

Crexendo, Inc.  
Form 10-Q  
November 14, 2016

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

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 001-32277

Crexendo, Inc.  
(Exact name of registrant as specified in its charter)

Delaware 87-0591719  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

1615 South 52nd Street, Tempe, AZ 85281  
(Address of Principal Executive Offices) (Zip Code)  
(602) 714-8500  
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer  
Non-accelerated filer Smaller reporting company

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

Yes No

The number of shares outstanding of the registrant's common stock as of October 31, 2016 was 13,413,556.





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## PART I - FINANCIAL INFORMATION

## Item 1.

## Financial Statements.

## CREXENDO, INC. AND SUBSIDIARIES

## Condensed Consolidated Balance Sheets

(In thousands, except par value and share data)

(unaudited)

September 30, 2016 December 31, 2015

## Assets

## Current assets:

|   |         |         |
|---|---------|---------|
| Cash and cash equivalents   | \$854   | \$1,497 |
| Restricted cash   | 100     | 112     |
| Trade receivables, net of allowance for doubtful accounts of \$34 as of September 30, 2016 and \$35 as of December 31, 2015           | 303     | 364     |
| Inventories   | 124     | 134     |
| Equipment financing receivables   | 123     | 131     |
| Prepaid expenses  | 862     | 1,046   |
| Other current assets  | 8       | 15      |
| Total current assets  | 2,374   | 3,299   |
| Certificate of deposit  | 252     | 251     |
| Long-term trade receivables, net of allowance for doubtful accounts of \$17 as of September 30, 2016 and \$24 as of December 31, 2015 | 46      | 81      |
| Long-term equipment financing receivables   | 208     | 319     |
| Property and equipment, net   | 21      | 33      |
| Deferred income tax assets, net   | 482     | 482     |
| Intangible assets, net  | 368     | 466     |
| Goodwill  | 272     | 272     |
| Long-term prepaid expenses  | 250     | 288     |
| Other long-term assets  | 138     | 169     |
| Total assets  | \$4,411 | \$5,660 |

## Liabilities and Stockholders' Equity

## Current liabilities:

|                                   |       |       |
|-----------------------------------|-------|-------|
| Accounts payable                  | \$308 | \$76  |
| Accrued expenses                  | 941   | 812   |
| Notes payable, current portion    | 98    | 57    |
| Income taxes payable              | 4     | -     |
| Contingent consideration          | -     | 99    |
| Deferred income tax liability     | 482   | 482   |
| Deferred revenue, current portion | 827   | 775   |
| Total current liabilities         | 2,660 | 2,301 |

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|  |          |          |
|--|----------|----------|
| Deferred revenue, net of current portion   | 46       | 81       |
| Notes payable, net of current portion  | 973      | 965      |
| Other long-term liabilities  | 39       | 109      |
| Total liabilities  | 3,718    | 3,456    |
| Stockholders' equity:  |          |          |
| Preferred stock, par value \$0.001 per share - authorized 5,000,000 shares;<br>none issued   | —        | —        |
| Common stock, par value \$0.001 per share - authorized 25,000,000 shares,<br>13,413,556<br>shares issued and outstanding as of September 30, 2016 and 13,227,489<br>shares issued and<br>outstanding as of December 31, 2015 | 13       | 13       |
| Additional paid-in capital   | 58,370   | 57,614   |
| Accumulated deficit  | (57,690) | (55,423) |
| Total stockholders' equity   | 693      | 2,204    |
| Total Liabilities and Stockholders' Equity   | \$4,411  | \$5,660  |

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





CREXENDO, INC. AND SUBSIDIARIES  
Condensed Consolidated Statements of Operations  
(In thousands, except per share and share data)  
(unaudited)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2016                                | 2015       | 2016                               | 2015       |
| Revenue                                     | \$2,333                             | \$1,972    | \$6,774                            | \$5,714    |
| Operating expenses:                         |                                     |            |                                    |            |
| Cost of revenue                             | 932                                 | 882        | 2,762                              | 2,598      |
| Selling and marketing                       | 681                                 | 624        | 1,927                              | 1,807      |
| General and administrative                  | 1,140                               | 1,309      | 3,705                              | 4,244      |
| Research and development                    | 189                                 | 209        | 634                                | 577        |
| Total operating expenses                    | 2,942                               | 3,024      | 9,028                              | 9,226      |
| Loss from operations                        | (609)                               | (1,052)    | (2,254)                            | (3,512)    |
| Other income/(expense):                     |                                     |            |                                    |            |
| Interest income                             | 4                                   | 6          | 12                                 | 19         |
| Interest expense                            | (39)                                | (3)        | (105)                              | (16)       |
| Other income, net                           | 27                                  | 16         | 91                                 | 264        |
| Total other income/(expense), net           | (8)                                 | 19         | (2)                                | 267        |
| Loss before income tax                      | (617)                               | (1,033)    | (2,256)                            | (3,245)    |
| Income tax provision                        | (4)                                 | (10)       | (11)                               | (28)       |
| Net loss                                    | \$(621)                             | \$(1,043)  | \$(2,267)                          | \$(3,273)  |
| Net loss per common share:                  |                                     |            |                                    |            |
| Basic                                       | \$(0.05)                            | \$(0.08)   | \$(0.17)                           | \$(0.25)   |
| Diluted                                     | \$(0.05)                            | \$(0.08)   | \$(0.17)                           | \$(0.25)   |
| Weighted-average common shares outstanding: |                                     |            |                                    |            |
| Basic                                       | 13,411,569                          | 13,207,041 | 13,316,277                         | 12,870,728 |
| Diluted                                     | 13,411,569                          | 13,207,041 | 13,316,277                         | 12,870,728 |

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



## CREXENDO, INC. AND SUBSIDIARIES

## Condensed Consolidated Statements of Stockholders' Equity

For the Nine Months Ended September 30, 2016

(In thousands, except share data)

(unaudited)

|   | Common Stock |        | Additional Paid-in Capital |                     | Total                |
|---|--------------|--------|----------------------------|---------------------|----------------------|
|   | Shares       | Amount | Capital                    | Accumulated Deficit | Stockholders' Equity |
| Balance, January 1, 2016  | 13,227,489   | \$13   | \$57,614                   | \$(55,423)          | \$2,204              |
| Expense for stock options granted to employees                      | -            |        | 504                        |                     | 504                  |
| Stock issued under stock award plans                                | 8,310        |        | 9                          |                     | 9                    |
| Issuance of common stock in a business acquisition                  | 17,757       |        | 40                         |                     | 40                   |
| Issuance of common stock for interest on related party note payable | 75,000       |        | 101                        |                     | 101                  |
| Issuance of common stock for exercise of common stock warrants      | 85,000       |        | 102                        |                     | 102                  |
| Net loss  | -            |        | -                          | (2,267)             | (2,267)              |
| Balance, September 30, 2016   | 13,413,556   | \$13   | \$58,370                   | \$(57,690)          | \$693                |

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



CREXENDO, INC. AND SUBSIDIARIES  
Condensed Consolidated Statements of Cash Flows  
(In thousands)  
(unaudited)

|  | Nine Months Ended<br>September 30, |                |
|--|------------------------------------|----------------|
|  | 2016                               | 2015           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                  |                                    |                |
| Net loss   | \$(2,267)                          | \$(3,273)      |
| Adjustments to reconcile net loss to net cash used for operating activities: |                                    |                |
| Amortization of prepaid rent   | 242                                | 242            |
| Depreciation and amortization  | 110                                | 216            |
| Non-cash interest expense  | 18                                 | -              |
| Expense for stock options issued to employees                                | 504                                | 784            |
| Amortization of deferred gain  | (70)                               | (70)           |
| Changes in assets and liabilities:   |                                    |                |
| Trade receivables  | 96                                 | 111            |
| Equipment financing receivables  | 119                                | 130            |
| Inventories  | 10                                 | (43)           |
| Prepaid expenses   | 81                                 | (69)           |
| Other assets   | 38                                 | (96)           |
| Accounts payable and accrued expenses  | 361                                | (40)           |
| Income tax payable   | 4                                  | 27             |
| Deferred revenue   | 17                                 | 112            |
| Net cash used for operating activities                                       | (737)                              | (1,969)        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                  |                                    |                |
| Purchase of property and equipment   | -                                  | (29)           |
| Release of restricted cash   | 12                                 | 9              |
| Purchase of long-term investment   | (1)                                | -              |
| Net cash provided by/(used for) investing activities                         | 11                                 | (20)           |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                  |                                    |                |
| Proceeds from notes payable  | 150                                | -              |
| Repayments made on notes payable   | (119)                              | -              |
| Proceeds from exercise of options  | 9                                  | 49             |
| Proceeds from exercise of warrants   | 102                                | 690            |
| Payment of contingent consideration  | (59)                               | (61)           |
| Net cash provided by financing activities                                    | 83                                 | 678            |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                             | <b>(643)</b>                       | <b>(1,311)</b> |
| <b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD</b>              | <b>1,497</b>                       | <b>2,906</b>   |

|   |       |         |
|---|-------|---------|
| CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD                                    | \$854 | \$1,595 |
| Supplemental disclosure of cash flow information:                                     |       |         |
| Cash used during the period for:  |       |         |
| Income taxes, net   | \$(2) | \$(1)   |
| Supplemental disclosure of non-cash investing and financing information:              |       |         |
| Issuance of common stock for prepayment of interest on related-party note payable     | \$101 | \$-     |
| Issuance of common stock for contingent consideration related to business acquisition | \$40  | \$40    |

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



## CREXENDO, INC. AND SUBSIDIARIES

### Notes to Condensed Consolidated Financial Statements (unaudited)

1.

#### Significant Accounting Policies

Description of Business - Crexendo, Inc. (CXDO) is incorporated in the state of Delaware. As used hereafter in the notes to condensed consolidated financial statements, we refer to Crexendo, Inc. and its wholly owned subsidiaries, as “we,” “us,” “the Company,” or “our Company”. We are a hosted services company that provides hosted telecommunications services, broadband internet services and website hosting for businesses. Our services are designed to make enterprise-class hosting services available to any size businesses at affordable monthly rates. The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services.

The Company has transformed into a start-up company with the inherent risks and uncertainties of funding operations until profitability is achieved. We currently plan to fund our operations during the next twelve months using our cash and cash equivalents of \$854,000. However, after considering the Company’s historical negative cash flow from operating activities as well as internal forecasts, such amount does not appear adequate to fund our anticipated cash needs for the next twelve months. Accordingly, the Company will be required to obtain additional debt or equity financing such as that available from its CEO to sustain operations. The Company received a commitment from the CEO, and majority shareholder, in November 2016 that in addition to the \$1,000,000 available under the note payable agreement, he would exercise all warrants received in connection with the note payable agreement dated December 30, 2015 (Note 8) if additional capital is necessary to fund operations through December 31, 2017. Based on such commitment, along with its cash resources and loan borrowing availability, the Company believes it will have sufficient funds to sustain its operations during the next twelve months as a result of the sources of funding detailed above.

