of product revenue | 4,041 | 3,203 | 11,171 | 8,585 |
| Research and development | 3,325 | 2,117 | 8,301 | 5,973 |
| Sales and marketing | 16,051 | 11,561 | 42,868 | 32,629 |
| General and administrative | 5,547 | 2,119 | 11,444 | 6,226 |
| Gain on patent sale | - | - | - | (11,965) |
| Total operating expenses | 34,548 | 23,890 | 89,363 | 56,632 |
| Income (loss) from operations | (1,803) | 2,515 | 3,448 | 19,338 |
| Other income, net | 586 | 73 | 602 | 90 |
| Income (loss) from continuing operations before provision (benefit) for income taxes | (1,217) | 2,588 | 4,050 | 19,428 |
| Provision (benefit) for income taxes | (1,306) | 814 | 481 | 7,494 |
| Income from continuing operations | 89 | 1,774 | 3,569 | 11,934 |
| Income from discontinued operations, net of income tax provision | - | 146 | 301 | 344 |
| Gain on disposal of discontinued operations, net of income tax provision of \$463 | - | - | 589 | - |
| Net Income | \$ 89 | \$ 1,920 | \$ 4,459 | \$ 12,278 |
| Income per share - continuing operations: | | | | |
| Basic | \$ 0.00 | \$ 0.03 | \$ 0.05 | \$ 0.17 |
| Diluted | \$ 0.00 | \$ 0.03 | \$ 0.05 | \$ 0.16 |
| Income per share - discontinued operations: | | | | |
| Basic | \$ 0.00 | \$ 0.00 | \$ 0.01 | \$ 0.00 |
| Diluted | \$ 0.00 | \$ 0.00 | \$ 0.01 | \$ 0.00 |
| Net income per share: | | | | |
| Basic | \$ 0.00 | \$ 0.03 | \$ 0.06 | \$ 0.17 |
| Diluted | \$ 0.00 | \$ 0.03 | \$ 0.06 | \$ 0.16 |
| Weighted average number of shares: | | | | |
| Basic | 79,742 | 71,611 | 75,071 | 71,197 |
| Diluted | 83,182 | 74,988 | 78,389 | 74,483 |

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

8X8, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands, unaudited)

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|----------|-----------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income | \$ 89 | \$ 1,920 | \$ 4,459 | \$ 12,278 |
| Other comprehensive income (loss), net of tax | | | | |
| Unrealized gain (loss) on investments in securities | (8) | (44) | (63) | 23 |
| Foreign currency translation adjustment | 326 | - | 326 | - |
| Comprehensive income | \$ 407 | \$ 1,876 | \$ 4,722 | \$ 12,301 |

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)

| | Nine Months Ended December 31, | |
|---|-----------------------------------|-----------|
| | 2013 | 2012 |
| Cash flows from operating activities: | | |
| Net income | \$ 4,459 | \$ 12,278 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 1,888 | 1,816 |
| Amortization of intangible assets | 1,074 | 1,071 |
| Amortization of capitalized software | 92 | - |
| Gain on disposal of discontinued operations | (589) | - |
| Gain on escrow settlement | (565) | - |
| Stock-based compensation | 5,245 | 1,827 |
| Deferred income tax provision | 87 | 7,359 |
| Other | 490 | 409 |
| Changes in assets and liabilities: | | |
| Accounts receivable, net | (1,104) | (1,700) |
| Inventory | (245) | (25) |
| Other current and noncurrent assets | (570) | (48) |
| Deferred cost of goods sold | 211 | (18) |
| Accounts payable | (1,290) | (38) |
| Accrued compensation | 1,217 | 663 |
| Accrued warranty | 182 | 35 |
| Accrued taxes and fees | 62 | 495 |
| Deferred revenue | 757 | 61 |
| Other current and noncurrent liabilities | 172 | 1,806 |
| Net cash provided by operating activities | 11,573 | 25,991 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (2,081) | (5,245) |
| Acquisition of business, net of cash acquired | (18,474) | - |
| Proceeds from disposition of discontinued operations, net of transaction costs | 3,000 | - |
| Cost of capitalized software | (590) | - |
| Net cash used in investing activities | (18,145) | (5,245) |
| Cash flows from financing activities: | | |
| Capital lease payments | (26) | (73) |
| Repurchase of common stock | (320) | (285) |
| Proceeds from issuance of common stock, net of issuance costs | 125,758 | - |
| Proceeds from issuance of common stock under employee stock plans | 2,959 | 1,743 |
| Net cash provided by financing activities | 128,371 | 1,385 |
| Effect of exchange rate changes on cash | 10 | - |
| Net increase in cash and cash equivalents | 121,809 | 22,131 |
| Cash and cash equivalents at the beginning of the period | 50,305 | 22,426 |
| Cash and cash equivalents at the end of the period | \$ 172,114 | \$ 44,557 |
| Supplemental cash flow information | | |
| Income taxes paid | 479 | 415 |
| Interest paid | 4 | 8 |

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 a comprehensive portfolio of cloud-based communication and collaboration solutions that include hosted cloud telephony, unified communications, contact center, video conferencing and virtual desktop software and services. These unified communication and collaboration services are offered from the Internet cloud via a software-as-a-service subscription. The Company also provides cloud-based computing services. As of December 31, 2013, the Company had approximately 36,800 business customers.

The Company was incorporated in California in February 1987 and was reincorporated in Delaware in December 1996. The Company's fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in these notes to the condensed consolidated financial statements refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2014 refers to the fiscal year ending March 31, 2014).

Common Stock Offering

In November 2013, the Company completed an underwritten registered offering of common stock in which it sold 14,375,000 shares for total cash proceeds of approximately \$125.8 million, net of issuance costs of \$0.6 million. The shares issued in the offering had been registered under a shelf registration statement previously filed with the Securities and Exchange Commission relating to up to \$250,000,000 of the Company's securities. A member of the Company's board of directors participated in the offering and purchased 30,000 shares at the public offering price.

Acquisition of Voicenet Solutions Limited

On November 11, 2013, the Company entered into a share purchase agreement with the shareholders and optionholders of Voicenet Solutions Limited, a provider of cloud communications and collaboration services in the United Kingdom. See note 12.

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 consolidated financial statements for the fiscal year ended March 31, 2013. In the opinion of the Company's management, these interim condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of our financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from these estimates.

The March 31, 2013 year-end condensed consolidated balance sheet data in this document was derived from audited consolidated financial statements and does not include all of the disclosures required by U.S. generally accepted accounting principles. These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements as of and for the fiscal year ended March 31, 2013 and notes thereto included in the Company's fiscal 2013 Annual Report on Form 10-K.

RECLASSIFICATION

Certain amounts previously reported within the Company's consolidated statements of income have been reclassified to conform to the current period presentation. The reclassification included certain prior-period amounts related to the Company's discontinued operations which have been reclassified to conform to the current period presentation.

The reclassification had no impact on the Company's previously reported net income or basic and diluted net income per share amounts.

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

Service and Product Revenue

The Company recognizes service revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, price is fixed or determinable and collectability is reasonably assured. The Company defers recognition of service revenues in instances when cash receipts are received before services are delivered and recognizes deferred revenues ratably as services are provided.

The Company recognizes revenue from product sales for which there are no related services to be rendered upon shipment to customers provided that persuasive evidence of an arrangement exists, the price is fixed, title has transferred, collection of resulting receivables is reasonably assured, there are no customer acceptance requirements, and there are no remaining significant obligations. Gross outbound shipping and handling charges are recorded as revenue, and the related costs are included in cost of goods sold. Reserves for returns and allowances for customer sales are recorded at the time of shipment. In accordance with the ASC 985-605, the Company records shipments to distributors, retailers, and resellers, where the right of return exists, as deferred revenue. The Company defers recognition of revenue on sales to distributors, retailers, and resellers until products are resold to the customer.

The Company records revenue net of any sales-related taxes that are billed to its customers. The Company believes this approach results in consolidated financial statements that are more easily understood by users.

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

Multiple Element Arrangements

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 605-25 requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if the deliverables in the arrangement meet specific criteria. The provisioning of the 8x8 cloud service with the accompanying 8x8 IP telephone constitutes a revenue arrangement with multiple deliverables. For arrangements with multiple deliverables, the Company allocates the arrangement consideration to all units of accounting based on their relative selling prices. In such circumstances, the accounting principles establish a hierarchy to determine the relative selling price to be used for allocating arrangement consideration to units of accounting as follows: (i) vendor-specific objective evidence of fair value ("VSOE"), (ii) third-party evidence of selling price ("TPE"), and (iii) best estimate of the selling price ("BESP").

VSOE generally exists only when the Company sells the deliverable separately, on more than a limited basis, at prices within a relatively narrow range. When VSOE cannot be established, the Company attempts to establish the selling

price of deliverables based on relevant TPE. TPE is determined based on manufacturer's prices for similar deliverables when sold separately, when possible. When the Company is unable to establish selling price using VSOE or TPE, it uses a BESP for the allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service was sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for new or highly customized offerings. The Company determines BESP for a product or service by considering multiple factors including, but not limited to:

- the price list established by its management which is typically based on general pricing practices and targeted gross margin of products and services sold; and
- analysis of pricing history of new arrangements, including multiple element and stand-alone transactions.

In accordance with the guidance of ASC 605-25, when the Company enters into revenue arrangements with multiple deliverables the Company allocates arrangement consideration, including activation fees, among the 8x8 IP telephones and subscriber services based on their relative selling prices. Arrangement consideration allocated to the IP telephones is recognized as product revenues during the period of the sale less the allowance for estimated returns during the 30-day trial period. Arrangement consideration allocated to subscriber services is recognized ratably as service revenues as the related services are provided, which is generally over the initial contract term.

