SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(MARK ONE)

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

For the fiscal year ended March 31, 2006

OR

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

FOR THE TRANSITION PERIOD FROM __________ TO ____________

Commission file number 000-21783

8X8, INC.

(Exact name of Registrant as Specified in its Charter)

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

3151 Jay Street
Santa Clara, CA 95054
(Address of Principal Executive Offices including Zip Code)

(408) 727-1885
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: COMMON STOCK, PAR VALUE $.001 PER SHARE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. [ ] Yes [X] No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. [ ] Yes [X] No

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 such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X]   No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. [X]

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

Large accelerated filer [ ]   Accelerated filer [X]   Non-accelerated filer [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.)

Yes [ ]   No [X]

Based on the closing sale price of the Registrant's common stock on the NASDAQ Capital Market System on September 30, 2005, the aggregate market value of the voting stock held by non-affiliates of the Registrant was $108,594,602.

The number of shares of the Registrant's common stock outstanding as of May 26, 2006 was 61,138,280.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10, 11, 12, 13 and 14 of Part III incorporate information by reference from the Proxy Statement to be filed within 120 days of March 31, 2006 for the 2006 Annual Meeting of Stockholders.

8X8, INC.

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FOR THE YEAR ENDED MARCH 31, 2006

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PART I

ITEM 1. BUSINESS

Forward-Looking Statements and Risk Factors

Statements contained in this annual report on Form 10-K, or Annual Report, regarding our expectations, beliefs, estimates, intentions or strategies are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act and include statements regarding our expectation concerning the adequacy of our facilities; our estimates of litigation exposure and our beliefs about the sufficiency of our supplier arrangements. 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. You should not place undue reliance on these forward-looking statements. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including a shifting of internal research and development focus based on changes in the market or adequacy of funding; a failure of customers to adopt voice and video over internet protocol technology or advances in competing systems and services; our business may grow in an unanticipated manner causing us to require different types of facilities; ordinary course litigation may cause a greater than anticipated impact due to factual matters or issues beyond our control; and our ability to source our products may be interrupted if our manufacturers cease operations or no longer desire to do business with us. Please also see the section entitled "Risk Factors" for additional risks that may impact our business. We undertake no obligation to revise or update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this Annual Report. Readers are urged to carefully review and consider the various disclosures made in this Annual Report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations and prospects.

Our fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in this Annual Report, refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2006 refers to the fiscal year ended March 31, 2006). Unless the context requires otherwise, references to “we,” “us,” “our,” “8x8” and the “Company” refer to 8x8, Inc. and its consolidated subsidiaries.

Overview

We develop, market and sell telecommunication services and technology for Internet protocol, or IP, telephony and video applications. We offer the Packet8 broadband voice over Internet protocol, or VoIP, phone service, Packet8 Virtual Office service and Packet8 videophone equipment and service. We shipped our first VoIP product in 1998, launched our Packet8 service in November 2002, launched the Packet8 Virtual Office business service in March 2004 and launched the Packet8 videophone service in June 2004. As of March 31, 2006, we had approximately 133,000 Packet8 lines in service. Lines in service represent subscriber lines of our residential, business and videophone subscribers and include toll-free and virtual phone numbers.

The Packet8 voice and video broadband phone service (Packet8) enables broadband Internet users to add digital voice and video communications services to their high-speed Internet connection. Customers can choose a direct-dial phone number from any of the rate centers offered by the service, and then use an 8x8-supplied terminal adapter to connect any telephone to a broadband Internet connection and make or receive calls from a regular telephone number. All Packet8 telephone accounts come with voice mail, caller ID, call waiting, call waiting caller ID, call forwarding, hold, line-alternate, 3-way conferencing, web and voice-prompt access to account controls, and online billing. In addition, we offer a videophone in conjunction with our video service plans that connects to a customer’s high-speed Internet connection to deliver all of the voice features above, as well as unlimited video calls to any other Packet8 videophone customer in the world. We also offer IP telephones with built-in connectivity to Packet8 via an IP connector on the phone. We also sell pre-programmed analog telephones with speakerphones and a display screen, in conjunction with our Virtual Office service plans, which enable our business customers to access additional features of Virtual Office through on-screen menus on the phone.

During fiscal 2006, we completed one equity financing transaction for gross proceeds of approximately $15 million. As of March 31, 2006, we had cash, cash equivalents and investments of approximately $23 million as compared to $31.8 million at March 31, 2005.

Available Information

We maintain a corporate Internet website with the address http://www.8x8.com. The contents of this website are not incorporated in or otherwise to be regarded as part of this Annual Report. We file reports with the Securities and Exchange Commission, or SEC, which are available on our website free of charge. These reports include annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports, each of which is provided on our website as soon as reasonably practicable after we electronically file such materials with or furnish them to the SEC. You can also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You can obtain additional information about the operation of the Public Reference Room by calling the SEC at 1.800.SEC.0330. In addition, the SEC maintains a website (www.sec.gov) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us.

Industry Background

VoIP is a technology that enables communications over the Internet through the compression of voice, video and/or other media into data packets that can be efficiently transmitted over data networks and then converted back into the original media at the other end. Data networks, such as the Internet or local area networks, or LANs, have always utilized packet-switched technology to transmit information between two communicating terminals (for example, a PC downloading a page from a web server, or one computer sending an e-mail message to another computer). The most common protocol used for communicating on these packet switched networks is IP. VoIP allows for the transmission of voice along with other data over these same packet switched networks, and provides an alternative to traditional telephone networks, which use a fixed electrical path to carry voice signals through a series of switches to a destination.

As a result of the potential cost savings and added features of VoIP, consumers, enterprises, traditional telecommunication service providers and cable television providers are viewing VoIP as the future of telecommunications. VoIP has experienced significant growth in recent years due to:

- Demand for lower cost telephone service;
- Improved quality and reliability of VoIP calls due to technological advances, increased network development and greater bandwidth capacity; and
- New product innovations that allow VoIP providers to offer services not currently offered by traditional telephone companies.

Technology research firms and analysts predict that VoIP telephony services will grow from less than 1,000,000 U.S. households at the end of 2004 to up to 20 million U.S. households by 2009.

The traditional telephone networks maintained by many local and long distance telephone companies were designed solely to carry low-fidelity audio signals with a high level of reliability. Although these traditional telephone networks are very reliable for voice communications, these networks are not well suited to service the explosive growth of digital communication applications for the following reasons:

- They are expensive to build because each subscriber's telephone must be individually connected to the central office switch, which is usually several miles away from a typical subscriber's location;
- They transmit data at very low rates and resolutions, making them poorly suited for delivering high-fidelity audio, entertainment-quality video or other rich multimedia content;
- They use dedicated circuits for each telephone call, which allot fixed bandwidth throughout the duration of each call, whether or not voice is actually being transmitted; and

- They may experience difficulty in providing new or differentiated services or functions, such as video communications, that the network was not originally designed to accommodate.

Until recently, traditional telephone companies have avoided the use of packet switched networks for transmitting voice calls due to the potential for poor sound quality attributable to latency issues (delays) and lost packets which can prevent real-time transmission. Recent improvements in packet switch technology, compression and broadband access technologies, as well as improved hardware and provisioning techniques, have significantly improved the quality and usability of packet-switched voice calls.

Historically, packet-switched networks were built mainly for carrying non real-time data, although they are now fully capable of transmitting real time data. The advantages of such networks are their efficiency, flexibility and scalability. Bandwidth is only consumed when needed. Networks can be built in a variety of configurations to suit the number of users, client/server application requirements and desired availability of bandwidth, and many terminals can share the same connection to the network. As a result, significantly more traffic can be transmitted over a packet switched network, such as a home network or the Internet, than a circuit-switched telephony network. Packet switching technology allows service providers to converge their traditionally separate voice and data networks and more efficiently utilize their networks by carrying voice, video, facsimile and data traffic over the same network. The improved efficiency of packet switching technology creates network cost savings that can be passed on to the consumer in the form of lower telephony rates.

The growth of the Internet in recent years has proven the scalability of these underlying packet switched networks. As broadband connectivity, including cable modem and digital subscriber line, or DSL, has become more available and less expensive, it is now possible for service providers like us to offer voice and video services that run over these IP networks to businesses and residential consumers. Providing such services has the potential to both substantially lower the cost of telephone service and equipment costs to these customers and to increase the breadth of features available to our subscribers. Services like full-motion, two-way video are now supported by the bandwidth spectrum commonly available to broadband customers, whether business or residential.

Our Strategy

Our objective is to provide reliable, scalable, and profitable worldwide Internet communication services with unmatched quality. Our goal is to achieve this objective by delivering innovative technologies and services and balancing the needs of our customers with the needs of our business. We foster an environment that empowers our employees to provide the best service to our customers and partners in every way that they interact with us. We intend to bring the best possible voice and video products and services, at an affordable price, to residential consumers and businesses and enhance the ways in which these customers communicate with each other, and with the world.

Specific strategies to accomplish this objective include:

- *Focus on our Packet8 Virtual Office product line.* Towards the end of fiscal 2006, we began to shift the focus of our sales and marketing efforts to growing the Packet8 Virtual Office services and applications. Packet8 Virtual Office generates higher margins for us as compared to the residential consumer service. The businesses that subscribe to the service pay for the premise equipment and generate higher monthly service revenues. In addition, they are more likely to subscribe to our additional services and are less likely to leave the service.

- *Capitalize on our technological expertise to introduce new products and features.* Over the past ten years, we have developed or acquired several core technologies that form the backbone of our video and voice over IP service and which we intend to use to develop product enhancements and future products. We developed the endpoint technologies used to provide video and voice service at the customer premise, and control the embedded software that run these endpoint devices. As a result, we are able to update the software functionality of our customers' endpoints without any third party assistance. We are the only voice over IP service provider shipping two-way video-enabled hardware, and the features in our Packet8 Virtual Office services are unique in the industry.

- *Offer the best possible service and support to our customers with a world class customer support organization.* We have established a call center and customer support group at our headquarters in

Santa Clara, California and have outsourced call center operations in Syracuse, New York, Iowa City, Iowa and Santa Maria, California. We are also investing in significant upgrades to our existing back office infrastructure to enhance the support we can provide to new and existing subscribers, as well as our distribution partners. In an emerging industry with world-changing technologies, we are focused on our customers and their experience with Packet8.

- *Develop additional distribution channels.* We have established relationships with resellers, retailers and other distributors of telecommunications products and services. To further accelerate growth of our Packet8 residential and business offerings, we intend to build upon our existing relationships and establish new relationships with distributors, value added resellers and system integrators, other service providers, equipment manufacturers and retailers to make our products more readily available and accessible to potential customers of our services.

Our Packet8 Solution

Packet8 is an Internet-based communication service that works over virtually any high-speed Internet connection in the world, and allows calls to or from any phone in the world, whether that phone is an IP phone or a regular public switched telephone network, or PSTN, phone. Packet8 utilizes IP communication endpoints (i.e., a broadband phone adapter) which, when used in conjunction with the Packet8 network software and any standard telephone, enable plug and play installation and a familiar dialtone user interface. The Packet8 service also uses web-based technologies to enable account setup, account management, billing and customer support. We have developed a significant amount of the technology underlying our Packet8 service, which works with third party carriers to terminate VoIP calls on the PSTN network. As part of the Packet8 service, we currently resell private-branded telephone IP terminal adapters, which allow a regular analog telephone to be connected to an IP network, IP telephones and videophones, and preprogrammed business telephones. These devices, some of which are manufactured by certain of our former semiconductor customers, utilize our licensed semiconductor technology and certain unique software modifications to the protocol and application code that enable them to connect to 8x8's Packet8 IP services platform. The designs of these devices are based on our former semiconductor reference designs. We continue to enhance and develop new functionality in the software code that is embedded in these devices.

Products and Services

PACKET8 VoIP & VIDEO TELEPHONE SERVICE

Our Packet8 VoIP telephone service was introduced in November 2002. Customers enter into a service agreement with us, and select a calling plan based on their anticipated use of the service. Service plans provide various minutes of usage, up to unlimited, for calls in North America and Canada that are made to non-Packet8 customers. Subscribers are charged at a per-minute rate for international calls to non-Packet8 customers, and, depending on the level of plan selected, may be charged for calls to the PSTN if they exceed the minutes allowed under their plan. Depending on the service plan selected, 8x8 will either sell or provide at no cost to the user the 8x8 broadband phone adapter or desktop videophone to use with the Packet8 service. Each subscriber is assigned a telephone number in any of the area codes and underlying rate centers currently offered by the service. We currently offer area codes in forty-five U.S. states and the ability for a subscriber to port a number from another service provider. All Packet8 customers receive access to a variety of telephone features, including voice mail, caller ID, call forwarding, call waiting, 3-way calling, online account management and billing, international call blocking and caller ID blocking. We currently offer enhanced 911, or E911, service on all Packet8 calling plans with a United States service address. A Packet8 E911 call is routed as 911 emergency traffic and is accompanied by caller information, which enables emergency personnel to ensure that callers receive the exact same response that they receive from 911 services provided by landline incumbent telephone carriers. Subscribers may also have toll-free numbers (e.g., 800 numbers or virtual numbers. A virtual number is an additional phone number, which will ring through to an existing subscriber line. We are also offering video over IP service using the DV326 videophone product which includes all of the voice features described above plus unlimited video calls to any other Packet8 videophone subscriber anywhere in the world. As of March 31, 2006, Packet8 residential and video lines represented approximately 81% of our lines in service.

PACKET8 VIRTUAL OFFICE BUSINESS TELEPHONE SERVICE

Our Packet8 Virtual Office business class telephone service was launched in March 2004 and is targeted at the small and medium-sized business market. Packet8 Virtual Office is an easy-to-use alternative to traditional PBX systems or Centrex class services from legacy telecommunications providers, and provides features and services that neither can provide. Packet8 Virtual Office allows users with a high-speed Internet connection anywhere in the world to be part of a virtual PBX that includes automated attendants to assist callers, conference bridges, extension-to-extension dialing and ring groups, in addition to a rich variety of other business class PBX features normally found on dedicated PBX equipment.

Packet8 Virtual Office subscribers have the ability to choose any phone number available to Packet8 subscribers or regardless of a user's geographic location. Subscribers can also port numbers, including toll-free numbers, from other service providers. Each extension in the virtual PBX can be located anywhere in the world where there is access to the Internet. Packet8 Virtual Office extension-to-extension calls and transfers are accomplished over the Internet, anywhere in the world, free of extra charges to third party telecommunications carriers. Packet8 Virtual Office offers the services small and medium-sized businesses need most, including:

- Auto-attendant providing dial by extension, name or by group;
- Unlimited calling to the US, Canada and other Packet8 subscribers, as well as low international rates;
- Unlimited Packet8 extension-to-extension dialing anywhere in the world;
- Direct Inward Dial (DID) phone number with any desired area code for each extension;
- Conference bridge, 3-Way conferencing, music on hold, call park/pick-up, call transfer, hunt groups, and do not disturb;
- Business-class voice mail including email alerts, and direct transfer to mailbox;
- Call waiting / Caller-ID;
- Distinctive ringing; and
- Optional receptionist console application offering:
    - Multiple call viewing and handling;
    - Direct transfer to extension's voicemail;
    - Supervised transfers; and
    - View of extension status.

Packet8 Virtual Office extensions can be provisioned without requiring dedicated communications infrastructure to be installed in an office or remote location. The service is installed and runs over an office’s existing Internet connection, so no dedicated phone lines or digital subscriber lines (like a T1) need to be installed, as is the case with traditional Centrex or PBX products. As of March 31, 2006, Packet8 Virtual Office represented approximately 17% of our lines in service.

WHOLESALE VOICE AND VIDEO SERVICES

Our wholesale voice and video services include a complete suite of VoIP platforms with a Session Initiation Protocol, or SIP, IP switching infrastructure at its core, and voice, video and wireless endpoint devices to form a complete, end-to-end solution. Our technology delivers differentiating features for residential, business and video value-added services with co-branding and private branding options available to enable our partners to offer a differently labeled service similar to Packet8. Our network address traversal, or NAT, firewall traversal technologies, and quality of service, or QOS, techniques are also integrated into the wholesale solution. A wholesale billing interface is also included, enabling service providers to deploy a private-branded offering that integrates into existing broadband billing platforms.

During fiscal 2006, we launched new private label services with DSG international in the United Kingdom (under the *freetalk* brand) and with BellSouth in its nine state region bundled with BellSouth's FastAccess DSL services. As of March 31, 2006, these private label services represented approximately 2% of our lines in service.

BROADBAND PHONE ADAPTER

Our broadband phone adapter, or BPA, product line is a set of telephone handset-to-Ethernet adapters that interface regular analog phones with IP-based telephony networks. We use the BPA-410 for our Virtual Office service and the broadband phone gateway, or BPG-510, for our residential service. The BPA or BPG is installed by the subscriber at their premises and supports up to two voice ports with its own direct dial phone number. These adapters run a variety of communication and network protocols, including SIP and MGCP.

DESKTOP IP VIDEOPHONE

Our desktop videophone product, the DV326, is an IP videophone that contains all of the voice features of a regular Packet8 service. In addition, when a Packet8 videophone subscriber calls another Packet8 videophone subscriber, the videophones connect with instant-on high-speed video sent over the Internet. The videophones can be configured by the user to use a maximum total data bandwidth between 84 kilobits per second and 640 kilobits per second. The video quality of the call varies with the data bandwidth selected and other network conditions. The Packet8 videophone is designed to be compatible with other SIP protocol devices. During the fourth quarter of fiscal 2006, we suspended purchases of the DV326, which were a major contributor to our negative product margins. We are evaluating alternatives as we continue to work with our original equipment manufacturer, or OEM, partner on a new, lower cost videophone. We are also in the final testing stages of a new software communications client, Packet8 Softalk, which will include video communications capabilities from any camera connected to a personal computer.

PACKET8 ENABLED HANDSETS

Uniden America Corporation, or Uniden, offers three Packet8 service-ready whole house VoIP phone systems: the UIP1868, the UIP160P and the UIP165P. These products are Packet8-enabled 5.8GHz digital expandable corded/cordless phones that are expandable to multiple handsets, deploying VoIP capability to each handset using a single high-speed Internet connection. Incorporating 8x8's Internet telephony software, these Uniden phones offer plug-and-play access to Packet8's feature-rich broadband telephone service, and include a built-in 1-port router. The Uniden Packet8-enabled phones also include one phone port to interface external analog phone devices, such as an answering machine or facsimile machine, to the base station.

Sales, Marketing and Promotional Activities

We currently sell and market our Packet8 and Packet8 Virtual Office services to end users through our direct sales force, website, retail channels, online channels, network marketing firms and third party resellers. We launched the retail channel in fiscal 2005 and entered into arrangements with numerous brick and mortar retailers, such as CompUSA, Fry's and J&R Music World, and on-line retailers including Amazon.com and TigerDirect. We have developed a network marketing channel and entered into agreements with 5Linx, Cognigen, Escape International and Melaleuca, among others. These network marketing firms have networks of independent agents who resell the service in exchange for payment of bounties and commissions by us.

