

Crexendo, Inc.
Form 10-Q
August 06, 2014

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 June 30, 2014

OR

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

For the transition period from _____ to _____.

Commission file number 001-32277

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

Delaware
(State or other jurisdiction of
incorporation or organization)

87-0591719
(I.R.S. Employer Identification No.)

1615 South 52nd Street, Tempe, AZ
(Address of Principal Executive Offices)

85281
(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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (check one).

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>

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 August 1, 2014 was 11,202,244.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

CREXENDO, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets
(In thousands, except par value and share data)
(unaudited)

	June 30, 2014	December 31, 2013
Assets		
Current Assets:		
Cash and cash equivalents	\$2,677	\$3,076
Restricted cash	482	487
Trade receivables, net of allowance of doubtful accounts of \$58 as of June 30, 2014 and \$163 as of December 31, 2013	651	1,090
Inventories	115	217
Equipment financing receivables	141	94
Income taxes receivable	43	55
Prepaid expenses and other	1,050	620
Total Current Assets	5,159	5,639
Certificate of deposit	251	250
Long-term trade receivables, net of allowance of doubtful accounts of \$13 as of June 30, 2014 and \$37 as of December 31, 2013	94	116
Long-term equipment financing receivables	473	398
Property and equipment, net	189	2,195
Deferred income tax assets, net	244	244
Intangible assets	820	571
Goodwill	272	75
Long-term prepaid rent	537	-
Other long-term assets	43	119
Total Assets	\$8,082	\$9,607
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	\$27	\$201
Accrued expenses and other	1,318	1,095
Deferred income tax liability	244	244
Deferred revenue, current portion	776	1,199
Contingent consideration	228	51
Total Current Liabilities	2,593	2,790
Deferred revenue, net of current portion	94	116
Other long-term liabilities	249	-

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Total Liabilities	2,936	2,906
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 100,000,000 shares; 11,202,244 shares outstanding as of June 30, 2014 and 10,801,315 shares outstanding as of December 31, 2013	11	11
Additional paid-in capital	52,708	50,998
Contingent consideration	59	198
Accumulated deficit	(47,632)	(44,506)
Total Stockholders' Equity	5,146	6,701
Total Liabilities and Stockholders' Equity	\$8,082	\$9,607

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

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

	Three Months Ended June		Six Months Ended June 30,	
	2014	30, 2013	2014	2013
Revenue	\$1,808	\$2,737	\$3,880	\$5,759
Operating expenses:				
Cost of revenue	884	970	1,814	2,012
Selling and marketing	504	717	1,157	1,625
General and administrative	1,548	1,852	3,298	3,290
Research and development	435	414	849	895
Total operating expenses	3,371	3,953	7,118	7,822
Loss from operations	(1,563)	(1,216)	(3,238)	(2,063)
Other income (expense):				
Interest income	37	146	85	365
Other income (expense), net	45	(26)	74	(33)
Total other income, net	82	120	159	332
Loss before income tax provision	(1,481)	(1,096)	(3,079)	(1,731)
Income tax benefit (provision)	(13)	26	(47)	263
Net loss	\$(1,494)	\$(1,070)	\$(3,126)	\$(1,468)
Net loss per common share:				
Basic	\$(0.13)	\$(0.10)	\$(0.28)	\$(0.14)
Diluted	\$(0.13)	\$(0.10)	\$(0.28)	\$(0.14)
Weighted average common shares outstanding:				
Basic	11,173,762	10,682,393	11,043,770	10,675,990
Diluted	11,173,762	10,682,393	11,043,770	10,675,990

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

CREXENDO, INC. AND SUBSIDIARIES
Condensed Consolidated Statement of Stockholders' Equity
For the Six Months Ended June 30, 2014
(In thousands, except share data)
(unaudited)

