

Crexendo, Inc.
Form 10-Q
November 01, 2017

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, 2017

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)

Nevada 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)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file 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, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer”, “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (check one).

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
		Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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, 2017 was 14,275,555.

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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, 2017 December 31, 2016

Assets

Current assets:

Cash and cash equivalents	\$1,207	\$619
Restricted cash	100	100
Trade receivables, net of allowance for doubtful accounts of \$27 as of September 30, 2017 and \$34 as of December 31, 2016	387	346
Inventories	153	170
Equipment financing receivables	126	121
Prepaid expenses	469	686
Other current assets	8	8
Total current assets	2,450	2,050
Certificate of deposit	-	252
Long-term trade receivables, net of allowance for doubtful accounts of \$10 as of September 30, 2017 and \$13 as of December 31, 2016	33	43
Long-term equipment financing receivables	78	176
Property and equipment, net	10	18
Intangible assets, net	262	335
Goodwill	272	272
Long-term prepaid expenses	171	251
Other long-term assets	122	136
Total assets	\$3,398	\$3,533

Liabilities and Stockholders' Equity

Current liabilities:

Accounts payable	\$63	\$116
Accrued expenses	936	997
Notes payable, current portion	98	66
Income taxes payable	9	5
Deferred revenue, current portion	984	809
Total current liabilities	2,090	1,993

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Deferred revenue, net of current portion	33	43
Notes payable, net of current portion	43	966
Other long-term liabilities	-	16
Total liabilities	2,166	3,018
Stockholders' equity:		
Preferred stock, par value \$0.001 per share - authorized 5,000,000 shares; none issued	—	—
Common stock, par value \$0.001 per share - authorized 25,000,000 shares, 14,275,555 shares issued and outstanding as of September 30, 2017 and 13,578,556 shares issued and outstanding as of December 31, 2016	14	14
Additional paid-in capital	60,446	58,716
Accumulated deficit	(59,228)	(58,215)
Total stockholders' equity	1,232	515
Total Liabilities and Stockholders' Equity	\$3,398	\$3,533

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 September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Service revenue	\$2,305	\$1,946	\$6,552	\$5,606
Product revenue	385	387	967	1,168
Total revenue	2,690	2,333	7,519	6,774
Operating expenses:				
Cost of service revenue	709	776	2,106	2,279
Cost of product revenue	152	156	384	483
Selling and marketing	734	681	2,133	1,927
General and administrative	955	1,140	3,135	3,705
Research and development	194	189	569	634
Total operating expenses	2,744	2,942	8,327	9,028
Loss from operations	(54)	(609)	(808)	(2,254)
Other income/(expense):				
Interest income	3	4	8	12
Interest expense	(135)	(39)	(206)	(105)
Other income, net	5	27	9	91
Total other income/(expense), net	(127)	(8)	(189)	(2)
Loss before income tax	(181)	(617)	(997)	(2,256)
Income tax provision	(8)	(4)	(16)	(11)
Net loss	\$(189)	\$(621)	\$(1,013)	\$(2,267)
Net loss per common share:				
Basic	\$(0.01)	\$(0.05)	\$(0.07)	\$(0.17)
Diluted	\$(0.01)	\$(0.05)	\$(0.07)	\$(0.17)
Weighted-average common shares outstanding:				
Basic	13,951,480	13,411,569	13,824,307	13,316,277
Diluted	13,951,480	13,411,569	13,824,307	13,316,277

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, 2017

(In thousands, except share data)

(unaudited)

	Common Stock		Additional		Total
			Paid-in	Accumulated	Stockholders'
	Shares	Amount	Capital	Deficit	Equity
Balance, January 1, 2017	13,578,556	\$14	\$58,716	\$(58,215)	\$515
Share-based compensation	27,000		481		481
Issuance of common stock for exercise of stock option	594,999		1,140		1,140
Issuance of common stock for interest on related party note payable	75,000		109		109
Net loss				(1,013)	(1,013)
Balance, September 30, 2017	14,275,555	\$14	\$60,446	\$(59,228)	\$1,232

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 September 30,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$(1,013)	\$(2,267)
Adjustments to reconcile net loss to net cash used for operating activities:		
Amortization of prepaid rent	54	242
Depreciation and amortization	81	110
Non-cash interest expense	198	18
Share-based compensation	481	504
Amortization of deferred gain	(16)	(70)
Changes in assets and liabilities:		
Trade receivables	(31)	96
Equipment financing receivables	93	119
Inventories	17	10
Prepaid expenses	244	81
Other assets	14	38
Accounts payable and accrued expenses	(114)	361
Income tax payable	4	4
Deferred revenue	165	17
Net cash (used for)/provided by operating activities	177	(737)
CASH FLOWS FROM INVESTING ACTIVITIES		
Sale of certificate of deposit	252	-
Purchase of long-term investment	-	(1)
Release of restricted cash	-	12
Net cash provided by investing activities	252	11
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from notes payable	111	150
Repayments made on notes payable	(1,092)	(119)
Proceeds from exercise of options	1,140	9
Proceeds from exercise of warrants	-	102
Payment of contingent consideration	-	(59)
Net cash provided by financing activities	159	83
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	588	(643)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD	619	1,497

CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	\$1,207	\$854
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Supplemental disclosure of cash flow information:

Cash used during the period for:

Income taxes, net	\$(12)	\$(2)
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Supplemental disclosure of non-cash investing and financing information:

Issuance of common stock for prepayment of interest on related-party note payable	\$109	\$101
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Issuance of common stock for contingent consideration related to business acquisition	\$-	\$40
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Prepaid assets financed through notes payable	\$111	\$-
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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 Nevada. 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 next generation CLEC and an award-winning leader and provider of UCaaS cloud telecom services, broadband internet services, and other cloud business services that are designed to provide enterprise-class cloud services to any size businesses at affordable monthly rates. The Company has two operating segments, which consist of Cloud Telecommunications and Web Services.

The Company continues to generate losses. However, revenue for the nine month period ended September 30, 2017 increased compared to the nine month period ended September 30, 2016 and management continues to focus on managing expenses and reducing cash used for operations. Our net losses for the three and nine month periods ended September 30, 2017 showed improvement over the comparable three and nine month periods ended September 30, 2016. Management evaluated the significance of the negative cash flows and believes that the operational improvements are probable of occurring and the borrowing availability under the existing Loan Agreement mitigate the substantial doubt raised by our historical operating results and satisfying our estimated liquidity needs 12 months from the issuance of the financial statements. However, management cannot predict, with certainty, the outcome of our actions to generate liquidity or whether such actions would generate the expected liquidity as currently planned.