We are marketing the wholesale voice and video service offering to Internet service providers, cable television companies and digital subscriber line, or DSL, providers. Packet8 is offered to these third parties through reseller agreements, hosted and prepaid service agreements or OEM technology license agreements.

We offer individuals and businesses the opportunity to become resellers of our Packet8 services through an affiliate program, which is administered by a third party. Resellers are able to purchase bulk Packet8 accounts and hardware at reseller specific rates and they are then able to resell these accounts to consumers under the Packet8 brand or a co-branding arrangement.

Competition

Competitors for the Packet8 residential service include AT&T Callvantage, iConnectHere, Lingo, Net2Phone, Sunrocket, Voicepulse and Vonage, as well as cable television companies, such as Cablevision, Cox, Comcast and Time Warner, incumbent telephone carriers, such as AT&T and Verizon and other providers of traditional and legacy telephone service. Our videophone service competes with other providers of videophone services and videoconferencing systems, including Polycom, Lifesize, Tandberg, and various software offerings that implement videophone functionality on a personal computer. Competitors for the Packet8 Virtual Office service include traditional PBX and key system manufacturers and their resellers, including Avaya and Toshiba, Centrex services offered by incumbent telephone companies, and VoIP services offered by Covad and other companies.

Operations

We have a centrally managed platform consisting of data management, monitoring, control and billing systems, which support all of our products and services. We have invested substantial resources to develop and implement our real-time call management information system. Key elements of this system include: customer provisioning, customer access, fraud control, network security, call routing, call monitoring, media processing and normalization, call reliability and detailed call records. Our platform monitors our process of digitizing and compressing voice and video into packets and transmitting these packets over data networks around the world. We maintain a call switching platform, which is a software-based product that manages call admission, call control, call rating and routes calls to an appropriate destination or endpoint. Unless the recipient is using an Internet telephony device, the packets (representing a voice and/or video call initiated by a Packet8 subscriber) are sent to a gateway belonging to one of our partner telecommunications carriers where the packets are reassembled and the call is transferred to the PSTN and directed to a regular telephone anywhere in the world. Our billing and back office systems manage and enroll customers and bill calls as they originate and terminate on the service.

Network Operations Center

We maintain a Network Operations Center, or NOC, at our headquarters in Santa Clara, California and employ a staff of individuals with experience in both voice and data operations to provide twenty-four hour operations support We use various tools to monitor and manage all elements of our network in real-time. Additionally, our NOC provides technical support to troubleshoot equipment and network problems. We also rely upon the network operations centers and resources of our telecommunications carrier partners to augment our monitoring and response efforts.

Customer and Technical Support

We maintain a call center at our headquarters in Santa Clara, California and have a staff of employees and contractors that provide customer service and technical support to customers. In addition, we have outsourced certain customer support activities to third parties. We also provide customer service and technical support directly to our resellers, and certain resellers provide their own support directly to their sub-resellers and end users. Customers who access our services directly through the web site receive customer service and technical support through multilingual telephone communication, web-based customer service and e-mail support.

Interconnection Agreements

We are party to telecommunications interconnect and service agreements with VoIP providers and PSTN telecommunications carriers. Pursuant to these agreements, VoIP calls originating on our network can be terminated on other VoIP networks or the PSTN. Correspondingly, calls originating on other VoIP networks and the PSTN can be terminated on our network.

Suppliers

We outsource the manufacturing of the videophones, broadband phone adapters, business telephones and cordless handsets to third-party manufacturers. We do not have long-term purchase agreements with our contract manufacturers. We currently rely on one telecommunications provider to originate and two telecommunication providers to terminate substantially all of our PSTN telephone calls. While we believe that relations with our suppliers are good, there can be no assurance that our suppliers will be able or willing to supply products and services to us in the future. While we believe that we could replace our suppliers if necessary, our ability to provide service to our subscribers would be impacted during this timeframe, and this could have an adverse effect on our business, financial condition and results of operations.

Research and Development

The VoIP market is characterized by rapid technological changes and advances. Accordingly, we make substantial investments in the design and development of new products and services and enhancements and features to existing products and services. Our current and future research and development efforts relate to our Packet8 service offerings and the development of new endpoints for subscribers of our service. Future development will also focus on emerging audio and video telephony standards and protocols, quality and performance enhancements to multimedia compression algorithms, and 802.11 standard and other wireless applications. The development of new products and the enhancement of existing products are essential to our success.

We currently employ twenty-seven individuals in research, development and engineering activities in our facilities in Santa Clara, California and Sophia Antipolis, France. Research and development expenses in each of the fiscal years ended March 31, 2006, 2005 and 2004 were $5.9 million, $3.1 million and $2.7 million, respectively.

Regulatory

The use of the Internet and private IP networks to provide voice, video and other forms of real-time, two-way communications services is a relatively recent development. Although the provisioning of such services is currently permitted by United States law and largely unregulated within the United States, several foreign governments have adopted laws and/or regulations that could restrict or prohibit the provisioning of voice communications services over the Internet or private IP networks. More aggressive domestic or international regulation of the Internet, in general, and Internet telephony providers and services, specifically, may materially and adversely affect our business, financial condition, operating results and future prospects, particularly if increased numbers of governments impose regulations restricting the use and sale of IP telephony services.

On April 10, 1998, the Federal Communications Commission, or FCC, issued a Universal Service Report to Congress, commonly known as the Stevens Report. At that time, there was a petition pending before the FCC asking the FCC to impose common telecommunications carrier regulation on every entity enabling the transmission of real-time voice communication over the Internet. While the petition was being evaluated, Congress instructed the FCC to study the impact of unregulated Internet access and related services on the federal universal service fund, which is a program designed to provide subsidies to providers of telephone service in rural and high cost areas. The FCC issued the Stevens Report in response to Congress' request, and in that report declined to assert regulatory authority over IP telephony. The FCC did not conclude that IP telephony services constitute telecommunications services, and indicated that it would undertake a subsequent examination of the question whether certain forms of Internet telephony constitute information services or telecommunications services.

The FCC indicated that, in the future, it would consider the extent to which telephony providers could be considered "telecommunications carriers" such that they could be subject to the regulations governing traditional telephone companies such as the imposition of access charges. The FCC stated that, although it did not have a sufficient record upon which to make a definitive ruling, the record suggested that, to the extent that certain forms of IP telephony appear to possess the same characteristics as traditional telecommunications services and to the extent the providers of those services obtain the same circuit-switched access as obtained by interexchange carriers, the FCC may find it reasonable that they pay similar access charges. The FCC also recognized, however, that it would consider whether it should forbear from imposing any of the rules that would apply to Internet telephony providers as "telecommunications carriers." To date, the FCC has not imposed regulatory surcharges or traditional common carrier regulation upon providers of Internet communications services such as ours. Although the FCC treats providers of Internet telephony services no differently from providers of other information and enhanced services that are exempt from payment of interstate access charges, this decision may be reconsidered in the future. On February 12, 2004 the FCC began a Notice of Proposed Rulemaking, or NPRM, process to institute a new examination of regulatory policy and how VoIP services should be classified. The FCC has indicated that this rulemaking may address, among other things, 911 requirements, disability access requirements, access charges, and universal service requirements. The FCC has also begun a separate rulemaking proceeding to consider the obligations of IP-based voice services providers and network providers under the Communications Assistance to Law Enforcement Act, which establishes federal requirements for wiretapping and other electronic surveillance capabilities. These NPRM processes are currently underway (the latest information on these proceedings is available from the FCC's VoIP website at http://www.fcc.gov/voip). We are unable to predict the outcome of these processes at this time.

In addition to the NPRM process, several recent decisions by, and the outcome of the various proceedings pending before, the FCC may affect the regulatory status of Internet telephony. On October 18, 2002, AT&T filed a petition with the FCC seeking a declaratory ruling that would prevent incumbent local exchange carriers, or ILECs, from imposing traditional circuit-switched access charges on phone-to-phone IP services. This petition was denied on April 14, 2004. On February 5, 2003, pulver.com filed a petition with the FCC seeking a declaratory ruling that its "Free World Dialup," which facilitates point-to-point broadband Internet protocol voice communications, is neither telecommunications nor a telecommunications service as these terms are defined in the Telecommunications Act of 1996. This petition was granted on February 12, 2004. In September 2003, Vonage filed a petition for declaratory ruling requesting that the FCC find an Order of the Minnesota Public Utilities Commission, MPUC, requiring Vonage to comply with state laws governing providers of traditional telephone service to be pre-empted because Vonage's broadband Internet telephony service is an information service. On November 9, 2004, the FCC adopted an order granting Vonage's request for pre-emption. In that order, the FCC ruled that Vonage's service was inherently interstate and subject to exclusive federal jurisdiction, but declined to rule on the issue of whether it is a telecommunications service or an information service. Judicial appeals from the FCC's Vonage order are pending. On February 5, 2004, SBC Communications Inc. filed two petitions with the FCC relating to IP communications. The first requests a declaratory ruling that all services offered on an IP platform are interstate information services, not telecommunications services, and that they are immune from state regulation as a result. The FCC has incorporated this petition into its generic IP-enabled services rulemaking, where it will consider the regulatory status of Internet protocol voice communications. The second SBC petition requests that the FCC forbear from applying certain common carrier regulation to services offered on IP platforms. On May 5, 2005, the FCC issued an opinion and order denying SBC's forbearance petition, and concluding that the petition was procedurally defective.

Several states have also demonstrated an interest in regulating VoIP services at a state public utility level, as they do for providers of traditional telephone service from regulated carriers. In certain cases, these state governments and their regulatory authorities have moved to assert jurisdiction over the provision of intrastate IP communications services (calls that begin in that state and end in that state) where they believe that their telecommunications regulations are broad enough to cover regulation of IP services. If this trend continues, and if state regulation is not preempted by action by the FCC we may become subject to a "patchwork quilt" of state regulations and taxes, which would increase our costs of doing business, and adversely affect our operating results and future prospects.

We have been contacted by several state regulatory authorities regarding our Packet8 service. By letter dated August 13, 2003, the Public Service Commission of Wisconsin, or WPSC, notified us that the WPSC believes that we, via our Packet8 voice and video communications service, are offering intrastate telecommunications services in the state of Wisconsin without certification from the WPSC. According to the WPSC's letter, it believes that we cannot legally provide Packet8-based resold intrastate services in Wisconsin without certification from the WPSC. In addition, the WPSC believes that Packet8 bills for intrastate services to Wisconsin customers are void and not collectible. The letter also states that if we do not obtain certification to offer intrastate telecommunications services, the matter will be referred to the State of Wisconsin Attorney General for enforcement action. The letter also states that even if we were certified by the WPSC, the previous operation without certification may still subject us to referral to the State of Wisconsin Attorney General for enforcement action and possible forfeitures. On October 15, 2003, we responded to the WPSC and disputed its assertions by asserting that we are an information services provider and not a telecommunications provider. While we do not believe that the potential amounts of any forfeitures would be material to us, if we are subject to an enforcement action, we may become subject to liabilities and may incur expenses that adversely affect our results of operations.

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

On September 22, 2003, the California Public Utilities Commission, or CPUC, sent us a letter that alleged that we are offering intrastate telecommunications services for profit in California without having received formal certification from the CPUC to provide such service. The CPUC also requested that we file an application with the CPUC for authority to conduct business as a telecommunications utility no later than October 22, 2003. After consultation with regulatory counsel, we responded to the CPUC, disputed its assertions and did not file the requested application. In our October 22, 2003 response to the CPUC, we disagreed with the CPUC's classification of us as a telephone corporation under the California Public Utilities Code. We asserted that we are an information services provider and not a telecommunications provider. The letter from the CPUC did not indicate, and we cannot predict, what any potential penalties or consequences in failing to obtain certification might be. If we are subjected to penalties, or if we are required to comply with CPUC regulations affecting telecommunications service providers, our business may be adversely affected. On November 13, 2003, the CPUC held a hearing in San Francisco to hear testimony from CPUC staff and industry representatives regarding what course of action the CPUC should take with respect to Internet telephony. A representative from 8x8 testified at the hearing. On February 11, 2004, the CPUC stated that, as a tentative conclusion of law, they believe that VoIP providers are telecommunications providers and should be treated as such from a regulatory standpoint. The CPUC initiated an investigation into appropriate regulation of VoIP providers under state law, and acknowledged that it has not enforced the same regulatory regime over VoIP as applies to telecommunications services. The CPUC is considering a number of potential regulatory requirements, including contribution to state universal service programs, provision of 911 services, payment of access charges to interconnect with the PSTN and compliance with North American Numbering Plan (NANP) protocols and basic consumer protection laws. The CPUC is also considering whether exempting VoIP providers from requirements applicable to traditional providers of voice telephony creates unfair competitive advantages, if the regulatory framework governing the provision of VoIP should vary based on the market served and whether VoIP providers should be subject to the current system of intercompany compensation arrangements. The CPUC has indicated that this process could last up to 18 months, but there is no way for us to predict the timetable or outcome of this process. On April 7, 2005, the CPUC instituted a rulemaking to assess and revise the regulation of all telecommunications utilities in California except for small incumbent local exchange carriers, or ILECs. The primary goal of this proceeding is to develop a uniform regulatory framework for all telecommunications utilities, except small ILECs, to the extent that it is feasible and in the public interest to do so. In May 2006, the administrative law judge, or ALJ, presiding over the CPUC VoIP proceeding released a draft decision closing the proceeding. Since the FCC has preempted states from regulating VoIP services, the ALJ reasoned that it would be premature for the CPUC to consider a VoIP regulatory framework.

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

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

In July 2004, the Internal Revenue Service, or IRS, issued an Advance Notice of Proposed Rulemaking to determine whether to propose regulations that would revise the existing Federal Excise Tax requirements to reflect changes in communications technologies. Additionally, there are several amendments to the Internet Tax Freedom Act, or ITFA, pending in the federal legislature that aim to expressly exclude VoIP from the tax freedom enjoyed by Internet services under the ITFA. On May 25, 2006, the United States Treasury Department issued a news release that the IRS would cease collecting the Federal Excise Tax on long distance telephone services and VoIP services effective July 31, 2006, but providing service providers the right to immediately cease collection and remittance of the tax. Accordingly, we ceased collecting and remitting the tax in June 2006.

In November 2004, the FCC ruled that the VoIP service of a competitor and "similar" services are jurisdictionally interstate and not subject to state certification, tariffing and other legacy telecommunication carrier regulations. The FCC ruling has been appealed by several states and the outcome of these appeals cannot be determined at this time.

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

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

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

On May 19, 2005, the FCC unanimously adopted an Order and NPRM that requires VoIP providers that interconnect with the PSTN, or interconnected VoIP providers, to provide emergency 911, or E911, service. On June 3, 2005, the FCC released the text of the First Report and Order and Notice of Proposed Rulemaking in the VoIP E911 proceeding, the VoIP E911 Order. As a result of the VoIP E911 Order, interconnected VoIP providers are required to offer the E911 emergency calling capabilities present on traditional switched and cellular phone lines. All interconnected VoIP providers must deliver 911 calls to the appropriate local public safety answering point, or PSAP, through the PSTN's legacy wireline selective router, which is used to deliver E911 calls, along with call back number and location, where the PSAP is able to receive that information. E911 must be included in the basic service offering; it cannot be an optional or extra feature. The PSAP delivery obligation, along with call back number and location information must be provided regardless of whether the VoIP service is "fixed" or "nomadic." User registration of location is permissible initially, although the FCC is committed to an advanced form of E911 that will determine user location without user intervention, one of the topics of the further NPRM. The VoIP E911 Order mandates that existing and prospective customers must be notified, prominently and in plain language, of the capabilities and limitations of VoIP service with respect to emergency calling, and interconnected VoIP providers must obtain and maintain affirmative acknowledgement from each customer that the customer has read and understood the notice of limitations and distribute warning labels or stickers alerting consumers and other potential users of the limitations of VoIP E911 service to each new subscriber prior to the initiation of service. In addition, an interconnected VoIP provider must make it possible for customers to update their address (i.e., change their registered location) via at least one option that requires no equipment other than that needed to access the VoIP service. On July 26, 2005 the FCC issued guidance to all interconnected VoIP providers regarding the July 29, 2005 notification deadline. In this guidance, the FCC determined that it would not initiate enforcement action until August 30, 2005, against any provider of interconnected VoIP service regarding the requirement that it obtain affirmative acknowledgement by every existing subscriber on the condition that the provider file a detailed report with the FCC by August 10, 2005, containing a variety of detailed descriptions. The FCC's notice further stated that it expected interconnected VoIP providers who had not received subscriber acknowledgements from one hundred percent of existing subscribers by August 29, 2005 to disconnect, no later than August 30, 2005, all subscribers from whom it had not received such acknowledgement. We filed the status reports requested by the FCC, and suspended service of an insignificant number of subscribers on August 30, 2005. We also filed a VoIP E911 compliance report, as required by the FCC, on November 28, 2005. As was detailed in the compliance report, we currently cannot offer E911 services that route directly to a local PSAP to all of its customers, as the direct interconnection to local PSAPs is not available in certain rate centers from which telephone numbers are provisioned for the Packet8 service. The Company is addressing this issue with its telecommunication interconnection partners. On November 28, 2005, we began routing certain nomadic 911 calls and 911 calls that cannot be directly connected to a local PSAP, along with location information, to a national emergency call center. The emergency dispatchers in this national call center utilize the location information provided to route the call to the correct PSAP or first responder. The FCC may determine that the our nomadic E911 solution does not satisfy the requirements of the VoIP E911 order because, in some instances, we will not be able to connect Packet8 subscribers directly to a PSAP In this case, the FCC could require us to disconnect a significant number of subscribers. The effect of such disconnections or any enforcement action initiated by the FCC or other agency or task force against us could have a material adverse effect on the our financial position, results of operations and cash flows. On January 1, 2006, we began charging its customers a monthly fee of $1.99 for E911 services on all Packet8 phone numbers capable of placing outbound calls in order to recoup some of the expenses associated with providing nomadic E911 service. The impact of this price increase on our customers or our inability to recoup its costs or liabilities in providing E911 services or other factors could have a material adverse effect on our financial position, results of operations and cash flows.

In May 2005, we began charging a Regulatory Recovery Fee, currently an additional $1.50 per month, on each telephone number that is used by our customers, including toll free and virtual numbers. The Regulatory Recovery Fee is charged monthly to offset costs incurred by us in complying with inquiries and obligations imposed by federal, state and municipal regulatory bodies/governments and the related legal and billing expenses. This fee is not a tax or charge required or assessed by any government. Many of our competitors charge similar fees.

