

Crexendo, Inc.  
Form 10-Q  
April 30, 2019

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 March 31, 2019

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 April 26, 2019 was 14,399,109.

INDEX

|   | PAGE |
|---|------|
| PART I – FINANCIAL INFORMATION  |      |
| <u>Item 1.</u> <u>Financial Statements</u>  | 1    |
| <u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 20   |
| <u>Item 3.</u> <u>Quantitative and Qualitative Disclosures about Market Risk</u>                            | 30   |
| <u>Item 4.</u> <u>Controls and Procedures</u>   | 30   |
| PART II – OTHER INFORMATION   |      |
| <u>Item 1.</u> <u>Legal Proceedings</u>   | 30   |
| <u>Item 1A.</u> <u>Risk Factors</u>   | 30   |
| <u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 30   |
| <u>Item 6.</u> <u>Exhibits</u>  | 31   |
| <u>Signatures</u>   | 32   |



## PART I - FINANCIAL INFORMATION

Item 1.  
Financial Statements.CREXENDO, INC. AND SUBSIDIARIES  
Condensed Consolidated Balance Sheets  
(Unaudited, in thousands, except par value and share data)

|   | March 31,<br>2019 | December 31,<br>2018 |
|---|-------------------|----------------------|
| Assets  |                   |                      |
| Current assets:   |                   |                      |
| Cash and cash equivalents   | \$2,094           | \$1,849              |
| Restricted cash   | 100               | 100                  |
| Trade receivables, net of allowance for doubtful accounts of \$12 as of March 31, 2019 and \$14 as of December 31, 2018 | 586               | 419                  |
| Contract assets   | 16                | 12                   |
| Inventories   | 340               | 270                  |
| Equipment financing receivables   | 73                | 67                   |
| Contract costs  | 418               | 371                  |
| Prepaid expenses  | 183               | 244                  |
| Income tax receivable   | -                 | 1                    |
| Total current assets  | 3,810             | 3,333                |
| Long-term trade receivables, net of allowance for doubtful accounts of \$0 as of March 31, 2019 and December 31, 2018   | 8                 | 10                   |
| Long-term equipment financing receivables, net  | 272               | 184                  |
| Property and equipment, net   | 115               | 124                  |
| Operating lease right-of-use assets   | 1,031             | -                    |
| Intangible assets, net  | 154               | 167                  |
| Goodwill  | 272               | 272                  |
| Contract costs, net of current portion  | 338               | 342                  |
| Other long-term assets  | 102               | 117                  |
| Total Assets  | \$6,102           | \$4,549              |
| Liabilities and Stockholders' Equity  |                   |                      |
| Current liabilities:  |                   |                      |
| Accounts payable  | \$149             | \$155                |
| Accrued expenses  | 1,275             | 1,131                |
| Finance leases  | 26                | 28                   |

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|  |          |          |
|--|----------|----------|
| Notes payable  | 16       | 56       |
| Operating lease liabilities  | 238      | -        |
| Income taxes payable   | 2        | -        |
| Contract liabilities   | 698      | 641      |
| Total current liabilities  | 2,404    | 2,011    |
| Contract liabilities, net of current portion   | 466      | 422      |
| Finance leases, net of current portion   | 109      | 116      |
| Operating lease liabilities, net of current portion  | 793      | -        |
| Total liabilities  | 3,772    | 2,549    |
| 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, 14,396,607 shares issued and outstanding as of March 31, 2019 and 14,394,113 shares issued and outstanding as of December 31, 2018 | 14       | 14       |
| Additional paid-in capital   | 61,244   | 61,153   |
| Accumulated deficit  | (58,928) | (59,167) |
| Total stockholders' equity   | 2,330    | 2,000    |
| Total Liabilities and Stockholders' Equity   | \$6,102  | \$4,549  |

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



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

|   | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2019                            | 2018       |
| Service revenue                             | \$3,008                         | \$2,442    |
| Product revenue                             | 484                             | 366        |
| Total revenue                               | 3,492                           | 2,808      |
| Operating expenses:                         |                                 |            |
| Cost of service revenue                     | 877                             | 729        |
| Cost of product revenue                     | 249                             | 187        |
| Selling and marketing                       | 899                             | 829        |
| General and administrative                  | 1,014                           | 945        |
| Research and development                    | 212                             | 181        |
| Total operating expenses                    | 3,251                           | 2,871      |
| Income/(loss) from operations               | 241                             | (63)       |
| Other income/(expense):                     |                                 |            |
| Interest income                             | 1                               | 2          |
| Interest expense                            | (5)                             | (1)        |
| Other income, net                           | 5                               | 3          |
| Total other income, net                     | 1                               | 4          |
| Income/(loss) before income tax             | 242                             | (59)       |
| Income tax provision                        | (3)                             | (4)        |
| Net income/(loss)                           | \$239                           | \$(63)     |
| Earnings/(loss) per common share:           |                                 |            |
| Basic                                       | \$0.02                          | \$(0.00)   |
| Diluted                                     | \$0.02                          | \$(0.00)   |
| Weighted-average common shares outstanding: |                                 |            |
| Basic                                       | 14,394,645                      | 14,287,734 |
| Diluted                                     | 15,139,858                      | 14,287,734 |

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







CREXENDO, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Stockholders' Equity

Three Months Ended March 31, 2019 and 2018

(Unaudited, in thousands, except share data)

|                                   | Common Stock |        | Additional | Accumulated | Total         |
|-----------------------------------|--------------|--------|------------|-------------|---------------|
|                                   | Common Stock |        | Paid-in    | Accumulated | Stockholders' |
|                                   | Shares       | Amount | Capital    | Deficit     | Equity        |
| Balance, January 1, 2019          | 14,394,113   | \$14   | \$61,153   | \$(59,167)  | \$2,000       |
| Share-based compensation          | -            | -      | 91         | -           | 91            |
| Vesting of restricted stock units | 2,494        | -      | -          | -           | -             |
| Net income                        | -            | -      | -          | 239         | 239           |
| Balance, March 31, 2019           | 14,396,607   | \$14   | \$61,244   | \$(58,928)  | \$2,330       |

|  | Common Stock |        | Additional | Accumulated | Total         |
|--|--------------|--------|------------|-------------|---------------|
|  | Common Stock |        | Paid-in    | Accumulated | Stockholders' |
|  | Shares       | Amount | Capital    | Deficit     | Equity        |
| Balance, January 1, 2018                               | 14,287,556   | \$14   | \$60,560   | \$(58,944)  | \$1,630       |
| Share-based compensation                               | -            | -      | 62         | -           | 62            |
| Issuance of common stock for exercise of stock options | 1,100        | -      | 2          | -           | 2             |
| Net loss   | -            | -      | -          | (63)        | (63)          |
| Balance, March 31, 2018                                | 14,288,656   | \$14   | \$60,624   | \$(59,007)  | \$1,631       |