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 (“GAAP”) and pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”), 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, 2016. Because these financial statements address interim periods, they do not include all of the information and footnotes required by U.S. GAAP 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, 2017 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, 2016.

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, 2017 and December 31, 2016, we had cash and cash equivalents in financial institutions in excess of federally insured limits in the amount of \$1,003,000 and \$413,000, respectively.

Restricted Cash – We classified \$100,000 and \$100,000 as restricted cash as of September 30, 2017 and December 31, 2016, respectively. Cash is restricted for compensating balance requirements on purchasing card agreements. As of September 30, 2017 and December 31, 2016, we had restricted cash in financial institutions in excess of federally

insured limits in the amount of \$100,000 and \$100,000, respectively.

Trade Receivables – Trade receivables from our Cloud 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 net realizable value (first-in, first-out method). In accordance with applicable accounting guidance, we regularly evaluate whether inventory is stated at the lower of cost or net realizable value. If net realizable value is less than cost, the difference is recognized as a loss in earnings in the period in which it occurs.

Certificate of Deposit - Certificate of Deposit (“CD”) is collateral for merchant accounts. The CD was classified as long-term in the condensed consolidated balance sheet at December 31, 2016. In March 2017, the bank removed the collateral requirement; therefore we sold the CD and transferred the proceeds to our cash and cash equivalents.

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 \$2,000 and \$3,000 for the three months ended September 30, 2017 and 2016, respectively and \$8,000 and \$12,000 for the nine months ended September 30, 2017 and 2016, 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 period.

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.

Service and Product 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 Cloud Telecommunications 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.

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 such as 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.

Cloud Telecommunications and Web Service Revenue - Fees collected for cloud telecommunications and website hosting services are recognized as revenue 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 cloud telecommunications services begin.

Fees generated from renting our cloud telecommunication equipment (IP or cloud telephone desktop 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 Service Revenue – Cost of service includes Cloud Telecommunications and Web Services cost of service revenue. Cloud Telecommunications cost of service revenue primarily consists of fees we pay to third-party telecommunications and business Internet providers, costs of other third party services we resell, personnel and travel expenses related to system implementation, and customer service. Web Services cost of service revenue consists primarily of customer service costs and outsourcing fees related to fulfillment of our professional web management services.

Cost of Product Revenue – Cost of product revenue primarily consists of the costs associated with the purchase of desktop devices and other third party equipment we purchase for resale.

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.

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, 2017 and 2016.

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 Cloud Telecommunications and Web Services. Research and development expenses are allocated to Cloud Telecommunications and Web Services segments based on the level of effort, measured primarily by wages and benefits attributed to our engineering department. 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, 2017 and 2016. One telecom customer accounted for 10% of our total trade accounts receivable as of September 30, 2017 and one telecom customer accounted for 11% of total trade accounts receivable as of December 31, 2016.

Recently Adopted Accounting Pronouncements - In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, Compensation - Stock Compensation (Topic 718), improvement to employee share-based payment accounting. The new standard contains several amendments that will simplify the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, statutory tax withholding requirements, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The changes in the new standard eliminate the accounting for excess tax benefits to be recognized in additional paid-in capital and tax deficiencies recognized either in the income tax provision or in additional paid-in capital. The Company elected early adoption of ASU 2016-09 in 2016. Due to the Company's valuation allowance on its deferred tax assets, no income tax benefit was recognized in 2016 as a result of the adoption of ASU 2016-09. There was no change to retained earnings with respect to excess tax benefits, as this is not applicable to the Company. The treatment of forfeitures has not changed as we are electing to continue our current process of estimating the number of forfeitures. As such, this has no cumulative effect on retained earnings. With the early adoption of 2016-09, we have elected to present the cash flow statement on a prospective transition method and no prior periods have been adjusted.

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) and early adoption is permitted. ASU 2015-17 may be either applied prospectively to all deferred tax assets and liabilities or retrospectively to all periods presented. We elected to early adopt ASU 2015-17 prospectively in the fourth quarter of 2016. As a result, we have presented all deferred tax assets and liabilities as noncurrent on our consolidated balance sheet as of June 30, 2017 and December 31, 2016. There was no impact on our results of operations as a result of the adoption of ASU 2015-17.

In September 2015, the FASB issued ASU 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 an impact on our consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, Inventory, which will require an entity to measure in scope inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using LIFO or the retail inventory method. The amendments do not apply to inventory that is measured using last-in, first-out (LIFO) or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out (FIFO) or average cost. We adopted this guidance effective January 1, 2017. The adoption of this guidance did not have an 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 an 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). We adopted this guidance on December 31, 2016 and management assessed the entity’s ability to continue as a going concern. After considering the Company’s historical negative cash flow from operating activities as well as a range of internal forecast outcomes, our cash and cash equivalents of \$619,000 at December 31, 2016 does not appear adequate to meet our obligations as they become due within one year following the date the financial statements are issued. Management evaluated the significance of the potential negative cash flows and determined that borrowing availability under an existing Loan Agreement would be sufficient to alleviate concerns about the Company’s ability to continue as a going concern, the Company entered into an amendment to our Loan Agreement with Steven G. Mihaylo, extending the ability of the Board of Directors to request the remaining \$1.0 million available under the Loan Agreement if necessary to fund operations through May 30, 2018. Substantial doubt was alleviated as a result of considerations of management’s plans. Certain disclosures were added to comply with the disclosure requirements of the ASU.

In June 2014, the FASB issued ASU 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 adopted ASU 2014-12 effective January 1, 2017. The adoption of this ASU did not impact our condensed consolidated financial statements for the three and nine months ended September 30, 2017, as there are no performance targets associated with outstanding awards.