Deferred Cost of Goods Sold

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

Intangible Assets

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

| | December 31, 2013 | | | March 31, 2013 | | |
|---|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Technology | \$ 8,242 | \$ (1,874) | \$ 6,368 | \$ 8,242 | \$ (1,256) | \$ 6,986 |
| Customer relationships | 9,483 | (1,202) | 8,281 | 3,305 | (1,054) | 2,251 |
| Trade names/domains | 957 | - | 957 | 957 | - | 957 |
| Total acquired identifiable intangible assets | \$ 18,682 | \$ (3,076) | \$ 15,606 | \$ 12,504 | \$ (2,310) | \$ 10,194 |

At December 31, 2013, annual amortization of intangible assets, based upon our existing intangible assets and current useful lives, is estimated to be the following (in thousands):

| | Amount |
|----------------|-----------|
| Remaining 2014 | \$ 567 |
| 2015 | 2,252 |
| 2016 | 2,252 |
| 2017 | 2,245 |
| 2018 | 1,997 |
| Thereafter | 5,336 |
| Total | \$ 14,649 |

Research, Development and Software Costs

The Company accounts for software to be sold or otherwise marketed in accordance with ASC 985-20 - *Costs of Software to be Sold, Leased or Marketed*, which requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. The Company defines establishment of technological feasibility as the completion of a working model. Software development costs for software to be sold or otherwise marketed incurred prior to the establishment of technological feasibility are included in research and development and are expensed as incurred. Software development costs incurred subsequent to the establishment of technological feasibility through the period of general market availability of the product are capitalized, if material.

In the first nine months of fiscal 2014, the Company capitalized approximately \$590,000 of software development costs in accordance with ASC 985-20. At December 31, 2013, total capitalized software development costs included in other long-term assets was approximately \$779,000 and accumulated amortization costs related to capitalized software was approximately \$92,000.

Foreign Currency Translation

The Company has determined that the functional currency of its UK foreign subsidiary is the subsidiary's local currency, the British Pound Sterling ("GBP"), which the Company believes most appropriately reflects the current economic facts and circumstances of the UK subsidiary's operations. The assets and liabilities of the subsidiary are translated at the applicable exchange rate as of the end of the balance sheet period and revenue and expenses are translated at an average rate over the period presented. Resulting currency translation adjustments are recorded as a component of accumulated other comprehensive income or loss within the stockholder's equity in the consolidated balance sheets.

Stock Purchase Right/Restricted Stock Unit and Option Activity

Stock purchase right activity for the nine months ended December 31, 2013 is summarized as follows:

| | Number of Shares | Weighted Average Grant-Date Fair Market Value | Weighted Average Remaining Contractual Term (in Years) |
|------------------------------|---------------------|---|--|
| Balance at March 31, 2013 | 958,575 | \$ 4.11 | 2.52 |
| Granted | 19,180 | 9.42 | |
| Vested | (318,591) | 3.33 | |
| Forfeited | (81,109) | 4.96 | |
| Balance at December 31, 2013 | 578,055 | \$ 4.59 | 2.04 |

Restricted stock unit and performance stock unit activity for the nine months ended December 31, 2013 is summarized as follows:

| | Number of Shares | Weighted Average Purchase Price | Weighted Average Remaining Contractual Term (in Years) |
|------------------------------|---------------------|--|--|
| Balance at March 31, 2013 | 25,000 | \$ - | 2.47 |
| Granted | 1,235,350 | - | |
| Vested | (1,250) | - | |
| Forfeited | (34,320) | - | |
| Balance at December 31, 2013 | 1,224,780 | \$ - | 2.00 |

Option activity for the nine months ended December 31, 2013 is summarized as follows:

| | Shares Available for Grant | Shares Subject to Options Outstanding | Weighted Average Exercise Price Per Share |
|---|----------------------------------|--|---|
| Balance at March 31, 2013 | 3,175,261 | 5,991,544 | \$ 2.52 |
| Change in options available for grant | 1,000,000 | | - |
| Granted - options | (1,390,400) | 1,390,400 | 9.57 |
| Stock purchase rights/restricted stock unit (1) | (1,254,530) | - | - |
| Exercised | - | (921,685) | 2.41 |
| Canceled/forfeited - options | 56,048 | (56,048) | 3.38 |
| Canceled/forfeited - restricted stock unit | 34,320 | | |
| Termination of plans | (1,774) | - | - |
| Balance at December 31, 2013 | 1,618,925 | 6,404,211 | \$ 4.06 |

(1) The reduction to shares available for grant includes awards granted of 1,254,530 shares.

The following table summarizes the stock options outstanding and exercisable at December 31, 2013:

| Range of Exercise Price | Shares | Options Outstanding | | | Options Exercisable | | |
|----------------------------|-----------|---|---|---------------------------------|---------------------|---|---------------------------------|
| | | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value | Shares | Weighted Average Exercise Price Per Share | Aggregate Intrinsic Value |
| \$0.55 - \$1.26 | 1,735,000 | \$ 1.04 | 4.0 | \$ 15,806,760 | 1,735,000 | \$ 1.04 | \$ 15,806,760 |
| \$1.27 - \$1.88 | 1,284,568 | \$ 1.53 | 2.1 | 11,067,416 | 1,284,568 | \$ 1.53 | 11,067,416 |
| \$1.89 - \$5.87 | 1,963,492 | \$ 4.45 | 5.8 | 11,187,811 | 981,709 | \$ 3.99 | 6,044,878 |
| \$5.88 - \$9.74 | 1,346,151 | \$ 9.40 | 9.7 | 1,014,399 | 41,651 | \$ 8.41 | 72,417 |
| \$9.75 - \$10.97 | 75,000 | \$ 10.97 | 9.8 | - | - | \$ - | - |
| | 6,404,211 | | | \$ 39,076,386 | 4,042,928 | | \$ 32,991,471 |

Stock-based Compensation Expense

The Company accounts for its employee stock options, stock purchase rights, restricted stock units, and restricted performance stock units granted under the 1996 Stock Plan, 1996 Director Option Plan, 1999 Nonstatutory Stock Option Plan, the 2006 Stock Plan, the 2003 Contractual Plan, the 2012 Equity Incentive Plan, the 2013 New Employee Inducement Incentive Plan and stock purchase rights under the 1996 Employee Stock Purchase Plan (collectively "Equity Compensation Plans") under the provisions of ASC 718 - *Stock Compensation*. Under the provisions of ASC 718, stock-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant), net of estimated forfeitures.

To value option grants, stock purchase rights and restricted stock units under the Equity Compensation Plans for stock-based compensation, the Company used the Black-Scholes option valuation model. Fair value determined using the Black-Scholes option valuation model varies based on assumptions used for the expected stock prices volatility, expected life, risk-free interest rates and future dividend payments. For the three and nine months ended December 31, 2013 and 2012, the Company used the historical volatility of its stock over a period equal to the expected life of the options. The expected life assumptions represent the weighted-average period stock-based awards are expecting to remain outstanding. These expected life assumptions were established through the review of historical exercise behavior of stock-based award grants with similar vesting periods. The risk-free interest rate is based on the closing market bid yields on actively traded U.S. treasury securities in the over-the-counter market for the expected term equal to the expected term of the option. The dividend yield assumption is based on the Company's history and expectation of future dividend payout. Compensation expense for stock-based payment awards is recognized using the straight-line single-option method and includes the impact of estimated forfeitures.

The Company issued restricted performance stock units to a group of executives with vesting that is contingent on both market performance and continued service. For the market-based restricted performance stock units issued during the nine months ended December 31, 2013:

- the number of shares of the Company's stock to be received at vesting if applicable service requirements are also met will range from 0% to 100% of the target amount based total shareholder return ("TSR"), which compares the performance of the price per share of the Company's common stock with the NASDAQ Composite Index ("Index") for the three performance periods ending March 31, 2015, March 31, 2016 and March 31, 2017, in the following manner: where in each such measurement period, (1) if the performance return on the price per share of the Company's common stock exceeds the performance return on the NASDAQ Composite Index, (which shall be determined by subtracting the percentage return on the NASDAQ Composite Index from the percentage return on the price per share of the Common Stock), then all of the TSR Performance Shares for such measurement period will be deemed earned and will vest; (2) if the performance return on the price per share of Common Stock is more than 50% lower than the performance return on the NASDAQ Composite Index, then none of the TSR Performance Shares for such measurement period will be deemed earned and will vest; and (3) if the performance return on the price per share of Common Stock is between 0% and 50% lower than the performance return on the NASDAQ Composite Index, then the number of TSR Performance Shares deemed earned and vesting for such measurement period will be reduced by 2% for each 1% by which the performance return on the NASDAQ Composite Index exceeds the performance return on the Common Stock, and
- the number of shares of the Company's stock to be received at vesting will range from 0% or 100% of the target amount based on four tranches, with each tranche vesting at the later of (a) the satisfaction of the applicable service-based vesting requirement for that tranche, and (b) on the first date that the average stock price of the Company's common stock for a consecutive 30 trading day period exceeds 150% of the grant date stock price. The minimum service vesting requirement for each tranche is as follows:
 - ◆ Tranche 1: One year following the date of the grant
 - ◆ Tranche 2: Two years following the date of the grant
 - ◆ Tranche 3: Three years following the date of the grant
 - ◆ Tranche 4: Four years following the date of the grant

To value these market-based restricted performance stock units under the Equity Compensation Plans, the Company used a Monte Carlo simulation model on the date of grant. Fair value determined using the Monte Carlo simulation model varies based on the assumptions used for the expected stock price volatility, the correlation coefficient between the Company and the NASDAQ Composite Index, risk free interest rates, and future dividend payments. For the nine months ended December 31, 2013, the Company used the historical volatility and correlation of our stock and the Index over a period equal to the remaining performance period as of the grant date. The risk-free interest rate was 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 remaining performance period as of the grant date. The dividend yield assumption was based on our history and expectation of future dividend payout. Compensation expense for restricted stock units with performance and market conditions is recognized over the requisite service period using the straight-line method on a tranche by tranche basis and includes the impact of estimated forfeitures.