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



CREXENDO, INC. AND SUBSIDIARIES  
Condensed Consolidated Statements of Cash Flows  
(Unaudited, in thousands)

|   | Three Months<br>Ended March 31, |                |
|---|---------------------------------|----------------|
|   | 2019                            | 2018           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                                 |                |
| Net income/(loss)   | \$239                           | \$(63)         |
| Adjustments to reconcile net income/(loss) to net cash provided by/(used for) operating activities: |                                 |                |
| Depreciation and amortization   | 22                              | 19             |
| Share-based compensation  | 91                              | 62             |
| Changes in assets and liabilities:  |                                 |                |
| Trade receivables   | (165)                           | 11             |
| Contract assets   | (4)                             | (1)            |
| Equipment financing receivables   | (94)                            | 27             |
| Inventories   | (70)                            | (59)           |
| Contract costs  | (43)                            | (4)            |
| Prepaid expenses  | 61                              | (165)          |
| Income tax receivable   | 1                               | -              |
| Other assets  | 15                              | 2              |
| Accounts payable and accrued expenses   | 138                             | 95             |
| Income tax payable  | 2                               | 4              |
| Contract liabilities  | 101                             | (55)           |
| Net cash provided by/(used for) operating activities  | 294                             | (127)          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |                                 |                |
| Net cash provided by investing activities   | -                               | -              |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                                 |                |
| Repayments made on finance leases   | (9)                             | -              |
| Repayments made on notes payable  | (40)                            | (40)           |
| Proceeds from exercise of options   | -                               | 2              |
| Net cash used for financing activities  | (49)                            | (38)           |
| <b>NET INCREASE/(DECREASE) IN CASH, CASH EQUIVALENTS, AND RESTRICTED CASH</b>                       | <b>245</b>                      | <b>(165)</b>   |
| <b>CASH, CASH EQUIVALENTS, AND RESTRICTED CASH AT THE BEGINNING OF THE PERIOD</b>                   | <b>1,949</b>                    | <b>1,382</b>   |
| <b>CASH, CASH EQUIVALENTS, AND RESTRICTED CASH AT THE END OF THE PERIOD</b>                         | <b>\$2,194</b>                  | <b>\$1,217</b> |

Cash used during the year for:

Interest expense

\$(5)

\$(1)

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. 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,” or “our Company.” Crexendo is an award-winning premier provider of cloud communications, UCaaS (Unified Communications as a Service), call center, collaboration services, and other cloud business services that are designed to provide enterprise-class cloud services to any size business at affordable monthly rates. The Company has two operating segments, which consist of Cloud Telecommunications and Web Services.

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. and Crexendo International, Inc. All intercompany account balances and transactions have been eliminated in consolidation. The condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“US GAAP”) and pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). These condensed consolidated financial statements reflect the results of operations, financial position, changes in stockholders’ equity, and cash flows of our Company.

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 March 31, 2019 and December 31, 2018, we had cash and cash equivalents in financial institutions in excess of federally insured limits in the amount of \$1,991,000 and \$1,645,000, respectively.

Restricted Cash – We classified \$100,000 and \$100,000 as restricted cash as of March 31, 2019 and December 31, 2018, respectively. Cash is restricted for compensating balance requirements on purchasing card agreements. As of March 31, 2019 and December 31, 2018, we had restricted cash in financial institutions in excess of federally insured limits in the amount of \$100,000 and \$100,000, respectively.

The following table provides a reconciliation of cash and cash equivalents and restricted cash reported on the balance sheet to the cash, cash equivalents, and restricted cash shown in the condensed consolidated statement of cash flows (in thousands):

|   | March 31,   | March 31,   |
|---|-------------|-------------|
|   | 2019        | 2018        |
| Cash and cash equivalents   | \$2,094,000 | \$1,117,000 |
| Restricted cash   | 100,000     | 100,000     |
| Total cash, cash equivalents, and restricted cash shown in the condensed consolidated statement of cash flows | \$2,194,000 | \$1,217,000 |



**Trade Receivables** – Trade receivables from our cloud telecommunications and web services segments are recorded at invoiced amounts.

**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.

**Contract Assets** – Contract assets primarily relate to the Company's rights to consideration for work completed but not billed as of the reporting date. The contract assets are transferred to receivables when the rights become unconditional.

**Contract Costs** - Contract costs primarily relate to incremental commission costs paid to sales representatives and sales leadership as a result of obtaining telecommunications contracts which are recoverable. The Company capitalized contract costs in the amount of \$756,000 and \$713,000 at March 31, 2019 and December 31, 2018, respectively. Capitalized commission costs are amortized based on the transfer of goods or services to which the assets relate which typically range from thirty-six to sixty months, and are included in selling and marketing expenses. During the three months ended March 31, 2019 and 2018, the Company amortized \$115,000 and \$112,000, respectively, and there was no impairment loss in relation to the costs capitalized.



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 write-down is recognized as a loss in earnings in the period in which the excess occurs.

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 is 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 \$8,000 and \$1,000 for the three months ended March 31, 2019 and 2018, 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 the statement of operations.

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.

Contract Liabilities – Our contract liabilities consist primarily of advance consideration received from customers for telecommunications contracts. The product and monthly service revenue is recognized on completion of the implementation and the remaining activation fees are reclassified as deferred revenue.

Use of Estimates - In preparing the condensed 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 condensed 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.

Product and Service Revenue Recognition - Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration we expect to receive in exchange for those products

or services and excludes any amounts collected on behalf of third parties. We enter into contracts that can include various combinations of products and services, which are generally capable of being distinct and accounted for as separate performance obligations. 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. Revenue is recognized net of any taxes collected from customers, which are subsequently remitted to governmental authorities. For more detailed information about revenue, see Note 3.

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 broadband 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.

Product Warranty – We provide for the estimated cost of product warranties at the time we recognize revenue. We evaluate our warranty obligations on a product group basis. Our standard product warranty terms generally include post-sales support and repairs or replacement of a product at no additional charge for a specified period of time. We base our estimated warranty obligation upon warranty terms, ongoing product failure rates, and current period product shipments. If actual product failure rates, repair rates or any other post-sales support costs were to differ from our estimates, we would be required to make revisions to the estimated warranty liability. Warranty terms generally last for the duration that the customer has service. Estimated cost of product warranties is included in accrued expenses (see Note 8).

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.

Lease Obligations – We determine if an agreement is a lease at inception. We evaluate the lease terms to determine whether the lease will be accounted for as an operating or finance lease. Operating leases are included in operating lease right-of-use (“ROU”) assets, operating lease liabilities, current portion, and operating lease liabilities, net of current portion in our condensed consolidated balance sheets.

ROU assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. We use the implicit rate when readily determinable. The operating lease ROU asset also includes any lease payments made and excludes lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

A lease that transfers substantially all of the benefits and risks incidental to ownership of property are accounted for as finance leases. At the inception of a finance lease, an asset and finance lease obligation is recorded at an amount equal to the lesser of the present value of the minimum lease payments and the property's fair market value. Finance lease obligations are classified as either current or long-term based on the due dates of future minimum lease payments, net of interest.

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 condensed 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 and restricted stock units (“RSUs”).

**Comprehensive Income/(Loss)** – There were no other components of comprehensive income/(loss) other than net income/(loss) for the three months ended March 31, 2019 and 2018.

**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. Indirect sales and marketing expenses are allocated to the Cloud Telecommunications and Web Services segments based on level of effort, measured by month-to-date contract bookings. General and administrative expenses are allocated to both segments based on revenue recognized for each segment. Accounting guidance also establishes standards for related disclosure about products and services, geographic areas and major customers. We generate over 90% of our total revenue from customers within North America (United States and Canada) and less than 10% of our total revenues from customers in other parts of the world.

**Significant Customers** – No customer accounted for 10% or more of our total revenue for the three months ended March 31, 2019 and 2018. One telecommunications services customer accounted for 18% and 11% of total trade accounts receivable as of March 31, 2019 and 2018, respectively.