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

On March 7, 2006, the Attorney General of Missouri sent us an investigative demand for information related to our provisioning and marketing of E911 services since January 1, 2005. We submitted our response on March 31, 2006.

Regulation of the Internet

In addition to regulations addressing Internet telephony and broadband services, other regulatory issues relating to the Internet in general could affect our ability to provide our services. Congress has adopted legislation that regulates certain aspects of the Internet, including online content, user privacy, taxation, liability for third-party activities and jurisdiction. In addition, a number of initiatives pending in Congress and state legislatures would prohibit or restrict advertising or sale of certain products and services on the Internet, which may have the effect of raising the cost of doing business on the Internet generally.

Federal, state, local and foreign governmental organizations are considering other legislative and regulatory proposals that would regulate the Internet. We cannot predict whether new taxes will be imposed on our services, and depending on the type of taxes imposed, whether and how our services would be affected thereafter. Increased regulation of the Internet may decrease its growth and hinder technological development, which may negatively impact the cost of doing business via the Internet or otherwise materially adversely affect our business, financial condition and results of operations.

Intellectual Property and Proprietary Rights

Our ability to compete depends, in part, on our ability to obtain and enforce intellectual property protection for our technology in the United States and internationally. We currently rely primarily on a combination of trade secrets, patents, copyrights, trademarks and licenses to protect our intellectually property. As of March 31, 2006, we had sixty-one (61) United States patents that have issued and a number of United States and foreign patent applications pending, none of which we consider critical to our business. Our patents expire on dates ranging from 2009 to 2021. We cannot predict whether our pending patent applications will result in issued patents.

To protect our trade secrets and other proprietary information, we require our employees to sign agreements providing for the maintenance of confidentiality and also the assignment of rights to inventions made by them while in our employ. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competition will not independently develop technologies that are similar or superior to our technology, duplicate our technology or design around any of our patents. We are also subject to the risks of adverse claims and litigation alleging infringement of the intellectual property rights of others. The communications and software industries are subject to frequent litigation regarding patent and other intellectual property rights. In addition, the laws of foreign countries in which our products are or may be sold do not protect our intellectual property rights to the same extent as do the laws of the United States. Our failure to protect our proprietary information could cause our business and operating results to suffer.

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

Licensing and Development Arrangements

Historically, we entered into licensing and development arrangements with our semiconductor and IP PBX customers to promote the design, development, manufacture and sale of our products. We have licensed portions of our systems technology and software object code for our semiconductors to virtually all of our semiconductor customers. Such arrangements may enable these companies to use our technology to produce products that compete with our Packet8 telephony and video products. We have also licensed the right to manufacture certain of our video and VoIP telephony semiconductor products to several original equipment manufacturers, or OEMs. These licenses generally provide for the payment of royalties. Only certain of these OEM licensees may sell semiconductors based on the licensed technology to third parties, while other licensees are limited to sales of such semiconductors as part of multimedia communication systems or sub-systems. We expect to continue licensing our technology to others, many of whom may be located outside of the United States. In addition to licensing our technology to others, we, from time to time, may take a license to technology owned by third parties and currently rely upon certain technology, including hardware and software, licensed from third parties.

Information about Segments and Geographic Areas

We have only one reportable segment. Financial information relating to our product lines and information on revenues generated in different geographic areas are set forth in Note 11 to our consolidated financial statements contained in Part II, Item 8 of this Report.

Employees

As of March 31, 2006, our workforce consisted of one hundred and thirty-nine employees and thirty-six contractors. None of our employees are represented by a labor union or are subject to a collective bargaining arrangement.

ITEM 1A. RISK FACTORS

Before you invest in our common stock, you should become aware of various risks, including those described below. You should carefully consider these risk factors, together with all of the other information included in this Annual Report, including the documents incorporated in this Annual Report by reference, before you decide whether to purchase the securities. The risks set out below may not be exhaustive.

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

We recorded an operating loss of approximately $25 million for the year ended March 31, 2006, and we ended the period with an accumulated deficit of $195 million. In addition, we recorded operating losses of $20 million and $4 million for the fiscal years ended March 31, 2005 and 2004, respectively. We expect that we will continue to incur operating losses for the foreseeable future, and such losses may be substantial. We will need to generate significant revenue growth to achieve an operating profit. Given our history of fluctuating revenues and operating losses, we cannot be certain that we will be able to achieve profitability on either a quarterly or annual basis in the future.

Our stock price has been highly volatile.

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

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

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

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

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

Semiconductor and related software revenues represented approximately 83% of our consolidated revenues for fiscal 2004. However, these revenues were not sufficient to profitably operate our semiconductor business. Therefore, we significantly reduced the scope of these operations and in 2003, we completed the end-of-life of our legacy videoconferencing semiconductor products. In November 2003, we sold the VIP1 video semiconductor development effort to Leadtek Research, Inc. (Leadtek). Under the terms of the transaction, Leadtek acquired the VIP1 development activities, key engineers, software tools and equipment. In January 2004, we initiated an end-of-life program for our VoIP telephony semiconductor products, including the Audacity T2 and T2U products. Semiconductor and related software revenues represented approximately 2% of our consolidated fiscal revenues for fiscal 2006. The semiconductor business may continue to generate revenue in the future, although we expect the amounts to decrease, both on an absolute basis and as a percentage of our consolidated revenues.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our success depends on third parties in our distribution channels.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Circuit-switched telephony networks feature very high reliability, with a guaranteed quality of service. In addition, such networks have imperceptible delay and consistently satisfactory audio quality. Emerging broadband IP networks, such as LANs, WANs, and the Internet, or emerging last mile technologies such as cable, digital subscriber lines, and wireless local loop, may not be suitable for telephony unless such networks and technologies can provide reliability and quality consistent with these standards. We periodically experience outages during which our customers are unable to make or receive calls. Generally, these outages are of a very short duration. A prolonged outage could have a material adverse effect on our business, financial condition or operating results.

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

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

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

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

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

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

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

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

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

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

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

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

On September 22, 2003, the California Public Utilities Commission, or CPUC, sent us a letter that alleged that we are offering intrastate telecommunications services for profit in California without having received formal certification from the CPUC to provide such service. The CPUC also requested that we file an application with the CPUC for authority to conduct business as a telecommunications utility no later than October 22, 2003. After consultation with regulatory counsel, we responded to the CPUC, disputed its assertions and did not file the requested application. In our October 22, 2003 response to the CPUC, we disagreed with the CPUC's classification of us as a telephone corporation under the California Public Utilities Code. We asserted that we are an information services provider and not a telecommunications provider. The letter from the CPUC did not indicate, and we cannot predict, what any potential penalties or consequences in failing to obtain certification might be. If we are subjected to penalties, or if we are required to comply with CPUC regulations affecting telecommunications service providers, our business may be adversely affected. On November 13, 2003, the CPUC held a hearing in San Francisco to hear testimony from CPUC staff and industry representatives regarding what course of action the CPUC should take with respect to Internet telephony. A representative from 8x8 testified at the hearing. On February 11, 2004, the CPUC stated that, as a tentative conclusion of law, they believe that VoIP providers are telecommunications providers and should be treated as such from a regulatory standpoint. The CPUC initiated an investigation into appropriate regulation of VoIP providers under state law, and acknowledged that it has not enforced the same regulatory regime over VoIP as applies to telecommunications services. The CPUC is considering a number of potential regulatory requirements, including contribution to state universal service programs, provisioning of 911 services, payment of access charges to interconnect with the PSTN and compliance with NANP protocols and basic consumer protection laws, including California's telecommunications "bill of rights." The CPUC is also considering whether exempting VoIP providers from requirements applicable to traditional providers of voice telephony creates unfair competitive advantages that should be proactively addressed, if the regulatory framework governing the provision of VoIP should vary based on the market served and whether VoIP providers should be subject to the current system of intercompany compensation arrangements. The CPUC has indicated that this process could last up to 18 months, but there is no way for us to predict the timetable or outcome of this process. On April 7, 2005, the CPUC instituted a rulemaking to assess and revise the regulation of all telecommunications utilities in California except for small incumbent local exchange carriers, or ILECs. The primary goal of this proceeding is to develop a uniform regulatory framework for all telecommunications utilities, except small ILECs, to the extent that it is feasible and in the public interest to do so. In May 2006, the administrative law judge, or ALJ, presiding over the CPUC VoIP proceeding released a draft decision closing the proceeding. Since the FCC has preempted states from regulating VoIP services, the ALJ reasoned that it would be premature for the CPUC to consider a VoIP regulatory framework.

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

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

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

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

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

On March 7, 2006, the Attorney General of Missouri sent us an investigative demand for information related to our provisioning and marketing of E911 services since January 1, 2005. We submitted our response on March 31, 2006.

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

In accordance with current industry practice, we have not collected state and federal telecommunications taxes, other than federal excise tax, or FET, or other telecommunications surcharges with respect to our Packet8 service. In July 2004, the Internal Revenue Service, or IRS, issued an Advance Notice of Proposed Rulemaking to determine whether to propose regulations that would revise the existing Federal Excise Tax requirements to reflect changes in communications technologies. Additionally, there are several amendments to the Internet Tax Freedom Act, or ITFA, pending in the federal legislature that aim to expressly exclude VoIP from the tax freedom enjoyed by Internet services under the ITFA. On May 25, 2006, the United States Treasury Department issued a news release that the IRS would cease collecting the Federal Excise Tax on long distance telephone services and VoIP services effective July 31, 2006, but providing service providers the right to immediately cease collection and remittance of the tax. Accordingly, we ceased collecting and remitting the tax in June 2006.

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

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

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

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

In May 2005, the FCC unanimously adopted an Order and Notice of Proposed Rulemaking, or NPRM, which requires VoIP providers that interconnect with the PSTN, or interconnected VoIP providers, to provide emergency 911, or E911, service. On June 3, 2005, the FCC released the text of the First Report and Order and Notice of Proposed Rulemaking in the VoIP E911 proceeding, or the VoIP E911 Order. As a result of the VoIP E911 Order, interconnected VoIP providers were required to implement the E911 emergency calling capabilities offered by traditional landline phone companies. All interconnected VoIP providers must deliver 911 calls to the appropriate local public safety answering point, or PSAP, through the PSTN's legacy wireline selective router, which is used to deliver E911 calls, along with call back number and location, where the PSAP is able to receive that information. E911 must be included in the basic service offering; it cannot be an optional or extra feature. The PSAP delivery obligation, along with call back number and location information must be provided regardless of whether the VoIP service is "fixed" or "nomadic." User registration of location is permissible initially, although the FCC is committed to an advanced form of E911 that will determine user location without user intervention. The VoIP E911 Order mandates that existing and prospective customers must be notified of the capabilities and limitations of VoIP service with respect to emergency calling, and interconnected VoIP providers must obtain and maintain affirmative acknowledgement from each customer that the customer has read and understood the notice of limitations and distribute warning labels or stickers alerting consumers and other potential users of the limitations of VoIP E911 service to each new subscriber prior to the initiation of service. In addition, an interconnected VoIP provider must make it possible for customers to update their address (i.e., change their registered location) via at least one option that requires no equipment other than that needed to access the VoIP service. All interconnected VoIP providers were required to comply with the requirements of the VoIP E911 Order by November 28, with the exception that the customer notification obligations had to be complied with by July 29, 2005.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Products as complex as those we offer frequently contain errors, defects, and functional limitations when first introduced or as new versions are released. We have in the past experienced such errors, defects or functional limitations. We sell products into markets that are extremely demanding of robust, reliable, fully functional products. Therefore, delivery of products with production defects or reliability, quality or compatibility problems could significantly delay or hinder market acceptance of such products, which could damage our credibility with our customers and adversely affect our ability to retain our existing customers and to attract new customers. Moreover, such errors, defects or functional limitations could cause problems, interruptions, delays or a cessation of sales to our customers. Alleviating such problems may require significant expenditures of capital and resources by us.

Despite our testing, our suppliers or our customers may find errors, defects or functional limitations in new products after commencement of commercial production. This could result in additional development costs, loss of, or delays in, market acceptance, diversion of technical and other resources from our other development efforts, product repair or replacement costs, claims by our customers or others against us, or the loss of credibility with our current and prospective customers.

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

As of March 31, 2006, we had cash, cash equivalents and investments of approximately $23 million, which we believe is sufficient cash to fund operations and other commitments for at least the next twelve months. Unless we achieve and maintain profitability thereafter, we will need to raise additional capital to meet our objectives. We may not be able to obtain such additional financing as needed on acceptable terms, or at all, which may require us to reduce our operating costs and other expenditures, including reductions of personnel and capital expenditures. If we issue additional equity or convertible debt securities to raise funds, the ownership percentage of our existing stockholders would be reduced and they may experience significant dilution. New investors may demand rights, preferences or privileges senior to those of existing holders of our common stock. If we are not successful in these actions, we may be forced to cease operations.

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

Our common stock trades on the Nasdaq Capital Market, which has certain compliance requirements for continued listing of common stock. We have in the past been subject to delisting procedures due to a drop in the price of our common stock. If our minimum closing bid price per share falls below $1.00 for a period of 30 consecutive business days in the future, we may again be subject to delisting procedures. As of the close of business on May 26, 2006, our common stock had a closing bid price of $1.39 per share. We must also meet additional continued listing requirements contained in Nasdaq Marketplace Rule 4310(c)(2)(b), which requires that we have a minimum of $2,500,000 in stockholders' equity or $50,000,000 market value of listed securities or $500,000 of net income from continuing operations for the most recently completed fiscal year (or two of the three most recently completed fiscal years). As of May 26, 2006, based on our closing price as of that day, the market value of our securities approximated $85 million and we were in compliance with Nasdaq Marketplace Rule 4310(c)(2)(b). There can be no assurance that we will continue to meet the continued listing requirements.

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

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

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal operations are located in an approximately 47,000 square foot facility in Santa Clara, California that is leased through August 2009. Design, testing, research and development, sales and marketing, shipping, customer service and administrative activities are performed in this facility. We also lease office space for our research and development operation in Sophia-Antipolis, France. We believe that our existing facilities are adequate to meet our current and foreseeable future needs. For additional information regarding our obligations under leases see Note 8 to the consolidated financial statements contained in Part II, Item 8 of this Report.

ITEM 3. LEGAL PROCEEDINGS

We are involved in various legal claims and litigation that have arisen in the normal course of our operations. While the results of such claims and litigation cannot be predicted with certainty, we believe that the final outcome of such matters will not have a significantly adverse effect on our financial position, results of operations or cash flows. However, should we not prevail in any such litigation, our operating results, financial condition or cash flows could be adversely impacted.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2005.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED SECURITY HOLDER MATTERS

We completed our initial public offering on July 2, 1997 under the name 8x8, Inc. From that date through April 3, 2000, our common stock was traded on the NASDAQ National Market (the NASDAQ) under the symbol "EGHT." From April 4, 2000 through July 18, 2001, our common stock was traded on the NASDAQ under the symbol "NTRG." Since July 19, 2001 our common stock has traded under the symbol "EGHT." In July 2002, our listing was transferred to the Nasdaq Capital Market. We have never paid cash dividends on our common stock and have no plans to do so in the foreseeable future. We did not repurchase any of our equity securities during the fourth quarter of fiscal 2006. As of May 26, 2006, there were 307 holders of record of our common stock.

The following table sets forth the range of high and low sale prices for each period indicated:

Period		High	Low
Fiscal 2006:			
	First quarter	$ 2.49	$ 1.03
	Second quarter	$ 2.50	$ 1.45
	Third quarter	$ 3.39	$ 1.21
	Fourth quarter	$ 2.16	$ 1.55
Fiscal 2005:			
	First quarter	$ 3.54	$ 2.25
	Second quarter	$ 3.84	$ 1.38

Third quarter	$ 4.49	$ 2.52
Fourth quarter	$ 4.08	$ 1.61

ITEM 6. SELECTED FINANCIAL DATA

	Years Ended March 31,				
	2006	**2005**	**2004**	**2003 (2)**	**2002 (1)(3)**
	(in thousands, except per share amounts)				
Total revenues	$ 31,892	$ 11,475	$ 9,308	$ 11,003	$ 14,691
Net loss	$ (24,139)	$ (19,148)	$ (3,039)	$ (11,403)	$ (9,105)
Net loss per share:					
Basic	$ (0.43)	$ (0.43)	$ (0.09)	$ (0.40)	$ (0.33)
Diluted	$ (0.43)	$ (0.43)	$ (0.09)	$ (0.40)	$ (0.33)
Total assets	$ 31,120	$ 39,080	$ 15,571	$ 6,705	$ 19,653
Contingently redeemable common stock	$ --	$ --	$ --	$ 669	$ 813
Accumulated deficit	$ (195,005)	$ (170,866)	$ (151,718)	$ (148,679)	$ (137,276)
Total stockholders' equity	$ 20,093	$ 29,744	$ 12,786	$ 2,164	$ 13,234

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(1) Net loss and net loss per share include an extraordinary gain of $779,000 resulting from the early extinguishment of our convertible subordinated debentures.

(2) Net loss and net loss per share include restructuring and other charges of $3.4 million.

(3) Beginning fiscal 2003, Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," was adopted, and we ceased to amortize approximately $1.5 million of goodwill, net of amortization, including intangibles that were classified as goodwill upon adoption of SFAS No. 142. The 2002 consolidated financial data includes amortization of goodwill and intangibles totaling $0.7 million.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We were founded in 1987 and completed an initial public offering of common stock in 1997. We develop and market telecommunication services for Internet protocol, or IP, telephony and video applications. We offer the Packet8 broadband voice over Internet protocol, or VoIP, and video communications service, Packet8 Virtual Office service and videophone equipment and services. We shipped our first VoIP product in 1998, launched our Packet8 service in November 2002, and launched the Packet8 Virtual Office business service offering in March 2004. As of March 31, 2006, we had approximately 133,000 Packet8 lines in service. Since fiscal 2004, substantially all of the Company's revenues have been generated from the sale, license and provision of VoIP products, services and technology. Prior to fiscal 2003, our focus was on our VoIP semiconductor business.

During fiscal 2006, we completed an equity financing for gross proceeds of approximately $15 million**.** As of March 31, 2006, we had cash, cash equivalents and investments of approximately $23 million as compared to $31.8 million at March 31, 2005.

CRITICAL ACCOUNTING POLICIES & ESTIMATES

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. Note 1 to the consolidated financial statements in Part II, Item 8 of this Report describes the significant accounting policies and methods used in the preparation of our consolidated financial statements.

We have identified the policies below as some of the more critical to our business and the understanding of our results of operations. These policies may involve a higher degree of judgment and complexity in their application and represent the critical accounting policies used in the preparation of our financial statements. Although we believe our judgments and estimates are appropriate, actual future results may differ from our estimates. If different assumptions or conditions were to prevail, the results could be materially different from our reported results. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results.