On October 18, 2013, the board of directors approved the modification of unvested stock options to purchase 74,479 shares of common stock and unvested stock purchase rights totaling 37,000 shares of common stock held by the Company's president upon his resignation. The options held by the Company's president upon his resignation, taken as a whole, had a weighted average exercise price of \$4.05 per share and range from \$2.72 to \$5.87 per share, and a weighted average remaining vesting term of 0.5 years. Approximately \$1,068,000 of the \$3,232,000 of stock-based compensation charge in the third quarter of 2013 applied to the options held by the former president of the Company and was recorded in general and administrative expenses.

As of December 31, 2013, there was \$18.8 million of unamortized stock-based compensation expense related to unvested stock awards which is expected to be recognized over a weighted average period of 3.02 years.

The following table summarizes the assumptions used to compute reported stock-based compensation to employees and directors for the three and nine months ended December 31, 2013 and 2012:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|------------|-----------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| Expected volatility | 63% | 68% | 64% | 68% |
| Expected dividend yield | - | - | - | - |
| Risk-free interest rate | 1.62% | 0.68% | 1.86% | 0.70% |
| Weighted average expected option term | 5.59 years | 4.50 years | 6.00 years | 5.28 years |
| Weighted average fair value of options granted | \$ 5.64 | \$ 3.18 | \$ 5.64 | \$ 3.32 |

In accordance with ASC 718 - *Stock Compensation*, the Company recorded \$2,069,000 and \$650,000 in compensation expense relative to stock-based awards for the three months ended December 31, 2013 and 2012, and \$3,827,000 and \$1,471,000 for the nine months ended December 31, 2013 and 2012, respectively.

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan, or ESPP, eligible employees can participate and purchase common stock semi-annually through payroll deductions at a price equal to 85% of the fair market value of the common stock at the beginning of each one year offering period or the end of the applicable nine month purchase period within that offering period, whichever is lower. The contribution amount may not exceed 10% of an employee's base compensation, including commissions but not including bonuses and overtime. The Company accounts for the ESPP as a compensatory plan and recorded compensation expense of \$95,000 and \$115,000 for the three months ended December 31, 2013 and 2012, and \$350,000 and \$356,000 for the nine months ended December 31, 2013 and 2012, respectively, in accordance with ASC 718.

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|------|-----------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| Expected volatility | - | - | 38% | 34% |
| Expected dividend yield | - | - | - | - |
| Risk-free interest rate | - | - | 0.11% | 0.16% |
| Weighted average expected ESPP option term | - | - | 0.75 years | 0.75 years |
| Weighted average fair value of ESPP options granted | \$ - | \$ - | \$ 2.60 | \$ 1.45 |

As of December 31, 2013, there was \$58,000 of total unrecognized compensation cost related to employee stock purchases. This cost is expected to be recognized over a weighted average period of 0.5 years.

ASC 718 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 realization of tax benefits related to stock-based compensation is dependent upon the timing of employee exercises and future taxable income, among other factors. The Company did not realize any tax benefit from the stock-based compensation charges incurred during the three and nine months ended December 31, 2013 and 2012.

The following table summarizes the classification of stock-based compensation expense related to employee stock options and employee stock purchases under ASC 718 among the Company's operating functions for the three and nine months ended December 31, 2013 and 2012 which was recorded as follows (in thousands):

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|--------|-----------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| Cost of service revenue | \$ 101 | \$ 63 | \$ 237 | \$ 149 |
| Cost of product revenue | - | - | - | 1 |
| Research and development | 339 | 125 | 634 | 295 |
| Sales and marketing | 660 | 355 | 1,400 | 979 |
| General and administrative | 2,132 | 222 | 2,974 | 403 |
| Total stock-based compensation expense related to employee stock options and employee stock purchases, pre-tax | 3,232 | 765 | 5,245 | 1,827 |
| Tax benefit | - | - | - | - |
| Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax | \$ 3,232 | \$ 765 | \$ 5,245 | \$ 1,827 |

Recent Accounting Pronouncements

In July 2013, the FASB issued ASU No. 2013-11, "Income Taxes (Topic 740): *Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax credit Carryforward Exist*" ("ASU 2013-11"). ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The guidance requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except in certain situations. ASU 2013-11 will be effective for the fiscal years, and interim periods within those years, beginning after December 15, 2013, with early adoption permitted. The Company does not believe that the adoption of ASU 2013-11 will have a material impact on the Company's consolidated results of operation and financial condition.

3. FAIR VALUE MEASUREMENT

The following tables present the Company's fair value hierarchy for assets and liabilities measured at fair value on a recurring basis at December 31, 2013 and March 31, 2013 (in thousands):

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance at December 31, 2013 |
|-------------------------|---|--|--|------------------------------------|
| Cash equivalents: | | | | |
| Money market funds | \$ 14,379 | \$ - | \$ - | \$ 14,379 |
| Short-term investments: | | | | |
| Mutual funds | 1,901 | - | - | 1,901 |
| Total | \$ 16,280 | \$ - | \$ - | \$ 16,280 |

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance at March 31, 2013 |
|-------------------------|---|--|--|---------------------------------|
| Cash equivalents: | | | | |
| Money market funds | \$ 14,376 | \$ - | \$ - | \$ 14,376 |
| Short-term investments: | | | | |
| Mutual funds | 1,964 | - | - | 1,964 |
| Total | \$ 16,340 | \$ - | \$ - | \$ 16,340 |

4. BALANCE SHEET DETAIL

| | December 31, 2013 | March 31, 2013 |
|---------------------------|----------------------|-------------------|
| Inventory (in thousands): | | |
| Work-in-process | \$ 22 | \$ 23 |
| Finished goods | 806 | 488 |
| | \$ 828 | \$ 511 |

5. NET INCOME PER SHARE

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|--|----------|-----------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands, except per share amounts) | | | |
| Numerator: | | | | |
| Income from continuing operations | \$ 89 | \$ 1,774 | \$ 3,569 | \$ 11,934 |
| Income from discontinued operations, net of income tax provision | - | 146 | 890 | 344 |
| Net income available to common stockholders | 89 | 1,920 | 4,459 | 12,278 |
| Denominator: | | | | |
| Common shares | 79,742 | 71,611 | 75,071 | 71,197 |
| Denominator for basic calculation | 79,742 | 71,611 | 75,071 | 71,197 |
| Employee stock options | 2,982 | 3,023 | 2,938 | 2,947 |
| Stock purchase rights | 425 | 336 | 380 | 339 |
| Employee stock purchase plan | 33 | 18 | - | - |
| Denominator for diluted calculation | 83,182 | 74,988 | 78,389 | 74,483 |
| Income per share - continuing operations | | | | |
| Basic | \$ 0.00 | \$ 0.03 | \$ 0.05 | \$ 0.17 |
| Diluted | \$ 0.00 | \$ 0.03 | \$ 0.05 | \$ 0.16 |
| Income per share - discontinued operations | | | | |
| Basic | \$ 0.00 | \$ 0.00 | \$ 0.01 | \$ 0.00 |
| Diluted | \$ 0.00 | \$ 0.00 | \$ 0.01 | \$ 0.00 |
| Net income per share | | | | |
| Basic | \$ 0.00 | \$ 0.03 | \$ 0.06 | \$ 0.17 |
| Diluted | \$ 0.00 | \$ 0.03 | \$ 0.06 | \$ 0.16 |

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|------|-----------------------------------|------|
| | 2013 | 2012 | 2013 | 2012 |
| Employee stock options | 1,266 | 885 | 550 | 878 |
| Stock purchase rights | 18 | - | 190 | - |
| Total anti-dilutive employee stock-based securities | 1,284 | 885 | 740 | 878 |

6. INCOME TAXES

For the three months ended December 31, 2013, the Company recorded a benefit for income taxes of \$1.3 million. For the nine months ended December 31, 2013, the Company recorded a provision for income taxes of \$0.5 million which was primarily attributable to income from continuing operations (\$0.7 million), income from discontinued operations (\$0.2 million) and gain on disposal of discontinued operations (\$0.5 million), reduced by a tax benefit for an adjustment to credit carryforwards (\$0.9 million). For the three and nine months ended December 31, 2012, the Company recorded a provision for income taxes of \$0.9 million and \$7.7 million which was primarily attributable to income from continuing operations including the gain on sale of patents (\$0.8 million and \$7.5 million, respectively) and income from discontinued operations (\$0.1 million and \$0.2 million respectively).

The effective tax rate is calculated by dividing the income tax provision by net income before income tax expense.

At March 31, 2013, there were \$3.0 million of unrecognized tax benefits that, if recognized, would have affected the effective tax rate. At December 31, 2013, the Company determined that it was more-likely-than-not that some of the unrecognized tax benefit from credit carryforwards should be realized which resulted in the recognition of \$0.9 million benefit to income taxes.