Recently Issued Accounting Pronouncements – In May 2017, the FASB issued ASU 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting, the amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. Effective for all entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. 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 January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, which eliminates Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. This guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15,

2019. Early adoption is permitted. ASU 2017-04 should be adopted on a prospective basis. We are in the process of evaluating the adoption and potential impact of this new ASU on our consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. As a result, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments do not provide a definition of restricted cash or restricted cash equivalents. This guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The amendments should be applied using a retrospective transition method to each period presented. The adoption of this new ASU will not have a material impact on our consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, 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 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 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 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, 2017 and 2016 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 September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net loss (in thousands)	\$(189)	\$(621)	\$(1,013)	\$(2,267)
Weighted-average share reconciliation:				
Weighted-average basic shares outstanding	13,951,480	13,411,569	13,824,307	13,316,277

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Diluted shares outstanding	13,951,480	13,411,569	13,824,307	13,316,277
Net loss per common share:				
Basic	\$(0.01)	\$(0.05)	\$(0.07)	\$(0.17)
Diluted	\$(0.01)	\$(0.05)	\$(0.07)	\$(0.17)

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, 2017 and 2016, the common stock equivalent shares were, as follows:

	September 30, 2017	September 30, 2016
Shares of common stock issuable under equity incentive plans outstanding	3,598,710	3,935,812
Shares of common stock issuable upon conversion of warrants	-	165,000
Common stock equivalent shares excluded from diluted net loss per share	3,598,710	4,100,812

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,
	2017	2016
Trade receivables	\$409	\$366
Conforming EPTAs	43	66
Non-Conforming EPTAs:		
1 - 30 days	5	4
31 - 60 days	-	-
61 - 90 days	-	-
Gross trade receivables	457	436
Less: allowance for doubtful accounts	(37)	(47)
Trade receivables, net	\$420	\$389
Current trade receivables, net	\$387	\$346
Long-term trade receivables, net	33	43
Trade receivables, net	\$420	\$389

All current and long-term EPTAs in the table above had original contract terms of greater than one year. The Company wrote off \$3,000 of EPTAs during the nine months ended September 30, 2017 and \$37,000 during the year ended December 31, 2016, of which, all had original contract terms of greater than one year.

4.

Equipment Financing Receivables

We rent certain cloud 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 cloud telecommunication equipment through sales-type leases, were as follows (in thousands):

	September 30,	December 31,
	2017	2016

Gross financing receivables	\$332	\$573
Less unearned income	(128)	(276)
Financing receivables, net	204	297
Less: Current portion of finance receivables, net	(126)	(121)
Finance receivables due after one year	\$78	\$176

5.
Prepaid Expenses

Prepaid expenses consisted of the following (in thousands):

	September 30,	December 31,
	2017	2016
Prepaid commissions	\$449	\$503
Prepaid corporate insurance	69	45
Prepaid inventory deposits	34	156
Other prepaid expenses	88	233
Total prepaid assets	\$640	\$937

Included in the totals above is \$171,000 and \$251,000 of long-term prepaid commissions as of September 30, 2017 and December 31, 2016, respectively.

6.
Intangible Assets

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

	September 30,	December 31,
	2017	2016
Customer relationships	\$941	\$941
Developed technology	198	198
Less accumulated amortization:		
Customer relationships	(679)	(607)
Developed technology	(198)	(197)
Total	\$262	\$335

Amortization expense is included in general and administrative expenses and totaled \$24,000 and \$33,000 for the three months ended September 30, 2017 and 2016, respectively, and \$73,000 and \$98,000 for the nine months ended September 30, 2017 and 2016, respectively.

7.
Accrued Expenses

Accrued expenses consisted of the following (in thousands):

September 30, December 31,

	2017	2016
Accrued wages and benefits	\$359	\$369
Accrued accounts payable	174	230
Accrued sales and telecommunications taxes	321	310
Other	82	88
Total accrued expenses	\$936	\$997

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. The initial 250,000 warrants were exercised during 2016 generating proceeds of \$300,000. 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.

In February 2017, the Company entered into a second amendment to our Loan Agreement with Steven G. Mihaylo. The amendment extends the ability of the Board of Directors to request the remaining \$1.0 million available under the Loan Agreement if necessary to fund operations through May 30, 2018. All other terms remain the same as initial loan agreement.

In September 2017, Steven G. Mihaylo exercised 444,999 options for a total strike price of \$974,000. The Company used the proceeds from the stock options exercise to repay \$974,000 of the \$1.0 million outstanding related-party note payable. During the three month period ended September 30, 2017, the Company accelerated the amortization of the debt discount in the amount of \$75,000 and prepaid interest of \$34,000.

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,

	2017	2016
Related-party note payable	\$26	\$1,000
Other notes payable	117	124
	143	1,124
Less: notes payable discount	(2)	(92)
Net carrying value of notes payable	141	1,032
Less: current portion of long-term notes payable	(98)	(66)
Long-term notes payable	\$43	\$966

As of September 30, 2017, future principal payments are scheduled as follows (in thousands):

Year ending December 31,

2017	\$22
2018	89
2019	6
2020	26
Total	\$143

9.

Fair Value Measurements

We have financial instruments as of September 30, 2017 and December 31, 2016 for which the fair value is summarized below (in thousands):

	September 30, 2017		December 31, 2016	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets:				
Trade receivables, net	\$420	\$420	\$389	\$389
Equipment financing receivables	204	204	297	297
Certificate of deposit	—	—	252	252
Liabilities:				
Notes payable including discount from warrant grant	141	153	1,032	1,133

Assets for which fair value is recognized in the balance sheet on a recurring basis are summarized below as of September 30, 2017 and December 31, 2016 (in thousands):

Description	September 30, 2017	Fair value measurement at reporting date		
		Level 1	Level 2	Level 3
Assets:				
Certificate of deposit	\$-	\$-	\$-	\$-
Description	December 31, 2016	Level 1	Level 2	Level 3
Assets:				
Certificate of deposit	\$252	\$-	\$252	\$-

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

10.

Income Taxes

Our effective tax rate for the three and nine months ended September 30, 2017 was (4.4)% and (1.6)%, respectively, which resulted in an income tax provision of \$(8,000) and \$(16,000), respectively. The tax provision is for state tax payments made with extensions filed.

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 for 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.