**Recently Adopted Accounting Pronouncements** - In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-02, Leases (Topic 842), and in December 2018, ASU No. 2018-20, Narrow-Scope Improvements for Lessors, and in July 2018, ASU No. 2018-10, Codification Improvements to Topic 842, Leases, and ASU 2018-11, Leases (Topic 842) - Targeted Improvements (collectively, “the new lease standard” or “ASC 842”). The new standard requires lessees to record assets and liabilities on the balance sheet for all

leases with terms longer than 12 months. This ASU does not significantly change the previous lease guidance for how a lessee should recognize, measure, and present expenses and cash flows arising from a lease. Additionally, the criteria for classifying a finance lease versus an operating lease are substantially the same as the previous guidance. We adopted Topic 842 as of January 1, 2019, using the alternative transition method that allowed us to recognize a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the period of adoption. We used the package of practical expedients permitted under the transition guidance that allowed us to not reassess: (1) whether any expired or existing contracts are or contain leases, (2) lease classification for any expired or existing leases and (3) initial direct costs for any expired or existing leases. We elected the practical expedient that allows lessees to treat the lease and non-lease components of leases as a single lease component. Additionally, we elected the hindsight practical expedient to determine the reasonably certain lease terms for existing leases. The adoption of Topic 842 did not have a material adjustment to the opening balance of retained earnings. The adoption of Topic 842 had a material impact on our condensed consolidated balance sheet due to the recognition of right-of-use (“ROU”) assets and lease liabilities. As a result of the adoption of the standard, the Company recognized ROU assets and lease liabilities of \$1,088,000 as of January 1, 2019. The adoption of Topic 842 did not have a material impact on our condensed consolidated statement of operations or our condensed consolidated statement cash flows.



In August 2018, the FASB issued ASU 2018-07, to simplify the accounting for share-based payments to nonemployees by aligning it with the accounting for share-based payments to employees, with certain exceptions. The new guidance expands the scope of Accounting Standards Codification (ASC) 718 to include share-based payments granted to nonemployees in exchange for goods or services used or consumed in an entity's own operations and supersedes the guidance in ASC 505-50. The guidance also applies to awards granted by an investor to employees and nonemployees of an equity method investee for goods or services used or consumed in the investee's operations. The guidance in ASC 718 does not apply to instruments issued to a lender or an investor in a financing (e.g., in a capital raising) transaction. It also does not apply to equity instruments granted when selling goods or services to customers in the scope of ASC 606. However, the guidance states that share-based payments granted to a customer in exchange for a distinct good or service to be used or consumed in the grantor's own operations are accounted for under ASC 718. The Company adopted ASU 2018-07 effective January 1, 2019. The adoption of this ASU did not have an impact on our condensed consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805) Clarifying the Definition of a Business, that provides guidance to assist entities with evaluating when a set of transferred assets and activities (set) is a business. Under the new guidance, an entity first determines whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If this threshold is met, the set is not a business. If it's not met, the entity then evaluates whether the set meets the requirement that a business include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Under today's guidance, it doesn't matter whether all the value relates primarily to one asset. Under ASU 2017-01, a set is not a business when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. The ASU includes guidance on which types of assets can and cannot be combined into a single identifiable asset or a group of similar identifiable assets for the purpose of applying the threshold. We adopted this guidance effective January 1, 2018. The adoption of this guidance did not have an impact on our condensed 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. We adopted the new accounting standards effective January 1, 2018. Amounts generally described as restricted cash are now presented with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. As a result of adoption, there was no impact to cash flows from operating, investing or financing activities for the three months ended March 31, 2019 and 2018. A reconciliation of cash and cash equivalents and restricted cash presented on the balance sheet to the totals presented in the statement of cash flows as cash, cash equivalents, and restricted cash has been added to the footnote disclosures, see Note 1.

In August 2016, the FASB issued ASU No. 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 changes to the classification of how certain cash receipts and payments are presented within the statement of cash flows had no impact on our condensed consolidated financial statements. The Company adopted ASU 2016-5 effective January 1, 2018. The adoption of these new ASUs required us to restate the previously reported cash and cash equivalent amounts reported in prior periods to include restricted cash.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. The objective of ASU 2014-09 is to establish a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. The Company adopted this guidance on January 1, 2018 utilizing the full retrospective

method of adoption allowed by the standard, in order to provide for comparative results in all periods presented. Under the standard, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. We elected to adopt the standard effective January 1, 2018. The most significant impact of the standard relates to our accounting for incremental costs to obtain a contract and principal versus agent considerations. Specifically, incremental sales leadership commission were expensed immediately rather than ratably over the term of the related contracts. Revenue from the resell of broadband Internet services and professional website management services were recognized on a gross basis as a principal rather than on net basis as an agent. The new standard focuses on control of the specified goods and service as the overarching principle and the Company does not control the delivery of the goods and services. Revenue recognition related to our hardware, telecommunications services and website hosting services remains substantially unchanged.

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. The Company adopted ASU 2017-09 effective January 1, 2018. The adoption of this ASU did not impact our condensed consolidated financial statements.



Recently Issued Accounting Pronouncements - In August 2018, the FASB issued ASU 2018-13, which changes the fair value measurement disclosure requirements of ASC 820. The amendments in this ASU are the result of a broader disclosure project called FASB Concepts Statement, Conceptual Framework for Financial Reporting — Chapter 8: Notes to Financial Statements, which the Board finalized in August 2018. The Board used the guidance in the Concepts Statement to improve the effectiveness of ASC 820's disclosure requirements. The ASU is effective for all entities for fiscal years beginning after December 15, 2019, including interim periods therein. Early adoption is permitted. The Company is in the process of evaluating the impact of this new ASU on our condensed 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. The Company is in the process of evaluating the potential impact of this new ASU on our condensed consolidated financial statements.

2.

### Changes in Accounting Principles

Except for the changes below, the Company has consistently applied the accounting principles to all periods presented in these condensed consolidated financial statements. The Company adopted Topic 842, Leases with a date of the initial application of January 1, 2019.

We adopted Topic 842 as of January 1, 2019, using the alternative transition method that allowed us to recognize a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the period of adoption. We used the package of practical expedients permitted under the transition guidance that allowed us to not reassess: (1) whether any expired or existing contracts are or contain leases, (2) lease classification for any expired or existing leases and (3) initial direct costs for any expired or existing leases. We elected the practical expedient that allows lessees to treat the lease and non-lease components of leases as a single lease component. Additionally, we elected the hindsight practical expedient to determine the reasonably certain lease terms for existing leases. The adoption of Topic 842 did not have a material adjustment to the opening balance of retained earnings. The adoption of Topic 842 had a material impact on our condensed consolidated balance sheet due to the recognition of right-of-use ("ROU") assets and lease liabilities. As a result of the adoption of the standard, the Company recognized ROU assets and lease liabilities of \$1,088,000 as of January 1, 2019. The adoption of Topic 842 did not have a material impact on our condensed consolidated statement of operations or our condensed consolidated statement cash flows.

3.

### Revenue

Revenue is measured based on a consideration specified in a contract with a customer, and excludes any sales incentives and amounts collected on behalf of third parties. The Company recognizes revenue when it satisfies a performance obligation by transferring control over a product or service to a customer. Taxes assessed by a

governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction, that are collected by the Company from a customer, are excluded from revenue. The following is a description of principal activities – separated by reportable segments – from which the Company generates its revenue. For more detailed information about reportable segments, see Note 13.

#### Telecommunications Segment

Products and services may be sold separately or in bundled packages. The typical length of a contract for service is thirty-six to sixty months. Customers are billed for these services on a monthly basis. For bundled packages, the Company accounts for individual products and services separately if they are distinct – i.e. if a product or service is separately identifiable from other items in the bundled package and if a customer can benefit from it on its own or with other resources that are readily available to the customer. The consideration (including any discounts) is allocated between separate products and services in a bundle based on their relative stand-alone selling prices. The stand-alone selling prices are determined based on the prices at which the Company separately sells the desktop devices and telecommunication services. For items that are not sold separately (e.g. additional features) the Company estimates stand-alone selling prices using the adjusted market assessment approach. 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.





Desktop Devices - Revenue generated from the sale of telecommunications equipment (desktop devices) is recognized when the customer takes possession of the devices and the cloud telecommunications services begin. The Company typically bills and collects the fees for the equipment upon entering into a contract with a customer. Cash receipts are recorded as a contract liability until implementation is complete and the services begin.

Equipment Financing Revenue - 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.

Cloud Telecommunications Services - Telecommunication services include voice, data, and collaboration software. The Company recognizes revenue as services are provided in service revenue. Telecommunications services are billed and paid on a monthly basis.