The Company does not expect the remaining unrecognized tax benefit to change materially in the next 12 months. To the extent that the remaining unrecognized tax benefits are ultimately recognized, they will have an impact on the effective tax rate in future periods.

The Company is subject to taxation in the U.S., California and various other states and foreign jurisdictions in which it has or had a subsidiary or branch operations or it is collecting sales tax. All tax returns from fiscal 1995 to fiscal 2013 may be subject to examination by the Internal Revenue Service, California and various other states. As of January 24, 2014, there were no active federal or state income tax audits. Returns filed in foreign jurisdictions may be subject to examination for the fiscal years 2009 to 2013.

7. SEGMENT REPORTING

ASC 280, "Segment Reporting" 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 ASC 280, 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.

No customer represented greater than 10% of the Company's total revenues for the three or nine months ended December 31, 2013 or 2012. The Company's revenue distribution by geographic region (based upon the destination of shipments and the customer's service address) was as follows:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---------------------------|------------------------------------|------|-----------------------------------|------|
| | 2013 | 2012 | 2013 | 2012 |
| Americas (principally US) | 96% | 99% | 98% | 99% |
| Europe | 3% | 0% | 1% | 0% |
| Asia Pacific | 1% | 1% | 1% | 1% |
| | 100% | 100% | 100% | 100% |

Geographic area data is based upon the location of the property and equipment and is as follows (in thousands):

| | December 31, 2013 | March 31, 2013 |
|----------------|----------------------|-------------------|
| United States | \$ 5,787 | \$ 6,673 |
| United Kingdom | 1,352 | - |
| Asia | 346 | - |
| Total | \$ 7,485 | \$ 6,673 |

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

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

Product Warranties

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--------------------------------|------------------------------------|--------|-----------------------------------|--------|
| | 2013 | 2012 | 2013 | 2012 |
| Balance at beginning of period | \$ 552 | \$ 376 | \$ 452 | \$ 387 |
| Accruals for warranties | 274 | 168 | 744 | 445 |
| Settlements | (192) | (122) | (562) | (410) |
| Balance at end of period | \$ 634 | \$ 422 | \$ 634 | \$ 422 |

Minimum Third Party Customer Support Commitments

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

Minimum Third Party Network Service Provider Commitments

The Company entered into contracts with multiple vendors for third party network services that expire on various dates in fiscal 2014 through 2016. At December 31, 2013, future minimum annual payments under these third party network service contracts were as follows (in thousands):

| | |
|------------------------------|----------|
| <u>Year ending March 31:</u> | |
| Remaining 2014 | \$ 502 |
| 2015 | 1,579 |
| 2016 | 52 |
| Total minimum payments | \$ 2,133 |

Legal Proceedings

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

On February 22, 2011, the Company was named a defendant in a lawsuit, Bear Creek Technologies, Inc. v. 8x8, Inc. *et al.*, along with 20 other defendants. On August 17, 2011, the Company was dismissed without prejudice from this lawsuit under Rule 21 of the Federal Rules of Civil Procedure. On August 17, 2011, the Company was sued again by Bear Creek Technologies, Inc. in the United States District Court for the District of Delaware. The Company believes it has factual and legal defenses to these claims and is presenting a vigorous defense. Further, on November 28, 2012, the U.S. Patent & Trademark Office initiated a Reexamination proceeding with a Reexamination Declaration explaining that there is a substantial new question of patentability, based on four separate grounds, affecting each claim of the patent which is the basis for the complaint filed against the Company. On March 26, 2013, the USPTO issued a first Office Action in the Reexamination, with all claims of the '722 patent being rejected on each of the four separate grounds raised in the Request for Reexamination. On July 10, 2013, the Company filed an informational pleading in support of (and joining) a pending motion to stay the proceeding in the District Court, which granted the motion on July 17, 2013, based on the possibility that at least one of the USPTO rejections will be upheld and considering the USPTO's conclusion that Bear Creek's patent suffers from a defective claim for priority. The Company cannot estimate potential liability in this case at this early stage of litigation.

On October 25, 2011, the Company was named a defendant in a lawsuit, Klausner Technologies, Inc. v. Oracle Corporation *et al.*, along with 30 other defendants. The lawsuit alleges infringement of a patent that is now believed to have expired. On November 1, 2011, Klausner dismissed the Complaint voluntarily and filed new complaints separating the defendants, including a new Complaint against 8x8. The Company believes it has factual and legal defenses to these claims and is presenting a vigorous defense. The Company has filed several motions, including a motion to transfer and a motion to dismiss the complaint on February 23, 2012. On March 21, 2013, the District Court granted 8x8's Motion to Change Venue, and has ordered the transfer of the case to the US District Court for the Northern District of California. The Company has not answered the complaint yet and cannot estimate potential liability in this case at this early stage of the litigation.

State and Municipal Taxes

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

9. GAIN ON SETTLEMENT OF ESCROW CLAIM

In December 2013, the Company settled an escrow claim for indemnification with the sellers of Contactual, Inc. Under the terms of the settlement, the Company recorded a gain of \$0.6 million. Under the terms of the Contactual merger agreement and the escrow agreement, each indemnifying seller must pay his, her or its pro rata share of the obligations owed to the Company by January 30, 2014. Also, under the Contactual merger agreement each indemnifying seller may individually elect to pay such pro rata share in cash instead of shares of the Company's common stock in the escrow fund valued at the Company's average closing price of \$4.146667 per share in his, her or its sole discretion. The settlement proceeds have been recognized in other income. Upon receipt of the cash or shares on or before January 30, 2014, the remaining escrow account balance will be released to the sellers.

10. PATENT SALE

On June 22, 2012, the Company entered into a patent purchase agreement and sold a family of patents to a third party for \$12.0 million plus a future payment of up to a maximum of \$3.0 million based on future license agreements entered into by the third party purchaser. In the fourth quarter of fiscal 2013, the Company collected and recognized a gain of \$1.0 million attributable to a license agreement obtained by the third party purchaser. As of December 31, 2013, there remained a maximum of \$2.0 million of potential future payments under the agreement based on future license agreements obtained by the third party purchaser. Under the terms and conditions of the patent purchase agreement, the Company has retained certain limited rights to continue to use the patents. The patent purchase agreement contains representations and warranties customary for transactions of this type.

11. DISCONTINUED OPERATIONS

On September 30, 2013, the Company completed the sale of its dedicated server hosting business to IRC Company, Inc. ("IRC") and, as a result, no longer provides dedicated server hosting services. In the transaction, IRC purchased 100% of the stock of Central Host, Inc., which had been wholly owned by the Company and all of the assets specific to the dedicated server hosting business.

The Company sold its dedicated server hosting business for total consideration of \$3.0 million in cash, which was received on October 1, 2013.

The dedicated server hosting business has been reported as discontinued operations. The results of operations and financial position of these discontinued operations are as follows:

Results of operations:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|--------|-----------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| Revenue | \$ - | \$ 935 | \$ 1,430 | \$ 2,993 |
| Operating expense | - | 690 | 922 | 2,417 |
| Income before income taxes | - | 245 | 508 | 576 |
| Provision for income taxes | - | 99 | 207 | 232 |
| Income from discontinued operations | - | 146 | 301 | 344 |
| Gain on disposal of discontinued operations, net of income tax provision of \$463k | - | - | 589 | - |

Financial position:

| | December 31, 2013 | March 31, 2013 |
|-----------------------------|----------------------|-------------------|
| Assets | | |
| Property and equipment, net | \$ - | \$ 845 |
| Intangible assets, net | - | 8 |
| Goodwill | - | 1,210 |
| | \$ - | \$ 2,063 |

12. ACQUISITION

Voicenet Solutions Limited

On November 11, 2013, the Company entered into a share purchase agreement with the shareholders and optionholders of Voicenet Solutions Limited ("Voicenet"), a provider of cloud communications and collaboration services in the United Kingdom (the "Transaction"). The Company completed the acquisition of Voicenet on November 29, 2013. The Company purchased all of the outstanding shares of Voicenet for total consideration transferred of \$19.3 million; \$3.0 million was placed in escrow and eligible for release to the Voicenet shareholders and optionholders in installments on the first and second anniversaries of the closing date. The shares of Voicenet are held by a wholly-owned subsidiary of 8x8 recently formed in the United Kingdom, such that Voicenet is an indirect, wholly-owned subsidiary of 8x8.

The Company recorded the acquired tangible and identifiable intangible assets and liabilities assumed based on their estimated fair values. The excess of the consideration transferred over the aggregate fair values of the assets acquired and liabilities assumed is recorded as goodwill. The amount of goodwill recognized is primarily attributable to the operating synergies expected to be realized through the acquisition of Voicenet and the workforce of the acquired business. The finite-lived intangible assets consist of customer relationship, with an estimated weighted-average useful life of 7 years. The fair value assigned to identifiable intangible assets acquired was based on estimates and assumptions made by management using the excess earnings method. Intangible assets will be amortized on a straight-line basis.

The preliminary fair values of the assets acquired and liabilities assumed are as follows (in thousands):

| | Estimated Fair Value |
|--|-------------------------|
| Assets acquired: | |
| Cash | \$ 854 |
| Current assets | 1,134 |
| Property and equipment | 956 |
| Intangible asset - customer relationship | 6,381 |
| Total assets acquired | 9,325 |
| Liabilities assumed: | |
| Current liabilities | (4,058) |
| Total liabilities assumed | (4,058) |
| Net identifiable assets acquired | 5,267 |
| Goodwill | 14,061 |
| Total consideration transferred | \$ 19,328 |

Voicenet contributed revenue of approximately \$0.8 million and a net loss of approximately \$0.2 million for the period from the date of acquisition to December 31, 2013. The Company determined that the acquisition was not deemed to be a material business combination and it is impractical to include such pro forma information given the difficulty in obtaining the historical financial information of Voicenet. Inclusion of such information would require the Company to make estimates and assumptions regarding Voicenet's historical financial results that we believe may ultimately prove inaccurate.