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11. Commitments and Contingencies

Operating Leases

We lease certain of our corporate offices under a non-cancelable operating lease agreement expiring in 2018. The operating lease for our Reno, NV office contains customary escalation clauses. Rent expense incurred on operating leases for the three months ended September 30, 2017 and 2016 was approximately \$5,000 and \$87,000, respectively. Rent expense incurred on operating leases for the nine months ended September 30, 2017 and 2016 was approximately \$15,000 and \$261,000, respectively.

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 was amortized over the initial lease term of 36 months to offset rent expense. Deferred gain amortization for the three months ended September 30, 2017 and 2016 was \$0 and \$23,000, respectively. Deferred gain amortization for the nine months ended September 30, 2017 and 2016 was \$16,000 and \$70,000, respectively.

Effective March 1, 2017 the rent agreement was renewed for a three year term with rent payable in cash. Rent expense incurred on the sale-leaseback during the three months ended September 30, 2017 and 2016 was \$75,000 and \$57,000, respectively. Rent expense incurred on the sale-leaseback during the nine months ended September 30, 2017 and 2016 was \$213,000 and \$171,000, respectively.

Future aggregate minimum lease obligations under the operating lease and sale-leaseback as of September 30, 2017, exclusive of taxes and insurance, are as follows (in thousands):

Year ending December 31,

2017	\$80
2018	315
2019	300
2020	50
Total	\$745

12. Segments

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenue:				
Cloud telecommunications	\$2,427	\$2,013	\$6,704	\$5,711
Web services	263	320	815	1,063
Consolidated revenue	2,690	2,333	7,519	6,774
Income/(loss) from operations:				
Cloud telecommunications	(196)	(716)	(1,185)	(2,551)
Web services	142	107	377	297
Total operating loss	(54)	(609)	(808)	(2,254)
Other income/(expense), net:				
Cloud telecommunications	(122)	(11)	(184)	(21)
Web services	(5)	3	(5)	19
Total other income/(expense), net	(127)	(8)	(189)	(2)
Income/(loss) before income tax provision				
Cloud telecommunications	(318)	(727)	(1,369)	(2,572)
Web services	137	110	372	316
Loss before income tax provision	\$(181)	\$(617)	\$(997)	\$(2,256)

Depreciation and amortization was \$23,000 and \$31,000 for the Cloud Telecommunications segment for the three months ended September 30, 2017 and 2016, respectively. Depreciation and amortization was \$73,000 and \$94,000 for the Cloud Telecommunications segment for the nine months ended September 30, 2017 and 2016, respectively. Depreciation and amortization was \$3,000 and \$5,000 for the Web Services segment for the three months ended September 30, 2017 and 2016, respectively. Depreciation and amortization was \$8,000 and \$16,000 for the Web Services segment for the nine months ended September 30, 2017 and 2016, respectively.

Interest income was \$3,000 and \$4,000 for the Web Services segment for the three months ended September 30, 2017 and 2016, respectively. Interest income was \$8,000 and \$12,000 for the Web Services segment for the nine months ended September 30, 2017 and 2016, respectively.

Interest expense was \$123,000 and \$34,000 for the Cloud Telecommunications segment for the three months ended September 30, 2017 and 2016, respectively. Interest expense was \$186,000 and \$90,000 for the Cloud Telecommunications segment for the nine months ended September 30, 2017 and 2016, respectively. Interest expense was \$12,000 and \$5,000 for the Web Services segment for the three months ended September 30, 2017 and 2016, respectively. Interest expense was \$20,000 and \$15,000 for the Web Services segment for the nine months ended September 30, 2017 and 2016, 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, 2016 (the “2016 Form 10-K”) filed with the SEC and the Condensed Consolidated Financial Statements and notes thereto included in the 2017 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 next generation CLEC and an award-winning leader and provider of UCaaS cloud telecom services, broadband internet services, and other cloud business services that are designed to provide enterprise-class cloud services to any size businesses at affordable monthly rates. The Company has two operating segments, which consist of Cloud Telecommunications and Web Services.

Cloud Telecommunications segment - Our cloud 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 cloud telecommunications and broadband Internet services. Our cloud 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 cloud 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.

Our Cloud Telecommunications service revenue increased 26% or \$416,000 to \$2,042,000 for the three months ended September 30, 2017 as compared to \$1,626,000 for the three months ended September 30, 2016. Cloud Telecommunications service revenue increased 26% or \$1,194,000 to \$5,737,000 for the nine months ended September 30, 2017 as compared to \$4,543,000 for the nine months ended September 30, 2016. Our Cloud Telecommunications product revenue decreased 1% or \$2,000 to \$385,000 for the three months ended September 30, 2017 as compared to \$387,000 for the three months ended September 30, 2016. Cloud Telecommunications product revenue decreased 17% or \$201,000 to \$967,000 for the nine months ended September 30, 2017 as compared to \$1,168,000 for the nine months ended September 30, 2016. As of September 30, 2017 and 2016, our backlog was \$18,264,000 and \$15,957,000, respectively.

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

Our Web Services revenue decreased 18% or \$57,000 to \$263,000 for the three months ended September 30, 2017 as compared to \$320,000 for the three months ended September 30, 2016. Web Services revenue decreased 23% or \$248,000 to \$815,000 for the nine months ended September 30, 2017 as compared to \$1,063,000 for the nine months ended September 30, 2016.

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:

Cloud Telecommunications - Our cloud telecommunications offering includes hardware and collaboration software and unified communication solutions for businesses using IP or cloud technology over any high-speed internet connection. These services are rendered through a variety of devices and user interfaces such as Crexendo branded desktop phones, mobile and desktop applications. Some examples of mobile devices are Android cell phones, iPhones, iPads or Android tablets. These services enable our customers to seamlessly communicate with others through phone calls that originate/terminate on our network or PSTN networks. Our cloud telecommunications services are powered by our proprietary implementation of standard Internet, Web and IP or cloud technologies. Our services also use our complex infrastructure that we build and manage based on industry standard best practices to achieve greater efficiencies and customer satisfaction. Our infrastructure comprises of computing, storage, network technologies, 3rd party products and vendor relationships. We also develop end user portals for account management, license management, billing and customer support and adopt other cloud technologies through our partnerships.