Broadband Internet Access – Fees generated from reselling broadband Internet access are recognized as revenue net of the costs charged by the third party service providers. Broadband Internet access services are billed and paid on a monthly basis.

Professional Services Revenue – Professional services revenue includes activation fees and any professional installation services. Installation services are recognized as revenue when the services are completed. The Company generally allocates a portion of the activation fees to the desktop devices, which is recognized at the time of the installation or customer acceptance, and a portion to the service, which is recognized over the contract term using the straight-line method. Our telecommunications services contracts typically have a term of thirty-six to sixty months.

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.

#### Web Services Segment

Website Hosting Service – Fees generated from hosting customer websites are recognized as revenue as the services are provided in service revenue. Website hosting services are billed and collected on a monthly basis.

Professional Website Management Service and Other– Fees generated from reselling professional website management services are recognized as revenue net of the costs charged by the third party service providers. Professional website management services are billed and paid on a monthly basis.

#### Disaggregation of Revenue

In the following table, revenue is disaggregated by primary major product line, and timing of revenue recognition. The table also includes a reconciliation of the disaggregated revenue with the reportable segments.

11



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| Three Months Ended March 31, 2019                  | Cloud              |              | Total      |
|--|--------------------|--------------|------------|
| (In thousands)                                     | Telecommunications | Web Services | Reportable |
|  | Segment            | Segment      | Segments   |
| Major products/services lines                      |                    |              |            |
| Desktop devices                                    | \$484              | \$-          | \$484      |
| Equipment financing revenue                        | 22                 | -            | 22         |
| Telecommunications services                        | 2,507              | -            | 2,507      |
| Fees, commissions, and other, recognized over time | 191                | -            | 191        |
| One time fees, commissions and other               | 110                | -            | 110        |
| Website hosting services                           | -                  | 146          | 146        |
| Website management services and other              | -                  | 32           | 32         |
|  | \$3,314            | \$178        | \$3,492    |
| Timing of revenue recognition                      |                    |              |            |
| Products and fees recognized at a point in time    | \$594              | \$-          | \$594      |
| Services and fees transferred over time            | 2,720              | 178          | 2,898      |
|  | \$3,314            | \$178        | \$3,492    |
|  |                    |              |            |
| Three Months Ended March 31, 2018                  | Cloud              |              | Total      |
| (In thousands)                                     | Telecommunications | Web Services | Reportable |
|  | Segment            | Segment      | Segments   |
| Major products/services lines                      |                    |              |            |
| Desktop devices                                    | \$366              | \$-          | \$366      |
| Equipment financing revenue                        | 31                 | -            | 31         |
| Telecommunications services                        | 2,042              | -            | 2,042      |
| Fees, commissions, and other, recognized over time | 137                | -            | 137        |
| One time fees, commissions and other               | 7                  | -            | 7          |
| Website hosting services                           | -                  | 204          | 204        |
| Website management services and other              | -                  | 21           | 21         |
|  | \$2,583            | \$225        | \$2,808    |
| Timing of revenue recognition                      |                    |              |            |
| Products and fees recognized at a point in time    | \$373              | \$-          | \$373      |
| Services and fees transferred over time            | 2,210              | 225          | 2,435      |
|  | \$2,583            | \$225        | \$2,808    |

Contract balances

The following table provides information about receivables, contract assets, and contract liabilities from contracts with customers.

|  | March 31, | December 31, |
|--|-----------|--------------|
| (In thousands)   | 2019      | 2018         |
| Receivables, which are included in Trade receivables, net of allowance |           |              |
| for doubtful accounts  | \$594     | \$429        |
| Contract assets  | 16        | 12           |
| Contract liabilities   | 1,164     | 1,063        |



Significant changes in the contract assets and the contract liabilities balances during the period are as follows:

| (In thousands)  | Three Months Ended |                      | For the Year Ended |                      |
|---|--------------------|----------------------|--------------------|----------------------|
|   | March 31, 2019     |                      | December 31, 2018  |                      |
|   | Contract assets    | Contract Liabilities | Contract assets    | Contract Liabilities |
| Revenue recognized that was included in the contract liability balance at the beginning of the period | \$-                | \$(806)              | \$-                | \$(837)              |
| Increase due to cash received, excluding amounts recognized as revenue during the period              | -                  | 907                  | -                  | 912                  |
| Transferred to receivables from contract assets recognized at the beginning of the period             | (2)                | -                    | (2)                | -                    |
| Increase due to additional unamortized discounts  | 6                  | -                    | 11                 | -                    |

Transaction price allocated to the remaining performance obligations

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied (or partially unsatisfied) at the end of the reporting period (in thousands):

|                            | 2019    | 2020  | 2021  | 2022  | 2023  | 2024 | Total    |
|----------------------------|---------|-------|-------|-------|-------|------|----------|
| Desktop devices            | \$246   | -     | -     | -     | -     | -    | \$246    |
| Telecommunications service | \$6,598 | 7,162 | 5,293 | 3,341 | 1,548 | 38   | \$23,980 |

All consideration from contracts with customers is included in the amounts presented above

#### 4. Earnings/(Loss) Per Common Share

Basic earnings/(loss) per common share is computed by dividing the net income/(loss) for the period by the weighted-average number of common shares outstanding during the period. Diluted earnings/(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 months ended March 31, 2018 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 earnings/(loss) per common share:

|  | Three Months Ended<br>March 31, |      |
|--|---------------------------------|------|
|  | 2019                            | 2018 |
|  |                                 |      |



|   |            |            |
|---|------------|------------|
| Net income/(loss) (in thousands) (A)          | \$239      | \$(63)     |
| Weighted-average share reconciliation:        |            |            |
| Weighted-average basic shares outstanding (B) | 14,394,645 | 14,287,734 |
| Dilutive effect of stock-based awards         | 745,213    | -          |
| Diluted shares outstanding (C)                | 15,139,858 | 14,287,734 |
| Earnings/(loss) per common share:             |            |            |
| Basic (A/B)                                   | \$0.02     | \$(0.00)   |
| Diluted (A/C)                                 | \$0.02     | \$(0.00)   |



For the three months ended March 31, 2018, 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 March 31, 2019 and 2018, the common stock equivalent shares were, as follows:

|  | March 31, | March 31, |
|--|-----------|-----------|
|  | 2019      | 2018      |
| Shares of common stock issuable under equity incentive plans outstanding       | 3,848,393 | 3,842,428 |
| Common stock equivalent shares excluded from diluted earnings/(loss) per share | 3,848,393 | 3,842,428 |

5.  
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 our trade receivables as shown on our balance sheet (in thousands):

|                                       | March 31, | December 31, |
|---------------------------------------|-----------|--------------|
|                                       | 2019      | 2018         |
| Gross trade receivables               | \$606     | \$443        |
| Less: allowance for doubtful accounts | (12)      | (14)         |
| Trade receivables, net                | \$594     | \$429        |
| Current trade receivables, net        | \$586     | \$419        |
| Long-term trade receivables, net      | 8         | 10           |
| Trade receivables, net                | \$594     | \$429        |

6.  
Prepaid Expenses

Prepaid expenses consisted of the following (in thousands):

|                               | March 31, | December 31, |
|-------------------------------|-----------|--------------|
|                               | 2019      | 2018         |
| Prepaid corporate insurance   | \$17      | \$43         |
| Prepaid software services     | 36        | 28           |
| Prepaid tax liability deposit | 23        | 48           |

|                            |       |       |
|----------------------------|-------|-------|
| Prepaid inventory deposits | 26    | 61    |
| Other prepaid expenses     | 81    | 64    |
| Total prepaid expenses     | \$183 | \$244 |



7.