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

FORWARD-LOOKING STATEMENTS

This Management Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as "may," "will," "should," "estimates," "predicts," "potential," "continue," "strategy," "believes," "anticipates," "plans," "expects," "intends," and similar expressions are intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Actual results and trends may differ materially from historical results or those projected in any such forward-looking statements depending on a variety of factors. These factors include, but are not limited to, customer acceptance and demand for our cloud communications and collaboration services, the quality and reliability of our services, the prices for our services, customer renewal rates, customer acquisition costs, our ability to compete effectively in the hosted telecommunications and cloud-based computing services business, actions by our competitors, including price reductions for their competitive services, our ability to provide cost-effective and timely service and support to larger distributed enterprises, potential federal and state regulatory actions, compliance costs, potential warranty claims and product defects, our need for and the availability of adequate working capital, our ability to innovate technologically, the timely supply of products by our contract manufacturers, our management's ability to execute its plans, strategies and objectives for future operations, including the execution of integration plans, and to realize the expected benefits of our acquisitions, and potential future intellectual property infringement claims and other litigation that could adversely affect our business and operating results. All forward-looking statements included in this report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In addition to the factors discussed elsewhere in this Form 10-Q, see the Risk Factors discussion in Item 1A of our 2013 Form 10-K. The forward-looking statements included in this Form 10-Q are made only as of the date of this report, and we undertake no obligation to update the forward-looking statements to reflect subsequent events or circumstances.

BUSINESS OVERVIEW

We develop and market a comprehensive portfolio of cloud-based communication and collaboration solutions that include hosted cloud telephony, unified communications, contact center, video conferencing and virtual desktop software and services. These communication and collaboration services are offered from the Internet cloud via a software-as-a-service subscription. We also provide cloud-based computing services. As of December 31, 2013, we had approximately 36,800 business customers. Since fiscal 2004, substantially all of our revenue has been generated from the sale, license and provision of these cloud products, services and technology. Prior to fiscal 2003, our focus was on our Voice over Internet Protocol semiconductor business.

Our fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in this report refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2014 refers to the fiscal year ending March 31, 2014).

RECLASSIFICATION

Certain amounts previously reported within our consolidated statements of income have been reclassified to conform to the current period presentation. The reclassification included certain prior-period amounts that are related to our discontinued operations which have been reclassified to conform to the current period presentation.

The reclassification had no impact on our previously reported net income or basic and diluted net income per share amounts. The operating results discussed under "Results of Operations" exclude the impact of our discontinued

operations for all periods presented.

SUMMARY AND OUTLOOK

In the third quarter of fiscal 2014, we displayed continued momentum in four areas. First, we saw an increase in the number of new services added during the quarter, representing a year-over-year increase of 38%, reflecting demand for our services in our domestic small and medium businesses, or SMBs, and mid-market and distributed enterprise customer market. We intend to continue to pursue opportunities to sell our comprehensive suite of services to SMBs and mid-market and distributed enterprises who wish to consolidate their cloud communications and collaborative service requirements with a single service provider.

Second, our continued focus on mid-market and channels resulted in 35% of our new monthly recurring revenue sold in the quarter coming from this sector. We continued to show an increase in the average number of services to which our new business customers subscribed, leading to improvement in our average monthly service revenue per customer.

Third, we continued to focus on selling a greater number of services to our existing customer base. Our comprehensive suite of services, combined with our highly scalable service architecture enables our customers to quickly and easily deploy additional 8x8 products and services to distributed locations and remote employees.

Fourth, we continued to build on our Global Reach initiative by acquiring Voicenet in the United Kingdom in November 2013. In addition, we installed our services infrastructure in a new Hong Kong data center in January 2014. We are in the process of migrating services for non-US customers to our new overseas infrastructure and plan to open our next data center in South America in fiscal 2015. Beyond serving the needs of existing customers, it is our intent to penetrate these markets through a variety of additional methods including strategic alliances, partners and acquisitions.

To support these initiatives and strengthen our business, we intend to continue investing in research and development and sales and marketing at rates comparable to the third quarter of fiscal 2014 for the foreseeable future.

CRITICAL ACCOUNTING POLICIES & ESTIMATES

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of assets and liabilities. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended March 31, 2013.

Except for the changes to our critical accounting policies and estimates discussed below, we believe that there were no significant changes in those critical accounting policies and estimates during the period ended December 31, 2013.

Stock-Based Compensation

We account for our employee stock options, stock purchase rights, restricted stock units, and restricted performance stock units granted under the 1996 Stock Plan, 1996 Director Option Plan, 1999 Nonstatutory Stock Option Plan, the 2006 Stock Plan, the 2003 Contractual Plan, the 2012 Equity Incentive Plan, the 2013 New Employee Inducement Incentive Plan and stock purchase rights under the 1996 Employee Stock Purchase Plan (collectively "Equity Compensation Plans") under the provisions of ASC 718 - *Stock Compensation*. Under the provisions of ASC 718, stock-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is

recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant), net of estimated forfeitures.

Stock-based compensation expense recognized in the Condensed Consolidated Statements of Income was measured based on ASC 718 criteria. Compensation expense for share-based payment awards is recognized using the straight-line single-option method and includes the impact of estimated forfeitures. Compensation expense for restricted stock units with performance and market conditions is recognized over the requisite service period using the straight-line method and includes the impact of estimated forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

To value option grants, stock purchase rights and restricted stock units under the Equity Compensation Plans for stock-based compensation, we used the Black-Scholes option valuation model. Fair value determined using the Black-Scholes option valuation model varies based on assumptions used for the expected stock prices volatility, expected life, risk-free interest rates and future dividend payments. For the three and nine months ended December 31, 2013 and 2012, we used the historical volatility of our stock over a period equal to the expected life of the options to their fair value. The expected life assumptions represent the weighted-average period stock-based awards are expecting to remain outstanding. These expected life assumptions were established through the review of historical exercise behavior of stock-based award grants with similar vesting periods. The risk-free interest was 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 was based on our history and expectation of future dividend payout.

To value restricted performance stock units under the Equity Compensation Plans, we used a Monte Carlo simulation model. Fair value determined using the Monte Carlo simulation model varies based on the assumptions used for the expected stock price volatility, the correlation coefficient between the Company and the NASDAQ Composite Index, risk free interest rates, and future dividend payments. For the three and nine months ended December 31, 2013, we used the historical volatility and correlation of our stock and the Index over a period equal to the remaining performance period as of the grant date. The risk-free interest rate was 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 remaining performance period as of the grant date. The dividend yield assumption was based on our history and expectation of future dividend payout.

ASC 718 requires us to calculate the additional paid-in-capital pool, or APIC Pool, available to absorb tax deficiencies recognized subsequent to adopting ASC 718, as if we had adopted ASC 718 at its effective date of January 1, 1995. There are two allowable methods to calculate our APIC Pool: (1) the long form method or (2) the short form method as set forth in ASC 718. We have elected to use the long form method under which we track each award grant on an employee-by-employee basis and grant-by-grant basis to determine if there is a tax benefit or tax deficiency for such award. We then compared the fair value expense to the tax deduction received for each grant and aggregated the benefits and deficiencies to establish the APIC Pool.

Due to the adoption of ASC 718, some option exercises result in tax deductions in excess of book deductions based on the option value at the time of grant. We recognize these windfall tax benefits associated with the exercise of stock options directly to stockholders' equity only when realized. We use the "with and without" approach as described in ASC 740, in determining the order in which our tax attributes are utilized. The "with and without" approach results in the recognition of the windfall stock option tax benefits only after all other tax attributes of ours have been considered in the annual tax accrual computation. Also, we have elected to ignore the indirect tax effects of share-based compensation deductions in computing our research and development tax credits and alternative tax credits and as such, we recognize the full effect of these deductions in the consolidated income statement in the period in which the taxable event occurs.