Basis of Presentation – The condensed consolidated financial statements include the accounts and operations of Crexendo, Inc. and its wholly owned subsidiaries, which include Crexendo Business Solutions, Inc., StoresOnline Inc., StoresOnline International Canada ULC, Avail 24/7 Inc., and Crexendo International, Inc. All intercompany account balances and transactions have been eliminated in consolidation. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“US GAAP”), consistent in all material respects with those applied in our consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. Because these financial statements address interim periods, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Such interim financial information is unaudited but reflects all adjustments that in the opinion of management are necessary for the fair presentation of the interim periods presented. The results of operations presented in this Quarterly Report on Form 10-Q are not necessarily indicative of the results that may be expected for the year ending December 31, 2016 or for any future periods. This Quarterly Report on Form 10-Q should be read in conjunction with the Company’s audited consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

Certain prior year amounts have been reclassified for consistency with the current period presentation. These reclassifications had no effect on the reported results of operations.

Cash and Cash Equivalents - We consider all highly liquid, short-term investments with maturities of three months or less at the time of purchase to be cash equivalents. As of September 30, 2016 and December 31, 2015, we had cash and cash equivalents in financial institutions in excess of federally insured limits in the amount of \$626,000 and \$1,384,000, respectively.

Restricted Cash – We classified \$100,000 and \$112,000 as restricted cash as of September 30, 2016 and December 31, 2015, respectively. Cash is restricted for compensating balance requirements on purchasing card agreements. As of September 30, 2016, we had restricted cash in financial institutions in excess of federally insured limits in the amount of \$100,000.

Trade Receivables – Trade receivables from our hosted telecommunications and web services segments are recorded at invoiced amounts. We have historically offered to our web site development software customers the option to finance,



typically through 24 and 36-month extended payment term agreements (“EPTAs”). EPTAs are reflected as short-term and long-term trade receivables, as applicable, as we have the intent and ability to hold the receivables for the foreseeable future, until maturity or payoff. EPTAs are recorded on a nonaccrual cash basis beginning on the contract date.

Allowance for Doubtful Accounts –The allowance represents estimated losses resulting from customers’ failure to make required payments. The allowance estimate is based on historical collection experience, specific identification of probable bad debts based on collection efforts, aging of trade receivables, customer payment history, and other known factors, including current economic conditions. We believe that the allowance for doubtful accounts is adequate based on our assessment to date, however, actual collection results may differ materially from our expectations.



Inventory – Finished goods telecommunications equipment inventory is stated at the lower of cost or market (first-in, first-out method). In accordance with applicable accounting guidance, we regularly evaluate whether inventory is stated at the lower of cost or market.

Certificate of Deposit - We hold a \$252,000 certificate of deposit as collateral for merchant accounts, which automatically renews every 12 months. The certificate of deposit is classified as long-term in the consolidated balance sheets.

Property and Equipment - Depreciation and amortization expense is computed using the straight-line method in amounts sufficient to allocate the cost of depreciable assets over their estimated useful lives ranging from two to five years. The cost of leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the term of the related lease. Depreciation expense is included in general and administrative expenses and totaled \$3,000 and \$13,000 for the three months ended September 30, 2016 and 2015, respectively and \$12,000 and \$49,000 for the nine months ended September 30, 2016 and 2015, respectively.

Depreciable lives by asset group are as follows:

|                               |              |
|-------------------------------|--------------|
| Computer and office equipment | 2 to 5 years |
| Computer software             | 3 years      |
| Furniture and fixtures        | 4 years      |
| Leasehold improvements        | 2 to 5 years |

Maintenance and repairs are expensed as incurred. The cost and accumulated depreciation of property and equipment sold or otherwise retired are removed from the accounts and any related gain or loss on disposition is reflected in net income or loss for the year.

Goodwill – Goodwill is tested for impairment using a fair-value-based approach on an annual basis (December 31) and between annual tests if indicators of potential impairment exist.

Intangible Assets - Our intangible assets consist primarily of customer relationships and developed technology. The intangible assets are amortized following the patterns in which the economic benefits are consumed. We periodically review the estimated useful lives of our intangible assets and review these assets for impairment whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. The determination of impairment is based on estimates of future undiscounted cash flows. If an intangible asset is considered to be impaired, the amount of the impairment will be equal to the excess of the carrying value over the fair value of the asset.

Use of Estimates - In preparing the consolidated financial statements, management makes assumptions, estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of net sales and expenses during the reported periods. Specific estimates and judgments include valuation of goodwill and intangible assets in connection with business acquisitions, allowances for doubtful accounts, uncertainties related to certain income tax benefits, valuation of deferred income tax assets, valuations of share-based payments and recoverability of long-lived assets. Management’s estimates are based on historical experience and on our expectations that are believed to be reasonable. The combination of these factors forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from our current estimates and those differences may be material.

Revenue Recognition - In general, we recognize revenue when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the product or service has been provided to the customer; (3) the amount of fees to be paid by the customer is fixed or determinable; and (4) the collection of our fees is probable. We recognize revenue from our Hosted Telecommunications Services and Web Services segments on an accrual basis, with the exception of our extended payment term agreement cash receipts which are recognized on a cash basis.

Specifics to revenue category are as follows:

We enter into agreements where revenue is derived from multiple deliverables including any mix of products and/or services. For these arrangements, we determine whether the delivered item(s) has value to the customer on a stand-alone basis, and in the event the arrangement includes a general right of return relative to the delivered item(s), whether the delivery or performance of the undelivered item(s) is considered probable and substantially in our control. If these criteria are met, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative selling price. If these criteria are not met, the arrangement is accounted for as a single unit of accounting which would result in revenue being recognized ratably over the contract term or deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. The amount of product and services revenue recognized for arrangements with multiple deliverables is impacted by the allocation of arrangement consideration to the deliverables in the arrangement based on the relative selling prices. In determining our selling prices, we apply the selling price hierarchy using vendor specific objective evidence ("VSOE") when available, third-party evidence of selling price ("TPE") if VSOE does not exist, and best estimated selling price ("BESP") if neither VSOE nor TPE is available.



VSOE of fair value for elements of an arrangement is based upon the normal pricing and discounting practices for a deliverable when sold separately. In determining VSOE, we require that a substantial majority of the selling prices fall within a reasonably narrow pricing range, generally evidenced by a substantial majority of such historical stand-alone transactions falling within a reasonably narrow range of the median rate. In addition, we consider major service groups, geographies, customer classifications, and other variables in determining VSOE.

We are typically not able to determine TPE for our products or services. TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, our offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality is difficult to obtain. Furthermore, we are unable to reliably determine what similar competitor products' selling prices are on a stand-alone basis.

When we are unable to establish the selling price using VSOE or TPE, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels.

We recognize revenue for delivered elements only when we determine there are no uncertainties regarding customer acceptance. Changes in the allocation of the sales price between delivered and undelivered elements can impact the timing of revenue recognized but does not change the total revenue recognized on any agreement.

Professional Services Revenue - Fees collected for professional services, including website design and development, search engine optimization services, link-building, paid search management services, and telecom installation services are recognized as revenue, net of expected customer refunds, over the period during which the services are performed, based upon the value for such services.

Telecommunications Services Hosting and Web Hosting Revenue - Fees collected for hosting revenue are recognized ratably as services are provided. Customers are billed for these services on a monthly or annual basis at the customer's option. We recognize revenue ratably over the applicable service period. When we provide a free trial period, we do not begin to recognize recurring revenue until the trial period has ended and the customer has been billed for the services.

Equipment Sales and Financing Revenue - Revenue generated from the sale of telecommunications equipment is recognized when the devices are installed and hosted telecommunications services begin.

Fees generated from renting our hosted telecommunication equipment (IP or cloud telephone devices) through leasing contracts are recognized as revenue based on whether the lease qualifies as an operating lease or sales-type lease. The two primary accounting provisions which we use to classify transactions as sales-type or operating leases are: 1) lease term to determine if it is equal to or greater than 75% of the economic life of the equipment and 2) the present value of the minimum lease payments to determine if they are equal to or greater than 90% of the fair market value of the equipment at the inception of the lease. The economic life of most of our products is estimated to be three years, since this represents the most frequent contractual lease term for our products, and there is no residual value for used equipment. Residual values, if any, are established at the lease inception using estimates of fair value at the end of the lease term. The vast majority of our leases that qualify as sales-type leases are non-cancelable and include cancellation penalties approximately equal to the full value of the lease receivables. Leases that do not meet the criteria for sales-type lease accounting are accounted for as operating leases. Revenue from sales-type leases is recognized upon installation and the interest portion is deferred and recognized as earned. Revenue from operating leases is recognized

ratably over the applicable service period.

**Commission Revenue** - We have affiliate agreements with third-party entities that are resellers of satellite television services and internet service providers. We receive commissions when the services are bundled with our offerings and we recognize commission revenue when received.

**Cost of Revenue – Cost of Hosted Telecommunications Service** revenue primarily consists of fees we pay to third-party telecommunications and business internet providers, personnel and travel expenses related to system implementation, customer service, and the costs associated with the purchase of desktop devices and other third party equipment. **Cost of Web Services** revenue consists primarily of customer service costs and outsourcing fees related to fulfillment of our professional web management services.

**Prepaid Sales Commissions** - For arrangements where we recognize revenue over the relevant contract period, we defer related commission payments to our direct sales force and amortize these amounts over the same period that the related revenues are recognized. This is done to match commissions with the related revenues. Commission payments are nonrefundable unless amounts due from a customer are determined to be uncollectible or if the customer subsequently changes or terminates the level of service, in which case commissions which were paid are recoverable by us.





Research and Development - Research and development costs are expensed as incurred. Costs related to internally developed software are expensed as research and development expense until technological feasibility has been achieved, after which the costs are capitalized.

Fair Value Measurements - The fair value of our financial assets and liabilities was determined based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

Level 1 — Unadjusted quoted prices that are available in active markets for the identical assets or liabilities at the measurement date.

Level 2 — Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets in non-active markets;
- Inputs other than quoted prices that are observable for the asset or liability; and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 — Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

Notes Payable – We record notes payable net of any discounts or premiums. Discounts and premiums are amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.