	Common Stock		Additional	Contingent	Accumulated	Total
	Shares	Amount	Paid-in Capital	Consideration	Deficit	Stockholders' Equity
Balance, January 1, 2014	10,801,315	\$ 11	\$50,998	\$ 198	\$ (44,506)	\$ 6,701
Expense for stock options granted to employees	-	-	429	-	-	429
Issuance of common stock for rent	300,000	-	966	-	-	966
Common stock issued upon exercise of options	17,394	-	42	-	-	42
Issuance of common stock for business acquisition	40,521	-	134	-	-	134
Issuance of common stock from contingent consideration	43,014	-	139	(139)	-	-
Net loss	-	-	-	-	(3,126)	(3,126)
Balance, June 30, 2014	11,202,244	\$ 11	\$52,708	\$ 59	\$ (47,632)	\$ 5,146

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

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

	Six Months Ended June 30,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$(3,126)	\$(1,468)
Adjustments to reconcile net loss to net cash used in operating activities:		
Lease abandonment	-	(606)
Depreciation and amortization	393	598
Expense for stock options issued to employees	429	430
Change in uncertain tax positions	-	(253)
Gain on disposal of property and equipment	(1)	-
Amortization of deferred gain	(32)	-
Change in fair value of contingent consideration	3	-
Changes in assets and liabilities:		
Trade receivables	461	1,945
Equipment financing receivables	(121)	(123)
Inventories	102	40
Income taxes receivable	12	371
Prepaid expenses and other	(108)	(177)
Non-cash amortization of prepaid rent	107	-
Other long-term assets	76	2
Accounts payable, accrued expenses and other	38	(1,202)
Deferred revenue	(445)	(1,960)
Net cash used in operating activities	(2,212)	(2,403)
CASH FLOWS FROM INVESTING ACTIVITIES		
Redemption of certificate of deposit	-	250
Release of restricted cash	5	-
Acquisition of property and equipment	(3)	(60)
Sale of property and equipment	2,002	-
Acquisition of PBX Central	-	(300)
Acquisition of One Stop Voice	(195)	-
Purchase of long-term investment	(1)	-
Net cash provided by (used for) investing activities	1,808	(110)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from exercise of stock options	42	3
Payments made on contingent consideration	(37)	-
Net cash provided by financing activities	5	3
NET DECREASE IN CASH AND CASH EQUIVALENTS	(399)	(2,510)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,076	7,440
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$2,677	\$4,930

Supplemental disclosure of cash flow information:

Cash received during the period:

Income taxes	\$ 11	\$ 382
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Supplemental disclosure of non-cash investing and financing information:

Business acquisition with stock (Note 9)	\$ 134	\$ 107
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Contingent consideration related to acquisition (Note 9)	\$ 211	\$ 363
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Prepayment of rent with common stock	\$ 966	\$ -
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The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

CREXENDO, INC. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements (unaudited)

(1) Significant Accounting Policies

Description of Business - Crexendo, Inc. is incorporated in the state of Delaware. As used hereafter in the notes to consolidated financial statements, we refer to Crexendo, Inc. and its wholly owned subsidiaries, as “we,” “us,” or “our Company”. We are a hosted services company that provides web hosting, hosted telecom services, e-commerce software, website development software, and broadband internet services for businesses and entrepreneurs. Our services are designed to make enterprise-class hosting services available to small, medium-sized and enterprise-sized businesses at affordable monthly rates. The Company has two operating segments, which consist of Hosted Telecom Services and Web Services.

The Company has transformed into a start-up company with the inherent risks and uncertainties of funding operations until profitability is achieved. We currently plan to fund our operations during the next twelve months primarily using our cash and cash equivalents of \$2,677,000. However, in the event that any factors impacting future cash flows fall below management's expectations, the Company would be required to obtain additional debt or equity financing such as that available from its CEO to sustain operations. The Company received a commitment from the CEO, and major shareholder, in July 2014 that he would provide the necessary level of financial support to enable the Company to pay its debts as they become due through November 15, 2015. Accordingly, the Company believes it will have sufficient funds to sustain its operations during the next twelve months as a result of the sources of funding detailed above.