RECENT ACCOUNTING PRONOUNCEMENTS

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

SELECTED OPERATING STATISTICS

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

| | Selected Operating Statistics (1) | | | | | |
|--|-----------------------------------|-------------------|------------------|-------------------|-----------------|-------------------|
| | Dec 31, 2013 | Sept. 30, 2013 | June 30, 2013 | March 31, 2013 | Dec 31, 2012 | Sept. 30, 2012 |
| Gross business customer additions (2) | 3,001 | 2,961 | 2,693 | 2,800 | 2,612 | 2,908 |
| Number of new services sold (2)(3) | 61,286 | 52,412 | 47,318 | 50,670 | 44,366 | 42,853 |
| Average number of subscribed services per new business customer (4) | 20.4 | 17.7 | 17.6 | 18.1 | 17.0 | 14.7 |
| Business subscriber acquisition cost per service (5) | \$ 92 | \$ 94 | \$ 96 | \$ 91 | \$ 97 | \$ 86 |
| Total business customers (2)(6) | 36,753 | 34,674 | 33,374 | 32,242 | 31,177 | 30,191 |
| Average number of subscribed services per business customer (7) | 12.6 | 12.2 | 12.0 | 11.6 | 11.3 | 10.8 |
| Business customer average monthly service revenue per customer (8) | \$ 274 | \$ 268 | \$ 263 | \$ 256 | \$ 252 | \$ 247 |
| Monthly business customer churn (less cancellations within 30 days of sign-up) (9) | 1.6% | 1.5% | 1.5% | 1.7% | 1.6% | 2.4% |
| Monthly business service revenue churn | 1.5% | 1.2% | 1.2% | 1.2% | 2.3% | 0.9% |
| Overall service margin | 81% | 81% | 82% | 81% | 80% | 77% |
| Overall product margin | -34% | -27% | -22% | -17% | -34% | -22% |
| Overall gross margin | 71% | 71% | 72% | 71% | 69% | 69% |

- (1) Selected operating statistics table include continuing operations and excludes dedicated server hosting business sold September 30, 2013.
- (2) Does not include customers of Virtual Office Solo, DNS or Cloud VPS.
- (3) Number of recurring revenue services sold to business customers during the period.
- (4) Number of new services sold divided by gross business customer additions.
- (5) The combined costs of advertising, marketing, promotions, sales commissions and equipment subsidies for new services sold during the period divided by the number of new services sold during the period.
- (6) Business customers are defined as customers paying for service. Customers that are currently in the 30-day trial period are considered to be customers that are paying for service. Customers subscribing to Virtual Office Solo, DNS or Cloud VPS services are not included as business customers.
- (7) The simple average number of subscribed services divided by the simple average number of business customers during the period. The simple average number of subscribed services is the number of subscribed services on the first day of the period plus the number of subscribed services on the last day of the period divided by two. The simple average number of business customers is the number of business customers on the first day of the period plus the number of business customers on the last day of the period divided by two.
- (8) Business customer average monthly service revenue per customer is service revenue from business customers in the period divided by the number of months in the period divided by the simple average number of business customers during the period.
- (9)

Business customer churn is calculated by dividing the number of business customers that terminated (after the expiration of the 30-day trial) by the simple average number of business customers and dividing the result by the number of months in the period. In the quarter ended September 30, 2012, an affiliate with 411 business customers representing approximately \$9,000 of monthly service revenue cancelled service. Excluding these 411 cancellations, business customer churn (less cancellations within 30 days of sign-up) was 1.9%.

RESULTS OF OPERATIONS

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

| <u>Service revenue</u> | 2013 | December 31, 2012 | Dollar Change | Percent Change |
|-----------------------------|-----------|-------------------------------|------------------|-------------------|
| | | (dollar amounts in thousands) | | |
| Three months ended | \$ 29,737 | \$ 24,023 | \$ 5,714 | 23.8% |
| Percentage of total revenue | 90.8% | 91.0% | | |
| Nine months ended | \$ 84,062 | \$ 69,314 | \$ 14,748 | 21.3% |
| Percentage of total revenue | 90.6% | 91.2% | | |

Service revenue consists primarily of revenue attributable to the provision of our 8x8 cloud communication and collaboration services, and royalties earned from cloud technology licenses. We expect that 8x8 service revenues will continue to comprise nearly all of our service revenues for the foreseeable future. 8x8 service revenues increased in the third quarter of fiscal 2014 primarily due to the increase in our business customer subscriber base and an increase in the average monthly service revenue per customer. Our business subscriber base grew from approximately 31,500 business customers on December 31, 2012, to approximately 36,800 on December 31, 2013. The increase in revenues for the first nine months of fiscal 2014 also was primarily attributable to the increase in our business customer base from approximately 32,200 businesses on April 1, 2013 to approximately 36,800 on December 31, 2013 and an increase in the average monthly service revenue per customer.

| <u>Product revenue</u> | 2013 | December 31, 2012 | Dollar Change | Percent Change |
|-----------------------------|----------|-------------------------------|------------------|-------------------|
| | | (dollar amounts in thousands) | | |
| Three months ended | \$ 3,008 | \$ 2,382 | \$ 626 | 26.3% |
| Percentage of total revenue | 9.2% | 9.0% | | |
| Nine months ended | \$ 8,749 | \$ 6,656 | \$ 2,093 | 31.4% |
| Percentage of total revenue | 9.4% | 8.8% | | |

Product revenue consists primarily of revenue from sales of IP telephones in conjunction with our 8x8 cloud telephony service. Product revenue increased for the three and nine months ended December 31, 2013 primarily due to an increase in equipment sales to business customers.

No customer represented greater than 10% of the Company's total revenues for the three or nine months ended December 31, 2013 or 2012. The Company's revenue distribution by geographic region (based upon the destination of shipments and the customer's service address) was as follows:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---------------------------|------------------------------------|------|-----------------------------------|------|
| | 2013 | 2012 | 2013 | 2012 |
| Americas (principally US) | 96% | 99% | 98% | 99% |
| Europe | 3% | 0% | 1% | 0% |
| Asia Pacific | 1% | 1% | 1% | 1% |
| | 100% | 100% | 100% | 100% |

| | December 31, | | Dollar | Percent |
|--------------------------------|-------------------------------|-----------|--------|---------|
| <u>Cost of service revenue</u> | 2013 | 2012 | Change | Change |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 5,584 | \$ 4,890 | \$ 694 | 14.2% |
| Percentage of service revenue | 18.8% | 20.4% | | |
| Nine months ended | \$ 15,579 | \$ 15,184 | \$ 395 | 2.6% |
| Percentage of service revenue | 18.5% | 21.9% | | |

The cost of service revenue primarily consists of costs associated with network operations and related personnel, telephony origination and termination services provided by third party carriers and technology license and royalty expenses. Cost of service revenue for the three months ended December 31, 2013 increased over the comparable period in the prior fiscal year primarily due to a \$0.4 million increase in expenses due to the acquisition of Voicenet, a \$0.1 million increase in payroll and related expenses, a \$0.1 million increase in license and fee expenses and a \$0.1 million increase in other cost of service expenses.

Cost of service revenue for the nine months ended December 31, 2013 increased from the comparable period in the prior fiscal year primarily due to a \$0.4 million increase in payroll and related expenses, a \$0.4 million increase in expenses incurred by Voicenet, a \$0.1 million increase in amortization of capitalized software costs, and a \$0.1 million increase in expensed computer and software expenses. The increase in cost of service revenue was partially offset by a \$0.6 million decrease in third party network service fees.

| | December 31, | | Dollar | Percent |
|--------------------------------|-------------------------------|----------|----------|---------|
| <u>Cost of product revenue</u> | 2013 | 2012 | Change | Change |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 4,041 | \$ 3,203 | \$ 838 | 26.2% |
| Percentage of product revenue | 134.3% | 134.5% | | |
| Nine months ended | \$ 11,171 | \$ 8,585 | \$ 2,586 | 30.1% |
| Percentage of product revenue | 127.7% | 129.0% | | |

The cost of product revenue consists primarily of IP Telephones, estimated warranty obligations and direct and indirect costs associated with product purchasing, scheduling, shipping and handling. The amount of revenue allocated to product revenue based on the relative selling price is less than the cost of the IP phone equipment. The cost of product revenue for the three and nine months ended December 31, 2013 increased over the comparable period in the prior fiscal year primarily due to an increase in equipment shipped to customers and the acquisition of Voicenet (\$0.1 million).

| | December 31, | | Dollar | Percent |
|---------------------------------|-------------------------------|----------|----------|---------|
| <u>Research and development</u> | 2013 | 2012 | Change | Change |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 3,325 | \$ 2,117 | \$ 1,208 | 57.1% |
| Percentage of total revenue | 10.2% | 8.0% | | |
| Nine months ended | \$ 8,301 | \$ 5,973 | \$ 2,328 | 39.0% |
| Percentage of total revenue | 8.9% | 7.9% | | |

Historically, our research and development expenses have consisted primarily of personnel, system prototype design, and equipment costs necessary for us to conduct our development and engineering efforts. During the three months ended December 31, 2013, we capitalized \$0.1 million of software development costs in accordance with ASC 985-20. We expensed all other research and development costs as they were incurred. The research and development expenses for the three months ended December 31, 2013 increased over the comparable period in the prior fiscal year primarily due to a \$0.6 million increase in payroll and related costs, a \$0.5 million increase in consulting and outside service expenses and a \$0.1 million increase in travel and meal expenses, net of capitalized software development costs.

During the nine months ended December 31, 2013, we capitalized \$0.6 million of software development costs in accordance with ASC 985-20. The research and development expenses for the nine months ended December 31, 2013 increased over the comparable period in the prior fiscal year due to a \$1.1 million increase in payroll and related costs, a \$1.0 million increase in consulting and outside service expenses, a \$0.1 million increase in travel and meal expenses and a \$0.1 million increase in other research and development expenses, net of the capitalized software development costs.

| <u>Sales and marketing</u> | December 31, | | Dollar Change | Percent Change |
|-----------------------------|-------------------------------|-----------|------------------|-------------------|
| | 2013 | 2012 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 16,051 | \$ 11,561 | \$ 4,490 | 38.8% |
| Percentage of total revenue | 49.0% | 43.8% | | |
| Nine months ended | \$ 42,868 | \$ 32,629 | \$ 10,239 | 31.4% |
| Percentage of total revenue | 46.2% | 42.9% | | |

Sales and marketing expenses consist primarily of personnel and related overhead costs for sales, marketing, and customer service. Such costs also include outsourced customer service call center operations, sales commissions, as well as trade show, advertising and other marketing and promotional expenses. Sales and marketing expenses for the third quarter of fiscal 2014 increased over the same quarter in the prior fiscal year primarily because of a \$2.7 million increase in payroll and related costs, a \$0.4 million increase in advertising expenses, a \$0.4 million increase in expenses incurred by Voicenet, a \$0.3 million increase in temporary personnel, consulting and outside service expenses, a \$0.2 million increase in indirect channel commission expenses, a \$0.1 million increase in credit card discount fees, a \$0.1 million increase in expensed software, \$0.1 million increase in travel and meal expenses, and a \$0.1 million increase in tradeshow expenses.