Use of Estimates

The preparation of the consolidated financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and equity and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates, including, but not limited to, those related to bad debts, valuation of inventories, and litigation and other contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates under different assumptions or conditions. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets, liabilities and equity that are not readily apparent from other sources. Actual results could differ from those estimates under different assumptions or conditions. Additional information regarding risk factors that may impact our estimates is included above in Item 1A, "Risk Factors."

Revenue Recognition

Our revenue recognition policies are described in Note 1 to the consolidated financial statements in Part II, Item 8 of this Report. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

We recognize new subscriber revenue from our Packet8 service offerings upon expiration of any applicable acceptance period has expired. New customers may terminate their service within thirty days of order placement and receive a full refund of fees previously paid. As we have been providing our Packet8 service for a limited period of time, we have not developed sufficient history to apply a return rate and reserve against new order revenue. Accordingly, we defer new subscriber revenue for thirty days to ensure that the thirty day acceptance period has expired. We will have sufficient history and commence recording a returns reserve in fiscal 2007.

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

At the time of each revenue transaction we assess whether the revenue amount is fixed and determinable and whether or not collection is reasonably assured. We assess whether the fee is fixed and determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are thirty to ninety days from invoice date, we account for the fee as not being fixed and determinable. In these cases, we recognize revenue as the fees become due. We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We generally do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of payment.

During fiscal 2006 and 2005, revenues from software licensing and related arrangements were limited. For arrangements with multiple obligations (for example, undelivered maintenance and support), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to us. This means that we defer revenue from the arranged fee that is equivalent to the fair value of the undelivered elements. Fair values for the ongoing maintenance and support obligations for our technology licenses are based upon separate sales of renewals to other customers or upon renewal rates quoted in the contracts. We base the fair value of services, such as training or consulting, on separate sales of these services to other customers. We recognize revenue for maintenance services ratably over the contract term. Our training and consulting services are billed based on hourly rates and we generally recognize revenue as these services are performed.

If a software license arrangement includes acceptance criteria, revenue is not recognized until we can objectively demonstrate that the software or service can meet the acceptance criteria or when the customer has signed formal acceptance documentation. If a software license arrangement obligates us to deliver unspecified future products, revenue is recognized on a subscription basis, ratably over the term of the contract.

For all sales, except those completed via the Internet, we use either a binding purchase order or other signed agreement as evidence of an arrangement. For sales over the Internet, we use a credit card authorization as evidence of an arrangement, and recognize revenue upon settlement of the transaction, if there are no customer acceptance conditions. We do not settle credit card transactions until equipment related to the transaction, if any, is shipped to a customer.

Our ability to enter into revenue generating transactions and recognize revenue in the future is subject to a number of business and economic risks discussed above in Item 1A,"Risk Factors."

Collectibility of Accounts Receivable

We must make estimates of the collectibility of our accounts receivable. Management specifically analyzes accounts receivable, including historical bad debts, customer concentrations, customer creditworthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. The accounts receivable balance was $776,000, net of an allowance for doubtful accounts of $55,000 as of March 31, 2006, including a reserve for disputed credit card charges. If the financial condition of our customers were to deteriorate, our actual losses may exceed our estimates, and additional allowances would be required.

Valuation of Inventories

We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand, market conditions and replacement costs. If actual future demand or market conditions are less favorable than those projected by us, additional inventory write-downs may be required.

Income Taxes

As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. In the event that we determine that we would be able to realize deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

Significant management judgment is required in determining the valuation allowance recorded against our net deferred tax assets, which primarily consist of net operating loss and tax credit carry forwards. We have recorded a valuation allowance of approximately $71 million as of March 31, 2006, due to uncertainties related to our ability to utilize most of our deferred tax assets before they expire. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable.

Litigation

From time to time, we receive notices that our products or manufacturing processes may be infringing the patent or intellectual property rights of others. We account for litigation and contingencies in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for Contingencies" ("SFAS 5"). SFAS No. 5 requires that we record an estimated loss from a loss contingency when information available prior to issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. At March 31, 2006, liabilities related to litigation matters were not significant. Because of the uncertainties related to both the amount and range of loss on pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability, if any, related to our pending litigation and revise our estimates. Such revisions in our estimates of the potential liability could materially impact our results of operations, financial position or cash flows.

Key Business Metrics

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

- Churn: Average monthly subscriber line churn for a particular period is calculated by dividing the number of lines that terminated during that period by the simple average number of lines during the period and dividing the result by the number of months in the period. The simple average number of lines during the period is the number of lines on the first day of the period, plus the number of lines on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first thirty days after purchasing our service. Management reviews this metric to evaluate whether we are retaining our existing subscribers in accordance with our business plans.

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

• Average monthly revenue per line: Average monthly revenue per line for a particular period is calculated by dividing our total Packet8 revenue for that period by the simple average number of subscriber lines for the period and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two.

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

RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our Consolidated Financial Statements and related notes included elsewhere in this Report.

REVENUES

	Year Ended March 31,			Year-Over-Year Change			
	2006	2005	2004	2005 to 2006		2004 to 2005	
	(dollar amounts in thousands)						
Product revenues	$ 5,779	$ 2,389	$ 2,679	$ 3,390	141.9%	$ (290)	-10.8%
Percentage of total revenues	18.1%	20.8%	28.8%				

Product revenues consist of revenues from sales of VoIP terminal adapters, telephones and videophones, primarily attributable to our Packet8 service. For fiscal 2006, 2005 and 2004, product revenues also included sales of VoIP semiconductors and other system products of $0.2 million, $0.6 million and $2.3 million, respectively.

The increase in fiscal 2006, as compared to fiscal 2005, was primarily attributable to a $3.8 million increase in Packet8 product revenues attributable to the growth in the subscriber base compared to the prior year, partially offset by a $0.4 million decrease in sales of VoIP semiconductors. During fiscal 2006, our Packet8 lines in service increased by 133% from approximately 57,000 at March 31, 2005 to approximately 133,000 at March 31, 2006.

The decrease in fiscal 2005, as compared to fiscal 2004, was primarily attributable to a $1.7 million decrease in sales of video and VoIP semiconductors as we began to focus our business on the Packet8 service in fiscal 2004. This decrease was partially offset by a $1.4 million increase in Packet8 product revenues attributable to the growth in the subscriber base compared to the prior year. During fiscal 2005, our Packet8 lines in service increased by 418% from approximately 11,000 at March 31, 2004 to approximately 57,000 at March 31, 2005.

	Year Ended March 31,			Year-Over-Year Change			
	2006	2005	2004	2005 to 2006		2005 to 2004	
	(dollar amounts in thousands)						
License and service revenues	$ 26,113	$ 9,086	$ 6,629	$ 17,027	187.4%	$ 2,457	37.1%
Percentage of total revenues	81.9%	79.2%	71.2%				

Service revenues consist primarily of revenues attributable to the provision of our Packet8 service and VoIP technology licenses and any royalties earned under such licenses. Prior to fiscal 2004, our service revenues were primarily generated by nonrecurring license transactions and related maintenance revenues.

The increase in fiscal 2006, as compared to fiscal 2005, was primarily attributable to a $17.4 million increase in

Packet8 service revenues attributable to the significant growth in the subscriber base, which was partially offset by a decrease of $0.4 million in license and royalty revenues associated with our IP semiconductor technology and hosted iPBX product. In addition, we began charging a regulatory recovery fee of $1.50 per line effective in May 2005 and a $1.99 emergency 911 service cost recovery fee of $1.99 per line effective in January 2006. These fees are recorded as service revenues.

The increase in fiscal 2005, as compared to fiscal 2004, was primarily attributable to a $7.3 million increase in Packet8 service revenues attributable to the growth in the subscriber base, which was partially offset by a decrease of $4.8 million in license and maintenance revenues associated with our hosted iPBX product and IP semiconductor telephony technology.

Our average monthly revenue per line, or ARPU, increased to $27.39 for fiscal 2006 from $24.52 for the same period of fiscal 2005. The increase for fiscal 2006 was primarily attributable to our implementation of regulatory recovery and emergency 911 fees in fiscal 2006 combined with an increase in Virtual Office lines in service, which have higher monthly service fees. We did not compute or analyze ARPU for fiscal 2004, as Packet8 was an insignificant portion of our business.

Churn approximated 3.0% for fiscal 2006 and 3.7% for fiscal 2005. The decrease in churn was due to a reduction in service outages and an increase in voice quality and customer service staffing levels. If we are unable to compete effectively against our other existing competitors as well as against potential new entrants into the VoIP telephone service business, in both retaining our existing subscribers and attracting new subscribers, our churn will likely increase and our business will be adversely affected. We did not compute or analyze churn for fiscal 2004, as Packet8 was an insignificant portion of our business.

Revenues from our ten largest customers in the fiscal years ended March 31, 2006, 2005 and 2004 accounted for approximately 3%, 11% and 73%, respectively, of our total revenues. No single customer represented more than 10% of our total revenues during fiscal 2006 or 2005. Two customers represented 26% and 16% of our total revenues in fiscal 2004.

Sales to customers outside the United States represented 2%, 9% and 71% of total revenues in the fiscal years ended March 31, 2006, 2005 and 2004, respectively. The following table illustrates our net revenues by geographic area. Revenues are attributed to countries based on the destination of shipment (in thousands):

	Year Ended March 31,		
	2006	2005	2004
United States	$ 31,141	$ 10,472	$ 2,728
Europe	291	646	1,309
Taiwan	127	157	4,163
Japan	1	--	568
Other	332	200	540
	$ 31,892	$ 11,475	$ 9,308

Cost of Product Revenues

	Year Ended March 31,			Year-Over-Year Change			
	2006	2005	2004	2005 to 2006		2004 to 2005	
	(dollar amounts in thousands)						
Cost of product revenues	$ 10,732	$ 4,546	$ 1,768	$ 6,186	136.1%	$ 2,778	157.1%
Percentage of total revenues	33.7%	39.6%	19.0%				

The cost of product revenues consists of costs associated with systems, components, estimated warranty obligations and direct and indirect costs associated with product purchasing, scheduling, quality assurance, shipping and handling. We generally do not charge Packet8 subscribers for the terminal adapters used to provide our service when they subscribe on our website. We have also offered incentives to customers who purchase terminal adapters in our retail channels to offset the cost of the equipment purchased from a retailer. In accordance with Emerging Issues Task Force Issue No. 00-21, a portion of Packet8 revenues is allocated to product revenues, but these revenues are less than the cost of the terminal adapters. Accordingly, cost of product revenues exceeds product revenues, and we expect this trend to continue. We began shipping lower cost broadband phone gateways and we suspended purchases of DV326 videophones in the fourth quarter of fiscal 2006, and we expect the cost of product revenues to decrease as a percentage of revenues.

The increase in fiscal 2006, as compared to fiscal 2005, was primarily due to an approximately $6.6 million increase attributable to equipment provided and sold to Packet8 subscribers upon commencement of service and related manufacturing, personnel, handling, overhead and shipping costs. The increase in Packet8 expenses was partially offset by a decrease in cost of revenues for semiconductor products due to the decrease in sales of such products during fiscal 2005 due to the end of life of these products initiated in fiscal 2004.

The increase in fiscal 2005, as compared to fiscal 2004, was primarily due to a $3.3 million increase attributable to equipment provided and sold to Packet8 subscribers upon commencement of service and related manufacturing, personnel, handling, overhead and shipping costs. The increase in Packet8 expenses was partially offset by a decrease in cost of revenues for semiconductor products due to the decrease in sales of such products during fiscal 2005 due to the end of life of these products initiated in fiscal 2004.

Cost of License and Service Revenues

	Year Ended March 31,			Year-Over-Year Change			
	2006	2005	2004	2005 to 2006		2004 to 2005	
	(dollar amounts in thousands)						
Cost of license and service revenues....	$ 12,367	$ 5,195	$ 2,594	$ 7,172	138.1%	$ 2,601	100.3%
Percentage of total revenues..................	38.8%	45.3%	27.9%				

The cost of license and service revenues consists of costs primarily associated with network operations and related personnel, telephony origination and termination services provided by third party carriers and royalty expenses. During the fourth quarter of fiscal 2006, we began terminating a substantial portion of our phone traffic with a new carrier and we expect this to reduce the cost of service revenues as a percentage of service revenues.

The increase in cost of license and service revenues in fiscal 2006, as compared to fiscal 2005, was primarily due to an increase in Packet8 network operations headcount, third party telephony origination and termination service fees and other costs due to the significant year over year growth in Packet8 lines in service.

The increase in cost of license and service revenues in fiscal 2005, as compared to fiscal 2004, was primarily due to a $4.1 million increase in Packet8 network operations, third party carrier service and other costs due to the year over year growth in Packet8 lines in service. This increase was offset by a $1.5 million decrease in license and royalty costs attributable to our IP semiconductor technology, primarily attributable to video semiconductor product development efforts conducted during fiscal 2004. As the costs of developing this video semiconductor product related to a revenue generating contract, they were included in cost of license and service revenues in fiscal 2004. In the third quarter of fiscal 2004, we terminated this video semiconductor development effort in connection with the license and sale of the related technology.

RESEARCH AND DEVELOPMENT EXPENSES

	Year Ended March 31,			Year-Over-Year Change			
	2006	2005	2004	2005 to 2006		2004 to 2005	
	(dollar amounts in thousands)						
Research and development.....................	$ 5,916	$ 3,109	$ 2,747	$ 2,807	90.3%	$ 362	13.2%
Percentage of total revenues..................	18.6%	27.1%	29.5%				

Research and development expenses have historically consisted primarily of personnel, system prototype design, and equipment costs necessary for us to conduct our development and engineering efforts. Research and development costs, including software development costs, are expensed as incurred.

The increase in research and development expenses for fiscal 2006, as compared to fiscal 2005, was primarily due to a $2.7 million increase in personnel costs due to additional employee and contractor headcount.

The increase in research and development expenses for fiscal 2005, as compared to fiscal 2004, was primarily due to a $0.9 million increase in personnel costs due to additional employee and contractor headcount. These increases were offset by decreases in depreciation, tooling and maintenance expenses.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

	Year Ended March 31,			Year-Over-Year Change			
	2006	**2005**	**2004**	**2005 to 2006**		**2004 to 2005**	
	(dollar amounts in thousands)						
Selling, general and administrative	$ 27,863	$ 18,534	$ 6,060	$ 9,329	50.3%	$ 12,474	205.8%
Percentage of total revenues	87.4%	161.5%	65.1%				

Selling, general and administrative expenses consist primarily of personnel and related overhead costs for sales, marketing, customer support, finance, human resources and general management. Such costs also include outsourced customer service call center operations, sales commissions, trade show, advertising and other marketing and promotional expenses.

The increase in selling, general and administrative expenses for fiscal 2006, as compared to fiscal 2005, was primarily attributable to a $2.5 million increase in compensation expense for personnel due to headcount additions, a $1.0 million increase in advertising, public relations and other marketing and promotional expenses, a $1.2 million increase in contractor expenses relating to the increase in staffing of our telemarketing and customer service organizations, a $3.6 million increase in sales agent and retailer commissions and a $0.9 million increase in credit card transaction processing fees. These increases were partially offset by a $0.3 million decrease in consultant and auditor expenses related to compliance with Sarbanes Oxley Section 404 and a $0.6 million decrease in legal fees attributable to reduced patent and regulatory legal expenses.

The increase in selling, general and administrative expenses for fiscal 2005, as compared to fiscal 2004, was primarily attributable to a $1.4 million increase in compensation expense for personnel due to headcount additions, a $4.9 million increase in advertising, public relations and other marketing and promotional expenses, a $1.8 million increase in contractor expenses due to the increase in staffing of our telemarketing and customer service organizations, a $1 million increase in sales agent and retailer commissions, a $0.8 million increase in consultant and auditor expenses related to compliance with Sarbanes Oxley Section 404, a $0.5 million increase in legal fees and a $0.4 million increase in credit card transaction processing fees.

Subscriber acquisition costs increased to $122 for fiscal 2006 from $113 for fiscal 2005. Subscriber acquisition cost increased for fiscal 2006 as compared to fiscal 2005 due to an increase in overall marketing program spending in the retail distribution channel and spending on a per acquired subscriber basis and higher one-time bounty payments to sales agents. We did not compute or analyze subscriber acquisition costs for fiscal 2004, as Packet8 was an insignificant portion of our business.

OTHER INCOME, NET

	Year Ended March 31,			Year-Over-Year Change			
	2006	**2005**	**2004**	**2005 to 2006**		**2004 to 2005**	
	(dollar amounts in thousands)						
Other income, net	$ 847	$ 558	$ 822	$ 289	51.8%	$ (264)	-32.1%
Percentage of total revenues	2.7%	4.9%	8.8%				

The increase in other income, net in fiscal 2006 was primarily due to higher interest rates earned on our cash balances as these funds were invested in marketable securities. In fiscal 2006, other income, net was primarily comprised of interest and investment income earned on our cash, cash equivalents and investment balances.

The decrease in other income, net in fiscal 2005 was primarily attributable to a $790,000 one time gain recorded in fiscal 2004 in connection with the sale of Centile Europe SA, partially offset by an increase in interest income of $276,000 due to higher cash balances maintained during fiscal 2005 and the receipt of escrow funds of $180,000 from a cost basis common stock investment in an entity acquired in 1999 by a third party.

BENEFIT FOR INCOME TAXES

	Year Ended March 31,			Year-Over-Year Change			
	2006	2005	2004	2005 to 2006		2004 to 2005	
	(dollar amounts in thousands)						
Benefit for income taxes	$ --	$ (203)	$ --	$ 203	-100.0%	$ (203)	n/a
Percentage of total revenues	--	-1.8%	--				

We had no provisions for the fiscal years ended March 31, 2006, 2005 and 2004. We recorded a $203,000 benefit in fiscal 2005, which was primarily attributable to the release of income tax reserves recorded in prior years and $20,000 attributable to an income tax refund received by one of our foreign subsidiaries.

At March 31, 2006, we had net operating loss carryforwards for federal and state income tax purposes of approximately $132 million and $86 million, respectively, which expire at various dates beginning in 2006 and continuing through 2026. In addition, at March 31, 2006, we had research and development credit carryforwards for federal and state tax reporting purposes of approximately $3.4 million and $2.7 million, respectively. The federal credit carryforwards will begin expiring in 2010 continuing through 2023, while the California credit will carryforward indefinitely. Under the ownership change limitations of the Internal Revenue Code of 1986, as amended, the amount and benefit from the net operating losses and credit carryforwards may be impaired or limited in certain circumstances.

At March 31, 2006 and 2005, we had gross deferred tax assets of approximately $70.5 million and $60.9 million. We believe that, based on a number of factors, the weight of objective available evidence indicates that it is more likely than not that we will not be able to realize our deferred tax assets, and a full valuation allowance was recorded at March 31, 2006 and 2005.