Crexendo's cloud 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 1, 2017 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 Income/(Loss)

(Unaudited)

Three Months Ended September 30,		Nine Months Ended September 30,	
2017	2016	2017	2016
(In thousands)		(In thousands)	

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U.S. GAAP net loss	\$(189)	\$(621)	\$(1,013)	\$(2,267)
Share-based compensation	89	153	481	504
Amortization of rent expense paid in stock, net of deferred gain	-	58	38	172
Amortization of intangible assets	24	33	73	98
Non-cash interest expense	132	37	198	94
Non-GAAP net income/(loss)	\$56	\$(340)	\$(223)	\$(1,399)
Non-GAAP net income/(loss) per common share:				
Basic	\$0.00	\$(0.03)	\$(0.02)	\$(0.11)
Diluted	\$0.00	\$(0.03)	\$(0.02)	\$(0.11)
Weighted-average common shares outstanding:				
Basic	13,951,480	13,411,569	13,824,307	13,316,277
Diluted	14,278,141	13,411,569	13,824,307	13,316,277

Reconciliation of U.S. GAAP Net Loss to EBITDA to Adjusted EBITDA

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(In thousands)		(In thousands)	
U.S. GAAP net loss	\$(189)	\$(621)	\$(1,013)	\$(2,267)
Depreciation and amortization	26	36	81	110
Interest expense	135	39	206	105
Interest and other income	(8)	(31)	(17)	(103)
Income tax provision	8	4	16	11
EBITDA	(28)	(573)	(727)	(2,144)
Share-based compensation	89	153	481	504
Amortization of rent expense paid in stock, net of deferred gain	-	58	38	172
Adjusted EBITDA	\$61	\$(362)	\$(208)	\$(1,468)

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, 2016 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 Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Service revenue	\$2,305	\$1,946	\$6,552	\$5,606
Product revenue	385	387	967	1,168
Total revenue	2,690	2,333	7,519	6,774
Loss before income taxes	(181)	(617)	(997)	(2,256)
Income tax provision	(8)	(4)	(16)	(11)
Net loss	(189)	(621)	(1,013)	(2,267)
Basic net loss per share	\$(0.01)	\$(0.05)	\$(0.07)	\$(0.17)
Diluted net loss per share	\$(0.01)	\$(0.05)	\$(0.07)	\$(0.17)

Three months ended September 30, 2017 compared to three months ended September 30, 2016

Service Revenue

Service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, broadband Internet services, website hosting, and web management services. Service revenue increased 18% or \$359,000, to \$2,305,000 for the three months ended September 30, 2017 as compared to \$1,946,000 for the three months ended September 30, 2016. Cloud Telecommunications service revenue increased 26% or \$416,000, to \$2,042,000 for the three months ended September 30, 2017 as compared to \$1,626,000 for the three months ended September 30, 2016. Web service revenue decreased 18% or \$57,000, to \$263,000 for the three months ended September 30, 2017 as compared to \$320,000 for the three months ended September 30, 2016.

Product Revenue

Product revenue consists primarily of fees collected for the sale of desktop phone devices and third party equipment. Product revenue decreased by less than 1% or \$2,000, to \$385,000 for the three months ended September 30, 2017 as compared to \$387,000 for the three months ended September 30, 2016. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence. We believe growth will initially be seen through increase in our backlog.

Loss Before Income Taxes

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Loss before income tax decreased 71% or \$436,000, to \$181,000 for the three months ended September 30, 2017 as compared to loss before income tax of \$617,000 for the three months ended September 30, 2016. The decrease in loss before income tax is primarily due to the increase in revenue of \$357,000 and a decrease in operating expenses of \$198,000, offset by an increase in other expense of \$95,000 related to interest expense from the related party note payable and decrease in sublease income of \$24,000 from fulfillment of our lease obligations.

Income Tax Provision

We had an income tax provision of \$8,000 for the three months ended September 30, 2017 compared to an income tax provision of \$4,000 for the three months ended September 30, 2016. We had a pre-tax loss for the three months ended September 30, 2017 and 2016 of \$181,000 and \$617,000, respectively, and a full valuation allowance on all of our deferred tax assets for the three months ended September 30, 2017 and 2016.

Nine months ended September 30, 2017 compared to nine months ended September 30, 2016

Service Revenue

Service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, broadband Internet services, website hosting, and web management services. Service revenue increased 17% or \$946,000, to \$6,552,000 for the nine months ended September 30, 2017 as compared to \$5,606,000 for the nine months ended September 30, 2016. Cloud Telecommunications service revenue increased 26% or \$1,194,000, to \$5,737,000 for the nine months ended September 30, 2017 as compared to \$4,543,000 for the nine months ended September 30, 2016. Web Service revenue decreased 23% or \$248,000, to \$815,000 for the nine months ended September 30, 2017 as compared to \$1,063,000 for the nine months ended September 30, 2016.

Product Revenue

Product revenue consists primarily of fees collected for the sale of desktop phone devices and third party equipment. Product revenue decreased 17% or \$201,000, to \$967,000 for the nine months ended September 30, 2017 as compared to \$1,168,000 for the nine months ended September 30, 2016. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence. We believe growth will initially be seen through increase in our backlog.

Loss Before Income Taxes

Loss before income tax decreased 56% or \$1,259,000, to \$997,000 for the nine months ended September 30, 2017 as compared to loss before income tax of \$2,256,000 for the nine months ended September 30, 2016. The decrease in loss before income tax is primarily due to the increase in revenue of \$745,000, a decrease in operating expenses of \$701,000, offset by an increase in other expense of \$95,000 related to interest expense from the related party note payable and decrease in sublease income of \$88,000 from fulfillment of our lease obligations..

Income Tax Provision

We had an income tax provision of \$16,000 for the nine months ended September 30, 2017 compared to an income tax provision of \$11,000 for the nine months ended September 30, 2016. We had a pre-tax loss for the nine months ended September 30, 2017 and 2016 of \$997,000 and \$2,256,000, respectively, and a full valuation allowance on all of our deferred tax assets for the nine months ended September 30, 2017 and 2016.

Segment Operating Results

The Company has two operating segments, which consist of Cloud Telecommunications 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 service revenue, cost of product revenue, sales and marketing,

research and development, and general and administrative expenses.