Income Taxes - We recognize a liability or asset for the deferred tax consequences of all temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements that will result in taxable or deductible amounts in future years when the reported amounts of the assets and liabilities are recovered or settled. Accruals for uncertain tax positions are provided for in accordance with accounting guidance. Accordingly, we may recognize the tax benefits from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting guidance is also provided on de-recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in the financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, and cash flows. In assessing the need for a valuation allowance, we evaluate all significant available positive and negative evidence, including historical operating results, estimates of future taxable income and the existence of prudent and feasible tax planning strategies. We have placed a full valuation allowance on net deferred tax assets.

Interest and penalties associated with income taxes are classified as income tax expense in the condensed consolidated statements of operations.

We do not intend to indefinitely reinvest the undistributed earnings of our United Kingdom subsidiary, therefore, we have provided for U.S. deferred income taxes on such undistributed foreign earnings. All other foreign subsidiaries are considered disregarded foreign entities for US tax purposes.

**Stock-Based Compensation** - For equity-classified awards, compensation expense is recognized over the requisite service period based on the computed fair value on the grant date of the award. Equity classified awards include the issuance of stock options.

**Comprehensive Loss** – There were no other components of comprehensive loss other than net loss for the three and nine months ended September 30, 2016 and 2015.

**Operating Segments** - Accounting guidance establishes standards for the way public business enterprises are to report information about operating segments in annual financial statements and requires enterprises to report selected information about operating segments in financial reports issued to stockholders. The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. Research and development expenses are allocated to Hosted Telecommunications Services and Web Services segments based on the level of effort, measured primarily by wages and benefits attributed to our engineering department. Indirect sales and marketing expenses are allocated to the Hosted Telecommunications Services and Web Services segments based on level of effort, measured by month-to-date contract bookings. General and administrative expenses are allocated to both segments based on revenue recognized for each segment. Accounting guidance also establishes standards for related disclosure about products and services, geographic areas and major customers. We generate over 90% of our total revenue from customers within North America (United States and Canada) and less than 10% of our total revenues from customers in other parts of the world.



Significant Customers – No customer accounted for 10% or more of our total revenue for the three and nine months ended September 30, 2016 and 2015. No telecom customer accounted for 10% or more of our total trade accounts receivable as of September 30, 2016 and no customer accounted for 10% or more of our total trade accounts receivable as of December 31, 2015.

Recent Accounting Pronouncements – In August 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (ASU) No. 2016-15, which amends ASC 230, to clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. The FASB issued ASU 2016-15 with the intent of reducing diversity in practice with respect to eight types of cash flows. This guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. We are in the process of evaluating the adoption and potential impact of this new ASU on our consolidated financial statements.

In May 2016, the FASB issued ASU 2016-12, Narrow-Scope Improvements and Practical Expedients, makes certain targeted amendments to Topic 606, Revenue from Contracts with Customers:

Assessing collectibility. The amendments add a “substantially all” threshold to the collectibility criterion, and also clarify that the objective of the collectibility assessment is to determine whether the contract is valid and represents a substantive transaction based on whether a customer has the ability and intent to pay for the goods or services that will be transferred to the customer, as opposed to all of the goods or services promised in the contract. The ASU also clarifies how an entity may recognize as revenue consideration received in circumstances where a contract does not meet the criteria required at inception to apply the recognition guidance within the revenue standard.

Presenting sales taxes and other similar taxes collected from customers. The amendments provide an accounting policy election whereby an entity may exclude from the measurement of transaction price all taxes assessed by a taxing authority related to the specific transaction and that are collected from the customer. Such amounts would be presented “net” under this option.

Noncash consideration. The amendments clarify that the fair value of noncash consideration is measured at contract inception, and specify how to account for subsequent changes in the fair value of noncash consideration.

Contract modifications at transition. The amendments provide a new practical expedient whereby an entity electing either the full or modified retrospective method of transition is permitted to reflect the aggregate effect of all prior period modifications (using hindsight) when identifying satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to satisfied and unsatisfied obligations.

Completed contracts at transition. The amendments include certain practical expedients in transition related to completed contracts. The amendments also clarify the definition of a completed contract.

Disclosing the accounting change in the period of adoption. ASU 2016-12 provides an exception to the requirement in Topic 250, Accounting Changes and Error Corrections, to disclose the effect on the current period of retrospectively adopting a new accounting standard. As such, the disclosure requirement does not apply to adoption of the new revenue standard with respect to the year of adoption.

The effective date and transition requirements for ASU 2016-12 are the same as the effective date and transition requirements of ASU 2014-09 (Topic 606). The Company is currently in the process of evaluating the impact of adoption of the ASU on its consolidated financial statements.

In April 2016, the FASB issued ASU 2016-10, Identifying Performance Obligations and Licensing, more clearly articulates the guidance for assessing whether promises are separately identifiable in the overall context of the contract, which is one of two criteria for determining whether promises are distinct. The ASU also clarifies the factors

an entity should consider when assessing whether two or more promises are separately identifiable, and provides additional examples within the implementation guidance for assessing these factors. The ASU further clarifies that an entity is not required to identify promised goods or services that are immaterial in the context of the contract, although customer options to purchase additional goods or services that represent a material right should not be designated as immaterial in the context of the contract. The ASU also provides an accounting policy election whereby an entity may account for shipping and handling activities as a fulfillment activity rather than as an additional promised service in certain circumstances.



The ASU also clarifies whether a license of intellectual property (IP) represents a right to use the IP (which is satisfied at a point in time) or a right to access the IP (which is satisfied over time) by categorizing the underlying IP as either functional or symbolic. A promise to grant a license that is not a separate performance obligation must be considered in the context above (i.e., functional or symbolic), in order to determine whether the combined performance obligation is satisfied at a point in time or over time, and how to best measure progress toward completion if recognized over time. Regardless of a license's nature (i.e., functional or symbolic), an entity may not recognize revenue from a license of IP before 1) it provides or otherwise makes available a copy of the IP to the customer, and 2) the period during which the customer is able to use and benefit from the license has begun (i.e., the beginning of the license period). Additionally, the ASU clarifies that 1) an entity should not split a sales-based or usage-based royalty into a portion subject to the guidance on sales-based and usage-based royalties and a portion that is not subject to that guidance; and 2) the guidance on sales-based and usage-based royalties applies whenever the predominant item to which the royalty relates is a license of IP. Lastly, the amendments distinguish contractual provisions requiring the transfer of additional rights to use or access IP that the customer does not already control from provisions that are attributes of a license (e.g., restrictions of time, geography, or use). License attributes define the scope of the rights conveyed to the customer; they do not determine when the entity satisfies a performance obligation. The effective date and transition requirements for ASU 2016-10 are the same as the effective date and transition requirements of ASU 2014-09 (Topic 606). The Company is currently in the process of evaluating the impact of adoption of the ASU on its consolidated financial statements.

In March 2016, FASB issued ASU 2016-09, which amends Accounting Standards Codification ("ASC") Topic 718, Compensation – Stock Compensation. ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years and early adoption is permitted. The Company is currently in the process of evaluating the impact of adoption of the ASU on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases, in order to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous Generally Accepted Accounting Principles ("GAAP"). The ASU 2016-02 requires that a lessee should recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term on the balance sheet. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 (including interim periods within those periods) using a modified retrospective approach and early adoption is permitted. The Company is currently in the process of evaluating the impact of adoption of the ASU on its consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes, which will require entities to present deferred tax assets (DTAs) and deferred tax liabilities (DTLs) as noncurrent in a classified balance sheet. The ASU simplifies the current guidance, which requires entities to separately present DTAs and DTLs as current and noncurrent in a classified balance sheet. ASU 2015-17 is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The adoption of this guidance will eliminate the need to present DTAs as long-term and DTLs as current liabilities. We will adopt this guidance effective January 1, 2017.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations, which requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period for a business combination in the reporting period in which the adjustment amounts are determined. Prior to the issuance of the standard, entities were required to retrospectively apply adjustments made to provisional amounts recognized in a business combination. We adopted this guidance effective January 1, 2016. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In April 2015, the FASB issued ASU 2015-05, Intangibles—Goodwill and Other—Internal-Use Software, which provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element

of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The guidance will not change U.S. GAAP for a customer's accounting for service contracts. We adopted this guidance effective January 1, 2016. The adoption of this guidance did not have a material impact on our consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements – Going Concern, which requires management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the ASU (1) provides a definition of the term substantial doubt, (2) requires an evaluation every reporting period including interim periods, (3) provides principles for considering the mitigating effect of management's plans, (4) requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) requires an express statement and other disclosures when substantial doubt is not alleviated, and (6) requires an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). This standard is effective for the fiscal years ending after December 15, 2016, and for annual periods and interim periods thereafter. The adoption of ASU 2014-15 will not have a material impact on our consolidated financial statements.





In June 2014, the FASB issued ASU No. 2014-12, Compensation – Stock Compensation, which requires that a performance target that affects vesting and could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in ASC 718, Compensation-Stock Compensation, as it relates to such awards. ASU 2014-12 is effective for us in our first quarter of fiscal 2017 with early adoption permitted using either of two methods: (i) prospective to all awards granted or modified after the effective date; or (ii) retrospective to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter, with the cumulative effect of applying ASU 2014-12 as an adjustment to the opening retained earnings balance as of the beginning of the earliest annual period presented in the financial statements. The Company is currently assessing the impact of this pronouncement to its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which introduces a new five-step revenue recognition model in which an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU also requires disclosures sufficient to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. In August 2015, the FASB issued ASU 2015-14, which defers the effective date of ASU 2014-09 for all entities by one year. Accordingly, public business entities should apply the guidance in ASU 2014-09 to annual reporting periods (including interim periods within those periods) beginning after December 15, 2017. Early adoption is permitted but not before annual periods beginning after December 15, 2016. The standard permits the use of the retrospective or the modified approach method. We have not yet selected a transition method, and are currently in the process of evaluating the impact of adoption of this ASU on our consolidated financial statements and disclosures.