## Intangible Assets

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

|                                | March 31, | December 31, |
|--------------------------------|-----------|--------------|
|                                | 2019      | 2018         |
| Customer relationships         | \$941     | \$941        |
| Less: accumulated amortization | (787)     | (774)        |
| Total                          | \$154     | \$167        |

Amortization expense is included in general and administrative expenses and totaled \$13,000 and \$18,000 for the three months ended March 31, 2019 and 2018, respectively.

8.

## Accrued Expenses

Accrued expenses consisted of the following (in thousands):

|   | March 31, | December 31, |
|---|-----------|--------------|
|   | 2019      | 2018         |
| Accrued wages and benefits                | \$401     | \$301        |
| Accrued accounts payable                  | 323       | 243          |
| Accrued sales and telecommunication taxes | 477       | 480          |
| Product warranty liability                | 16        | 16           |
| Other                                     | 58        | 91           |
| Total accrued expenses                    | \$1,275   | \$1,131      |

The changes in aggregate product warranty liabilities for the year ended December 31, 2018 and three months ended March 31, 2019 were as follows (in thousands):

| Warranty Liabilities         |      |
|------------------------------|------|
| Balance at January 1, 2018   | \$-  |
| Accrual for warranties       | 31   |
| Warranty settlements         | (15) |
| Balance at December 31, 2018 | 16   |
| Accrual for warranties       | 5    |
| Warranty settlements         | (5)  |

Balance at March 31, 2019      \$16

Product warranty expense is included in cost of product revenue expense and totaled \$5,000 and \$5,000 for the three months ended March 31, 2019 and 2018, respectively.

9.

#### Notes Payable

Notes payable consists of short and long-term financing arrangements for software licenses, subscriptions, support, corporate insurance policies, and other. The Company's outstanding balances under its note payable agreements were \$16,000 and \$56,000 as of March 31, 2019 and 2018, respectively.

15





As of March 31, 2019, future principal payments are scheduled as follows (in thousands):

Year ending December 31,

|                |      |
|----------------|------|
| 2019 remaining | \$16 |
| Total          | \$16 |

10.

#### Fair Value Measurements

We have financial instruments as of March 31, 2019 and December 31, 2018 for which the fair value is summarized below (in thousands):

|                                 | March 31, 2019 |                      | December 31, 2018 |                      |
|---------------------------------|----------------|----------------------|-------------------|----------------------|
|                                 | Carrying Value | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| <b>Assets:</b>                  |                |                      |                   |                      |
| Trade receivables, net          | \$594          | \$594                | \$429             | \$429                |
| Equipment financing receivables | 345            | 345                  | 251               | 251                  |
| <b>Liabilities:</b>             |                |                      |                   |                      |
| Finance lease obligations       | \$135          | \$135                | \$144             | \$144                |
| Notes payable                   | 16             | 16                   | 56                | 56                   |

11.

#### Income Taxes

Our effective tax rate for the three months ended March 31, 2019 and 2018 was (1.4)% and (6.8)%, respectively, which resulted in an income tax provision of \$(3,000) and \$(4,000), respectively. The tax provision is due to state tax payments made with extensions filed.

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

12.

## Leases

### Lessee Accounting

We determine if an agreement is a lease at inception. We lease our corporate office space and equipment under operating leases. We lease data center equipment, including maintenance contracts under finance leases.

Operating leases are recorded as right-of-use (“ROU”) assets and lease liabilities on the balance sheet. ROU assets represent our right to use the leased asset for the lease term and lease liabilities represent our obligation to make lease payments. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, we use our estimated incremental borrowing rate at the commencement date to determine the present value of lease payments. The operating lease ROU assets also include any lease payments made and exclude lease incentives. The Company’s lease agreements do not contain any variable lease payments, material residual value guarantees or any restrictive covenants. Our lease terms may include options, at our sole discretion, to extend or terminate the lease. At the adoption date of ASC Topic 842, the Company is reasonably certain that we would exercise our option to renew our corporate office space operating lease. Lease expense is recognized on a straight-line basis over the lease term.



We lease the corporate office space in Tempe, Arizona from a Company that is owned by the major shareholder and CEO of the Company. Effective March 1, 2017, the lease agreement was renewed for a three year term with monthly rent payments of \$25,000. There is a renewal option for another three year term at the end of the lease that was considered in valuing the ROU asset as we are reasonably certain we would exercise the renewal option. Amortization of the ROU assets and operating lease liabilities for the three months ended March 31, 2019 and 2018 was \$57,000 and \$0, respectively. Rental expense incurred on operating leases for the three months ended March 31, 2019 and 2018 was approximately \$75,000 and \$80,000, respectively.

We have lease agreements with lease and non-lease components, and we account for the lease and non-lease components as a single lease component. Our lease agreements do not contain any material residual value guarantees or material restrictive covenants. The Company leases equipment and support under a finance lease agreement which extends through 2023. The outstanding balance for finance leases was \$135,000 and \$0 as of March 31, 2019 and 2018, respectively. The Company recorded assets classified as property and equipment under finance lease obligations of \$129,000 and \$0 as of March 31, 2019 and 2018, respectively. Related accumulated depreciation totaled \$22,000 and \$0 as of March 31, 2019 and 2018, respectively. The \$25,000 support contract was classified as a prepaid expense and is being amortized over the service period of 3 years. Amortization expense is included in general and administrative expenses and totaled \$2,000 and \$0 for the three months ended March 31, 2019 and 2018, respectively. The interest rate on the finance lease obligation is 6.7% and interest expense was \$3,000 and \$0 for the three months ended March 31, 2019 and 2018, respectively.

The maturity of operating leases and finance lease liabilities as of March 31, 2019 are as follows:

| Year ending December 31,                | Operating leases | Finance leases |
|---|------------------|----------------|
| 2019 remaining                          | \$225            | \$24           |
| 2020                                    | 300              | 37             |
| 2021                                    | 300              | 36             |
| 2022                                    | 300              | 37             |
| 2023                                    | 50               | 21             |
| Total minimum lease payments            | 1,175            | 155            |
| Less: amount representing interest      | (144)            | (20)           |
| Present value of minimum lease payments | \$1,031          | \$135          |

Lease term and discount rate March 31, 2019

Weighted-average remaining lease term (years)

|                                |      |
|--------------------------------|------|
| Operating leases               | 3.9  |
| Finance leases                 | 4.3  |
| Weighted-average discount rate |      |
| Operating leases               | 6.7% |
| Finance leases                 | 6.7% |

Three Months Ended March 31, 2019

Cash paid for amounts included in the measurement of lease liabilities:

|  |      |
|--|------|
| Operating cash flows from operating leases | \$75 |
| Operating cash flows from finance leases   | 3    |
| Financing cash flows from finance leases   | 9    |

We adopted ASC Topic 842 utilizing a practical expedient that does not require application to periods prior to adoption. As previously disclosed in our 2018 Annual Report on Form 10-K and under ASC Topic 840, the predecessor to Topic 842, future aggregate minimum lease obligations under the operating lease and sale-leaseback as of December 31, 2018, exclusive of taxes and insurance, are as follows (in thousands):



Year ending December 31,

|       |       |
|-------|-------|
| 2019  | \$300 |
| 2020  | 50    |
| Total | \$350 |

#### Lessor Accounting

Lessor accounting remained substantially unchanged with the adoption of ASC Topic 842. Crexendo offers its customers lease financing for the lease of our cloud telecommunication equipment (IP or cloud telephone desktop devices). We account for these transactions as sales-type leases. 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.