LIQUIDITY AND CAPITAL RESOURCES

As of March 31, 2006, we had $6.3 million of cash and cash equivalents, and $16.7 million in investments in marketable securities for a combined total of $23 million. In comparison, at March 31, 2005, we had $22.5 million in cash and cash equivalents, $0.3 million in restricted cash and $9 million in investments for a combined total of $31.8 million. We currently have no borrowing arrangements. Our cash and cash equivalents balance decreased $16.2 million and the combined balance decreased by $8.8 million during fiscal 2006. The decrease was primarily attributable to $21.2 million used for operating activities and $1.9 million of capital expenditures, as discussed below, partially offset by $14 million of net proceeds from financing activities. Our restricted cash balance decreased by $0.3 million due to termination of an agreement requiring a letter of credit.

Comparison of fiscal 2005 and 2006

Cash used in operations of $21.2 million in fiscal 2006 was primarily attributable to the net loss of $24 million, adjusted for $0.8 million of non-cash depreciation and amortization, a $0.2 million stock compensation charge and $0.1 million of amortization of discounts and premiums on marketable securities, a $0.1 million increase in inventory and a $0.4 million increase other current and noncurrent assets. Cash used in operations was partially offset by a $0.4 million decrease in accounts receivable, a $0.6 million decrease in deferred cost of goods sold, a $0.6 million increase in accounts payable and a $1.3 million increase in accrued compensation and other accrued liabilities. The increase in accounts payable was attributable to timing and an increase in payables for telecommunications service provider costs. The increase in accrued compensation and other accrued liabilities was primarily attributable to the increase in headcount in fiscal 2006, accrued salary for a terminated executive and an increase in sales, use and other tax liabilities.

Cash used in investing activities of $9.4 million for fiscal 2006 was primarily attributable to $1.9 million of purchases of fixed assets and purchases of investments of $16.4 million, partially offset by $8.9 million of proceeds received from sales and maturities of investments. The purchases of fixed assets were primarily attributable to equipment required by the growth of the Packet8 subscriber base and expenditures for implementation fees related to third party customer relationship management software.

Cash provided by financing activities of approximately $14.4 million in fiscal 2006 consisted primarily of $14 million of net proceeds received from a common stock offering completed in December 2005, $0.3 million of proceeds received from the sale of our common stock to employees through our employee stock purchase and stock option plans and $0.2 million attributable to a bank overdraft due to the timing of payments.

Comparison of fiscal 2004 and 2005

Cash used in operations of $16.5 million in fiscal 2005 was primarily attributable to the net loss of $19.1 million, adjusted for $0.2 million of non-cash depreciation and amortization, a $0.5 million increase in accounts receivable, a $1.5 million increase in inventory and a $1.8 million increase in deferred cost of goods sold. Cash used in operations was partially offset by a $2.1 million increase in deferred revenue, a $3.6 million increase in accounts payable and a $0.5 million increase in accrued compensation and other accrued liabilities. The increase in accounts receivable was primarily attributable to our development of the retail and distributor channels in fiscal 2005 combined with an increase in subscribers in fiscal 2005, and the increase in inventory was primarily attributable to the growth of the Packet8 service and ramping of production for desktop terminal adapters. The increases in deferred cost of goods sold and deferred revenue were primarily attributable to the growth in subscribers in fiscal 2005 and the retail and distributor channels that we did not have in fiscal 2004. The increase in accounts payable was attributable to timing and an increase in payables for inventory and telecommunications service provider costs.

Cash used in investing activities of $10.3 million for fiscal 2005 was primarily attributable to $1.6 million of purchases of fixed assets and purchases of investments of $9.7 million, partially offset by a net $0.3 million decrease in cash classified as restricted cash due to the termination of agreements requiring letters of credit and $0.6 million of proceeds received from maturities of investments. The purchases of fixed assets were primarily attributable to equipment required by the growth of the Packet8 subscriber base and expenditures for financial application and customer relationship management software and implementation fees.

Cash provided by financing activities of approximately $36.2 million in fiscal 2005 consisted primarily of $35.7 million of net proceeds received from common stock offerings completed in June and October 2004 and March 2005 and $0.4 million of proceeds received from the sale of our common stock to employees through our employee stock purchase and stock option plans.

We have sustained net losses and negative cash flows from operations since fiscal 1999 that have been funded primarily through the issuance of equity securities and borrowings. Management believes that current cash, cash equivalents and investments will be sufficient to finance our operations for at least the next twelve months. However, we continually evaluate our cash needs and may pursue additional equity or debt financing in order to achieve our overall business objectives. There can be no assurance that such financing will be available, or, if available, at a price or terms that are acceptable to us. Failure to generate sufficient revenues, raise additional capital or reduce certain discretionary spending could have an adverse impact on our ability to achieve our longer term business objectives.

Off Balance Sheet Arrangements

We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments or other contingent arrangements that expose us to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to us.

Contractual Obligations

At March 31, 2006, we had open purchase orders related to our contract manufacturers and other contractual obligations of approximately $2.9 million primarily related to inventory purchases. These purchase commitments are reflected in our consolidated financial statements once goods or services have been received or at such time when we are obligated to make payments related to these goods or services. At March 31, 2006, future minimum annual lease payments under noncancelable operating leases, net of sublease income, were as follows (in thousands):

Year Ending March 31,		
2007	$	482
2008		490
2009		493
2010		206
Total minimum payments	$	1,671

In April 2005, we entered into a series of noncancelable five year capital lease agreements for office equipment bearing interest at various rates. At March 31, 2006, future minimum annual lease payments were as follows (in thousands):

Year ending March 31:		
2007	$	25
2008		25
2009		25
2010		25
2011		2
Total minimum payments		102
Less: Amount representing interest		(11)
		91
Less: Short-term portion of capital lease obligations		(21)
Long-term portion of capital lease obligations	$	70

Assets under capital lease at March 31, 2006 totaled $108,000 with accumulated amortization of $20,000.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, "Share-Based Payment," requiring all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the consolidated financial statements based on their fair values. This standard includes two transition methods. Upon adoption, we will be required to use either the modified prospective or the modified retrospective transition method. Under the modified prospective method, awards that are granted, modified, or settled after the date of adoption should be measured and accounted for in accordance with SFAS No. 123R. Unvested equity-classified awards that were granted prior to the effective date should continue to be accounted for in accordance with SFAS No. 123 except that amounts must be recognized in the income statement. Under the modified retrospective approach, the previously-reported amounts are restated (either to the beginning of the year of adoption or for all periods presented) to reflect the SFAS No. 123 amounts in the income statement.

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") which provides guidance regarding the application of SFAS 123(R). SAB 107 expresses views of the SEC regarding the interaction between SFAS No. 123(R), Share-Based Payment, and certain SEC rules and regulations and provides the SEC's views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with non-employees, the transition from nonpublic to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS No. 123(R) in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS No. 123(R), the modification of employee share options prior to adoption of SFAS No. 123(R) and disclosures in Management's Discussion and Analysis ("MD&A") subsequent to adoption of SFAS 123(R).

On April 14, 2005, the SEC approved a new rule that delays the effective date for SFAS No. 123(R) to annual periods beginning after June 15, 2005. Our adoption of SFAS No. 123(R) on April 1, 2006 is expected to have a material impact on our consolidated results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board Opinion No. 20 and FASB Statement No. 3." SFAS No. 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so or another methodology is required by the standard. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS No. 154's retrospective application requirement replaces APB No 20's ("Accounting Changes") requirement to recognize most voluntary changes in accounting principle by including in net income (loss) of the period of the change the cumulative effect of changing to the new accounting principle. This Statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. The requirements are effective for accounting changes made in fiscal years beginning after December 15, 2005 and will only impact the consolidated financial statements in periods in which a change in accounting principle is made. We do not expect that the adoption of SFAS No. 154 in the first quarter of fiscal 2007 will have a material impact on our results of operations and financial condition.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The primary objective of our investment activities is to preserve principal while maximizing income without significantly increasing risk. Some of the securities in which we invest may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. To minimize this risk, we may maintain our portfolio of cash equivalents and investments in a variety of securities, including commercial paper, money market funds, debt securities and certificates of deposit. The risk associated with fluctuating interest rates is limited to our investment portfolio and we do not believe that a 10% change in interest rates would have a significant impact on our interest income.

During the years ended March 31, 2006 and 2005, we did not have any outstanding debt instruments other than equipment under capital lease and, therefore, we were not exposed to market risk relating to interest rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Schedules other than the one listed above have been omitted because they are inapplicable, because the required information has been included in the financial statements or notes thereto, or the amounts are immaterial.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of 8x8, Inc.

We have completed integrated audits of 8x8, Inc.'s 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of March 31, 2006 and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of 8x8, Inc. and its subsidiaries at March 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of March 31, 2006 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of March 31, 2006, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

San Jose, California
June 14, 2006

8X8, INC.

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	March 31, 2006	March 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,259	$ 22,515
Restricted cash	--	250
Short-term investments	12,726	9,035
Accounts receivable, net of allowance of $55 and $68	776	1,144
Inventory	1,738	1,600
Deferred cost of goods sold	1,542	2,122
Other current assets	774	363
Total current assets	23,815	37,029
Long-term investments	3,972	--
Property and equipment, net	3,071	1,788
Other assets	262	263
	$ 31,120	$ 39,080
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,907	$ 4,496
Accrued compensation	937	515
Accrued warranty	301	187
Deferred revenue	2,493	2,602
Other accrued liabilities	2,319	1,536
Total current liabilities	10,957	9,336
Non-current liabilities	70	--
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, $0.001 par value: Authorized: 5,000,000 shares; Issued and outstanding: no shares at March 31, 2006 and 1 share at March 31, 2005	--	--
Common stock, $0.001 par value: Authorized: 100,000,000 shares at March 31, 2006 and March 31, 2005; Issued and outstanding: 61,138,280 shares at March 31, 2006 and 53,816,989 shares at March 31, 2005	61	54
Additional paid-in capital	215,072	200,576
Accumulated other comprehensive loss	(35)	(20)
Accumulated deficit	(195,005)	(170,866)
Total stockholders' equity	20,093	29,744
	$ 31,120	$ 39,080

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

8X8, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Years Ended March 31, 2006	2005	2004
Service revenues	$ 26,113	$ 9,086	$ 6,629
Product revenues	5,779	2,389	2,679
Total revenues	31,892	11,475	9,308
Operating expenses:			
Cost of service revenues	12,367	5,195	2,594
Cost of product revenues	10,732	4,546	1,768
Research and development	5,916	3,109	2,747
Selling, general and administrative	27,863	18,534	6,060
Total operating expenses	56,878	31,384	13,169
Loss from operations	(24,986)	(19,909)	(3,861)
Other income, net	847	558	822
Loss before benefit for income taxes	(24,139)	(19,351)	(3,039)
Benefit for income taxes	--	(203)	--
Net loss	$ (24,139)	$ (19,148)	$ (3,039)
Basic and diluted loss per share	$ (0.43)	$ (0.43)	$ (0.09)
Basic and diluted shares outstanding	55,889	44,373	32,546

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

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(IN THOUSANDS, EXCEPT SHARES)

	Common Stock		Additional Paid-in	Deferred Compensa-	Accumulated other Comprehen- sive	Accumulated	
	Shares	Amount	Capital	tion	Loss	Deficit	Total
Balance at March 31, 2003	28,470,987	$ 28	$ 150,827	$ (12)	$ --	$ (148,679)	$ 2,164
Issuance of common stock under stock plans	1,445,438	2	1,880	--	--	--	1,882
Sale of common stock and warrants in financing transactions	4,899,773	4	7,896	--	--	--	7,900
Issuance of common stock on exercise of warrants	3,499,571	4	1,895	--	--	--	1,899
Stock compensation charge	--	--	1,308	--	--	--	1,308
Common stock no longer contingently redeemable	--	--	669	--	--	--	669
Deferred compensation related to stock options	--	--	(6)	9	--	--	3
Net loss	--	--	--	--	--	(3,039)	
Total comprehensive loss	--	--	--	--	--	--	(3,039)
Balance at March 31, 2004	38,315,769	38	164,469	(3)	--	(151,718)	12,786
Issuance of common stock under stock plans	294,830	--	424	--	--	--	424
Sale of common stock and warrants in financing transactions	15,206,390	16	35,681	--	--	--	35,697
Stock compensation charge	--	--	2	--	--	--	2
Deferred compensation related to stock options	--	--	--	3	--	--	3
Unrealized investment loss	--	--	--	--	(20)	--	
Net loss	--	--	--	--	--	(19,148)	
Total comprehensive loss	--	--	--	--	--	--	(19,168)
Balance at March 31, 2005	53,816,989	54	200,576	--	(20)	(170,866)	29,744
Issuance of common stock under stock plans	178,433	--	279	--	--	--	279
Sale of common stock and warrants in financing transactions	7,142,858	7	13,980	--	--	--	13,987
Stock compensation charge	--	--	237	--	--	--	237
Unrealized investment loss	--	--	--	--	(15)	--	
Net loss	--	--	--	--	--	(24,139)	
Total comprehensive loss	--	--	--	--	--	--	(24,154)
Balance at March 31, 2006	61,138,280	$ 61	$ 215,072	$ --	$ (35)	$ (195,005)	$ 20,093

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

8X8, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	Years Ended March 31,		
	2006	**2005**	**2004**
Cash flows from operating activities:			
Net loss	$ (24,139)	$ (19,148)	$ (3,039)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	787	215	565
Stock compensation expense	237	5	1,311
Amortization of discount and premium on marketable securities	96	--	--
Gain on sale of Centile Europe SA	--	--	(790)
Other	6	32	(69)
Changes in assets and liabilities, net of effects of businesses sold:			
Accounts receivable, net	363	(536)	682
Inventory	(136)	(1,522)	325
Other current and noncurrent assets	(410)	(28)	219
Deferred cost of goods sold	580	(1,812)	(310)
Accounts payable	258	3,642	263
Accrued compensation	422	100	(258)
Accrued warranty	114	(7)	(234)
Deferred revenue	(109)	2,055	2
Other current and noncurrent liabilities	725	453	(249)
Net cash used in operating activities	(21,206)	(16,551)	(1,582)
Cash flows from investing activities:			
Acquisitions of property and equipment	(1,900)	(1,588)	(106)
Purchase of investments	(16,424)	(9,665)	--
Sales of short-term investments	850	161	208
Maturities of short-term investments	8,050	450	--
Proceeds from the sale of equipment	--	--	79
Restricted cash decrease (increase)	--	300	(800)
Proceeds from sale of Centile Europe SA, net	--	--	398
Net cash used in investing activities	(9,424)	(10,342)	(221)
Cash flows from financing activities:			
Bank overdraft	153	--	--
Proceeds from equity financing transactions, net	13,960	35,735	9,799
Proceeds from issuance of common stock under employee stock plans	279	424	1,882
Capital lease payments	(18)	--	--
Net cash provided by financing activities	14,374	36,159	11,681
Net increase (decrease) in cash and cash equivalents	(16,256)	9,266	9,878
Cash and cash equivalents, beginning of year	22,515	13,249	3,371
Cash and cash equivalents, end of year	$ 6,259	$ 22,515	$ 13,249
Supplemental and non-cash disclosures:			
Assets acquired under capital lease	$ 108	$ --	$ --
Interest paid	$ 7	$ --	$ --

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. THE COMPANY AND SIGNIFICANT ACCOUNTING POLICIES

THE COMPANY

8x8, Inc., or 8x8, and its subsidiaries (collectively, the Company) develop and market communication technology and services for Internet protocol or, IP, telephony and video applications. The Company was incorporated in California in February 1987, and in December 1996 was reincorporated in Delaware. In August 2000, the Company changed its name from 8x8, Inc. to Netergy Networks, Inc. The Company changed its name back to 8x8, Inc. in July 2001.

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

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

The Company's fiscal year ends on March 31 of each calendar year. Each reference to a fiscal year in these notes to the consolidated financial statements refers to the fiscal year ending March 31 of the calendar year indicated (for example, fiscal 2006 refers to the fiscal year ended March 31, 2006).

LIQUIDITY

The Company has sustained net losses and negative cash flows from operations since fiscal 1999 that have been funded primarily through the issuance of equity securities and borrowings. Management believes that current cash, cash equivalents and investments will be sufficient to finance the Company's operations for at least the next twelve months. However, the Company continually evaluates its cash needs and may pursue additional equity or debt financing in order to achieve the Company's overall business objectives. There can be no assurance that such financing will be available, or, if available, at a price that is acceptable to the Company. Failure to generate sufficient revenues, raise additional capital or reduce certain discretionary spending could have an adverse impact on the Company's ability to achieve its longer term business objectives.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of 8x8 and its subsidiaries. All material intercompany accounts and transactions have been eliminated.

USE OF ESTIMATES

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and equity and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including, but not limited to, those related to bad debts, valuation of inventories, and litigation and other contingencies. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates under different assumptions or conditions.

REVENUE RECOGNITION

VoIP service revenue

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

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

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.

Product revenue

The Company recognizes revenue from product sales for which there are no related services to be rendered upon shipment to OEMs and end users provided that persuasive evidence of an arrangement exists, the price is fixed, title has transferred, collection of resulting receivables is reasonably assured, there are no customer acceptance requirements, and there are no remaining significant obligations. Gross outbound shipping and handling charges are recorded as revenue, and the related costs are included in cost of goods sold. Reserves for returns and allowances for OEM and end user sales are recorded at the time of shipment. The Company defers recognition of revenue on sales to distributors and resellers where the right of return exists until products are resold to the end user and the trial period has expired.

License and other revenue

During fiscal 2006 and 2005, revenues from software licensing and related arrangements were limited. The Company recognizes revenue from license contracts when a non-cancelable, non-contingent license agreement has been signed, the software product has been delivered, no uncertainties exist surrounding product acceptance, fees from the agreement are fixed and determinable, and collection is probable. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date if evidence of the fair value of all undelivered elements exists. If evidence of the fair value of the undelivered elements does not exist, revenue is deferred and recognized when delivery occurs. When the Company enters into a license agreement requiring that the Company provide significant customization of the software products, the license and consulting revenue is recognized using contract accounting. Revenue from maintenance agreements is recognized ratably over the term of the maintenance agreement, which in most instances is one year. The Company recognizes royalties upon notification of sale by its licensees. Revenue from consulting, training, and development services is recognized as the services are performed.

CASH, CASH EQUIVALENTS AND INVESTMENTS

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. Management determines the appropriate categorization of debt and equity securities at the time of purchase and reevaluates the classification at each reporting date. The cost of the Company's investments is determined based upon specific identification.