## 2.

### Net Loss Per Common Share

Basic net loss per common share is computed by dividing the net loss for the period by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share is computed giving effect to all dilutive common stock equivalents, consisting of common stock options and warrants. Diluted net loss per common share for the three and nine months ended September 30, 2016 and 2015 is the same as basic net loss per common share because the common share equivalents were anti-dilutive due to the net loss. The following table sets forth the computation of basic and diluted net loss per common share:

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2016                                | 2015       | 2016                               | 2015       |
| Net loss (in thousands)                   | \$(621)                             | \$(1,043)  | \$(2,267)                          | \$(3,273)  |
| Weighted-average share reconciliation:    |                                     |            |                                    |            |
| Weighted-average basic shares outstanding | 13,411,569                          | 13,207,041 | 13,316,277                         | 12,870,728 |
| Diluted shares outstanding                | 13,411,569                          | 13,207,041 | 13,316,277                         | 12,870,728 |

Net loss per common share:

|         |          |          |          |          |
|---------|----------|----------|----------|----------|
| Basic   | \$(0.05) | \$(0.08) | \$(0.17) | \$(0.25) |
| Diluted | \$(0.05) | \$(0.08) | \$(0.17) | \$(0.25) |

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Common stock equivalent shares are not included in the computation of diluted loss per share, as the Company has a net loss and the inclusion of such shares would be anti-dilutive due to the net loss. At September 30, 2016 and 2015, the common stock equivalent shares were, as follows:

|  | September 30, | September 30, |
|--|---------------|---------------|
|  | 2016          | 2015          |
| Shares of common stock issuable under equity incentive plans outstanding | 3,935,812     | 3,187,347     |
| Shares of common stock issuable upon conversion of warrants              | 165,000       | -             |
| Common stock equivalent shares excluded from diluted net loss per share  | 4,100,812     | 3,187,347     |

3.

Trade Receivables, net

Our trade receivables balance consists of traditional trade receivables and residual extended payment term agreements (EPTAs) sold prior to July 2011. Below is an analysis of the days outstanding of our trade receivables as shown on our balance sheet (in thousands):

|                                       | September 30, | December 31, |
|---------------------------------------|---------------|--------------|
|                                       | 2016          | 2015         |
| Trade receivables                     | \$323         | \$378        |
| Conforming EPTAs                      | 71            | 94           |
| Non-Conforming EPTAs:                 |               |              |
| 1 - 30 days                           | 4             | 11           |
| 31 - 60 days                          | -             | 4            |
| 61 - 90 days                          | 2             | 17           |
| Gross trade receivables               | 400           | 504          |
| Less: allowance for doubtful accounts | (51)          | (59)         |
| Trade receivables, net                | \$349         | \$445        |
| Current trade receivables, net        | \$303         | \$364        |
| Long-term trade receivables, net      | 46            | 81           |
| Trade receivables, net                | \$349         | \$445        |

All current and long-term EPTAs in the table above had original contract terms of greater than one year. The Company wrote off \$34,000 of EPTAs during the nine months ended September 30, 2016 and \$66,000 during the year ended December 31, 2015, of which, all had original contract terms of greater than one year.

4.

Equipment Financing Receivables

We rent certain hosted telecommunication equipment (IP telephone devices) through leasing contracts that we classify as either operating leases or sale-type leases. Equipment finance receivables are expected to be collected over the next thirty-six to sixty months. Equipment finance receivables arising from the rental of our hosted telecommunication equipment through sales-type leases, were as follows (in thousands):

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|   | September 30, | December 31, |
|---|---------------|--------------|
|   | 2016          | 2015         |
| Gross financing receivables                       | \$781         | \$1,030      |
| Less unearned income                              | (450)         | (580)        |
| Financing receivables, net                        | 331           | 450          |
| Less: Current portion of finance receivables, net | (123)         | (131)        |
| Finance receivables due after one year            | \$208         | \$319        |

5.

Prepaid Expenses

Prepaid expenses consisted of the following (in thousands):

|                               | September 30, | December 31, |
|-------------------------------|---------------|--------------|
|                               | 2016          | 2015         |
| Prepaid rent                  | \$134         | \$376        |
| Prepaid commissions           | 507           | 456          |
| Prepaid software support      | 66            | 181          |
| Prepaid software subscription | 13            | 103          |
| Prepaid inventory deposits    | 150           | -            |
| Other prepaid expenses        | 242           | 218          |
| Total prepaid assets          | \$1,112       | \$1,334      |

6.

Intangible Assets

The net carrying amount of intangible assets are as follows (in thousands):

|                               | September 30, | December 31, |
|-------------------------------|---------------|--------------|
|                               | 2016          | 2015         |
| Customer relationships        | \$941         | \$941        |
| Developed technology          | 198           | 198          |
| Less accumulated amortization |               |              |
| Customer relationships        | (576)         | (482)        |
| Developed technology          | (195)         | (191)        |
| Total                         | \$368         | \$466        |



Amortization expense is included in general and administrative expenses and totaled \$33,000 and \$43,000 for the three months ended September 30, 2016 and 2015, respectively, and \$98,000 and \$166,000 for the nine months ended September 30, 2016 and 2015, respectively.

7.

Accrued Expenses

Accrued expenses consisted of the following (in thousands):

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|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2016          | 2015         |
| Accrued wages and benefits                 | \$404         | \$298        |
| Accrued accounts payable                   | 177           | 153          |
| Accrued sales and telecommunications taxes | 214           | 223          |
| Other                                      | 146           | 138          |
| Total accrued expenses                     | \$941         | \$812        |

8.  
Notes Payable

Related-Party Note Payable

On December 30, 2015, the Company entered into a Term Loan Agreement (the "Loan Agreement"), with Steven G. Mihaylo, as Trustee of The Steven G. Mihaylo Trust dated August 19, 1999 (the "Lender"). Mr. Mihaylo is the principal shareholder and Chief Executive Officer of the Company. Pursuant to the Loan Agreement, the Lender has agreed to make an unsecured loan to the Company in the initial principal amount of \$1,000,000 (the "Loan"). The Loan Agreement contains a provision which requires the Lender to increase the amount of the Loan by up to an additional \$1,000,000 on the same terms and conditions as the initial advance if the independent directors of the Company, in their reasonable discretion, determine such an increase is necessary for the funding needs of the Company and that the terms of the Loan are in the best interests of the Company and its stockholders. The term of the Loan is five years, with simple interest paid at 9% per annum until a balloon payment is due December 30, 2020. The Loan Agreement provides for interest to be paid in shares of common stock of the Company (the "Common Stock") at a stock price of \$1.20 (which is the average of the high and low adjust close price of the Common Stock of the Company for each business day for the period starting December 23, 2015 and ending December 29, 2015.). For the first two years of the Loan term, interest will be paid in advance at the beginning of each year; for the last three years of the Loan term, interest will be paid at the end of each year. After the second year of the Loan term, there is no pre-payment penalty for early repayment of the outstanding principal amount of the Loan. If the Loan is repaid within the first two years of the Loan term, the Company will forfeit prepaid interest as a pre-payment penalty.

Contemporaneously with the execution of the Loan Agreement, the Company granted to the Lender a warrant to purchase 250,000 shares of Common Stock (the "Warrant"). The Warrant has a five-year term from the date of the Loan Agreement. The Warrant is exercisable by the Lender, at any time, and from time to time, during its term at a price of \$1.20 per share of Common Stock. In the event the principal amount of the Loan is increased by an additional \$1,000,000, as determined by the independent directors of the Company, the Company has agreed to issue to the Lender a warrant to purchase an additional 250,000 shares of Common Stock on the same terms and subject to the same conditions set forth in the Warrant.

On June 28, 2016, the Company entered into an Amendment to the Loan Agreement, extending the period which the Company can increase the loan up to an additional \$1,000,000 to May 30, 2017. All other terms remain the same as initial loan agreement.

Other notes payable

Other notes payable consists of short and long-term financing arrangements for software licenses, subscriptions, support and corporate insurance.

The Company's outstanding balances under its note payable agreements were as follows (in thousands):

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|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2016          | 2015         |
| Related-party note payable                       | \$1,000       | \$1,000      |
| Other notes payable                              | 169           | 137          |
|  | 1,169         | 1,137        |
| Less: notes payable discount                     | (98)          | (115)        |
| Net carrying value of notes payable              | 1,071         | 1,022        |
| Less: current portion of long-term notes payable | (98)          | (57)         |
| Long-term notes payable                          | \$973         | \$965        |

9.

Fair Value Measurements

We have financial instruments as of September 30, 2016 and December 31, 2015 for which the fair value is summarized below (in thousands):

|   | September 30, 2016 |                      | December 31, 2015 |                      |
|---|--------------------|----------------------|-------------------|----------------------|
|   | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| Assets:   |                    |                      |                   |                      |
| Trade receivables, net                              | \$349              | \$349                | \$445             | \$445                |
| Equipment financing receivables                     | 331                | 331                  | 450               | 450                  |
| Certificate of deposit                              | 252                | 252                  | 251               | 251                  |
| Liabilities:  |                    |                      |                   |                      |
| Acquisition related contingent consideration        | -                  | -                    | 99                | 99                   |
| Notes payable including discount from warrant grant | 1,071              | 1,178                | 1,022             | 1,146                |

Assets and liabilities for which fair value is recognized in the balance sheet on a recurring basis are summarized below as of September 30, 2016 and December 31, 2015 (in thousands):

| Description | September 30, 2016 | Fair value measurement at reporting date |         |         |
|-------------|--------------------|--|---------|---------|
|             |                    | Level 1                                  | Level 2 | Level 3 |
|             |                    |  |         |         |

Assets:

|                        |       |     |       |     |
|------------------------|-------|-----|-------|-----|
| Certificate of deposit | \$252 | \$- | \$252 | \$- |
|------------------------|-------|-----|-------|-----|

| Description | December 31, 2015 | Level 1 | Level 2 | Level 3 |
|-------------|-------------------|---------|---------|---------|
|-------------|-------------------|---------|---------|---------|

Assets:

|                        |       |     |       |     |
|------------------------|-------|-----|-------|-----|
| Certificate of deposit | \$251 | \$- | \$251 | \$- |
|------------------------|-------|-----|-------|-----|

Liabilities:

|  |    |   |   |    |
|--|----|---|---|----|
| Acquisition related contingent consideration | 99 | - | - | 99 |
|--|----|---|---|----|

The carrying amount of certificates of deposit approximates fair value, as determined by certificates of deposit with similar terms and conditions.

The recurring Level 3 measurement of our contingent consideration liability includes the following significant unobservable inputs at December 31, 2015 (in thousands):





| Contingent consideration liability | Fair Value at December 31, 2015 | Valuation technique  | Unobservable inputs              | Range |
|------------------------------------|---------------------------------|----------------------|----------------------------------|-------|
| Revenue - based payments           | \$99                            | Discounted cash flow | Discount Rate                    | 12.5% |
|                                    |                                 |                      | Probability of milestone payment | 100%  |
|                                    |                                 |                      | Projected year of payments       | 2016  |

Level 3 instruments are valued based on unobservable inputs that are supported by little or no market activity and reflect the Company's own assumptions in measuring fair value. Future changes in fair value of the contingent financial milestone consideration, as a result of changes in significant inputs such as the discount rate and estimated probabilities of financial milestone achievements, could have a material effect on the statement of operations and balance sheet in the period of the change.