Sales and marketing expenses for the first nine months of fiscal 2014 increased over the same period in the prior fiscal year primarily because of a \$6.2 million increase in payroll and related costs, \$1.3 million increase in advertising expense, a \$0.4 million increase in temporary personnel, consulting and outside service expenses, a \$0.4 million increase in expenses incurred by Voicenet, a \$0.4 million increase in indirect channel commission expenses, a \$0.2 million increase in credit card discount fees, a \$0.2 million increase in travel and meal expenses, a \$0.2 million increase in trade show expenses, a \$0.1 million increase in sales promotion expenses, a \$0.1 million increase in expensed software, a \$0.1 million increase in bad debt expense, a \$0.1 million increase in recruiting expenses, and a \$0.5 million increase in other sales and marketing expenses.

| <u>General and administrative</u> | December 31, | | Dollar Change | Percent Change |
|-----------------------------------|-------------------------------|----------|------------------|-------------------|
| | 2013 | 2012 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 5,547 | \$ 2,119 | \$ 3,428 | 161.8% |
| Percentage of total revenue | 16.9% | 8.0% | | |
| Nine months ended | \$ 11,444 | \$ 6,226 | \$ 5,218 | 83.8% |
| Percentage of total revenue | 12.3% | 8.2% | | |

General and administrative expenses consist primarily of personnel and related overhead costs for finance, human resources and general management. General and administrative expenses for the third quarter of fiscal 2014 increased over the same quarter in the prior fiscal year primarily because of a \$2.2 million increase in payroll and related costs, including a one-time charge of approximately \$0.1 million in severance pay and \$1.1 million in stock-based compensation related to the resignation of the Company's president in October 2013, a \$0.5 million increase in legal fees primarily related to the acquisition of Voicenet, a \$0.2 million increase in temporary personnel, consulting and outside service expenses, a \$0.2 million increase in accounting and tax expenses, a \$0.1 million increase in license and fee expenses, a \$0.1 million increase in facility maintenance and janitorial service expenses, a \$0.1 million increase in expenses due to the acquisition of Voicenet, a \$0.1 million increase in sales and use tax expense, and a \$0.1 million increase in property and franchise tax expense. The increase in general and administrative expenses was partially offset by a \$0.2 million reduction in other general and administrative expenses.

General and administrative expenses for the first nine months of fiscal 2014 increased over the same period in the prior fiscal year primarily because of a \$3.5 million increase in payroll and related expenses, including a one-time charge of approximately \$0.1 million in severance pay and \$1.1 million in stock-based compensation related to the resignation of the Company's president in October 2013, a \$0.7 million increase in legal expenses, a \$0.2 million increase in accounting and tax expenses, a \$0.2 million increase in rent expense, a \$0.2 million increase in depreciation expense, a \$0.2 million increase in facility maintenance and janitorial service expenses, a \$0.2 million increase in sales and use tax expense, a \$0.2 million increase in personal property and franchise taxes, a \$0.1 million increase in temporary personnel, consulting and outside service expenses a \$0.1 million increase in license and fee expenses, a \$0.1 million increase in expenses due to the acquisition of Voicenet, a \$0.1 million in travel and meal expenses, and a \$0.1 million increase in utility expenses. The increase in general and administrative expenses was partially offset by a \$0.1 million decrease in recruiting expenses and a \$0.6 million decrease in other general and administrative expenses.

| | December 31, | | Dollar | Percent |
|-----------------------------|-------------------------------|-------------|-----------|---------|
| <u>Gain on patent sale</u> | 2013 | 2012 | Change | Change |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ - | \$ - | \$ - | - |
| Percentage of total revenue | 0.0% | 0.0% | | |
| Nine months ended | \$ - | \$ (11,965) | \$ 11,965 | -100.0% |
| Percentage of total revenue | 0.0% | -15.7% | | |

In June 2012, we entered into a patent purchase agreement for the sale of a family of United States patents for \$12.0 million in cash. We recognized a \$12.0 million gain on this transaction, which we recorded as a reduction of operating expenses in the consolidated statements of operations. The gain was comprised of the \$12.0 million of proceeds, net of transaction costs.

| | December 31, | | Dollar | Percent |
|-----------------------------|-------------------------------|-------|--------|---------|
| <u>Other income, net</u> | 2013 | 2012 | Change | Change |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ 586 | \$ 73 | \$ 513 | 702.7% |
| Percentage of total revenue | 1.8% | 0.3% | | |
| Nine months ended | \$ 602 | \$ 90 | \$ 512 | 568.9% |
| Percentage of total revenue | 0.6% | 0.1% | | |

In the three and nine months ended December 31, 2013, other income, net primarily consisted of \$0.6 million gain related to settlement in December 2013 of an escrow claim related to the acquisition of Contactual, Inc. and interest income earned on our cash, cash equivalents and investments.

In the three and nine months ended December 31, 2012, other income, net primarily consisted of interest income earned on our cash, cash equivalents and investments.

| | December 31, | | Dollar | Percent |
|--|-------------------------------|----------|------------|---------|
| <u>Provision for income tax</u> | 2013 | 2012 | Change | Change |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ (1,306) | \$ 814 | \$ (2,120) | -260.4% |
| Percentage of income before provision for income taxes | 107.3% | 31.5% | | |
| Nine months ended | \$ 481 | \$ 7,494 | \$ (7,013) | -93.6% |
| Percentage of income before provision for income taxes | 11.9% | 38.6% | | |

For the three months ended December 31, 2013, we recorded a benefit for income taxes of \$1.3 million which was primarily attributable to income from continuing operations reduced by a tax benefit for an adjustment to credit carryforwards treated as a one-time item for the quarter. For the three months ended December 31, 2012, we recorded a provision for income taxes of \$0.8 million which was primarily attributable to income from continuing operations.

For the nine months ended December 31, 2013, we recorded a provision for income taxes of \$0.5 million which was primarily attributable to income from continuing operations, reduced by \$0.9 million for an adjustment to credit carryforwards and other true-ups for prior years that were treated as one-time items for fiscal 2014. For the nine months ended December 31, 2012, we recorded a provision for income taxes of \$7.5 million which was primarily attributable to income from continuing operations, including the gain on patent sale.

The effective tax rate is calculated by dividing the income tax provision by net income before income tax expense. We estimate our annual effective tax rate at the end of each quarter. In estimating the annual effective tax rate, we, in consultation with our tax advisors, consider, among other things, annual pre-tax income, permanent tax differences, the geographic mix of pre-tax income and the application and interpretations of existing tax laws.

| Income from discontinued operations, net of income tax provision | December 31, | | Dollar Change | Percent Change |
|---|-------------------------------|-------------|--------------------------|---------------------------|
| | 2013 | 2012 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ - | \$ 146 | \$ (146) | -100.0% |
| Percentage of total revenue | 0.0% | 0.6% | | |
| Nine months ended | \$ 301 | \$ 344 | \$ (43) | -12.5% |
| Percentage of total revenue | 0.3% | 0.5% | | |

On September 30, 2013, we sold our dedicated server hosting business. The current and historical results of our dedicated server hosting business have been reclassified to income from discontinued operations, net of income tax provision. For the three months ended December 31, 2013, we recorded a provision for income taxes of \$0.1 million related to discontinued operations. For the nine months ended December 31, 2013 and 2012, we recorded a provision for income taxes of \$0.2 million related to discontinued operations.

| Gain on disposal of discontinued operations, net of income tax provision | December 31, | | Dollar Change | Percent Change |
|---|-------------------------------|-------------|--------------------------|---------------------------|
| | 2013 | 2012 | | |
| | (dollar amounts in thousands) | | | |
| Three months ended | \$ - | \$ - | \$ - | 100.0% |
| Percentage of total revenue | 0.0% | 0.0% | | |
| Nine months ended | \$ 589 | \$ - | \$ 589 | 100.0% |
| Percentage of total revenue | 0.6% | 0.0% | | |

For the nine months ended December 31, 2013, we recorded a gain on disposal of our dedicated server hosting business of \$1.1 million, net of a tax provision of \$0.5 million.

Liquidity and Capital Resources

As of December 31, 2013, we had approximately \$174.0 million in cash, cash equivalents and short-term investments.

Cash provided by operating activities has historically been affected by the amount of net income, sales of subscriptions, changes in working capital accounts particularly in deferred revenue due to timing of annual plan renewals, add-backs of non-cash expense items such as the use of deferred tax assets, depreciation and amortization and the expense associated with stock-based awards. Net cash provided by operating activities for the nine months ended December 31, 2013 was approximately \$11.6 million, compared with \$26.0 million for the nine months ended December 31, 2012. The decrease in cash flow occurred primarily because the latter period included a \$12.0 million gain on the sale of a patent family in June 2012. The decrease in cash flows was partially offset by a \$0.9 million tax benefit for an adjustment to credit carryforwards treated as a one-time item in the third quarter of fiscal 2014, a \$0.6 million settlement of the Contractual escrow claim and a \$0.6 million gain on disposal of dedicated server hosting business, net of income taxes in the first nine months of fiscal 2014. We do not expect that the disposition of our dedicated server hosting business to have an adverse effect on our liquidity.