The Company's investments are comprised of U.S. obligations, U.S. government debt agencies, corporate debt, auction rate securities and certificates of deposit. At March 31, 2006 and 2005, all investments were classified as available-for-sale and reported at fair value, based upon quoted market prices, with unrealized gains and losses, net of related tax, if any, included in other comprehensive loss and disclosed as a separate component of stockholders' equity. Realized gains and losses on sales of all such investments are reported within the caption of other income, net in the statements of operations and computed using the specific identification method. The Company's investments in marketable securities are monitored on a periodic basis for impairment. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established.

Available-for-sale investments were (in thousands):

As of March 31, 2006	Amortized Costs	Gross Unrealized Loss	Estimated Fair Value
Money market funds	$ 3,663	$ --	$ 3,663
Commercial paper	997	--	997
Certificates of deposit	250	--	250
Federal agency securities	4,499	(15)	4,484
Auction rate securities	5,500	--	5,500
Corporate bonds	7,483	(20)	7,463
Total available-for-sale investments	$ 22,392	$ (35)	$ 22,357

Reported as (in thousands):	
Cash and cash equivalents	$ 5,659
Short-term investments	12,726
Long-term investments	3,972
Total	$ 22,357

As of March 31, 2005	Amortized Costs	Gross Unrealized Loss	Estimated Fair Value
Commercial paper	$ 10,565	$ (2)	$ 10,563
Federal agency securities	5,976	(6)	5,970
Auction rate securities	5,500	--	5,500
Corporate bonds	2,563	(12)	2,551
Total available-for-sale investments	$ 24,604	$ (20)	$ 24,584

Reported as (in thousands):	
Cash and cash equivalents	$ 15,549
Short-term investments	9,035
Total	$ 24,584

Contractual maturities of available-for-sale debt securities as of March 31, 2006 are set forth below (in thousands):

Due within one year	$ 14,864
Due after one year	1,993
Due after five years	5,500
Total	$ 22,357

The Company has classified certain long-term investments, consisting of auction rate securities, as short-term due to its intent not to hold them to maturity.

RESTRICTED CASH

Restricted cash at March 31, 2005 represented amounts held in certificates of deposit to support stand-by letters of credit used as security for third party vendors.

INVENTORY

Inventory is stated at the lower of standard cost, which approximates actual cost using the first-in, first-out method, or market. Inventory reserves are established when conditions indicate that the current replacement cost or market is below the carrying value due to obsolescence, changes in price levels, or other causes. Reserves are established for excess inventory generally based on inventory levels in excess of demand, as determined by management, for each specific product. Inventory at March 31, 2006 and 2005 was comprised of the following:

	March 31,	
	2006	2005
	(in thousands)	
Work-in-process	$ 1,192	$ 1,267
Finished goods	546	333
	$ 1,738	$ 1,600

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method. Estimated useful lives of three years are used for equipment and software and five years for furniture and fixtures. Amortization of leasehold improvements is computed using the shorter of the remaining facility lease term or the estimated useful life of the improvements. Property and equipment at March 31, 2006 and 2005 was comprised of the following:

	March 31,	
	2006	2005
	(in thousands)	
Machinery and computer equipment	$ 3,467	$ 3,372
Furniture and fixtures	82	121
Licensed software	1,579	1,059
Leasehold improvements	183	172
	5,311	4,724
Less: accumulated depreciation and amortization	(2,240)	(2,936)
	$ 3,071	$ 1,788

Maintenance, repairs and ordinary replacements are charged to expense. Expenditures for improvements that extend the physical or economic life of the property are capitalized. Gains or losses on the disposition of property and equipment are recorded in the loss from operations.

IMPAIRMENT OF LONG-LIVED ASSETS

8x8 reviews the recoverability of its long-lived assets, such as plant and equipment when events or changes in circumstances occur that indicate that the carrying value of the asset or asset group may not be recoverable. The assessment of possible impairment is based on the Company's ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows (undiscounted and without interest charges) of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-lived assets.

WARRANTY EXPENSE

The Company accrues for estimated product warranty cost upon revenue recognition. Accruals for product warranties are calculated based on the Company's historical warranty experience adjusted for any specific requirements.

RESEARCH, DEVELOPMENT AND SOFTWARE COSTS

Research and development costs are charged to operations as incurred. 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. The Company defines establishment of technological feasibility as the completion of a working model. 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. To date, all software development costs for software to be sold or otherwise marketed have been expensed as incurred. In accordance with American Institute of Certified Public Accountants Statement of Position (SOP) No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes purchase and implementation costs of internal use software. In accordance with SOP No. 98-1, during fiscal 2006, 2005 and 2004, the Company capitalized $679,000, $676,000 and $0, respectively.

ADVERTISING COSTS

Advertising costs are expensed as incurred and were $5,265,000, $4,100,000, and $283,000 for the years ended March 31, 2006, 2005 and 2004, respectively.

FOREIGN CURRENCY TRANSLATION

Assets and liabilities of the Company's foreign subsidiaries are translated from their respective functional currencies at exchange rates in effect at the balance sheet date, and revenues and expenses are translated at average exchange rates prevailing during the year. If the functional currency is the local currency, resulting translation adjustments are reflected as a separate component of stockholders' equity. If the functional currency is the U.S. dollar, resulting conversion adjustments are included in the results of operations. Foreign currency transaction gains and losses, which have been immaterial, are also included in results of operations. Total assets of the Company's foreign subsidiaries were $45,000, $39,000, and $174,000 as of March 31, 2006, 2005 and 2004, respectively. At March 31, 2006, the U.S. dollar was the functional currency for all foreign subsidiaries. The Company does not undertake any foreign currency hedging activities.

INCOME TAXES

Income taxes are accounted for using the asset and liability approach. Under the asset and liability approach, a current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year. A deferred tax liability or asset is recognized for the estimated future tax effects attributed to temporary differences and carryforwards. If necessary, the deferred tax assets are reduced by the amount of benefits that, based on available evidence, it is more likely than not expected to be realized.

CONCENTRATIONS

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents, investments and trade accounts receivable. The Company has cash equivalents and investment policies that limit the amount of credit exposure to any one financial institution and restricts placement of these funds to financial institutions evaluated as highly credit-worthy. The Company has not experienced any material losses relating to any investment instruments.

The Company sells its products to OEMs and distributors. The Company performs ongoing credit evaluations of its customers' financial condition, and generally does not require collateral from its customers. For each of the three years ended March 31, 2006, the Company experienced minimal write-offs for bad debts and doubtful accounts. At March 31, 2006, one customer accounted for 12% of accounts receivable. At March 31, 2005, three customers accounted for 26%, 16% and 11%, respectively, of accounts receivable.

The Company outsources the manufacturing of its hardware products to independent contract manufacturers. The inability of any contract manufacturer to fulfill supply requirements of the Company could materially impact future operating results, financial position or cash flows. If any of these contract manufacturers fail to perform on their obligations to the Company, such failure to fulfill supply requirements of the Company could materially impact future operating results, financial position and cash flows.

The Company also relies on primarily one third party network service provider to provide telephone numbers and public switched telephone network (PSTN) call termination and origination services for its customers. If this service provider failed to perform on its obligations to the Company, such failure could materially impact future operating results, financial position and cash flows.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value of financial instruments is determined by the Company using available market information and valuation methodologies considered to be appropriate. The carrying amounts of the Company's cash and cash equivalents, accounts receivable and accounts payable approximate their fair values due to their short maturities. The Company's investments are carried at fair values.

ACCOUNTING FOR STOCK-BASED COMPENSATION

The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB Opinion No. 25) and related interpretations thereof. As required under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), the Company provides pro forma disclosure of net loss and loss per share. If the Company had elected to recognize compensation costs based on the fair value at the date of grant of the awards, consistent with the provisions of SFAS No. 123, net loss and loss per share amounts would have been as follows (in thousands, except per share amounts):

	Year Ended March 31,		
	2006	**2005**	**2004**
Net loss:	$ (24,139)	$ (19,148)	$ (3,039)
Add: Employee stock-based compensation expense included in reported net loss	237	5	1,311
Deduct: Total employee stock-based compensation determined pursuant to SFAS No.123	(2,798)	(2,426)	(2,113)
Pro forma net loss	$ (26,700)	$ (21,569)	$ (3,841)
As reported net loss per share	$ (0.43)	$ (0.43)	$ (0.09)
Pro forma net loss per share	$ (0.48)	$ (0.49)	$ (0.12)

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, "Share-Based Payment," requiring all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the consolidated financial statements based on their fair values. This standard includes two transition methods. Upon adoption, the Company will be required to use either the modified prospective or the modified retrospective transition method. Under the modified prospective method, awards that are granted, modified, or settled after the date of adoption should be measured and accounted for in accordance with SFAS No. 123R. Unvested equity-classified awards that were granted prior to the effective date should continue to be accounted for in accordance with SFAS No. 123 except that amounts must be recognized in the income statement. Under the modified retrospective approach, the previously-reported amounts are restated (either to the beginning of the year of adoption or for all periods presented) to reflect the SFAS No. 123 amounts in the income statement.

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") which provides guidance regarding the application of SFAS No. 123(R). SAB 107 expresses views of the staff regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations and provides the staff's views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with non-employees valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, first-time adoption of SFAS No. 123(R) in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS No. 123(R), the modification of employee share options prior to adoption of SFAS No. 123(R) and disclosures in Management's Discussion and Analysis ("MD&A") subsequent to adoption of SFAS No. 123(R).

On April 14, 2005, the SEC approved a rule that delays the effective date for SFAS No. 123(R) to annual periods beginning after June 15, 2005. The adoption of SFAS No. 123(R) on April 1, 2006 is expected to have a material impact on the Company's consolidated results of operations.

RECENT ACCOUNTING PRONOUNCEMENTS

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board Opinion No. 20 and FASB Statement No. 3" ("SFAS No. 154"). SFAS No. 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so or another methodology is required by the standard. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS No. 154's retrospective application requirement replaces the requirement of APB Opinion No. 20 ("Accounting Changes") to recognize most voluntary changes in accounting principle by including in net income (loss) of the period of the change the cumulative effect of changing to the new accounting principle. This Statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. SFAS No. 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. The requirements are effective for accounting changes made in fiscal years beginning after December 15, 2005 and will only impact the consolidated financial statements in periods in which a change in accounting principle is made. The Company does not expect that the adoption of SFAS No. 154 in the first quarter of fiscal 2007 will have a material impact on its results of operations and financial condition.

COMPREHENSIVE LOSS

Comprehensive loss, as defined, includes all changes in equity (net assets) during a period from non-owner sources. The difference between net loss and comprehensive loss is due to unrealized losses on investments classified as available-for-sale. Comprehensive loss is reflected in the consolidated statements of stockholders' equity. During fiscal 2006, the Company recorded a reclassification adjustment of $6,000 due to realized gains, which had been included in comprehensive income for fiscal 2005.

RECLASSIFICATIONS

Certain prior year balances have been reclassified to conform with the current year presentation.

NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss available to common stockholders (numerator) by the weighted average number of common shares outstanding during the period (denominator). Due to net losses incurred for all periods presented, weighted average basic and diluted shares outstanding for the respective periods are the same. The following equity instruments were not included in the computations of net loss per share because the effect on the calculations would be anti-dilutive (in thousands):

	Years Ended March 31,		
	2006	**2005**	**2004**
Common stock options	8,871	7,146	6,213
Warrants	8,417	6,117	2,319
	17,288	13,263	8,532

2. COMMON STOCK OFFERINGS

In December 2005, the Company sold 7,142,858 shares of its common stock at $2.10 per share for aggregate proceeds of approximately $15,000,000, before placement fees and other offering expenses. The purchasers also received five year warrants to purchase 1,785,714 shares of 8x8 common stock at an exercise price of $3.00 per share. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission relating to the sale of up to $125,000,000 of 8x8 securities. The Company paid total cash fees of six percent of the gross proceeds to the placement agents, and issued to the placement agents three year warrants to purchase 142,858 common shares at $2.10 per share and 35,714 common shares at $3.00 per share. As a result of this offering, certain anti-dilution provisions included in warrants issued to investors in common stock offerings completed during fiscal 2005 were triggered. Accordingly, the Company modified a warrant to purchase 2,000,000 shares at an exercise price of $2.88 per share so that it is now exercisable for 2,071,818 shares at an exercise price of $2.79 per share. The Company also modified a warrant to purchase 1,498,538 shares at an exercise price of $3.84 per share so that it is now exercisable for 1,587,806 shares at an exercise price of $3.61 per share. No other terms of the warrants were affected. All of the warrants were outstanding as of March 31, 2006.

In March 2005, the Company sold 6,897,618 shares of its common stock at $2.10 per share for aggregate proceeds of approximately $14,500,000, before placement fees and other offering expenses. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission. The Company paid total cash fees of six percent of the gross proceeds to the placement agents, and issued three year warrants to purchase 137,952 common shares at $2.10 per share. As a result of this offering, certain anti-dilution provisions included in warrants issued to investors in common stock offerings completed during fiscal 2005 were triggered. Accordingly, the Company modified a warrant to purchase 1,920,000 shares at an exercise price of $3.00 per share so that it became exercisable for 2,000,000 shares at an exercise price of $2.88 per share. The Company also modified a warrant to purchase 1,404,000 shares at an exercise price of $4.10 per share so that it became exercisable for 1,498,538 shares at an exercise price of $3.84 per share. No other terms of the warrants were affected. All of the warrants were outstanding as of March 31, 2006. All of the warrants were outstanding as of March 31, 2006.

In October 2004, the Company sold 3,508,772 shares of its common stock at $3.42 per share for aggregate proceeds of approximately $12,000,000, before placement fees and other offering expenses. The purchaser also received a five year warrant to purchase 1,403,509 shares of 8x8 common stock at an exercise price of $4.10 per share. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission. The Company paid total cash fees of six percent of the gross proceeds to the placement agents, and issued three year warrants to purchase 175,438 common shares at $3.42 per share and 70,175 common shares at $4.10 per share. All of the warrants were outstanding as of March 31, 2006.

In June 2004, the Company sold 4,800,000 shares of its common stock at $2.50 per share for aggregate proceeds of approximately $12,000,000, before placement fees and other offering expenses. The purchaser also received a five year warrant to purchase 1,920,000 shares of 8x8 common stock at an exercise price of $3.00 per share. The shares issued in this offering were issued under a shelf registration statement previously filed with the Securities and Exchange Commission. The Company paid total cash fees of six percent of the gross proceeds to the placement agents, and issued three year warrants to purchase 240,000 common shares at $2.50 per share and 96,000 common shares at $3.00 per share. All of the warrants were outstanding as of March 31, 2006.

In November 2003, the Company completed a private placement of 2,639,773 shares of common stock at $2.83 per share for aggregate net proceeds of approximately $7 million. The investors also received common stock warrants with terms of five years to purchase 1,860,055 shares at $3.40 and 779,718 shares at $3.61. In addition, the investors were also granted certain preemptive rights that allow the investors to purchase additional shares of common stock from the Company, in proportion to their ownership percentage, to the extent that shares of the Company's common stock are issued in connection with financing activities. The Company paid a five percent cash fee and issued warrants to purchase 131,989 common shares at a price of $2.83 per share to its placement agent in the transaction. As of March 31, 2006, 1,311,676 warrants with an exercise price of $3.40 per share and 770,597 warrants with an exercise price of $3.61 per share were outstanding. All of the warrants issued to the placement agent were outstanding as of March 31, 2006.

In July 2003, the Company completed a private placement of 2,260,000 shares of common stock at $0.434 (the average closing price for the five days prior to the sale) per share for aggregate net proceeds of $859,000. The investors also received fully vested warrants with terms of five years to purchase 2,260,000 common shares at $0.60, 565,000 shares at $0.75 and 565,000 shares at $1.00. In addition, the investors were also granted certain preemptive rights that allow the investors to purchase additional shares of common stock from the Company, in proportion to their ownership percentage, to the extent that new shares of the Company's common stock are issued in connection with financing activities. The Company paid a five percent cash fee to its placement agent in the transaction. In December 2003, all of the non-insider investors exercised their warrants using cashless exercise provisions, and as of December 31, 2003 the preemptive rights had terminated. As a result of the cashless exercises, the Company cancelled warrants to purchase 342,928 shares, and issued 2,882,072 shares of common stock for which it received no proceeds. As of March 31, 2006, 70,000 warrants with an exercise price of $0.60 per share, 17,500 warrants with an exercise price of $0.75 per share and 17,500 warrants with an exercise price of $1.00 per share were outstanding.

3. SALE OF CENTILE EUROPE SA

On July 1, 2003, Centile, Inc. sold its European subsidiary, Centile Europe SA (Centile Europe), to Sunleigh Investments Ltd., now Eurotel SAS (Eurotel), for a purchase price of 1,100,000 Euros or approximately $1,250,000. Eurotel acquired substantially all the assets and liabilities of the business, and the Company was obligated to pay certain liabilities incurred by Centile Europe prior to the closing date, which were not material. In addition, Eurotel received a non-exclusive license to Centile's IPBX technology, and also received exclusivity for the European market for one year subsequent to the closing date. Correspondingly, Eurotel agreed that Centile, Inc. would have exclusivity for the North American market for the same period. Under the acquisition agreement, Eurotel was obligated to pay the purchase price, net of amounts withheld for pre-closing obligations, in installments through December 31, 2003. The Company and Eurotel disagreed over certain adjustments that Eurotel has made to the purchase price, but neither party commenced arbitration or litigation proceedings. The Company recognized a gain on this transaction of $790,000 during the quarter ended September 30, 2003. In October 2003, the Company collected $460,000, which was reflected in the gain computation. The additional $330,000 recognized was due to net liabilities assumed by Eurotel as part of the Centile Europe acquisition.

Revenues and operating losses attributable to the operations of Centile Europe approximated $20,000 and $400,000, respectively, for the year ended March 31, 2004.

4. DEBT

In December 1999, the Company issued $7,500,000 of 4% Series A and Series B convertible subordinated debentures (the Debentures) due in December 2002. In conjunction with the issuance of the Debentures, the lenders received warrants to purchase 531,915 8x8 common shares at $7.05 per share and 105,634 shares at $35.50 per share (the Lender Warrants).

In December 2001, the Company redeemed the Debentures for $4,500,000 in cash and 1,000,000 contingently redeemable shares of common stock. Additionally, the Company agreed to reduce the exercise price of the Lender Warrants to $0.898 per share. This transaction resulted in an extraordinary gain of $779,000, net of the incremental fair value of the repriced warrants, the write-off of unamortized debt discount and debt issue costs, and other costs associated with the early extinguishment of the Debentures. Under the terms of the registration rights agreement that the Company and the lenders entered into in connection with the issuance of the 1,000,000 shares of common stock associated with the extinguishment described above, the Company agreed to register the shares for resale and maintain the effectiveness of the registration statement for specified periods of time until the shares are resold or can be resold without the registration statement (the Maintenance Requirements). The Company further agreed that if it did not comply with the Maintenance Requirements in the future, it would be required to pay cash penalties and redeem all or a portion of the shares held by the lenders at the higher of $0.898 per share or the market price of the Company’s stock at the time of the redemption. The redemption rights expired in December 2003, and at December 31, 2003, the amount recorded as contingently redeemable common stock was reclassified to equity.