The progression of the Company's Level 3 instruments fair valued on a recurring basis for the nine months ended September 30, 2016 and the year ended December 31, 2015 are shown in the table below (in thousands):

#### Acquisition Related Contingent Consideration

|  |       |
|--|-------|
| Balance at January 1, 2015                             | \$211 |
| Change in fair value                                   | (11)  |
| Cash payments  | (61)  |
| Issuance of common stock from contingent consideration | (40)  |
| Balance at December 31, 2015                           | \$99  |
| Cash payments  | (59)  |
| Issuance of common stock from contingent consideration | (40)  |
| Balance at September 30, 2016                          | \$-   |

10.

#### Income Taxes

Our effective tax rate for the three and nine months ended September 30, 2016 was (0.6)% and (0.5)%, respectively, which resulted in an income tax provision of \$(4,000) and \$(11,000), respectively. The tax provision is due to state tax payments made with extensions filed.

Our effective tax rate for the three and nine months ended September 30, 2015 was (1.0)% and (0.9)%, respectively, which resulted in an income tax provision of \$10,000 and \$28,000, respectively. The tax provision is due to state tax payments made with extensions filed.

Significant management judgment is required in determining our provision for income taxes and in determining whether deferred tax assets will be realized in full or in part. In assessing the recovery of the deferred tax assets, we considered whether it is more likely than not that some portion or all of our deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income in the periods in which those temporary differences become deductible. We considered the scheduled reversals of future deferred tax assets, projected future taxable income, the suspension of the sale of product and services through the seminar sales channel, and tax planning strategies in making this assessment. As a result, we determined it was more likely than not that the deferred tax assets would not be realized; accordingly, we recorded a full valuation allowance.

Subsequent to placing a full valuation allowance on our net deferred tax assets, adjustments impacting our tax rate have been and are expected to continue to be insignificant.

11.

#### Commitments and Contingencies

##### Operating Leases

We lease certain of our equipment and corporate offices under non-cancelable operating lease agreements expiring at various dates through 2018. The operating leases for our Reno, NV and Draper, UT offices contain customary escalation clauses.

Rental expense for the three months ended September 30, 2016 and 2015 was approximately \$87,000 and \$87,000, respectively. Rental expense for the nine months September 30, 2016 and 2015 was approximately \$261,000 and \$261,000, respectively.

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## Sale-Leaseback

On February 28, 2014, the Company sold and leased back the land, building and furniture associated with the corporate headquarters in Tempe, Arizona to a Company that is owned by the major shareholder and CEO of the Company for \$2.0 million in cash. The Company recognized a deferred gain of \$281,000 on sale-leaseback, which will be amortized over the initial lease term of 36 months to offset rent expense. The net deferred gain is included in other long-term liabilities in the condensed consolidated balance sheets as of September 30, 2016 and December 31, 2015. Deferred gain amortization for the three months ended September 30, 2016 and 2015 was \$23,000 and \$23,000, respectively. Deferred gain amortization for the nine months ended September 30, 2016 and 2015 was \$70,000 and \$70,000, respectively.

The lease agreement called for rent payments for the initial three year term to be made in advance in the form of 300,000 shares of common stock of Crexendo, Inc. The fair value price per share at the time of the lease was \$3.22 per share, resulting in rent expense of \$322,000 per year for three years. Rent expense incurred on the sale-leaseback during the three months ended September 30, 2016 and 2015 was \$57,000 and \$57,000, respectively. Rent expense incurred on the sale-leaseback during the nine months ended September 30, 2016 and 2015 was \$171,000 and \$171,000, respectively.

12.

## Segments

Management has chosen to organize the Company around differences based on its products and services. Hosted Telecommunications Services segment generates revenue from selling hosted telecommunication services and broadband internet services. Web Services segment generates revenue from website hosting and search engine optimization/management. The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. Segment revenue and income (loss) before income tax provision was as follows (in thousands):

|                                       | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|---------------------------------------|-------------------------------------|---------|------------------------------------|---------|
|                                       | 2016                                | 2015    | 2016                               | 2015    |
| <b>Revenue:</b>                       |                                     |         |                                    |         |
| Hosted telecommunications services    | \$2,013                             | \$1,542 | \$5,711                            | \$4,287 |
| Web services                          | 320                                 | 430     | 1,063                              | 1,427   |
| Consolidated revenue                  | 2,333                               | 1,972   | 6,774                              | 5,714   |
| <b>Income/(loss) from operations:</b> |                                     |         |                                    |         |
| Hosted telecommunications services    | (716)                               | (1,119) | (2,551)                            | (3,560) |
| Web services                          | 107                                 | 67      | 297                                | 48      |
| Total operating loss                  | (609)                               | (1,052) | (2,254)                            | (3,512) |
| <b>Other income/(expense), net:</b>   |                                     |         |                                    |         |
| Hosted telecommunications services    | (11)                                | 19      | (21)                               | 58      |
| Web services                          | 3                                   | -       | 19                                 | 209     |

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|   |         |           |           |           |
|---|---------|-----------|-----------|-----------|
| Total other income/(expense), net         | (8)     | 19        | (2)       | 267       |
| Income/(loss) before income tax provision |         |           |           |           |
| Hosted telecommunications services        | (727)   | (1,100)   | (2,572)   | (3,502)   |
| Web services                              | 110     | 67        | 316       | 257       |
| Loss before income tax provision          | \$(617) | \$(1,033) | \$(2,256) | \$(3,245) |

Depreciation and amortization was \$31,000 and \$45,000 for the Hosted Telecommunications Services segment for the three months ended September 30, 2016 and 2015, respectively. Depreciation and amortization was \$94,000 and \$166,000 for the Hosted Telecommunications Services segment for the nine months ended September 30, 2016 and 2015, respectively. Depreciation and amortization was \$5,000 and \$11,000 for the Web Services segment for the three months ended September 30, 2016 and 2015, respectively. Depreciation and amortization was \$16,000 and \$50,000 for the Web Services segment for the nine months ended September 30, 2016 and 2015, respectively.

Interest income was \$4,000 and \$6,000 for the Web Services segment for the three months ended September 30, 2016 and 2015, respectively. Interest income was \$12,000 and \$19,000 for the Web Services segment for the nine months ended September 30, 2016 and 2015, respectively.

Interest expense was \$34,000 and \$3,000 for the Hosted Telecommunications Services segment for the three months ended September 30, 2016 and 2015, respectively. Interest expense was \$90,000 and \$7,000 for the Hosted Telecommunications Services segment for the nine months ended September 30, 2016 and 2015, respectively. Interest expense was \$5,000 and \$0 for the Web Services segment for the three months ended September 30, 2016 and 2015, respectively. Interest expense was \$15,000 and \$9,000 for the Web Services segment for the nine months ended September 30, 2016 and 2015, respectively.



Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as "anticipates," "expects," "believes," "plans," "predicts," and similar terms. Forward-looking statements are not guarantees of future performance and our Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part II, Item 1A, "Risk Factors," which are incorporated herein by reference. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2015 (the "2015 Form 10-K") filed with the SEC and the Condensed Consolidated Financial Statements and notes thereto included in the 2016 Form 10-Qs and elsewhere in this Form 10-Q. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.

OVERVIEW

We are a hosted services company that provides hosted telecommunications services, broadband internet services and website hosting for businesses. Our services are designed to make enterprise-class hosting services available to any size businesses at affordable monthly rates. The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services.

Hosted Telecommunications Services segment - Our hosted telecommunications services transmit calls using IP or cloud technology, which converts voice signals into digital data packets for transmission over the Internet or cloud. Each of our calling plans provides a number of basic features typically offered by traditional telephone service providers, plus a wide range of enhanced features that we believe offer an attractive value proposition to our customers. This platform enables a user, via a single "identity" or telephone number, to access and utilize services and features regardless of how the user is connected to the Internet or cloud, whether it's from a desktop device or a mobile device.

We generate recurring revenue from our hosted telecommunications and broadband Internet services. Our hosted telecommunications contracts typically have a thirty-six to sixty month term. We generate product revenue and equipment financing revenue from the sale and lease of our hosted telecommunications equipment. Revenues from the sale of equipment, including those from sales-type leases, are recognized at the time of sale or at the inception of the lease, as appropriate.

Web Services segment - We generate recurring revenue from website hosting and other professional services.

OUR SERVICES AND PRODUCTS

Our goal is to provide a broad range of Cloud-based products and services that nearly eliminate the cost of a businesses' technology infrastructure and enable businesses of any size to more efficiently run their business. By providing a variety of comprehensive and scalable solutions, we are able to provide these solutions on a monthly basis to businesses of all sizes without the need for expensive capital investments, regardless of where their business is in its lifecycle. Our products and services can be categorized in the following offerings:

Crexendo's hosted telecommunication service offers a wide variety of essential and advanced features for businesses of all sizes. Many of these features included in the service offering are:

Business Productivity Features such as dial-by extension and name, transfer, conference, call recording, Unlimited calling to anywhere in the US and Canada, International calling, Toll free (Inbound and Outbound)

Individual Productivity Features such as Caller ID, Call Waiting, Last Call Return, Call Recording, Music-On-Hold, Voicemail, Unified Messaging, Hot-Desking







Group Productivity Features such as Call Park, Call Pickup, Interactive Voice Response (IVR), Individual and Universal Paging, Corporate Directory, Multi-Party Conferencing, Group Mailboxes

Call Center Features such as Automated Call Distribution (ACD), Call Monitor, Whisper and Barge, Automatic Call Recording

Advanced Unified Communication Features such as Find-Me-Follow-Me, Sequential Ring and Simultaneous Ring

Mobile Features such extension dialing, transfer and conference and seamless hand-off from Wifi to/from 3G and 4G, as well as other data services. These features are also available on CrexMo, an intelligent mobile application for iPhones and Android smartphones, as well as iPads and Android tablets

Traditional PBX Features such as Busy Lamp Fields, System Hold. 16-48 Port density Analog Devices

Expanded Desktop Device Selection such as Entry Level Phone, Executive Desktop, DECT Phone for roaming users

Advanced Faxing solution such as Cloud Fax (cFax) allowing customers to send and receive Faxes from their Email Clients, Mobile Phones and Desktops without having to use a Fax Machine simply by attaching a file

Web based online portal to administer, manage and provision the system.

Many of these services are included in our basic offering to our customers for a monthly recurring fee and do not require a capital expense. Some of the advanced features such as Automatic Call Recording and Call Center Features require additional monthly fees. Crexendo continues to invest and develop its technology and SaaS offerings to make them more competitive and profitable.

Website Services - Our website services segment allows businesses to host their websites in our data center for a recurring monthly fee. For additional fees, we also provide professional web management services.