Operating Results of our Cloud Telecommunications Segment (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
Cloud Telecommunications	2017	2016	2017	2016
Service revenue	\$2,042	\$1,626	\$5,737	\$4,543
Product revenue	385	387	967	1,168
Total revenue	2,427	2,013	6,704	5,711
Operating expenses:				
Cost of service revenue	683	722	2,019	2,107
Cost of product revenue	152	156	384	483
Research and development	188	183	551	608
Selling and marketing	734	681	2,133	1,927
General and administrative	866	987	2,802	3,137
Total operating expenses	2,623	2,729	7,889	8,262
Operating loss	(196)	(716)	(1,185)	(2,551)
Other expense	(122)	(11)	(184)	(21)
Loss before tax provision	\$(318)	\$(727)	\$(1,369)	\$(2,572)

Three months ended September 30, 2017 compared to three months ended September 30, 2016

Service Revenue

Cloud Telecommunications service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, and broadband Internet services. Service revenue increased 26% or \$416,000, to \$2,042,000 for the three months ended September 30, 2017 as compared to \$1,626,000 for the three months ended September 30, 2016. The increase in service revenue is due to an increase in contracted service revenue, usage charges, and professional services revenue of \$455,000, offset by a decrease in equipment lease interest of \$26,000 and a decrease in broadband Internet revenue of \$13,000. A substantial portion of Cloud Telecommunications service revenue is generated through thirty-six to sixty month service contracts. As such, we believe growth in Cloud Telecommunications segment will initially be seen through increases in our backlog.

Product Revenue

Product revenue consists primarily of fees collected for the sale of desktop phone devices and third party equipment. Product revenue decreased 1% or \$2,000, to \$385,000 for the three months ended September 30, 2017 as compared to \$387,000 for the three months ended September 30, 2016. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence. We believe growth will initially be seen through increases in our backlog.

Backlog

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Backlog represents the total contract value of all contracts signed, less revenue recognized from those contracts as of September 30, 2017 and 2016. Below is a table which displays the Cloud Telecommunications segment revenue backlog as of July 1, 2017 and 2016, and September 30, 2017 and 2016, which we expect to recognize as revenue within the next thirty-six to sixty months (in thousands):

Cloud Telecommunications backlog as of July 1, 2017	\$18,045
Cloud Telecommunications backlog as of September 30, 2017	\$18,264
Cloud Telecommunications backlog as of July 1, 2016	\$15,434
Cloud Telecommunications backlog as of September 30, 2016	\$15,957

Cost of Service Revenue

Cost of service revenue consists primarily of fees we pay to third-party telecommunications, broadband internet, and software providers, costs related to installations, and customer service. Cost of service revenue decreased 5% or \$39,000, to \$683,000 for the three months ended September 30, 2017 as compared to \$722,000 for the three months ended September 30, 2016. The decrease in cost of service revenue was primarily due to a decrease in salary and benefits of \$57,000 associated with a reduction in customer service headcount, an \$8,000 decrease in broadband Internet costs related to a decrease in broadband Internet revenue. The decreases were offset by an increase in bandwidth costs of \$26,000 directly related to the increase in monthly recurring revenue.

Cost of Product Revenue

Cost of product revenue consists of the costs associated with the purchase of desktop phone devices and third party equipment. Cost of product revenue decreased 3% or \$4,000, to \$152,000 for the three months ended September 30, 2017 as compared to \$156,000 for the three months ended September 30, 2016 related to the decrease in product sales and from product mix.

Research and Development

Research and development expenses primarily consist of payroll and related expenses, related to the development of new cloud telecommunications features and products. Research and development salary expenses increased 3% or \$5,000, to \$188,000 for the three months ended September 30, 2017 as compared to \$183,000 for the three months ended September 30, 2016 due to fluctuations in salary and benefits.

Selling and Marketing

Selling and marketing expenses consist primarily of direct sales representative salaries and benefits, partner channel commissions, the production of marketing materials, and sales support software. Selling and marketing expenses increased 8% or \$53,000, to \$734,000 for the three months ended September 30, 2017 as compared to \$681,000 for the three months ended September 30, 2016. The increase in selling and marketing expense was due an increase in salary and benefits of \$74,000 resulting from hiring additional sales representatives to support our partner channel, and an increase in commission expenses of \$81,000 directly related to overall increase in sales and revenue, offset by a decrease in bad debt of \$34,000, a decrease in business development costs of \$28,000, and a decrease in sales support software costs of \$40,000.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting, other professional services, and other administrative corporate expenses. General and administrative expenses decreased 12% or \$121,000, to \$866,000 for the three months ended September 30, 2017 as compared to \$987,000 for the three months ended September 30, 2016. 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. Software support decreased \$64,000 resulting from utilizing more affordable software, stock options expense declined \$43,000 resulting from fully vested stock option grants, and a decrease in salary and benefits of \$14,000 resulting from a decrease in headcount.

Other Expense

Other expense primarily consists of interest expense, offset by sublease rental income. Net other expense increased 1009% or \$111,000, to \$122,000 for the three months ended September 30, 2017 as compared to \$11,000 for the three months ended September 30, 2016. We incurred interest expense on our related party long-term note payable and a decrease in sublease income resulting from completion of our lease agreement obligation in the fourth quarter of 2016 and related sub-lease.

Nine months ended September 30, 2017 compared to nine months ended September 30, 2016

Service Revenue

Cloud Telecommunications service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, and broadband Internet services. Service revenue increased 26% or \$1,194,000, to \$5,737,000 for the nine months ended September 30, 2017 as compared to \$4,543,000 for the nine months ended September 30, 2016. The increase in service revenue is due to an increase in contracted service revenue, usage charges, and professional services revenue of \$1,314,000, offset by a decrease in equipment lease interest of \$81,000 and a decrease in broadband Internet services revenue of \$39,000. A substantial portion of Cloud Telecommunications segment revenue is generated through thirty-six to sixty month service contracts. As such, we believe growth in Cloud Telecommunications segment will initially be seen through increases in our backlog.

Product Revenue

Product revenue consists primarily of fees collected for the sale of desktop phone devices and third party equipment. Product revenue decreased 17% or \$201,000, to \$967,000 for the nine months ended September 30, 2017 as compared to \$1,168,000 for the nine months ended September 30, 2016. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence. We believe growth will initially be seen through increases in our backlog.