5. TJF WARRANT

In connection with, and in consideration for, the execution of a marketing and distribution agreement with TJF Associates, LLC ("TJF") on December 10, 2004, the Company agreed to issue a warrant to TJF for the purchase of up to 4,500,000 shares of 8x8 common stock. The terms of the warrant provided that at any time prior to December 31, 2009, TJF or its transferees could exercise in whole or in part a warrant to acquire up to 4,500,000 shares (subject to certain customary adjustments) of 8x8 common stock, at a purchase price per share equal to $5.50 (subject to certain customary adjustments). Only the vested portion of the warrant could be exercised, and vesting was based on the number of customers subscribing to the Company’s Packet8 service that were referred by TJF. The shares subject to the warrant would commence vesting once TJF had delivered 50,000 subscribers to the Packet8 service. TJF did not deliver 50,000 subscribers to the Packet8 service, so no warrants had vested by December 31, 2005, and the warrant was automatically cancelled as of that date.

6. TRANSACTIONS WITH RELATED PARTIES

Relationship with STMicroelectronics NV

During the fourth quarter of fiscal 2000, the Company sold 3,700,000 shares of its common stock to STMicroelectronics NV (STM) at a purchase price of $7.50 per share and received net proceeds of $27,700,000 million. In December 2003, STM’s representative on the Company’s Board resigned and STM subsequently began to sell on the open market shares of 8x8, Inc. common stock that it was holding. As a result, STM ceased to be a related party of the Company as of December 31, 2003. During the first nine months of fiscal 2004, the Company purchased approximately $150,000 of semiconductors from a subsidiary of STM and paid a subsidiary of STM $237,500 for non-recurring engineering services.

Other Transactions

In March 2002, 8x8’s board of directors (the Board) authorized the Company to open securities trading accounts with two brokerage firms and make investments of up to $1,000,000 on behalf of 8x8, Inc. as directed by its then Chairman, Joe Parkinson, Chief Executive Officer or Chief Financial Officer. Since the formation of these accounts in 2002, neither the Company’s Chief Executive Officer nor Chief Financial Officers made any trades in the investment accounts as these officers had not agreed to reimburse the Company for any losses incurred as a result of their trading activity. Mr. Parkinson did not have use of any of the investment account funds for his personal benefit. The funds were always held in investment accounts in the Company’s name and all benefits belonged to 8x8. The Company invested in mutual funds, money market funds and equity and debt securities and options of publicly traded corporations. The investment accounts were not used to trade in the Company’s own stock. Under the arrangement, the Company was required to return to Mr. Parkinson the amount representing the increase in value of the investment account over $1,000,000 to the extent required to restore replenishment payments made by Mr. Parkinson in prior quarters. Through March 31, 2003, Mr. Parkinson made cumulative replenishment payments of approximately $137,000 to offset losses incurred. As of December 31, 2003, the Company had repaid all the replenishment payments received from Mr. Parkinson during fiscal 2003. In January 2004, the arrangement with Mr. Parkinson was terminated and the Company’s securities trading accounts were closed.

In February 2005, the Board approved a bonus program for two of the Company's officers. Under the terms of the bonus program, each of the officers would be entitled to receive 100,000 shares of common stock if the Company's operations, excluding certain transactions, were cash flow positive on an operating basis for the quarter ended September 30, 2005. In addition, each of the officers will be entitled to a cash bonus of $200,000 if the Company had been cash flow positive for the quarter ended September 30, 2005, as adjusted for the potential payment of such bonuses subsequent to September 30, 2005. The terms of the bonus program were not met, and no bonuses were awarded to either of the two officers.

7. INCOME TAXES

For the year ended March 31, 2005, the Company recorded a benefit for income taxes of $203,000, which was attributable to the release of income tax reserves recorded in prior years and a refund received by one of the Company's foreign subsidiaries. There were no income tax provisions for the years ended March 31, 2006 and 2004. The components of the consolidated benefit for income taxes for fiscal 2005 consisted of the following (in thousands):

Current:		
Federal	$	(157)
State		7
Foreign		(53)
	$	(203)

The Company's loss before income taxes included $25,000, $20,000, and $30,000 of foreign subsidiary income for the fiscal years ended March 31, 2006, 2005 and 2004, respectively.

Deferred tax assets were comprised of the following (in thousands):

	March 31,	
	2006	2005
Research and development credit carryforwards	$ 6,212	$ 5,711
Net operating loss carryforwards	49,862	39,370
Inventory valuation	453	220
Reserves and allowances	1,573	1,450
Fixed assets and intangibles	12,441	14,143
	70,541	60,894
Valuation allowance	(70,541)	(60,894)
Total	$ --	$ --

Management believes that, based on a number of factors, the weight of objective available evidence indicates that it is more likely than not that the Company will not be able to realize its deferred tax assets, and thus a full valuation allowance was recorded at March 31, 2006 and 2005.

At March 31, 2006, the Company had net operating loss carryforwards for federal and state income tax purposes of approximately $132,000,000 and $86,000,000, respectively, which expire at various dates beginning in 2006 and continuing through 2026. The net operating loss carryforwards include approximately $10,000,000 resulting from employee exercises of non-qualified stock options or disqualifying dispositions, the tax benefits of which, when realized, will be accounted for as an addition to additional paid-in capital rather than as a reduction of the provision for income taxes. In addition, at March 31, 2006, the Company had research and development credit carryforwards for federal and state tax reporting purposes of approximately $3,400,000 and $2,700,000, respectively. The federal credit carryforwards will expire at various dates beginning in 2010 and continuing through 2023, while the California credit will carryforward indefinitely. Under applicable tax laws, the amount of and benefits from net operating losses and credits that can be carried forward may be impaired or limited in certain circumstances. Events which may cause limitations in the amount of net operating loss carryforwards that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50% over a three year period.

A reconciliation of the tax provision (benefit) to the amounts computed using the statutory U.S. federal income tax rate of 34% is as follows (in thousands):

	Years Ended March 31,		
	2006	2005	2004
Benefit at statutory rate	$ (8,208)	$ (6,575)	$ (1,033)
State income tax benefit before valuation allowance, net of federal effect	(1,408)	(1,127)	(177)
Research and development credits	(501)	(45)	(208)
Change in valuation allowance	9,648	6,704	3,614
Release of income taxes previously accrued	--	(203)	--
Compensation/option differences	(9)	(332)	(1,549)
Prior year loss carryforward reduction	261	1,216	(1,599)
Non-deductible compensation	94	2	522
Foreign rate differences	(8)	(6)	(8)
Other	131	163	438
	$ --	$ (203)	$ --

Undistributed earnings of our foreign subsidiaries are indefinitely reinvested in foreign operations. No provision has been made for taxes that might be payable upon remittance of such earnings, nor is it practicable to determine the amount of this liability.

8. COMMITMENTS AND CONTINGENCIES

Guaranties

Indemnifications

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

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

Product Warranties

The Company accrues for the estimated costs that may be incurred under its product warranties upon revenue recognition. Changes in the Company's product warranty liability, which is included in cost of product revenues in the consolidated statements of operations, during the years ended March 31, 2006 and 2005 were as follows (in thousands):

	Years Ended March 31, 2006	Years Ended March 31, 2005
Balance at beginning of year	$ 187	$ 194
Accruals for warranties	576	217
Settlements	(375)	(121)
Changes in estimates	(87)	(103)
Balance at end of year	$ 301	$ 187

Standby letters of credit

At March 31, 2006 and 2005, the Company had standby letters of credit totaling $250,000 and $500,000, respectively, which were recorded as either restricted cash and other assets line items on the consolidated balance sheets. During fiscal 2006, the Company canceled one standby letter of credit and the amount previously recorded in the restricted cash line at March 31, 2005 was moved to the short-term investments line in the consolidated balance sheet. These standby letters of credits were issued to guarantee certain contractual obligations, and are secured by cash deposits at the Company's bank.

Leases

The Company leases its primary facility in Santa Clara, California under a non-cancelable operating lease agreement that expires in August 2009. The Company also has leased facilities in France and Canada. The facility leases include rent escalation clauses, and require the Company to pay taxes, insurance, and normal maintenance costs. At March 31, 2006, future minimum annual lease payments under non-cancelable operating leases, net of sublease income, were as follows (in thousands):

Year Ending March 31,	
2007	$ 482
2008	490
2009	493
2010	206
Total minimum payments	$ 1,671

Rent expense for the years ended March 31, 2006, 2005 and 2004 was $478,000, $394,000 and $489,000, respectively.

The Company subleases office space under an operating lease agreement expiring in 2007. The total future minimum rentals to be received under this noncancelable sublease agreement approximates $18,000 in fiscal 2007 and $12,000 in fiscal 2008.

Capital Leases

In April 2005, the Company entered into a series of five-year capital lease agreements for office equipment bearing interest at various rates. At March 31, 2006, future minimum annual lease payments under noncancelable capital leases were as follows (in thousands):

Year ending March 31:		
2007	$	25
2008		25
2009		25
2010		25
2011		2
Total minimum payments		102
Less: Amount representing interest		(11)
		91
Less: Short-term portion of capital lease obligations		(21)
Long-term portion of capital lease obligations	$	70

Capital leases included in office equipment were $108,000 at March 31, 2006. Total accumulated amortization was $20,000 at March 31, 2006. Amortization expense for assets recorded under capital leases is included in depreciation expense.

Legal Proceedings

The Company is also involved in various other legal claims and litigation that have arisen in the normal course of the Company's operations. Pending or future litigation could be costly, could cause the diversion of management's attention and could upon resolution, have a material adverse effect on the Company's business, results of operations, financial condition and cash flows.

State and Municipal Taxes

Currently, the Company does not collect or remit state or municipal taxes (such as sales and use, excise and ad valorem taxes), fees or surcharges ("Taxes") on the charges to the Company's customers for its services, except that the Company collects and remits California sales tax. The Company has received inquiries or demands from a few states and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from the customers of providers of traditional public switched telephone network services. The Company has consistently maintained that these Taxes do not apply to its service for a variety of reasons depending on the statute or rule that establishes such obligations. In addition, a few states address how VoIP providers should contribute to support public safety agencies, and in those states the Company will begin to remit fees to appropriate state agencies in fiscal 2007. The Company had recorded a reserve of $198,000 for the year ended March 31, 2005, and an additional $531,000 for the year ended March 31, 2006 as its best estimate of the probable tax exposure for retroactive assessments. The Company believes the estimated exposure for retroactive assessments is $729,000 as of March 31, 2006, and these reserves have been recorded in the other accrued liabilities line item in the consolidated balance sheets.

Regulatory

To date VoIP communication services have been largely unregulated in the United States. Many regulatory actions are underway or are being contemplated by federal and state authorities, including the Federal Communications Commission (FCC), and state regulatory agencies. To date, the FCC has treated Internet service providers as information service providers. Information service providers are currently exempt from federal and state regulations governing common carriers, including the obligation to pay access charges and contribute to the universal service fund. The FCC is currently examining the status of Internet service providers and the services they provide. The FCC initiated a notice of public rule-making in early 2004 to gather public comment on the appropriate regulatory environment for IP telephony. In November 2004, the FCC ruled that the VoIP service of a competitor and "similar" services are jurisdictionally interstate and not subject to state certification, tariffing and other legacy telecommunication carrier regulations. The FCC ruling has been appealed by several states and the outcome of these appeals cannot be determined at this time. If the FCC were to determine that internet service providers, or the services they provide, are subject to FCC regulation, including the payment of access charges and contribution to the universal service funds, it could have a material adverse effect on the Company's business and operating results. On May 19, 2005, the FCC unanimously adopted an Order and Notice of Proposed Rulemaking (NPRM) that requires VoIP providers to provide emergency 911 (E911) service. On June 3, 2005, the FCC released the text of the First Report and Order and Notice of Proposed Rulemaking in the VoIP E911 proceeding (the VoIP E911 Order). As a result of the VoIP E911 Order, VoIP service providers that interconnect to the PSTN, or interconnected VoIP providers, will be required to mimic the 911 emergency calling capabilities offered by traditional landline phone companies. All interconnected VoIP providers must deliver 911 calls to the appropriate local public safety answering point (PSAP), along with call back number and location, where the PSAP is able to receive that information. E911 must be included in the basic service offering; it cannot be an optional or extra feature. The PSAP delivery obligation, along with call back number and location information must be provided regardless of whether the service is "fixed" or "nomadic." User registration of location is permissible initially, although the FCC is committed to an advanced form of E911 that will determine user location without user intervention, one of the topics of the further NPRM to be released eventually. The VoIP E911 Order mandates that existing and prospective customers must be notified of the capabilities and limitations of VoIP service with respect to emergency calling, and interconnected VoIP providers must obtain and maintain affirmative acknowledgement from each customer that the customer has read and understood the notice of limitations and distribute warning labels or stickers alerting consumers and other potential users of the limitations of VoIP 911 service to each new subscriber prior to the initiation of service. In addition, an interconnected VoIP provider must make it possible for customers to update their address (i.e., change their registered location) via at least one option that requires no equipment other than that needed to access the VoIP service. All interconnected VoIP providers must comply with the requirements of the VoIP E911 Order within one-hundred and twenty days of the publication of the VoIP E911 Order in the Federal Register, which is expected by late June, with the exception that the customer notification obligations must be complied with within thirty days of the publication. The Company currently does not offer this service to all of its customers, as it was not available in certain rate centers from which telephone numbers are provisioned for the Packet8 service. The Company has begun to address this issue with its telecommunication interconnection partners. However, the Company may not be able to offer E911 service to all of its customers, and, as a result, may need to cease from offering service in certain rate centers. The effect of this ruling could have a material adverse effect on the Company's financial position, results of operations and cash flows.

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

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

9. STOCKHOLDERS' EQUITY

Exchangeable Shares and Preferred Stock

In conjunction with the acquisition of U|Force, Inc. in June 2000, the Company agreed to issue up to 2,107,780 shares of 8x8 common stock upon the exchange or redemption of the exchangeable shares (the Exchangeable Shares) of Canadian entities held by employee shareholders of U|Force stock. The Exchangeable Shares held by U|Force employees were subject to certain restrictions, including the Company's right to repurchase the Exchangeable Shares if an employee departed the Company prior to vesting. Upon vesting, the Exchangeable Shares were convertible into 8x8 common stock on a 1-for-1 basis. The Company also issued one share of preferred stock (the Special Voting Share) that provided holders of Exchangeable Shares with voting rights that are equivalent to the shares of common stock into which their shares are convertible. Upon the dissolution of the remaining Canadian subsidiaries during fiscal 2006, the one share of preferred stock was retired.

1992 Stock Option Plan

The Board reserved 2,000,000 shares of the Company's common stock for issuance under the 1992 Stock Option Plan (the 1992 Plan). The 1992 Plan expired in fiscal 2003.

1996 Stock Plan

In June 1996, the Board adopted the 1996 Stock Plan (the 1996 Plan) and reserved 1,000,000 shares of the Company's common stock for issuance under this plan. The Company's stockholders subsequently authorized increases in the number of shares of the Company's common stock reserved for issuance under the 1996 Plan of 500,000 shares in June 1997 and 2,000,000 shares in August 2000. The 1996 Plan also provides for an annual increase in the number of shares reserved for issuance under the 1996 Plan on the first day of the Company's fiscal year in an amount equal to 5% of the Company's common stock issued and outstanding at the end of the immediately preceding fiscal year, subject to a maximum annual increase of 1,000,000 shares. The annual increase was 1,000,000 shares in each of fiscal 2006, 2005 and 2004. To date, this provision has resulted in increases in shares reserved for issuance under the 1996 Plan totaling 7,535,967. The 1996 Plan provides for granting incentive stock options to employees and nonstatutory stock options to employees, directors or consultants. The stock option price of incentive stock options granted may not be less than the determined fair market value at the date of grant. Options generally vest over four years and expire ten years after grant. The 1996 Plan expires in June 2006.

1996 Director Option Plan

The Company's 1996 Director Option Plan (the Director Plan) was adopted in June 1996 and became effective in July 1997. A total of 150,000 shares of common stock were initially reserved for issuance under the Director Plan. The Company's stockholders subsequently authorized an increase in the number of shares of common stock reserved for issuance under the Director Plan to 500,000 shares in August 2000, and 1,000,000 in July 2002. The Director Plan provides for both discretionary and periodic grants of nonstatutory stock options to non-employee directors of the Company (the Outside Directors). The exercise price per share of all options granted under the Director Plan will be equal to the fair market value of a share of the Company's common stock on the date of grant. Options generally vest over a period of four years. Options granted to Outside Directors under the Director Plan have a ten year term, or shorter upon termination of an Outside Director's status as a director. The Director Plan expires in June 2006.

1999 Nonstatutory Stock Option Plan

In fiscal 2000, the Board approved the 1999 Nonstatutory Stock Option Plan (the 1999 Plan) with 600,000 shares initially reserved for issuance thereunder. In fiscal 2001, the number of shares reserved for issuance was increased to 3,600,000 shares by the Board. Under the terms of the 1999 Plan, options may not be issued to either officers or directors of the Company provided, however, that options may be granted to an officer in connection with the officer's initial employment by the Company. Options generally vest over four years and expire ten years after grant. The 1999 Plan has not been approved by the stockholders of the Company. In May 2006, the Board cancelled the 1999 Plan, and no new grants may be made from the 1999 Plan.

2006 Stock Plan

In May 2006, the Board approved the Company’s 2006 Stock Plan (the 2006 Plan) to replace the 1996 Plan, the Director Option Plan and the 1999 Plan. The 2006 Plan provides for option and restricted stock grants to employees, directors and consultants of the Company. The 2006 Plan must be approved by the stockholders of the Company before it can become effective.