#### USE OF NON-GAAP FINANCIAL MEASURES

To evaluate our business, we consider and use non-generally accepted accounting principles (Non-GAAP) net income (loss) and Adjusted EBITDA as a supplemental measure of operating performance. These measures include the same adjustments that management takes into account when it reviews and assesses operating performance on a period-to-period basis. We consider Non-GAAP net income (loss) to be an important indicator of overall business performance because it allows us to evaluate results without the effects of share-based compensation, rent expense paid with common stock, interest expense paid with common stock, and amortization of intangibles. We define EBITDA as U.S. GAAP net income (loss) before interest income, interest expense, other income and expense, provision for income taxes, and depreciation and amortization. We believe EBITDA provides a useful metric to investors to compare us with other companies within our industry and across industries. We define Adjusted EBITDA as EBITDA adjusted for share-based compensation, and rent expense paid with stock. We use Adjusted EBITDA as a supplemental measure to review and assess operating performance. We also believe use of Adjusted EBITDA facilitates investors' use of operating performance comparisons from period to period, as well as across companies.

In our November 11, 2016 earnings press release, as furnished on Form 8-K, we included Non-GAAP net loss, EBITDA and Adjusted EBITDA. The terms Non-GAAP net loss, EBITDA, and Adjusted EBITDA are not defined under U.S. GAAP, and are not measures of operating income, operating performance or liquidity presented in analytical tools, and when assessing our operating performance, Non-GAAP net loss, EBITDA, and Adjusted EBITDA should not be considered in isolation, or as a substitute for net loss or other consolidated income statement

data prepared in accordance with U.S. GAAP. Some of these limitations include, but are not limited to:

EBITDA and Adjusted EBITDA do not reflect our cash expenditures or future requirements for capital expenditures or contractual commitments;

they do not reflect changes in, or cash requirements for, our working capital needs;

they do not reflect the interest expense, or the cash requirements necessary to service interest or principal payments, on our debt that we may incur;

they do not reflect income taxes or the cash requirements for any tax payments;

although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will be replaced sometime in the future, and EBITDA and Adjusted EBITDA do not reflect any cash requirements for such replacements;

while share-based compensation is a component of operating expense, the impact on our financial statements compared to other companies can vary significantly due to such factors as the assumed life of the options and the assumed volatility of our common stock; and

other companies may calculate EBITDA and Adjusted EBITDA differently than we do, limiting their usefulness as comparative measures.



We compensate for these limitations by relying primarily on our U.S. GAAP results and using Non-GAAP net income (loss), EBITDA, and Adjusted EBITDA only as supplemental support for management's analysis of business performance. Non-GAAP net income (loss), EBITDA and Adjusted EBITDA are calculated as follows for the periods presented.

#### RECONCILIATION OF NON-GAAP FINANCIAL MEASURES

In accordance with the requirements of Regulation G issued by the SEC, we are presenting the most directly comparable U.S. GAAP financial measures and reconciling the unaudited Non-GAAP financial metrics to the comparable U.S. GAAP measures.

#### Reconciliation of U.S. GAAP Net Loss to Non-GAAP Net Loss (Unaudited)

|  | Three Months<br>Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|--|-----------|------------------------------------|-----------|
|  | 2016                                   | 2015      | 2016                               | 2015      |
|  | (In thousands)                         |           | (In thousands)                     |           |
| U.S. GAAP net loss   | \$(621)                                | \$(1,043) | \$(2,267)                          | \$(3,273) |
| Share-based compensation   | 153                                    | 201       | 504                                | 784       |
| Amortization of rent expense paid in stock, net of deferred gain | 57                                     | 57        | 171                                | 171       |
| Amortization of intangible assets                                | 33                                     | 43        | 99                                 | 166       |
| Amortization of interest expense paid in stock                   | 25                                     | -         | 71                                 | -         |
| Non-GAAP net loss  | \$(353)                                | \$(742)   | \$(1,422)                          | \$(2,152) |

#### Reconciliation of U.S. GAAP Net Loss to EBITDA to Adjusted EBITDA (Unaudited)

|                               | Three Months<br>Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|-------------------------------|--|-----------|------------------------------------|-----------|
|                               | 2016                                   | 2015      | 2016                               | 2015      |
|                               | (In thousands)                         |           | (In thousands)                     |           |
| U.S. GAAP net loss            | \$(621)                                | \$(1,043) | \$(2,267)                          | \$(3,273) |
| Depreciation and amortization | 35                                     | 56        | 110                                | 216       |
| Interest expense              | 39                                     | 3         | 105                                | 16        |
| Interest and other income     | (31)                                   | (22)      | (103)                              | (283)     |

|  |         |         |           |           |
|--|---------|---------|-----------|-----------|
| Income tax provision   | 4       | 10      | 11        | 28        |
| EBITDA   | (574)   | (996)   | (2,144)   | (3,296)   |
| Share-based compensation   | 153     | 201     | 504       | 784       |
| Amortization of rent expense paid in stock, net of deferred gain | 57      | 57      | 171       | 171       |
| Adjusted EBITDA  | \$(364) | \$(738) | \$(1,469) | \$(2,341) |

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing our financial statements, we make estimates, assumptions and judgments that can have a significant impact on our revenue, operating income or loss and net income or loss, as well as on the value of certain assets and liabilities on our balance sheet. We believe that the estimates, assumptions and judgments involved in our accounting policies described in Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015 have the greatest potential impact on our financial statements, so we consider them to be our critical accounting policies and estimates. Our senior management has reviewed the development and selection of our critical accounting policies and estimates and their disclosure in this Form 10-Q with the Audit Committee of our Board of Directors.

#### RESULTS OF OPERATIONS

The following discussion of financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto and other financial information included elsewhere in this Form 10-Q.



## Results of Consolidated Operations (in thousands):

|                            | Three Months<br>Ended<br>September 30, |          | Nine Months<br>Ended<br>September 30, |          |
|----------------------------|--|----------|---------------------------------------|----------|
|                            | 2016                                   | 2015     | 2016                                  | 2015     |
| Revenue                    | \$2,333                                | \$1,972  | \$6,774                               | \$5,714  |
| Loss before income taxes   | (617)                                  | (1,033)  | (2,256)                               | (3,245)  |
| Income tax provision       | (4)                                    | (10)     | (11)                                  | (28)     |
| Net loss                   | (621)                                  | (1,043)  | (2,267)                               | (3,273)  |
| Basic net loss per share   | \$(0.05)                               | \$(0.08) | \$(0.17)                              | \$(0.25) |
| Diluted net loss per share | \$(0.05)                               | \$(0.08) | \$(0.17)                              | \$(0.25) |

Three months ended September 30, 2016 compared to three months ended September 30, 2015

## Revenue

Total revenue increased 18% or \$361,000, to \$2,333,000 for the three months ended September 30, 2016 as compared to \$1,972,000 for the three months ended September 30, 2015. Hosted Telecommunications Services segment revenue increased 31% or \$471,000, to \$2,013,000 for the three months ended September 30, 2016 as compared to \$1,542,000 for the three months ended September 30, 2015. Web Services segment revenue decreased 26% or \$110,000, to \$320,000 for the three months ended September 30, 2016 as compared to \$430,000 for the three months ended September 30, 2015.

## Loss Before Income Taxes

Loss before income tax decreased 40% or \$416,000, to \$617,000 for the three months ended September 30, 2016 as compared to loss before income tax of \$1,033,000 for the three months ended September 30, 2015. The decrease in loss before income tax is primarily due to the increase in revenue of \$361,000, a decrease in operating expenses of \$82,000, offset by a decrease in other income of \$27,000.

## Income Tax Provision

Our effective tax rate for the three months ended September 30, 2016 and 2015 was (0.6)% and (1.0)%, respectively, which resulted in a provision for income taxes of \$(4,000) and \$(10,000), respectively. The provision for income taxes relates to minimum state tax requirements.

Nine months ended September 30, 2016 compared to nine months ended September 30, 2015

## Revenue

Total revenue increased 19% or \$1,060,000, to \$6,774,000 for the nine months ended September 30, 2016 as compared to \$5,714,000 for the nine months ended September 30, 2015. Hosted Telecommunications Services segment revenue increased 33% or \$1,424,000, to \$5,711,000 for the nine months ended September 30, 2016 as



compared to \$4,287,000 for the nine months ended September 30, 2015. Web Services segment revenue decreased 26% or \$364,000, to \$1,063,000 for the nine months ended September 30, 2016 as compared to \$1,427,000 for the nine months ended September 30, 2015.

#### Loss Before Income Taxes

Loss before income tax decreased 31% or \$989,000, to \$2,256,000 for the nine months ended September 30, 2016 as compared to loss before income tax of \$3,245,000 for the nine months ended September 30, 2015. The decrease in loss before income tax is primarily due to the increase in revenue of \$1,060,000, and a decrease in operating expenses of \$198,000, offset by a \$269,000 decrease in other income.

#### Income Tax Provision



Our effective tax rate for the nine months ended September 30, 2016 and 2015 was (0.5)% and (0.9)%, respectively, which resulted in a provision for income taxes of \$(11,000) and \$(28,000), respectively. The provision for income taxes relates to minimum state tax requirements.

### Segment Operating Results

The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. The information below is organized in accordance with our two reportable segments. Segment operating income (loss) is equal to segment net revenue less segment cost of revenue, sales and marketing, research and development, and general and administrative expenses.

Operating Results of our Hosted Telecommunications Services Segment (in thousands):

|                                    | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|------------------------------------|----------------------------------|-----------|---------------------------------|-----------|
| Hosted Telecommunications Services | 2016                             | 2015      | 2016                            | 2015      |
| Revenue                            | \$2,013                          | \$1,542   | \$5,711                         | \$4,287   |
| Operating expenses:                |                                  |           |                                 |           |
| Cost of revenue                    | 878                              | 799       | 2,590                           | 2,288     |
| Research and development           | 183                              | 197       | 608                             | 538       |
| Selling and marketing              | 681                              | 624       | 1,927                           | 1,793     |
| General and administrative         | 987                              | 1,041     | 3,137                           | 3,228     |
| Total operating expenses           | 2,729                            | 2,661     | 8,262                           | 7,847     |
| Operating loss                     | (716)                            | (1,119)   | (2,551)                         | (3,560)   |
| Other income/(expense)             | (11)                             | 19        | (21)                            | 58        |
| Loss before tax provision          | \$(727)                          | \$(1,100) | \$(2,572)                       | \$(3,502) |

Three months ended September 30, 2016 compared to three months ended September 30, 2015

### Revenue

Hosted Telecommunications Services segment revenue increased 31% or \$471,000, to \$2,013,000 for the three months ended September 30, 2016 as compared to \$1,542,000 for the three months ended September 30, 2015. Revenue from recurring and one-time services increased \$434,000 and equipment sales increased \$65,000. Sales-type lease and associated interest revenue decreased \$28,000 as the Company no longer provides equipment leasing for customers. Customers either purchase devices or lease them through a third-party leasing company. A substantial portion of Hosted Telecommunications Services segment revenue is generated through thirty-six to sixty month service contracts. As such, we believe growth in Hosted Telecommunications Services segment will initially be seen through increases in our backlog. Backlog represents the total contract value of all contracts signed, less revenue recognized from those contracts as of September 30, 2016 and 2015.