Backlog

Backlog represents the total contract value of all contracts signed, less revenue recognized from those contracts as of September 30, 2017 and 2016. Below is a table which displays the Cloud Telecommunications segment revenue backlog as of January 1, 2017 and 2016, and September 30, 2017 and 2016, which we expect to recognize as revenue within the next thirty-six to sixty months (in thousands):

Cloud Telecommunications backlog as of January 1, 2017	\$15,921
Cloud Telecommunications backlog as of September 30, 2017	\$18,264
Cloud Telecommunications backlog as of January 1, 2016	\$13,907
Cloud Telecommunications backlog as of September 30, 2016	\$15,957

Cost of Service Revenue

Cost of service revenue consists primarily of fees we pay to third-party telecommunications, broadband internet, and software providers, costs related to installations, and customer service. Cost of service revenue decreased 4% or \$88,000, to \$2,019,000 for the nine months ended September 30, 2017 as compared to \$2,107,000 for the nine months ended September 30, 2016. The decrease in cost of service revenue was primarily due to a decrease in salary and benefits of \$158,000 and a \$24,000 decrease in broadband Internet costs related to a decline in broadband Internet revenue. The decreases were offset by an increase in bandwidth costs of \$94,000 directly related to the growth in monthly recurring revenue.

Cost of Product Revenue

Cost of product revenue consists of the costs associated with the purchase of desktop phone devices and third party equipment. Cost of product revenue decreased 20% or \$99,000, to \$384,000 for the nine months ended September 30, 2017 as compared to \$483,000 for the nine months ended September 30, 2016 consistent with the decrease in product sales for the period.

Research and Development

Research and development expenses primarily consist of payroll and related expenses, related to the development of new cloud telecommunications features and products. Research and development salary expenses decreased 9% or \$57,000, to \$551,000 for the nine months ended September 30, 2017 as compared to \$ 608,000 for the nine months ended September 30, 2016 due to fluctuations in salary and benefits.

Selling and Marketing

Selling and marketing expenses consist primarily of direct sales representative salaries and benefits, partner channel commissions, the production of marketing materials and sales support software. Selling and marketing expenses increased 11% or \$206,000, to \$2,133,000 for the nine months ended September 30, 2017 as compared to \$ 1,927,000 for the nine months ended September 30, 2016. The increase in selling and marketing expense was due an increase in salary and benefits of \$210,000 resulting from hiring additional sales representatives to support our partner channel, and an increase in commission expenses of \$200,000 directly related to overall increase in sales and revenue, offset by a decrease in sales support software costs of \$90,000, a decrease in business development costs of \$80,000, and a decrease in bad debt expense of \$34,000.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting, other professional services, and other administrative corporate expenses. General and administrative expenses decreased 11% or \$335,000, to \$2,802,000 for the nine months ended September 30, 2017 as compared to \$3,137,000 for the nine months ended September 30, 2016. 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. Salary and benefits decreased \$148,000 resulting from a decrease in headcount, software support decreased \$76,000 resulting from utilizing more affordable software, computer equipment decreased \$42,000 due to a one-time charge in 2016, corporate audit and tax fees decreased \$32,000 due to reduced audit fees from a change in auditors and reduced tax fees from shutting down discontinued entities, utilities expense decreased \$24,000 due to the reconfiguration of the data center and renegotiation of rates, depreciation and amortization expense decreased \$22,000 due to certain intangible assets and fixed assets becoming fully amortized, and a decrease of \$27,000 in IT consulting fees. The decreases were offset by an increase in corporate employee stock options expense of \$36,000.

Other Expense

Other expense primarily consists of interest expense, offset by sublease rental income. Net other expense increased 776% or \$163,000, to \$184,000 for the nine months ended September 30, 2017 as compared to \$21,000 for the nine months ended September 30, 2016. We incurred interest expense on our related party long-term note payable and a decrease in sublease income resulting from completion of our lease agreement obligation in the fourth quarter of 2016 and related sub-lease.

Operating Results of Web Services segment (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Web Services				
Service revenue	\$263	\$320	\$815	\$1,063
Operating expenses:				
Cost of service revenue	26	54	87	172
Research and development	6	6	18	26
General and administrative	89	153	333	568
Total operating expenses	121	213	438	766
Operating income	142	107	377	297
Other income/(expense)	(5)	3	(5)	19
Income before tax provision	\$137	\$110	\$372	\$316

Three months ended September 30, 2017 compared to three months ended September 30, 2016

Service Revenue

Service revenue from Web Services is generated primarily through website hosting, professional web management services, and EPTAs. Web service revenue decreased 18% or \$57,000, to \$263,000 for the three months ended

September 30, 2017 as compared to \$320,000 for the three months ended September 30, 2016. The fluctuation in service revenue from the prior year is primarily related to a decrease in hosting revenue of \$51,000 and a decrease of \$9,000 from a decline in web management professional services, offset by a \$3,000 increase in EPTA revenue due to a slightly higher collection of previously written off accounts.

Cost of Service Revenue

Cost of service revenue consists primarily of bandwidth, customer service costs, and outsourcing fees related to fulfillment of our professional web management services. Cost of service revenue decreased 52% or \$28,000, to \$26,000 for the three months ended September 30, 2017 as compared to \$54,000 for the three months ended September 30, 2016. The cost of service revenue decrease is primarily related to cost savings from bringing customer support in house at the end of 2016.

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 were \$6,000 for the three months ended September 30, 2017 as compared to \$6,000 for the three months ended September 30, 2016.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting, other professional services, and other administrative corporate expenses. General and administrative expenses decreased 42% or \$64,000, to \$89,000 for the three months ended September 30, 2017 as compared to \$153,000 for the three months ended September 30, 2016. The decrease in general and administrative expenses is primarily due to less of an allocation of corporate general and administrative expenses resulting from the 18% decrease in service 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 16%, or \$185,000 to \$955,000 for the three months ended September 30, 2017 compared to \$1,140,000 for the three months ended September 30, 2016.

Other Income/(Expense)

Other income/(expense) primarily relates to interest income from the collection of EPTA receivables and the allocated portions of interest expense and sublease rental income. Other income/expense decreased 267% or \$8,000, to (\$5,000) for the three months ended September 30, 2017 as compared to income of \$3,000 for the three months ended September 30, 2016. The decrease is due to a decrease in interest income related to the decrease in EPTA revenue, an increase in interest expense on our related party long-term note payable, and a decrease in sublease income resulting from completion of our lease agreement obligation in the fourth quarter of 2016 and related sub-lease.