Option Activity

Option activity under the Company's stock option plans since March 31, 2003, excluding the stock option plans of its subsidiaries, Netergy Microelectronics, Inc. (Netergy) and Centile, Inc. (Centile) is summarized as follows:

	Shares Available for Grant	Shares Subject to Options Outstanding	Weighted Average Exercise Price Per Share
Balance at March 31, 2003	4,275,992	7,614,589	$ 2.65
Change in options available for grant	829,488	--	--
Granted	(2,420,000)	2,420,000	2.12
Exercised	--	(1,445,438)	1.30
Returned to plan	2,375,843	(2,375,843)	2.64
Balance at March 31, 2004	5,061,323	6,213,308	2.77
Change in options available for grant	975,000	--	--
Granted	(1,860,500)	1,860,500	2.39
Exercised	--	(251,610)	1.38
Returned to plan	676,462	(676,462)	5.06
Balance at March 31, 2005	4,852,285	7,145,736	2.50
Change in options available for grant	992,000	--	--
Granted	(2,401,500)	2,401,500	1.70
Exercised	--	(59,898)	1.41
Returned to plan	616,620	(616,620)	2.18
Balance at March 31, 2006	4,059,405	8,870,718	$ 2.31

Significant option groups outstanding at March 31, 2006 and related weighted average exercise price and contractual life information for 8x8, Inc.'s stock option plans are as follows:

	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (Years)	Shares	Weighted Average Exercise Price Per Share
$ 0.01 to $ 1.32	1,681,960	$ 1.08	6.8	1,265,994	$ 1.02
$ 1.42 to $ 1.72	1,846,377	$ 1.68	8.1	820,667	$ 1.69
$ 1.73 to $ 1.87	2,476,181	$ 1.83	7.0	1,443,532	$ 1.86
$ 1.88 to $ 3.35	1,626,224	$ 2.56	7.9	652,837	$ 2.64
$ 3.41 to $14.94	1,229,976	$ 5.48	5.2	1,070,910	$ 5.69
$18.00 to $18.00	10,000	$ 18.00	3.9	10,000	$ 18.00
	8,870,718			5,263,940	

The Company recognizes deferred compensation over the related vesting period of the options (which is generally forty-eight months). The Company recognized stock compensation expense in fiscal 2006 and 2004 of $239,000 and $1,311,000, respectively. Stock compensation expense in fiscal 2005 was not significant. Stock compensation expense in fiscal 2006 was primarily comprised of $239,000 attributable to the change in option terms for a former employee director in connection with his resignation from the Board. Stock compensation expense in fiscal 2004 was comprised of: i) $1,165,000 attributable to the change in option terms for certain employees that terminated employment, ii) $143,000 attributable to a change in option terms for a director of the Company upon his resignation from the Board and iii) $3,000 of expense related to amortization of deferred compensation. Deferred compensation is subject to reduction for any employee who terminates employment prior to the expiration of such employee's option vesting period.

Netergy Microelectronics, Inc. 2000 Stock Option Plan

Netergy's 2000 Stock Option Plan (the Netergy Plan) was adopted in December 2000 by the Netergy Board of Directors with 5,000,000 shares reserved for issuance. The Netergy Plan provided for granting incentive stock options (ISO) to employees and nonstatutory stock options (NSO) to employees, directors, and consultants of Netergy. Options granted under the Netergy Plan were granted for periods up to ten years and at prices no less than 85% of the estimated fair value of the shares on the date of grant as determined by the Netergy board of directors, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than 100% and 85% of the estimated fair value of the shares on the date of grant, respectively, and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively. Option activity during each of the three years ended March 31, 2006, was as follows:

	Shares Available for Grant	Shares Subject to Options Outstanding	Weighted Average Exercise Price Per Share
Balance at March 31, 2003	3,285,324	1,714,676	0.50
Returned to plan	1,714,676	(1,714,676)	0.50
Balance at March 31, 2004	5,000,000	--	--
Termination of plan	(5,000,000)	--	--
Balance at March 31, 2005	--	--	$ --

In fiscal 2005, the Company terminated the Netergy Plan.

Centile, Inc. 2001 Stock Option Plan

Centile's 2001 Stock Option Plan (the Centile Plan) was adopted in March 2001 by the Centile Board of Directors with 4,500,000 shares reserved for issuance. The Centile Plan provided for granting ISOs to employees and NSOs to employees, directors, and consultants of Centile. Options granted under the Centile Plan were granted for periods up to ten years and at prices no less than 85% of the estimated fair value of the shares on the date of grant as determined by the Centile Board of Directors, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than 100% and 85% of the estimated fair value of the shares on the date of grant, respectively, and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively. Option activity during each of the three years ended March 31, 2006, was as follows:

	Shares Available for Grant	Shares Subject to Options Outstanding	Weighted Average Exercise Price Per Share
Balance at March 31, 2003	2,598,128	1,901,872	$ 0.43
Returned to plan	1,901,872	(1,901,872)	0.43
Balance at March 31, 2004	4,500,000	--	--
Termination of plan	(4,500,000)	--	--
Balance at March 31, 2005	--	--	$ --

In fiscal 2005, the Company terminated the Centile Plan.

1996 Employee Stock Purchase Plan

The Company's 1996 Stock Purchase Plan (the Purchase Plan) was adopted in June 1996 and became effective upon the closing of the Company's initial public offering in July 1997. The Company suspended the Purchase Plan in 2003 and reactivated the Plan in fiscal 2005. Under the Purchase Plan, 500,000 shares of common stock were initially reserved for issuance. At the start of each fiscal year, the number of shares of common stock subject to the Purchase Plan increases so that 500,000 shares remain available for issuance. This provision resulted in an increase of 416,589 shares issuable under the Purchase Plan during the fiscal year ended March 31, 2003. During fiscal 2006 and 2005, 118,535 and 43,220 shares, respectively, were issued under the Purchase Plan. In May 2006, the Board approved a ten year extension of the Purchase Plan so that it would be effective until 2017. The extension of the Purchase Plan must be approved by the stockholders of the Company before it can become effective.

The Purchase Plan permits eligible employees to purchase common stock through payroll deductions at a price equal to 85% of the fair market value of the common stock at the beginning of each two year offering period or the end of a six month purchase period, whichever is lower. When the Purchase Plan was reinstated in fiscal 2005, the offering period was reduced from two to one years. The contribution amount may not exceed ten percent of an employee's base compensation, including commissions but not including bonuses and overtime. In the event of a merger of the Company with or into another corporation or the sale of all or substantially all of the assets of the Company, the Purchase Plan provides that a new exercise date will be set for each option under the plan which exercise date will occur before the date of the merger or asset sale.

Certain pro forma disclosures

The Company accounts for its stock plans in accordance with the provisions of APB Opinion No. 25. Had compensation cost for the Company's stock plans been determined based on the fair value of options at their grant dates, as prescribed in SFAS No. 123, the Company's net loss would have been as follows (in thousands, except per share amounts):

	Year Ended March 31,		
	2006	2005	2004
Net loss:			
As reported	$ (24,139)	$ (19,148)	$ (3,039)
Pro forma	$ (26,700)	$ (21,569)	$ (3,841)
Basic and diluted loss per share:			
As reported	$ (0.43)	$ (0.43)	$ (0.09)
Pro forma	$ (0.48)	$ (0.49)	$ (0.12)

For the purposes of the disclosure above, the fair value of each of the Company's option grants, excluding those options issued under the Netergy and Centile Plans, has been estimated on the date of grant using the Black-Scholes pricing model with the following assumptions:

	Year Ended March 31,		
	2006	2005	2004
Expected volatility	135%	142%	174%
Expected dividend yield	--	--	--
Risk-free interest rate	3.8% to 4.7%	3.7% to 4.3%	2.5% to 3.6%
Weighted average expected option term	3.5 years	5 years	4.9 years
Weighted average fair value of options granted	$ 1.34	$ 2.11	$ 2.02

The fair value of grants under the Netergy and Centile stock option plans, for purposes of the 2003 pro forma disclosures, have also been estimated on the date of grant using the Black-Scholes pricing model using the weighted average assumptions noted below. The expected volatility factors for the Netergy and Centile plans reflect the fact that the underlying shares of Netergy and Centile are not publicly traded and therefore the Company's overall volatility factor was reduced by 50% for these plans. The various risk free interest rates used in the computations reflect the different rates in effect at the respective grant dates.

	Year Ended March 31, 2003
Expected volatility	81%
Expected dividend yield	--
Risk-free interest rate	2.8% to 4.8%
Weighted average expected option term	5.16 years
Netergy weighted average fair value of options granted	$ 0.34
Centile weighted average fair value of options granted	$ 0.29

For the purpose of providing pro forma disclosures for the fiscal years during which the Purchase Plan was in effect, the estimated fair value of stock purchase rights granted under the Purchase Plan were estimated using the Black-Scholes pricing model with the following weighted-average assumptions:

	Year Ended March 31, 2006	Year Ended March 31, 2005
Expected volatility	135%	141%
Expected dividend yield	--	--
Risk-free interest rate	3.95%	1.79%
Weighted average expected rights term	0.72 years	0.5 years
Weighted average fair value of rights granted	$ 1.14	$ 0.33

10. EMPLOYEE BENEFIT PLAN

401(k) Savings Plan

In April 1991, the Company adopted a 401(k) savings plan (the Savings Plan) covering substantially all of its U.S. employees. Eligible employees may contribute to the Savings Plan from their compensation up to the maximum allowed by the Internal Revenue Service. No matching contributions were made in fiscal 2006, 2005 or 2004. The Savings Plan does not allow employee contributions to be invested in 8x8 common stock.

11. SEGMENT REPORTING

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," establishes annual and interim reporting standards for an enterprise's business segments and related disclosures about its products, services, geographic areas and major customers. Under SFAS No. 131, the method for determining what information to report is based upon the way management organizes the operating segments within the Company for making operating decisions and assessing financial performance. The Company has only one reportable segment.

The following table presents net revenues by groupings of similar products (in thousands).

	Year Ended March 31,		
	2006	2005	2004
Packet8 service, equipment and other	$ 31,221	$ 10,006	$ 1,306
Semiconductors and related software	624	1,348	7,730
Hosted iPBX solutions	47	121	272
Total revenues	$ 31,892	$ 11,475	$ 9,308

The following table illustrates net revenues by geographic area. Revenues are attributed to countries based on the destination of shipment (in thousands):

	Year Ended March 31,		
	2006	2005	2004
United States	$ 31,141	$ 10,472	$ 2,728
Europe	291	646	1,309
Taiwan	127	157	4,163
Japan	1	--	568
Other	332	200	540
	$ 31,892	$ 11,475	$ 9,308

The majority of the Company's long-lived assets were located in the United States. Long-lived assets consist primarily of property and equipment. The following table illustrates long-lived assets by country (in thousands):

	March 31,	
	2006	2005
United States	$ 3,069	$ 1,784
France	2	4
	$ 3,071	$ 1,788

No customer represented more than 10% of our total revenues in fiscal 2006 or 2005. Two customers represented more than 10% of our total revenues in fiscal 2004. These customers represented 26% and 16% of our total revenues.

8X8, INC.

SCHEDULE II -- VALUATION AND QUALIFYING ACCOUNTS
(IN THOUSANDS)

Description	Balance at Beginning of Year	Additions Charged to Costs, Expenses and Other	Deductions	Balance at End of Year
Year ended March 31, 2004:				
Allowance for doubtful accounts..........................	$ 141	$ --	$ 6	$ 135
Valuation allowance for deferred tax assets.........	50,576	3,614	--	54,190
Year ended March 31, 2005:				
Allowance for doubtful accounts..........................	135	--	67	68
Valuation allowance for deferred tax assets.........	54,190	6,704	--	60,894
Year ended March 31, 2006:				
Allowance for doubtful accounts..........................	68	5	18	55
Valuation allowance for deferred tax assets.........	60,894	9,647	--	70,541

8X8, INC.

CONSOLIDATED QUARTERLY FINANCIAL DATA

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	QUARTER ENDED							
	March 31, 2006	**Dec. 31, 2005**	**Sept. 30, 2005**	**June 30, 2005**	**March 31, 2005**	**Dec. 31, 2004**	**Sept. 30, 2004**	**June 30, 2004**
Service revenues	$ 8,629	$ 6,769	$ 5,719	$ 4,996	$ 3,440	$ 2,332	$ 1,843	$ 1,471
Product revenues	1,712	1,714	1,344	1,009	471	632	690	596
Total revenues	10,341	8,483	7,063	6,005	3,911	2,964	2,533	2,067
Operating expenses:								
Cost of service revenues	4,177	3,326	2,795	2,069	1,703	1,442	1,171	879
Cost of product revenues	2,733	3,357	2,537	2,105	1,685	1,073	876	912
Research and development	1,676	1,470	1,446	1,324	1,064	784	684	577
Selling, general, and administrative	8,712	7,244	6,042	5,865	6,750	5,650	3,622	2,512
Total operating expenses	17,298	15,397	12,820	11,363	11,202	8,949	6,353	4,880
Loss from operations	(6,957)	(6,914)	(5,757)	(5,358)	(7,291)	(5,985)	(3,820)	(2,813)
Other income, net	311	125	189	222	118	145	71	224
Benefit for income taxes	--	--	--	--	183	--	--	20
Net loss	$ (6,646)	$ (6,789)	$ (5,568)	$ (5,136)	$ (6,990)	$ (5,840)	$ (3,749)	$ (2,569)
Net loss per share:								
Basic	$ (0.11)	$ (0.12)	$ (0.10)	$ (0.10)	$ (0.14)	$ (0.13)	$ (0.09)	$ (0.07)
Diluted	$ (0.11)	$ (0.12)	$ (0.10)	$ (0.10)	$ (0.14)	$ (0.13)	$ (0.09)	$ (0.07)
Shares used in per share calculations:								
Basic	61,105	54,836	53,871	53,823	48,988	46,718	43,134	38,690
Diluted	61,105	54,836	53,871	53,823	48,988	46,718	43,134	38,690

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS & PROCEDURES

Changes in Internal Control Over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective.

Management's Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of the Company's management, including our principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting based on criteria established in the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, the Company's management concluded that its internal control over financial reporting was effective as of March 31, 2006.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP, the Company's independent registered public accounting firm, has audited management's assessment of the effectiveness of the Company's internal control over financial reporting as of March 31, 2006 as stated in their report which appears in Item 8 of this Report.

ITEM 9B. OTHER INFORMATION

None.

PART III

Certain information required by Part III is omitted from this Report on Form 10-K in that the Registrant will file its definitive Proxy Statement for its Annual Meeting of Stockholders (the 2006 Proxy Statement) pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of the fiscal year covered by this Report, and certain information included in the 2006 Proxy Statement is incorporated herein by reference.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this is included in the 2006 Proxy Statement under the captions "Election of Directors -- Nominees," "Additional Information -- Executive Officers," "Additional Information -- Section 16(a) Beneficial Ownership Reporting Compliance" and "Code of Business Conduct and Ethics" and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is included in the 2006 Proxy Statement under the captions "Election of Directors -- Compensation of Directors," "Additional Information -- Executive Compensation" and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is set forth in the 2006 Proxy Statement under the captions "Additional Information -- Security Ownership" and "Additional Information -- Equity Compensation Plan Information" and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information required by this Item is set forth in the 2006 Proxy Statement under the captions "Additional Information -- Employment Contracts and Termination of Employment and Change in Control Arrangements," "Additional Information -- Compensation Committee Interlocks and Insider Participation," "Additional Information -- Report of the Compensation Committee of the Board of Directors" and "Additional Information -- Stock Performance Graph" and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this Item is set forth in the 2006 Proxy Statement under the caption "Independent Registered Public Accounting Firm Fee Information" and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements. The information required by this item is included in Item 8.

(a)(2) Financial Statement Schedules. The information required by this item is included in Item 8.

(a)(3) Exhibits. The documents listed on the Exhibit Index appearing in this Report are filed herewith or hereby incorporated by reference. Copies of the exhibits listed in the Exhibit Index will be furnished, upon request, to holders or beneficial owners of the Company's common stock.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant, 8x8, Inc., a Delaware corporation, has duly caused this Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Santa Clara, State of California, on June 14, 2006.

8X8, INC.

By: /s/ BRYAN R. MARTIN
Bryan R. Martin,
Chairman and Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENT, that each person whose signature appears below constitutes and appoints Bryan R. Martin and James Sullivan, jointly and severally, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorney-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Report on Form 10-K has been signed by the following persons in the capacities and on the date indicated:

Signature	Title	Date
/s/ BRYAN R. MARTIN Bryan R. Martin	Chairman and Chief Executive Officer (Principal Executive Officer)	June 14, 2006
/s/ JAMES SULLIVAN James Sullivan	Chief Financial Officer, Vice President, Finance and Secretary (Principal Financial and Accounting Officer)	June 14, 2006
/s/ GUY L. HECKER Guy L. Hecker, Jr.	Director	June 14, 2006
/s/ CHRISTOPHER MCNIFFE Christopher McNiffe	Director	June 14, 2006
/s/ JOSEPH PARKINSON Joseph Parkinson	Director	June 14, 2006
/s/ DONN WILSON Donn Wilson	Director	June 14, 2006

8X8, INC.

EXHIBIT INDEX

Exhibit Number	Exhibit Title
3.1 (a)	Form of Amended and Restated Certificate of Incorporation of Registrant.
3.2 (b)	Bylaws of Registrant.
3.4 (c)	Certificate of Amendment of Amended and Restated Certificate of Incorporation of Registrant.
10.1 (a)	Form of Indemnification Agreement.
10.2 (a)	1992 Stock Option Plan, as amended, and form of Stock Option Agreement.
10.3 (d)	1996 Stock Plan, as amended, and form of Stock Option Agreement.
10.4 (a)	1996 Employee Stock Purchase Plan, as amended, and form of Subscription Agreement.
10.5 (e)	1996 Director Option Plan, as amended, and form of Director Option Agreement.
10.6 (f)	1999 Nonstatutory Stock Option Plan, as amended, and form of Stock Option Agreement.
10.7 (g)	Sublease dated September 29, 2004 between the Registrant and SafeNet, Inc.
10.8	Agreement dated January 22, 2006 between the Registrant and Dr. Barry Andrews.
21.1	Subsidiaries of Registrant.
23.1	Consent of Independent Registered Public Accounting Firm.
24.1	Power of Attorney.
31.1	Certification of Chief Executive Officer of the Registrant pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer of the Registrant pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer of the Registrant pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer of the Registrant pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(a) Incorporated by reference to identically numbered exhibits filed in response to Item 16 (a), "Exhibits," of the registrant's Registration Statement on Form S-1 (File No. 333-15627), as amended, declared effective July 1, 1997.

(b) Incorporated by reference to exhibit 3.2 filed in response to Item 8, “Exhibits” of the Registrant’s Form S-3 dated April 1, 2004.

(c) Incorporated by reference exhibits filed in response to Item 14(a), "Exhibits," of the Registrant's Annual Report on Form 10-K for the fiscal year ended March 31, 2001.

(d) Incorporated by reference to exhibit 4.1 filed in response to Item 8, "Exhibits," of the Registrant's Form S-8 dated November 7, 2000.

(e) Incorporated by reference to exhibit 4.2 filed in response to Item 8, "Exhibits," of the Registrant's Form S-8 dated November 7, 2000.

(f) Incorporated by reference to exhibit 4.1 filed in response to Item 8, "Exhibits," of the Registrant's Form S-8 dated July 17, 2000.

(g) Incorporated by reference to exhibit filed in response to Item 9.01, "Exhibits," of the Registrant's Report on Form 8-K filed on October 5, 2004.

(h) Incorporated by reference to exhibit 10.1 filed in response to Item 9.01 "Exhibits" of the Registrant's Report on Form 8-K filed on January 26, 2006.