Below is a table which displays the Hosted Telecommunications Services segment revenue backlog as of July 1, 2016 and 2015, and September 30, 2016 and 2015, which we expect to recognize as revenue within the next thirty-six to

sixty months (in thousands):

|   |          |
|---|----------|
| Hosted Telecommunications Services backlog as of July 1, 2016       | \$15,434 |
| Hosted Telecommunications Services backlog as of September 30, 2016 | \$15,957 |
| Hosted Telecommunications Services backlog as of July 1, 2015       | \$11,283 |
| Hosted Telecommunications Services backlog as of September 30, 2015 | \$12,612 |



### Cost of Revenue

Cost of revenue consists primarily of fees we pay to third-party telecommunications and business internet providers, costs related to installations, customer service, and the costs associated with the purchase of desktop devices phones and third party equipment. Cost of revenue increased 10% or \$79,000, to \$878,000 for the three months ended September 30, 2016 as compared to \$799,000 for the three months ended September 30, 2015. The increase in cost of revenue was primarily due to an increase in salary and benefits of \$40,000 associated with customer service and installation expenses, an increase in bandwidth of \$33,000, and an increase in equipment costs of \$6,000.

### Research and Development

Research and development expenses primarily consist of payroll and related expenses, related to the development of new hosted telecommunications features and products. Research and development salary expenses decreased 7% or \$14,000, to \$183,000 for the three months ended September 30, 2016 as compared to \$197,000 for the three months ended September 30, 2015 due to fluctuations in headcount.

### Selling and Marketing

Selling and marketing expenses consist primarily of direct sales representative salaries and benefits and the production of marketing materials. Selling and marketing expenses increased 9% or \$57,000, to \$681,000 for the three months ended September 30, 2016 as compared to \$624,000 for the three months ended September 30, 2015. The increase was primarily due to an increase in commission expenses resulting from increased sales.

### General and Administrative

General and administrative expenses consist of salaries and benefits, and related expenses for executives, administrative personnel, legal, rent, accounting and other professional services, and other general corporate expenses. General and administrative expenses decreased 5% or \$54,000, to \$987,000 for the three months ended September 30, 2016 as compared to \$1,041,000 for the three months ended September 30, 2015. Consolidated general and administrative expenses decreased 13%, or \$169,000 to \$1,140,000 for the three months ended September 30, 2016 compared to \$1,309,000 for the three months ended September 30, 2015.

### Other Income/(Expense)

Other income primarily relates to the allocated portions of interest expense and sublease rental income. Net other income/(expense) decreased 158% or \$30,000, to \$(11,000) for the three months ended September 30, 2016 as compared to \$19,000 for the three months ended September 30, 2015. The decrease is due to an increase in interest expense on notes payable.

Nine months ended September 30, 2016 compared to nine months ended September 30, 2015

### Revenue

Hosted Telecommunications Services segment revenue increased 33% or \$1,424,000, to \$5,711,000 for the nine months ended September 30, 2016 as compared to \$4,287,000 for the nine months ended September 30, 2015. Revenue from recurring and one-time services increased \$1,227,000 and desktop device sales increased \$312,000. Sales-type lease and associated interest revenue decreased \$115,000 as the Company no longer provides equipment leasing for customers. Customers either purchase devices or lease them through a third-party leasing. A substantial

portion of Hosted Telecommunications Services segment revenue is generated through thirty-six to sixty month service contracts. As such, we believe growth in Hosted Telecommunications Services segment will initially be seen through increases in our backlog. Backlog represents contracts signed with no service or payment provided at September 30, 2016 and 2015.

Below is a table which displays the Hosted Telecommunications Services segment revenue backlog as of January 1, 2016 and 2015, and September 30, 2016 and 2015, which we expect to recognize as revenue within the next thirty-six to sixty months (in thousands):

|   |          |
|---|----------|
| Hosted Telecommunications Services backlog as of January 1, 2016    | \$13,907 |
| Hosted Telecommunications Services backlog as of September 30, 2016 | \$15,957 |
| Hosted Telecommunications Services backlog as of January 1, 2015    | \$9,763  |
| Hosted Telecommunications Services backlog as of September 30, 2015 | \$12,612 |





### Cost of Revenue

Cost of revenue consists primarily of fees we pay to third-party telecommunications and business internet providers, costs related to installations, customer service, and the costs associated with the purchase of desktop devices and third party equipment. Cost of revenue increased 13% or \$302,000, to \$2,590,000 for the nine months ended September 30, 2016 as compared to \$2,288,000 for the nine months ended September 30, 2015. The increase in cost of revenue was primarily due to an increase in salary and benefit expenses of \$146,000 related to growth in our customer service department, an increase in product costs of \$67,000 related to increase in revenue, an increase in bandwidth of \$120,000, offset by a decrease in installation costs of \$31,000.

### Research and Development

Research and development expenses primarily consist of salaries and benefits, and related expenses, related to the development of new hosted telecommunications products. Research and development salary expenses increased 13% or \$70,000, to \$608,000 for the nine months ended September 30, 2016 as compared to \$538,000 for the nine months ended September 30, 2015 due to fluctuations in headcount.

### Selling and Marketing

Selling and marketing expenses consist primarily of direct sales representative salaries and benefits, dealer channel commissions, and the production of marketing materials. Selling and marketing expenses increased 8% or \$134,000, to \$1,927,000 for the nine months ended September 30, 2016 as compared to \$1,793,000 for the nine months ended September 30, 2015. The increase was primarily due to an increase in commission expense of \$177,000 which was offset by a decrease in salaries and benefits of \$37,000, and a decrease in travel, lodging, and meals of \$6,000.

### General and Administrative

General and administrative expenses consist of salaries and benefits, and related expenses for executives, administrative personnel, legal, rent, accounting and other professional services, and other general corporate expenses. General and administrative expenses decreased 3% or \$91,000, to \$3,137,000 for the nine months ended September 30, 2016 as compared to \$3,228,000 for the nine months ended September 30, 2015. The decrease in general and administrative expenses is primarily due to a company-wide reduction in general and administrative expenses as we continue to cut unnecessary expenses. Consolidated general and administrative expenses decreased 13%, or \$539,000 to \$3,705,000 for the nine months ended September 30, 2016 compared to \$4,244,000 for the nine months ended September 30, 2015. As Web Services revenue decreased significantly for nine months ended September 30, 2016, we allocated less of the general and administrative expenses to the Web Services segment and more expenses to the Hosted Telecommunications Services segment.

### Other Income/(Expense)

Other income primarily relates to the allocated portions of interest expense and sublease rental income. Other income decreased 136% or \$79,000, to \$(21,000) for the nine months ended September 30, 2016 as compared to \$58,000 for the nine months ended September 30, 2015. The decrease is due to an increase in interest expense on notes payable.



## Operating Results of Web Services segment (in thousands):

|                             | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |         |
|-----------------------------|-------------------------------------|-------|------------------------------------|---------|
| Web Services                | 2016                                | 2015  | 2016                               | 2015    |
| Revenue                     | \$320                               | \$430 | \$1,063                            | \$1,427 |
| Operating expenses:         |                                     |       |                                    |         |
| Cost of revenue             | 54                                  | 83    | 172                                | 310     |
| Research and development    | 6                                   | 12    | 26                                 | 39      |
| Selling and marketing       | -                                   | -     | -                                  | 14      |
| General and administrative  | 153                                 | 268   | 568                                | 1,016   |
| Total operating expenses    | 213                                 | 363   | 766                                | 1,379   |
| Operating income            | 107                                 | 67    | 297                                | 48      |
| Other income                | 3                                   | -     | 19                                 | 209     |
| Income before tax provision | \$110                               | \$67  | \$316                              | \$257   |

Three months ended September 30, 2016 compared to three months ended September 30, 2015

## Revenue

Revenue from Web Services is generated primarily through website hosting, professional services, and EPTAs. Web Services segment revenue decreased 26% or \$110,000, to \$320,000 for the three months ended September 30, 2016 as compared to \$430,000 for the three months ended September 30, 2015. The decrease in revenue from the prior year is primarily related to the decrease in cash collected on EPTAs of \$36,000, a decrease of \$19,000 from web management professional services, and a decrease in hosting revenue of \$55,000.

## Cost of Revenue

Cost of revenue consists primarily of bandwidth, customer service costs, and outsourcing fees related to fulfillment of our professional web management services and customer service costs. Cost of revenue decreased 35% or \$29,000, to \$54,000 for the three months ended September 30, 2016 as compared to \$83,000 for the three months ended September 30, 2015. The decrease is primarily related to a decrease in costs related to providing professional web management services of \$15,000 and a reduction in customer service salaries and benefits of \$14,000.

## Research and Development

Research and development expenses primarily consist of payroll and related expenses which are attributable to the development of our website development software products. Research and development expenses decreased 50% or \$6,000, to \$6,000 for the three months ended September 30, 2016 as compared to \$12,000 for the three months ended September 30, 2015. The decrease was related to a reduction of payroll and related expenses.

## General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting and other professional services, and other general corporate expenses. General and administrative expenses decreased 43% or \$115,000, to \$153,000 for the three months ended September 30, 2016 as compared to \$268,000 for the three months ended September 30, 2015. The decrease in general and administrative expenses is primarily due to less of an allocation of corporate general and administrative expenses resulting from the 26% decrease in revenue for the period, and a company-wide reduction in general and administrative expenses as we continue to cut unnecessary expenses. Consolidated general and administrative expenses decreased 13%, or \$169,000 to \$1,140,000 for the three months ended September 30, 2016 compared to \$1,309,000 for the three months ended September 30, 2015.

#### Other Income

Other income increased \$3,000, to \$3,000 for the three months ended September 30, 2016 as compared to \$0 for the three months ended September 30, 2015. This increase is primarily related to an increase in foreign exchange gain of \$9,000, offset by a decrease in interest income of \$2,000, and an increase in interest expense on notes payable of \$4,000.