Future minimum lease payments as of March 31, 2019, consisted of the following:

| Year ending December 31,              | Lease Receivables |
|---------------------------------------|-------------------|
| 2019 remaining                        | \$102             |
| 2020                                  | 141               |
| 2021                                  | 131               |
| 2022                                  | 93                |
| 2023                                  | 65                |
| 2024                                  | 5                 |
| Gross equipment financing receivables | 537               |
| Less: unearned income                 | (192)             |
| Equipment financing receivables, net  | \$345             |

#### 13. 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 are as follows (in thousands):





Three Months  
Ended March 31,

2019    2018

Revenue:

|                          |         |         |
|--------------------------|---------|---------|
| Cloud telecommunications | \$3,314 | \$2,583 |
| Web services             | 178     | 225     |
| Consolidated revenue     | 3,492   | 2,808   |

Income/(loss) from operations:

|                               |     |       |
|-------------------------------|-----|-------|
| Cloud telecommunications      | 163 | (188) |
| Web services                  | 78  | 125   |
| Total operating income/(loss) | 241 | (63)  |

Other income/(expense), net:

|                          |     |   |
|--------------------------|-----|---|
| Cloud telecommunications | (3) | 4 |
| Web services             | 4   | - |
| Total other income, net  | 1   | 4 |

Income/(loss) before income tax provision:

|   |       |        |
|---|-------|--------|
| Cloud telecommunications                  | 160   | (184)  |
| Web services                              | 82    | 125    |
| Income/(loss) before income tax provision | \$242 | \$(59) |

Depreciation and amortization was \$21,000 and \$18,000 for the Cloud Telecommunications segment for the three months ended March 31, 2019 and 2018, respectively. Depreciation and amortization was \$1,000 and \$1,000 for the Web Services segment for the three months ended March 31, 2019 and 2018, respectively.

Interest income was \$1,000 and \$2,000 for the Web Services segment for the three months ended March 31, 2019 and 2018, respectively.

Interest expense was \$5,000 and \$1,000 for the Cloud Telecommunications segment for the three months ended March 31, 2019 and 2018, 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, 2018 (the “2018 Form 10-K”) filed with the SEC and the Condensed Consolidated Financial Statements and notes thereto included in the 2019 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

Crexendo is an award-winning premier provider of cloud communications, UCaaS (Unified Communications as a Service), call center, collaboration services, and other cloud business services that are designed to provide enterprise-class cloud services to any size business at affordable monthly rates. The Company has two operating segments, which consist of Cloud Telecommunications and Web Services.

Cloud Telecommunications - 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 an application on 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 28% or \$613,000 to \$2,830,000 for the three months ended March 31, 2019 as compared to \$2,217,000 for the three months ended March 31, 2018. Our Cloud Telecommunications product revenue increased 32% or \$118,000 to \$484,000 for the three months ended March 31, 2019 as compared to \$366,000 for the three months ended March 31, 2018. As of March 31, 2019 and 2018, our backlog was \$24,226,000 and \$20,715,000, respectively.

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

Our Web Services revenue decreased 21% or \$47,000 to \$178,000 for the three months ended March 31, 2019 as compared to \$225,000 for the three months ended March 31, 2018.

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 cater to businesses of all sizes on a

monthly subscription basis 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 service offering includes hardware, 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 a Crexendo branded desktop phones and/or 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 standards based Web and VoIP cloud technologies. Our services use our highly scalable complex infrastructure that we build and manage based on industry standard best practices to achieve greater efficiencies, better quality of service (QoS) and customer satisfaction. Our infrastructure comprises of compute, 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/Message-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, Web and mobile devices based collaboration applications

Call Center Features such as Automated Call Distribution (ACD), Call Monitor, Whisper and Barge, Automatic Call Recording, One way call recording, Analytics

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

Mobile Features such as extension dialing, transfer and conference and seamless hand-off from WiFi to/from 3G and 4G, LTE, 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.

Asynchronous communication tools like SMS/MMS, chat and document sharing to keep in pace with emerging communication trends.

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 CPaaS 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.

## 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, except for per share amounts):

|                                   | Three Months<br>Ended March 31, |          |
|-----------------------------------|---------------------------------|----------|
|                                   | 2019                            | 2018     |
| Service revenue                   | \$3,008                         | \$2,442  |
| Product revenue                   | 484                             | 366      |
| Total revenue                     | \$3,492                         | \$2,808  |
| Income/(loss) before income taxes | 242                             | (59)     |
| Income tax provision              | (3)                             | (4)      |
| Net income/(loss)                 | 239                             | (63)     |
| Basic earnings/(loss) per share   | \$0.02                          | \$(0.00) |
| Diluted earnings/(loss) per share | \$0.02                          | \$(0.00) |





Three months ended March 31, 2019 compared to three months ended March 31, 2018

#### Service revenue

Service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, broadband Internet services, administrative fees, website hosting, and web management services. Service revenue increased 23% or \$566,000, to \$3,008,000 for the three months ended March 31, 2019 as compared to \$2,442,000 for the three months ended March 31, 2018. Cloud Telecommunications service revenue increased 28% or \$613,000, to \$2,830,000 for the three months ended March 31, 2019 as compared to \$2,217,000 for the three months ended March 31, 2018. Web service revenue decreased 21% or \$47,000, to \$178,000 for the three months ended March 31, 2019 as compared to \$225,000 for the three months ended March 31, 2018.

#### Product Revenue

Product revenue consists primarily of fees collected from the sale of desktop phone devices and third party equipment. Product revenue increased by 32% or \$118,000, to \$484,000 for the three months ended March 31, 2019 as compared to \$366,000 for the three months ended March 31, 2018. 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.

#### Income/(Loss) Before Income Taxes

Income/(loss) before income tax increased 510% or \$301,000, to \$242,000 income before income tax for the three months ended March 31, 2019 as compared to loss before income tax of (\$59,000) for the three months ended March 31, 2018. The increase in income before income tax is primarily due to the increase in revenue of \$684,000, offset by an increase in operating expenses of \$380,000 and a decrease in other income of \$3,000.

#### Income Tax Provision

We had an income tax provision of \$3,000 for the three months ended March 31, 2019 compared to an income tax provision of \$4,000 for the three months ended March 31, 2018. We had pre-tax income for the three months ended March 31, 2019 of \$242,000 and pre-tax loss for the three months ended March 31, 2018 of (\$59,000), respectively, and a full valuation allowance on all of our deferred tax assets for the three months ended March 31, 2019 and 2018.

#### 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 April 30, 2019 earnings press release, as furnished on Form 8-K, we included Non-GAAP net income/(loss), EBITDA and Adjusted EBITDA. The terms Non-GAAP net income/(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 income/(loss), EBITDA, and Adjusted EBITDA should not be considered in isolation, or as a substitute for net income/(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 Income/(Loss) to Non-GAAP Net Income/(Loss)

(Unaudited)

Three Months Ended  
March 31,

2019          2018

(In thousands)

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|                                   |       |        |
|-----------------------------------|-------|--------|
| U.S. GAAP net income/(loss)       | \$239 | \$(63) |
| Share-based compensation          | 91    | 62     |
| Amortization of intangible assets | 13    | 18     |
| Non-GAAP net income               | \$343 | \$17   |

Non-GAAP earnings per common share:

|         |        |        |
|---------|--------|--------|
| Basic   | \$0.02 | \$0.00 |
| Diluted | \$0.02 | \$0.00 |

Weighted-average common shares outstanding:

|         |            |            |
|---------|------------|------------|
| Basic   | 14,394,645 | 14,287,734 |
| Diluted | 15,139,858 | 15,199,950 |



Reconciliation of U.S. GAAP Net  
Income/(Loss) to EBITDA to Adjusted  
EBITDA

(Unaudited)

Three Months  
Ended March  
31,

2019 2018

(In thousands)

|                               |       |        |
|-------------------------------|-------|--------|
| U.S. GAAP net income/(loss)   | \$239 | \$(63) |
| Depreciation and amortization | 22    | 19     |
| Interest expense              | 5     | 1      |
| Interest and other income     | (6)   | (5)    |
| Income tax provision          | 3     | 4      |
| EBITDA                        | 263   | (44)   |
| Share-based compensation      | 91    | 62     |
| Adjusted EBITDA               | \$354 | \$18   |