Basis of Presentation – These unaudited condensed consolidated financial statements include the accounts and operations of Crexendo, Inc. and its wholly owned subsidiaries, which include Avail 24/7 Inc., Crexendo Business Solutions, Inc., StoresOnline Inc., StoresOnline International Canada ULC, StoresOnline International, Inc., StoresOnline International Ltd., StoresOnline International Canada, Ltd., Internet Training Group, Inc., Crexendo International, Inc., Crexendo Telecom, Inc., Crexendo India Limited, and Crexendo Property Management, LLC. All intercompany account balances and transactions have been eliminated in consolidation. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles, consistent in all material respects with those applied in our financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. Because these financial statements address interim periods, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Such interim financial information is unaudited but reflects all adjustments that in the opinion of management are necessary for the fair presentation of the interim periods presented. The results of operations presented in this Quarterly Report on Form 10-Q are not necessarily indicative of the results that may be expected for the year ending December 31, 2014 or for any future periods. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements and footnotes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

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.

Restricted Cash – We classified \$482,000 and \$487,000 as restricted cash as of June 30, 2014 and December 31, 2013, respectively. Cash is restricted for state licensing letters of credit, compensating balance requirements of our merchant accounts, and purchasing card agreements. As of June 30, 2014, we had restricted cash in financial institutions in excess of federally insured limits in the amount of \$482,000.

Trade Receivables – We have historically offered to our StoresOnline customers the option to finance, typically through 24 and 36-month extended payment term arrangements (“EPTAs”), purchases made at our Internet Training Workshops through our Web Services segment. EPTAs are reflected as short-term and long-term trade receivables, as applicable, as we have the intent and ability to hold the receivables for the foreseeable future, until maturity or payoff. EPTAs are recorded on a nonaccrual status beginning on the contract date.

Allowance for Doubtful Accounts – For sales made through EPTA contracts, we record an allowance for doubtful accounts each reporting period based on the Company’s ongoing assessment of collectability. The allowance represents estimated losses resulting from customers’ failure to make required payments. The allowance for doubtful accounts for EPTAs is netted against the current and long-term trade receivables balances. 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. Because revenue generated from customers financing through EPTAs is deferred and not recognized prior to the collection of cash, adjustments to the allowance for doubtful accounts related to our EPTA contracts increase or decrease deferred revenue. Trade receivables are written off against the allowance when the related customers are no longer making required payments and the trade receivables are determined to be uncollectible, typically 90 days past their original due date. For sales made in our Hosted Telecom Services and Web Services segments, the allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. We determine the allowance based on known troubled accounts, historical experience, and other currently available evidence.

Interest Income - Interest income is primarily earned from EPTA contracts. EPTA contract terms generally contain an 18% simple interest rate. Interest income is recognized on these accounts only to the extent cash is received as the receivables are generally 24 and 36-months in length and collection of the full amount of the receivable is not probable. We recognized \$37,000 and \$146,000 for the three months ended June 30, 2014 and 2013, respectively. We recognized \$85,000 and \$365,000 for the six months ended June 30, 2014 and 2013, respectively.

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

Certificate of Deposit - We hold a \$250,000 certificate of deposit as collateral for merchant accounts, which automatically renews every 12 months. The certificate of deposit is classified as long-term in the condensed consolidated balance sheets.

Property and Equipment - Depreciation and amortization expense is computed using the straight-line method in amounts sufficient to allocate the cost of depreciable assets over their estimated useful lives ranging from two to five years. The cost of leasehold improvements 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 and amortization expense is included in general and administrative expenses and totaled \$167,000 and \$317,000 for the three months ended June 30, 2014 and 2013, respectively and \$393,000 and \$598,000 for the six months ended June 30, 2014 and 2013, respectively.

Depreciable lives by asset group are as follows:

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

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

Goodwill – Goodwill of \$75,000 was recorded in connection with the acquisition of PBX Central on June 4, 2013 and \$197,000 in connection with the acquisition of One Stop Voice (OSV), on June 1, 2014. 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 assets acquired in the acquisition of PBX Central and OSV, which include customer relationships, developed technology, technical know-how, and a non-compete agreement. The fair value of identifiable intangible assets is based upon the lower of discounted future cash flow projections or the amount paid in an arm's length transaction. The intangible assets are amortized following the patterns in which the economic benefits are consumed. Amortization expense from these acquired assets is included in general and administrative expenses and totaled \$56,000 and \$17,000 for the three months ended June 30, 2014 and 2013, respectively, and \$104,000 and \$24,000 for the six months ended June 30, 2014 and 2013, respectively.