Nine months ended September 30, 2016 compared to nine months ended September 30, 2015

#### Revenue

Revenue from Web Services is generated primarily through website hosting, professional services, and EPTAs. Web Services segment revenue decreased 26% or \$364,000, to \$1,063,000 for the nine months ended September 30, 2016 as compared to \$1,427,000 for the nine months ended September 30, 2015. The decrease in revenue from the prior year is primarily related to the decrease in cash collected on EPTAs of \$104,000, a decrease of \$75,000 from web management professional services, and a decrease in hosting revenue of \$185,000.

#### Cost of Revenue

Cost of revenue consists primarily of bandwidth, customer service costs, and outsourcing fees related to fulfillment of our professional web management services. Cost of revenue decreased 45% or \$138,000, to \$172,000 for the nine months ended September 30, 2016 as compared to \$310,000 for the nine months ended September 30, 2015. The cost of revenue decrease is directly related to the reduction in revenue.

#### Research and Development

Research and development expenses primarily consist of salaries and benefits, and related expenses which are attributable to the development of our website development software products. Research and development expenses decreased 33% or \$13,000, to \$26,000 for the nine months ended September 30, 2016 as compared to \$39,000 for the nine months ended September 30, 2015. The decrease was related to a reduction of payroll and related expenses.

#### Selling and Marketing

Selling and marketing expenses consist primarily of salaries and benefits, commissions as well as advertising expenses. Selling and marketing expense decreased 100% or \$14,000, to \$0 for the nine months ended September 30, 2016 as compared to \$14,000 for the nine months ended September 30, 2015. The decrease is attributed to our shift in focus to our hosted telecommunication services segment.

#### General and Administrative

General and administrative expenses consist of salaries and benefits, and related expenses for executives, administrative personnel, legal, rent, accounting and other professional services, and other general corporate expenses. General and administrative expenses decreased 44% or \$448,000, to \$568,000 for the nine months ended September 30, 2016 as compared to \$1,016,000 for the nine months ended September 30, 2015. The decrease in general and administrative expenses is primarily due to less of an allocation of corporate general and administrative expenses resulting from the 26% decrease in revenue for the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015, and a company-wide reduction in general and administrative expenses as we continue to cut unnecessary expenses. Consolidated general and administrative expenses decreased 13%, or \$539,000 to \$3,705,000 for the nine months ended September 30, 2016 compared to \$4,244,000 for the nine months ended September 30, 2015.

#### Other Income

Other income decreased 91% or \$190,000, to \$19,000 for the nine months ended September 30, 2016 as compared to \$209,000 for the nine months ended September 30, 2015. This decrease is primarily related to the reversal of certain

legal accruals totaling \$193,000 during the nine months ended September 30, 2016 that were determined to no longer have a reasonable possibility of being paid out.

#### Liquidity and Capital Resources

The Company has transformed into a start-up company with the inherent risks and uncertainties of funding operations until profitability is achieved. We currently plan to fund our operations during the next twelve months using our cash and cash equivalents of \$854,000. However, after considering the Company's historical negative cash flows from operating activities as well as internal forecasts, such amount does not appear adequate to fund our anticipated cash needs for the next twelve months. Accordingly, the Company will be required to obtain additional debt or equity financing such as that available from its CEO to sustain operations. The Company received a commitment from the CEO, and majority shareholder, in November 2016 that in addition to the \$1,000,000 available under the note payable agreement, he would exercise all warrants received in connection with the note payable agreement dated December 30, 2015 (Note 8) if additional capital is necessary to fund operations through December 31, 2017. Based on such commitment, along with its cash resources and loan borrowing availability, the Company believes it will have sufficient funds to sustain its operations during the next twelve months as a result of the sources of funding detailed above.





#### Working Capital

Working capital decreased 129% or \$1,284,000, to \$(286,000) as of September 30, 2016 as compared to \$998,000 for the year ended December 31, 2015. The decrease in working capital was primarily related to the decrease in cash and cash equivalents of \$643,000, a decrease in restricted cash of \$12,000, a decrease in trade receivables, net of allowance for doubtful accounts of \$61,000, a decrease in inventories of \$10,000, a decrease in prepaid expenses of \$184,000, an increase in accounts payable of \$232,000, an increase in accrued expenses of \$129,000, an increase in notes payable, current portion of \$41,000, and an increase in deferred revenue, current portion of \$52,000, offset by the final payment of contingent consideration of \$99,000 during the nine months ended September 30, 2016.

#### Cash and Cash Equivalents

Cash and cash equivalents decreased 43% or \$643,000, to \$854,000 at September 30, 2016 as compared to \$1,497,000 as of December 31, 2015. During the nine months ended September 30, 2016, we used \$737,000 for operating activities, investing activities provided \$11,000, and financing activities provided \$83,000.

#### Trade Receivables

Current and long-term trade receivables, net of allowance for doubtful accounts, decreased 22% or \$96,000, to \$349,000 at September 30, 2016 as compared to \$445,000 at December 31, 2015. Long-term trade receivables, net of allowance for doubtful accounts, decreased 43% or \$35,000, to \$46,000 at September 30, 2016 as compared to \$81,000 at December 31, 2015. In prior years, we offered our customers an installment contract with payment terms between 24 and 36 months, as one of several payment options. The payments that become due more than 12 months after the end of the reporting period are classified as long-term trade receivables. The decrease in our accounts receivable balance is primarily related to balances with our third-party leasing companies.

#### Accounts Payable

Accounts payable increased 305% or \$232,000, to \$308,000 at September 30, 2016 as compared to \$76,000 at December 31, 2015. Our accounts payable as of September 30, 2016 were generally within our vendors' terms of payment. The increase is primarily related to the timing of check processing schedule.

#### Notes Payable

Notes payables increased 5% or \$49,000, to \$1,071,000 at September 30, 2016 as compared to \$1,022,000 at December 31, 2015. The increase is primarily related to financing of annual contract and amortization of debt discounts.

#### Capital

Total stockholders' equity decreased 69% or \$1,511,000, to \$693,000 at September 30, 2016 as compared to \$2,204,000 at December 31, 2015. The significant changes in stockholders' equity during the nine months ended September 30, 2016 included net loss of \$2,267,000, offset by an increase of additional paid-in capital of \$504,000 for stock options issued to employees, \$102,000 for the exercise of warrants, \$9,000 for the exercise of employee stock options, \$101,000 in common stock issued for annual interest payment on note payable, and \$40,000 issued to settle contingent consideration obligations.

#### Off Balance Sheet Arrangements

As of September 30, 2016, we are not involved in any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

#### Impact of Recent Accounting Pronouncements

The information set forth under Note 1 to the condensed consolidated financial statements under the caption "Recent Accounting Pronouncements" is incorporated herein by reference.



#### Forward-Looking Statements and Factors That May Affect Future Results and Financial Condition

With the exception of historical facts, the statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which reflect our current expectations and beliefs regarding our future results of operations, performance and achievements. These statements are subject to risks and uncertainties and are based upon assumptions and beliefs that may or may not materialize. These forward-looking statements include, but are not limited to, statements concerning:

our belief that our target market will increasingly look to Internet solutions providers who leverage industry and customer practices, increase predictability of success of their Internet initiatives and decrease implementation risks by providing low-cost, scalable solutions with minimal lead time;

our belief that we can compete successfully by relying on our infrastructure and marketing strategies as well as techniques, systems and procedures, and by adding additional products and services in the future;

our belief that we can continue our success by periodic review and revision of our methods of doing business and by continuing our expansion into domestic and international markets;

our belief that a key component of our success comes from a number of new, recently developed proprietary technologies and that these technologies and advances distinguish our services and products from our competitors and further help to substantially reduce our operating costs and expenses;

our contention that we do not offer our customers a "business opportunity" or a "franchise" as those terms are defined in applicable statutes of the states in which we operate;

our belief that there is a large, fragmented and under-served population of small businesses and entrepreneurs searching for professional services firms that offer business-to-consumer e-commerce solutions coupled with support and continuing education;

our expectation that our offering of products and services will evolve as some products are replaced by new and enhanced products intended to help our customers achieve success with their Internet-related businesses; and

our expectation that the costs and expenses we incur will be insignificant as deferred revenue amounts are recognized as product and other revenues when cash is collected.

We caution readers that our operating results are subject to various risks and uncertainties that could cause our actual results and outcomes to differ materially from those discussed or anticipated, including changes in economic conditions and internet technologies, interest rate fluctuations, and the factors set forth in the section entitled, "Risk Factors," under Part I, Item 1A of the 2015 Form 10-K. We also advise readers not to place any undue reliance on the forward-looking statements contained in this Form 10-Q, which reflect our beliefs and expectations only as of the date of this Report. We assume no obligation to update or revise these forward-looking statements to reflect new events or circumstances or any changes in our beliefs or expectations, other than as required by law.

Item 3.

Quantitative and Qualitative Disclosures about Market Risk

Not required

Item 4.

Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended

(the “Exchange Act’)) as of the end of the period covered by this Report, have concluded that, based on the evaluation of these controls and procedures, our disclosure controls and procedures were effective.

**Changes in Internal Control over Financial Reporting**

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the nine months ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



PART II - OTHER INFORMATION

Item 1.

Legal Proceedings

From time to time, we are involved in lawsuits, claims, investigations and proceedings that arise in the ordinary course of business. There are no matters pending or threatened that we expect to have a material adverse impact on our business, results of operations, financial condition or cash flows.

Item 1A.

Risk Factors

There are many risk factors that may affect our business and the results of our operations, many of which are beyond our control. Information on certain risks that we believe are material to our business is set forth in “Part I – Item 1A. Risk Factors” of the 2015 Form 10-K.

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 6.

Exhibits

Exhibits

- 31.1 Certification of Chief Executive Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities and Exchange Act of 1934, as amended
- 31.2 Certification of Chief Financial Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities and Exchange Act of 1934, as amended
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

101.INS\* XBRL INSTANCE DOCUMENT

101.SCH\* XBRL TAXONOMY EXTENSION SCHEMA DOCUMENT

101.CAL\* XBRL TAXONOMY EXTENSION CALCULATION LINKBASE DOCUMENT

101.DEF\* XBRL TAXONOMY EXTENSION DEFINITION LINKBASE DOCUMENT

101.LAB\* XBRL TAXONOMY EXTENSION LABEL LINKBASE DOCUMENT

101.PRE\* XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE DOCUMENT

In accordance with Rule 406T of Regulation S-T, these XBRL (eXtensible Business Reporting Language) documents are furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under these sections.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Crexendo, Inc.

November 11, 2016 By: /s/ Steven G. Mihaylo  
Steven G. Mihaylo  
Chief Executive Officer

November 11, 2016 By: /s/ Ronald Vincent  
Ronald Vincent  
Chief Financial Officer