Nine months ended September 30, 2017 compared to nine months ended September 30, 2016

Service Revenue

Service revenue from Web Services is generated primarily through website hosting, professional web management services, and EPTAs. Web service revenue decreased 23% or \$248,000, to \$815,000 for the nine months ended September 30, 2017 as compared to \$ 1,063,000 for the nine months ended September 30, 2016. The decrease in service revenue from the prior year is primarily related to a decrease in hosting revenue of \$158,000, a \$50,000 decrease in EPTA revenue due to a decrease in outstanding receivables, and a decrease of \$39,000 from a decline in web management professional services.

Cost of Service Revenue

Cost of service revenue consists primarily of bandwidth, customer service costs, and outsourcing fees related to fulfillment of our professional web management services. Cost of service revenue decreased 49% or \$85,000, to \$87,000 for the nine months ended September 30, 2017 as compared to \$172,000 for the nine months ended September 30, 2016. The cost of service revenue decrease is primarily related to cost savings from bringing customer support in house at the end of 2016.

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 31% or \$8,000, to \$18,000 for the nine months ended September 30, 2017 as compared to \$26,000 for the nine months ended September 30, 2016. The decrease was related to a reduction of salaries and benefits expenses.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting, other professional services, and other administrative corporate expenses. General and administrative expenses decreased 41% or \$235,000, to \$333,000 for the nine months ended September 30, 2017 as compared to \$568,000 for the nine months ended September 30, 2016. The decrease in general and administrative expenses is primarily due to less of an allocation of corporate general and administrative expenses resulting from the 23% decrease in service 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 15%, or \$570,000 to \$3,135,000 for the nine months ended September 30, 2017 compared to \$3,705,000 for the nine months ended September 30, 2016.

Other Income/(Expense)

Other income/(expense) primarily relates to the interest income from the collection of EPTA receivables and the allocated portions of interest expense and sublease rental income. Other income decreased 126% or \$24,000, to (\$5,000) for the nine months ended September 30, 2017 as compared to income of \$19,000 for the nine months ended September 30, 2016. The decrease is due to a decrease in interest income related to the decrease in EPTA revenue, an increase in interest expense on our related party long-term note payable, and a decrease in sublease income resulting from completion of our lease agreement obligation in the fourth quarter of 2016 and related sub-lease.

Liquidity and Capital Resources

The Company continues to generate losses. However, revenue for the nine month period ended September 30, 2017 increased compared to the nine month period ended September 30, 2016 and management continues to focus on managing expenses and reducing cash used for operations. Our net losses for the three and nine month periods ended September 30, 2017 showed improvement over the comparable three and nine month periods ended September 30, 2016. Management evaluated the significance of the negative cash flows and believes that the operational improvements are probable of occurring and the borrowing availability under the existing Loan Agreement mitigate the substantial doubt raised by our historical operating results and satisfying our estimated liquidity needs 12 months from the issuance of the financial statements. However, management cannot predict, with certainty, the outcome of our actions to generate liquidity or whether such actions would generate the expected liquidity as currently planned.

Working Capital

Working capital increased 532% or \$303,000, to \$360,000 as of September 30, 2017 as compared to \$57,000 at December 31, 2016. The increase in working capital was primarily related to the increase in cash and cash equivalents of \$588,000, an increase in trade receivables, net of allowance for doubtful accounts of \$41,000, an increase in equipment financing receivables of \$5,000, a decrease in accrued expenses of \$61,000, and a decrease in accounts payable of \$53,000, offset by a decrease in inventories of \$17,000, a decrease in prepaid expenses of \$217,000, an increase in deferred revenue, current portion of \$175,000, an increase in notes payable, current portion of \$32,000, and an increase in income taxes payable of \$4,000 during the nine months ended September 30, 2017.

Cash and Cash Equivalents

Cash and cash equivalents increased 95% or \$588,000, to \$1,207,000 at September 30, 2017 as compared to \$619,000 at December 31, 2016. During the nine months ended September 30, 2017, there was an increase of \$177,000 provided by operating activities. Investing activities provided \$252,000 the sale of our long-term CD. Financing activities provided \$159,000; primarily related to proceeds from stock option exercises of \$1,140,000 and proceeds from notes payable of \$111,000, offset by repayments on notes payable of \$1,092,000.

Trade Receivables

Current and long-term trade receivables, net of allowance for doubtful accounts, increased 8% or \$31,000, to \$420,000 at September 30, 2017 as compared to \$389,000 at December 31, 2016. The increase in current trade receivables can be attributed to an increase in receivables due from our merchant account processors. Long-term trade receivables, net of allowance for doubtful accounts, decreased 23% or \$10,000, to \$33,000 at September 30, 2017 as compared to \$43,000 at December 31, 2016. 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. As these agreements reach their end of term, the long-term portion decreases.

Accounts Payable

Accounts payable decreased 46% or \$53,000, to \$63,000 at September 30, 2017 as compared to \$116,000 at December 31, 2016. Our accounts payable as of September 30, 2017 were generally within our vendors' terms of payment. The decrease is primarily related to the timing of check processing schedule.

Notes Payable

Notes payable decreased 86% or \$891,000, to \$141,000 at September 30, 2017 as compared to \$1,032,000 at December 31, 2016. The decrease in notes payable can be primarily attributed to the \$974,000 repayment of the related party note payable. The remainder of the difference is made up of payments of \$118,000, offset by additional financing arrangements entered into during the period.

Capital

Total stockholders' equity increased 139% or \$717,000, to \$1,232,000 at September 30, 2017 as compared to \$515,000 at December 31, 2016. The significant changes in stockholders' equity during the nine months ended September 30, 2017 included net loss of \$1,013,000, offset by an increase of additional paid-in capital of \$481,000 from stock-based compensation expense, \$1,140,000 from the exercise of employee stock options, and \$109,000 in common stock issued for annual interest payment on related party note payable.

Off Balance Sheet Arrangements

As of September 30, 2017, 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 2016 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, 2017 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 2016 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.

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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 1, 2017 By: /s/ Steven G. Mihaylo
Steven G. Mihaylo
Chief Executive Officer

November 1, 2017 By: /s/ Ronald Vincent
Ronald Vincent
Chief Financial Officer