Net cash used in investing activities was \$18.1 million during the nine months ended December 31, 2013 during which period we acquired Voicenet for \$18.5 million, net of cash acquired, we spent approximately \$2.0 million on the purchase of property and equipment, and we capitalized \$0.6 million of software development costs. The cash used in investing activities was partially offset by the proceeds from disposition of our dedicated server hosting business. The net cash used in investing activities for the nine months ended December 31, 2012 was \$5.2 million during which period we spent approximately \$5.2 million on the purchase of additional furniture and fixtures and leasehold improvements in connection with our move to a new headquarters facility in San Jose, California and computer equipment.

Our financing activities for the nine months ended December 31, 2013 consisted primarily of cash from the underwritten registered offering of common stock in which it sold 14,375,000 shares for total cash proceeds of approximately \$125.8 million, net of issuance costs of \$0.6 million and the exercise of employee stock options and the purchase of shares under the employee stock purchase plan (\$3.0 million). Cash used to repurchase shares of our common stock (\$0.3 million). For the nine-month period ended December 31, 2012, our financing activities consisted primarily of cash proceeds of \$1.7 million related to the exercise of employee stock options and the purchase of shares under the employee stock purchase plan and \$0.3 million of cash used to repurchase shares of our common stock.

Contractual Obligations

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

We entered into a series of noncancelable capital lease agreements for office equipment bearing interest at various rates. Assets under capital lease at December 31, 2013 totaled \$110,000 with accumulated amortization of \$83,000.

In the third quarter of 2010, we amended the contract with one of our third party customer support vendors containing a minimum monthly commitment of approximately \$430,000. The agreement requires a 150-day notice to terminate. At December 31, 2013, the total remaining obligation under the contract was \$2.2 million.

We have entered into contracts with multiple vendors for third party network services. At December 31, 2013, future minimum annual payments under these third party network service contracts were \$502,000 in fiscal 2014, \$1,579,000 in fiscal 2015 and \$52,000 in fiscal 2016.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency

Our financial market risk consists primarily of risks associated with international operations and related foreign currencies. We derive a portion of our revenue from customers in Europe and Asia. In order to reduce the risk from fluctuation in foreign exchange rates, the vast majority of our sales are denominated in U.S. dollars. In addition, almost all of our arrangements with our contract manufacturers are denominated in U.S. dollars. We have not entered into any currency hedging activities. To date, our exposure to exchange rate volatility has not been significant; 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 and investments are generally classified as available for sale and, consequently, are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive loss. Part of this portfolio includes investments in mutual funds.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Effectiveness of Disclosure Controls and Procedures

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

As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our Disclosure Controls. Based on this evaluation our Chief Executive Officer and our Chief Financial Officer have concluded that our Disclosure Controls were effective as of December 31, 2013.

Limitations on the Effectiveness of Controls

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

Changes in Internal Control over Financial Reporting

During the third quarter of fiscal 2014, 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 1. Legal Proceedings

Descriptions of our legal proceedings are contained in Part I, Item 1, Financial Statements - Notes to Condensed Consolidated Financial Statements - "Note 8".

ITEM 1A. Risk Factors

We face many significant risks in our business, some of which are unknown to us and not presently foreseen. These risks could have a material adverse impact on our business, financial condition and results of operations in the future. We have disclosed a number of material risks under Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended March 31, 2013, which we filed with the Securities and Exchange Commission on May 28, 2013 and updated risk factor disclosures in Part II, Item 1A of our quarterly report on Form 10-Q filed November 8, 2013, and the following updated risk factor:

Our business depends on continued, unimpeded access to the Internet by us and our users, but Internet access providers and Internet backbone providers may be able to block, degrade or charge for access to or bandwidth use of certain of our products and services, which could lead to additional expenses and the loss of users.

Our products and services depend on the ability of our users to access the Internet, and certain of our products require significant bandwidth to work effectively. In addition, users who access our services and applications through mobile devices, such as smartphones and tablets, must have a high-speed connection, such as Wi-Fi, 3G, 4G or LTE, to use our services and applications. Currently, this access is provided by companies that have significant and increasing market power in the broadband and Internet access marketplace, including incumbent telephone companies, cable companies and mobile communications companies. Some of these providers offer products and services that directly compete with our own offerings, which give them a significant competitive advantage. Some of these providers have stated that they may take measures that could degrade, disrupt or increase the cost of user access to certain of our products by restricting or prohibiting the use of their infrastructure to support or facilitate our offerings, or by charging increased fees to us or our users to provide our offerings, while others, including some of the largest providers of broadband Internet access services, have committed to not engaging in such behavior. These providers have the ability generally to increase their rates, which may effectively increase the cost to our customers of using our cloud communications and collaboration services.

On December 23, 2010, the Federal Communications Commission, or FCC, adopted an order that imposes "network neutrality" obligations on providers of fixed and wireless broadband Internet access services, with wireless providers subject to a more limited set of rules. The FCC rules became effective on November 20, 2011. Numerous parties have appealed these rules, and these appeals were consolidated before the U.S. Court of Appeals for the District of Columbia. On January 14, 2014, this appellate court ruled that the FCC's Open Internet ("network neutrality") rules prohibiting broadband providers from discriminating against third party content and prohibiting the blocking of third party content exceed the FCC's authority under the Communications Act. The Court did, however, give the FCC a partial victory by finding that the FCC has general authority over broadband Internet services under Section 706 of Telecommunications Act of 1996 which directs the FCC to encourage broadband deployment on a reasonable and timely basis and take steps to accelerate broadband deployment when such deployment is lagging. The Court also found that the FCC's reasons for adopting the Open Internet rules were sufficiently related to hastening broadband deployment. The FCC's Chairman has released a preliminary statement that the FCC is considering all options, including an appeal. The FCC can seek a rehearing by the entire D.C. Circuit or can petition for review to the Supreme Court. We cannot predict the outcome of these appeals or the impact of these rules on our business at this time. Although we believe interference with access to our products and services is unlikely, broadband Internet access provider interference has occurred, in limited circumstances in the United States, and could result in a loss of existing users and increased costs, and could impair our ability to attract new users, thereby negatively impacting our revenue

and growth.

Acquisitions may divert our management's attention, result in dilution to our stockholders and consume resources that are necessary to sustain our business.

In fiscal 2014, we completed one acquisition in the United Kingdom and divested our dedicated server hosting business; in fiscal 2012, we completed two acquisitions of businesses; and in fiscal 2011, we completed one acquisition and one investment in another company and, if appropriate opportunities present themselves, we may make additional acquisitions or investments or enter into joint ventures or strategic alliances with other companies. Risks commonly encountered in such transactions include:

- the difficulty of assimilating the operations and personnel of the combined companies;
- the risk that we may not be able to integrate the acquired services or technologies with our current services, products, and technologies;
- the potential disruption of our ongoing business;
- the diversion of management attention from our existing business;
- the inability of management to maximize our financial and strategic position through the successful integration of the acquired businesses;
- difficulty in maintaining controls, procedures, and policies;
- the impairment of relationships with employees, suppliers, and customers as a result of any integration;
- the loss of an acquired base of customers and accompanying revenue;
- the assumption of leased facilities, other long-term commitments or liabilities that could have a material adverse impact on our profitability and cash flow; and
- the dilution to our existing stockholders from the issuance of additional shares of common stock or reduction of earnings per outstanding share in connection with an acquisition that fails to increase the value of our company.

As a result of these potential problems and risks, among others, businesses that we may acquire or invest in may not produce the revenue, earnings, or business synergies that we anticipate. In addition, there can be no assurance that any potential transaction will be successfully completed or that, if completed, the acquired business or investment will generate sufficient revenue to offset the associated costs or other potential harmful effects on our business.

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

As of December 31, 2013, we had cash and cash equivalents and investments of approximately \$174.0 million. While we believe these funds are sufficient to meet our current and anticipated liquidity requirements, we may need to raise additional capital to pursue our strategic objectives. We may seek additional funding through public or private equity or debt financing. We filed a shelf registration statement with the SEC that was declared effective on April 5, 2013. This shelf registration statement allows us to sell up to an additional amount of approximately \$120 million of our securities, after taking into account our common stock offering in November 2013, from time to time during the three year period subsequent to the effective date of the registration statement. We might decide to raise additional debt or equity capital at such times and upon such terms as management considers favorable and in our interests, but we cannot be certain that we will be able to complete offerings of our securities at such times and on such terms as we may consider desirable for us. Any such financings may be upon terms that are dilutive to existing stockholders. 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.

ITEM 6. EXHIBITS

| Exhibit Number | Description |
|-------------------|---|
| 10.8(t)* | <u>Severance Agreement and General Release</u> |
| 10.23(u) | <u>Share Purchase Agreement, dated November 11, 2013, by and among 8x8 UK Investments Limited and 8x8, Inc. and the material sellers and the material optionholders and Voicenet Solutions Limited.</u> |
| 31.1 | <u>Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 31.2 | <u>Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 32.1 | <u>Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| 32.2 | <u>Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase |

*

Indicates management contract or compensatory plan or arrangement.

(t)

Incorporated by reference to exhibit 10.8 to the Registrant's Form 8-K filed November 5, 2013 (File No. 000-21783)

(u)

Incorporated by reference to exhibit 2.2 to the Registrant's Form 8-K filed November 13, 2013 (File No. 000-21783).

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: January 30, 2014

8X8, INC.
(Registrant)

By: /s/ DANIEL WEIRICH
Daniel Weirich

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