#### 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, 2018 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.

#### 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 March 31,

| Cloud Telecommunications           | 2019    | 2018    |
|------------------------------------|---------|---------|
| Service revenue                    | \$2,830 | \$2,217 |
| Product revenue                    | 484     | 366     |
| Total revenue                      | \$3,314 | \$2,583 |
| Operating expenses:                |         |         |
| Cost of service revenue            | \$843   | \$708   |
| Cost of product revenue            | 249     | 187     |
| Research and development           | 206     | 175     |
| Selling and marketing              | 899     | 829     |
| General and administrative         | 954     | 872     |
| Total operating expenses           | 3,151   | 2,771   |
| Operating income/(loss)            | 163     | (188)   |
| Other income/(expense)             | (3)     | 4       |
| Income/(loss) before tax provision | \$160   | \$(184) |





Three months ended March 31, 2019 compared to three months ended March 31, 2018

#### Service Revenue

Cloud Telecommunications service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, administrative fees, and broadband Internet services. Service revenue increased 28% or \$613,000, to \$2,830,000 for the three months ended March 31, 2019 as compared to \$2,217,000 for the three months ended March 31, 2018. The increase in service revenue is due to an increase in contracted service revenue, usage charges, and professional services revenue of \$625,000, offset by a decrease in sales-type lease interest of \$9,000 and a decrease in broadband Internet services revenue of \$3,000. 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 from the sale of desktop phone devices and third party equipment. Product revenue increased 32% or \$118,000, to \$484,000 for the three months ended March 31, 2019 as compared to \$366,000 for the three months ended March 31, 2018. 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 March 31, 2019 and 2018. Below is a table which displays the Cloud Telecommunications segment revenue backlog as of January 1, 2019 and 2018, and March 31, 2019 and 2018, which we expect to recognize as revenue within the next thirty-six to sixty months (in thousands):

|  |          |
|--|----------|
| Cloud Telecommunications backlog as of January 1, 2019 | \$23,029 |
| Cloud Telecommunications backlog as of March 31, 2019  | \$24,226 |
| Cloud Telecommunications backlog as of January 1, 2018 | \$19,871 |
| Cloud Telecommunications backlog as of March 31, 2018  | \$20,715 |

#### Cost of Service Revenue

Cost of service revenue consists primarily of fees we pay to third-party telecommunications carriers, broadband Internet, and software providers, costs related to installations, and customer support. Cost of service revenue increased 19% or \$135,000, to \$843,000 for the three months ended March 31, 2019 as compared to \$708,000 for the three months ended March 31, 2018. The increase in cost of service revenue was primarily due to an increase in costs related to installations of \$59,000, an increase in salaries and benefits of \$43,000, an increase in bandwidth costs of \$15,000, an increase in credit card processing fees of \$12,000, an increase in freight of \$5,000, and an increase in other customer support costs of \$4,000, offset by a decrease in stock options expense of \$3,000. These increases are directly related to the growth in monthly recurring revenue.

#### Cost of Product Revenue

Cost of product revenue consists of the costs associated with desktop phone devices, inventory costs, and the purchase of third party equipment. Cost of product revenue increased 33% or \$62,000, to \$249,000 for the three months ended March 31, 2019 as compared to \$187,000 for the three months ended March 31, 2018. The increase is primarily due to the increase in product revenue.

#### 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 expenses increased 18% or \$31,000, to \$206,000 for the three months ended March 31, 2019 as compared to \$175,000 for the three months ended March 31, 2018. The increase is primarily due to an increase in costs for the development of a new customer user interface and an Android Crexmo application.



## Selling and Marketing

Selling and marketing expenses consist primarily of direct sales representative salaries and benefits, partner channel commissions, amortization of costs to acquire contracts, trade shows, the production of marketing materials, and sales support software. Selling and marketing expenses increased 8% or \$70,000, to \$899,000 for the three months ended March 31, 2019 as compared to \$829,000 for the three months ended March 31, 2018. The increase in selling and marketing expense resulting from an increase in commission expense of \$86,000 directly related to an increase in revenue and an increase in sales lead generation expense of \$33,000, offset by a decrease in salary and benefits of \$32,000 and a decrease in travel expenses of \$17,000.

## General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting and other professional services, and other administrative corporate expenses. General and administrative expenses increased 9% or \$82,000, to \$954,000 for the three months ended March 31, 2019 as compared to \$872,000 for the three months ended March 31, 2018. Consolidated general and administrative expenses increased 7%, or \$69,000 to \$1,014,000 for the three months ended March 31, 2019 as compared to \$945,000 for the three months ended March 31, 2018. As Web Services segment revenue continues to decrease and Cloud Telecommunications segment revenue continues to increase, a higher percentage of general and administrative costs are being allocated to the Cloud Telecommunications segment. The increase in consolidated general and administrative expenses is primarily due to an increase in stock options expense of \$37,000, an increase in software expense of \$18,000, an increase in computer supplies and office equipment of \$7,000, an increase in administrative salaries and benefits of \$7,000, an increase in other administrative corporate expenses of \$3,000, and an increase in repairs and maintenance of \$2,000, offset by a decrease in rent expense of \$5,000.

## Other Income/(Expense)

Other income/(expense) primarily relates to the allocated portions of interest expense, offset by sublease rental income. Net other income/(expense) decreased 175% or \$7,000, to other expense of (\$3,000) for the three months ended March 31, 2019 as compared to other income of \$4,000 for the three months ended March 31, 2018. The decrease in interest income/(expense) is due to an increase in allocated interest expense of \$4,000 for interest paid on finance agreements and a decrease in sub-lease rental income of \$3,000 for a lease agreement in Reno, NV, which expired in the third quarter of 2018.

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

|                            | Three Months<br>Ended March<br>31, |       |
|----------------------------|------------------------------------|-------|
|                            | 2019                               | 2018  |
| Web Services               |                                    |       |
| Service revenue            | \$178                              | \$225 |
| Operating expenses:        |                                    |       |
| Cost of service revenue    | 34                                 | 21    |
| Research and development   | 6                                  | 6     |
| General and administrative | 60                                 | 73    |

|                             |      |       |
|-----------------------------|------|-------|
| Total operating expenses    | 100  | 100   |
| Operating income            | 78   | 125   |
| Other income                | 4    | -     |
| Income before tax provision | \$82 | \$125 |

Three months ended March 31, 2019 compared to three months ended March 31, 2018

#### Service Revenue

Service revenue is generated primarily through website hosting, professional web management services, and extended payment term agreements (EPTAs). Web Services segment revenue decreased 21% or \$47,000, to \$178,000 for the three months ended March 31, 2019 as compared to \$225,000 for the three months ended March 31, 2018. The decrease in service revenue is primarily due to a decrease in hosting revenue of \$42,000, a \$3,000 decrease in EPTA revenue due to decrease in outstanding receivables, and a decrease of \$2,000 from a decline in web management professional services.



### Cost of Service Revenue

Cost of service revenue consists primarily of bandwidth, customer service costs, and credit card processing fees. Cost of service revenue increased 62% or \$13,000, to \$34,000 for the three months ended March 31, 2019 as compared to \$21,000 for the three months ended March 31, 2018. The increase in cost of revenue is primarily related to an increase in customer service costs of \$14,000, offset by a decrease in credit card fees of \$1,000, directly related to the decrease in revenue.

### Research and Development

Research and development expenses primarily consist of salaries and benefits, and related expenses which are attributable to the development of our website development software products. Research and development expenses were \$6,000 for the three months ended March 31, 2019 as compared to \$6,000 for the three months ended March 31, 2018.

### General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, accounting and other professional services, and other administrative corporate expenses. General and administrative expenses decreased 18% or \$13,000, to \$60,000 for the three months ended March 31, 2019 as compared to \$73,000 for the three months ended March 31, 2018. The decrease in general and administrative expenses is primarily due to less of an allocation of corporate general and administrative expenses resulting from the 21% decrease in revenue for the period. Consolidated general and administrative expenses increased 7%, or \$69,000 to \$1,014,000 for the three months ended March 31, 2019 as compared to \$945,000 for the three months ended March 31, 2018. As Web Services segment revenue continues to decrease and Cloud Telecommunications segment revenue continues to increase, a higher percentage of general and administrative costs are being allocated to the Cloud Telecommunications segment. The increase in consolidated general and administrative expenses is primarily due to an increase in stock options expense of \$37,000, an increase in software expense of \$18,000, an increase in computer supplies and office equipment of \$7,000, an increase in administrative salaries and benefits of \$7,000, an increase in other administrative corporate expenses of \$3,000, and an increase in repairs and maintenance of \$2,000, offset by a decrease in rent expense of \$5,000.

### Other Income

Other income primarily relates to interest income from the collection of EPTA receivables, foreign exchange gains or losses, and the allocated portions of interest expense and sublease rental income. Other income increased \$4,000, to \$4,000 for the three months ended March 31, 2019 as compared to \$0 for the three months ended March 31, 2018. The increase is due to an increase in net foreign exchange gains of \$5,000, offset by a \$1,000 decrease in interest income from the collection of EPTAs.

### Liquidity and Capital Resources

As of March 31, 2019 and 2018, we had cash and cash equivalents of \$2,194,000 and \$1,117,000, respectively. Changes in cash and cash equivalents are dependent upon changes in, among other things, working capital items such as contract liabilities, contract costs, accounts payable, accounts receivable, prepaid expenses, and various accrued expenses, as well as purchases of property and equipment and changes in our capital and financial structure due to debt repayments and issuances, stock option exercises, sales of equity investments and similar events. We believe that our operations along with existing liquidity sources will satisfy our cash requirements for at least the next 12 months. If the assumptions underlying our business plan regarding future revenue and expenses change or if unexpected



opportunities or needs arise, we may seek to raise additional cash by selling equity or debt securities.

#### Working Capital

Working capital increased 6% or \$84,000 to \$1,406,000 as of March 31, 2019 as compared to \$1,322,000 at December 31, 2018. The increase in working capital was primarily related to an increase in cash and cash equivalents of \$245,000, an increase in trade receivables, net of allowance for doubtful accounts of \$167,000, an increase in contract assets of \$4,000, an increase in inventories of \$70,000, an increase in equipment financing receivables of \$6,000, an increase in contract costs of \$47,000, a decrease in accounts payable of \$6,000, a decrease in finance leases, current portion, of \$2,000, and a decrease notes payable, current portion, of \$40,000, offset by a decrease in prepaid expenses of \$61,000, a decrease in income tax receivable of \$1,000, an increase in accrued expenses of \$144,000, an increase in operating lease liabilities, current portion, of \$238,000, an increase in income taxes payable of \$2,000, and an increase in contract liabilities, current portion, of \$57,000 during the three months ended March 31, 2019.



#### Cash, Cash Equivalents, and Restricted Cash

Cash, cash equivalents, and restricted cash increased 13% or \$245,000 to \$2,194,000 at March 31, 2019 as compared to \$1,949,000 at December 31, 2018. During the three months ended March 31, 2019, cash flows for operating activities provided \$294,000, and we used cash flows of \$49,000 for financing activities. The \$49,000 used for financing activities primarily related to repayments of notes payable of \$40,000 and repayments of finance leases of \$9,000 during the period.

#### Inventories

Inventories increased 26% or \$70,000 to \$340,000 at March 31, 2019 as compared to \$270,000 at December 31, 2018. Inventory balances fluctuate based on timing of installations and inventory shipments. The increase is due to additional inventory requirements from a strong bookings quarter.

#### Prepaid Expenses

Prepaid expenses decreased 25% or \$61,000 to \$183,000 at March 31, 2019 as compared to \$244,000 at December 31, 2018. The decrease is from a \$25,000 decrease in prepaid tax liability deposits due to timing of payments, a \$35,000 decrease in prepaid inventories for prepayments on shipments that will be received in the next 90 days, and a decrease of \$26,000 for prepaid corporate insurance, offset by a \$22,000 payment for a 2019 annual software subscription, and a \$3,000 increase in other prepaid expense accounts.

#### Accounts Payable and Accrued Expenses

Accounts payable decreased 4% or \$6,000 to \$149,000 at March 31, 2019 as compared to \$155,000 at December 31, 2018. The aging of accounts payable as of March 31, 2019 were generally within our vendors' terms of payment. The decrease is primarily related to the timing of check processing schedule.

Accrued expenses increased 13% or \$144,000 to \$1,275,000 at March 31, 2019 as compared to \$1,131,000 at December 31, 2018. The increase is from a \$100,000 increase in accrued salaries due to accruing ten days at March 31, 2019 as compared to six days at December 31, 2018, a \$36,000 increase in accrued paid time off due to fewer vacation days taken in the first quarter of 2019, and an \$8,000 increase in other accrued expense accounts.

#### Notes Payable

Notes payables decreased 71% or \$40,000 to \$16,000 at March 31, 2019 as compared to \$56,000 at December 31, 2018. The decrease in notes payable can be attributed to payments made on financing contracts of \$40,000.

#### Finance Lease

Finance lease obligations decreased 6%, or \$9,000, to \$135,000 as of March 31, 2019 as compared to \$144,000 at December 31, 2018. The decrease in finance lease obligations can be attributed to payments made on financing contracts of \$9,000.

#### Operating Lease Liabilities

Operating lease liabilities increased \$1,031,000 to \$1,031,000 at March 31, 2019 as compared to \$0 at December 31, 2018. The increase is related to the adoption of ASC 842, Leases.

## Contract Liabilities

Contract liabilities increased 10% or \$101,000 to \$1,164,000 at March 31, 2019 as compared to \$1,063,000 at December 31, 2018. The increase is primarily due to an increase in sales, resulting in an increase in customer down payments. First quarter was a record sales quarter, with March being the second highest month of sales in Crexendo's history. 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. With increased sales, there was an increased amount of down payments of uninstalled contracts as of March 31, 2019.



## Capital

Total stockholders' equity increased 17% or \$330,000, to \$2,330,000 as of March 31, 2019 as compared to \$2,000,000 at December 31, 2018. The increase in total stockholders' equity was attributable to net income of \$239,000, and an increase in additional paid-in capital of \$91,000 for stock options issued to employees.

## Off Balance Sheet Arrangements

As of March 31, 2019, 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 2018 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 three months ended March 31, 2019 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 2018 Form 10-K.

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds

None



Item 6.  
Exhibits

Exhibits

|             |  |
|-------------|--|
| <u>31.1</u> | 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 |
| <u>31.2</u> | 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 |
| <u>32.1</u> | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350  |
| <u>32.2</u> | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350  |
| 101.INS*    | XBRL INSTANCE DOCUMENT   |
| 101.SCH*    | XBRL TAXONOMY EXTENSION SCHEMA DOCUMENT  |
| 101.CAL*    | XBRL TAXONOMY EXTENSION CALCULATION LINKBASE DOCUMENT  |
| 101.DEF*    | XBRL TAXONOMY EXTENSION DEFINITION LINKBASE DOCUMENT   |
| 101.LAB*    | XBRL TAXONOMY EXTENSION LABEL LINKBASE DOCUMENT  |
| 101.PRE*    | XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE DOCUMENT   |

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



SIGNATURES

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

Crexendo, Inc.

April 30, 2019 By: /s/ Steven G. Mihaylo  
Steven G. Mihaylo  
Chief Executive Officer

April 30, 2019 By: /s/ Ronald Vincent  
Ronald Vincent  
Chief Financial Officer