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

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

Software licenses and DVD training courses sold under EPTAs are recognized as revenue upon receipt of cash from customers and not at the time of sale. Accounting standards require revenue to be deferred until customer payments are received if collection of the original principal balance is not probable.

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

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

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

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

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

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

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

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

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

Commission Revenue - We have contracts with third-party entities with respect to telemarketing product sales to our customers following the sale of the initial software licenses. These products and services are intended to assist the customers with their Internet businesses. These products are sold and delivered completely by third parties. We receive commissions from these third parties, and recognize the revenue as the commissions are received, net of expected customer refunds.

We have affiliate agreements with third-party entities that are resellers of satellite television services and internet service provider services. We receive commissions when the services are bundled with our hosted service offerings.

Cost of Revenue – Cost of revenue consists primarily of salaries for fulfillment services, and the cost of telecommunications equipment, services, and other products sold.

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

	June 30, 2014	December 31, 2013
Deferred sales commissions	\$259,000	\$189,000
Accumulated amortization	(61,000)	(13,000)
Deferred sales commissions, net	\$198,000	\$176,000

We amortized commission expense of \$33,000 and \$1,000 for the three months ended June 30, 2014 and 2013, respectively. We amortized commission expense of \$48,000 and \$1,000 for the six months ended June 30, 2014 and 2013, respectively.

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.

Financial Instruments - The carrying values of trade receivables, certificates of deposit, and equipment financing receivables approximate their fair values due to either the short maturity of the instruments or the recent date of the initial transaction.

Income Taxes - We recognize a liability or asset for the deferred tax consequences of all temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements that will result in taxable or deductible amounts in future years when the reported amounts of the assets and liabilities are recovered or settled. Accruals for uncertain tax positions are provided for in accordance with accounting guidance.

Accordingly, we may recognize the tax benefits from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting guidance is also provided on de-recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in the financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, and cash flows. In assessing the need for a valuation allowance, we evaluate all significant available positive and negative evidence, including historical operating results, estimates of future taxable income and the existence of prudent and feasible tax planning strategies. We have placed a full valuation allowance on deferred tax assets, see Note 5.

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

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

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

Comprehensive Income (Loss) – There were no other components of comprehensive income (loss) other than net income (loss) for the three and six months ended June 30, 2014 and 2013.

Operating Segments - Accounting guidance establishes standards for the way public business enterprises are to report information about operating segments in annual financial statements and requires enterprises to report selected information about operating segments in financial reports issued to stockholders. The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. Research and development expenses are allocated to Hosted Telecommunications Services and Web Services segments based on the level of effort, measured primarily by wages and benefits attributed to our engineering department. Indirect sales and marketing expenses are allocated to the Hosted Telecommunications Services and Web Services segments based on level of effort, measured by month-to-date contract bookings. General and administrative expenses are allocated to all two 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 or total accounts receivable for the three and six months ended June 30, 2014 and 2013.

Recently Issued Accounting Pronouncements - In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09 that introduces a new five-step revenue recognition model in which an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU also requires disclosures sufficient to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. This standard is effective for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. The Company is currently evaluating the new guidance to determine the impact it will have on its consolidated financial statements.

(2) Net Loss Per Common Share

Basic net income (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 net income per common share is computed giving effect to all dilutive common stock equivalents, consisting of common stock options and restricted shares held in escrow. Diluted net loss per common share for the three and six months ended June 30, 2014 and 2013 was the same as basic net loss per common share, as the common share equivalents were anti-dilutive. The following table sets forth the computation of basic and diluted net income (loss) per common share:

	Three Months Ended June		Six Months Ended June 30,	
	2014	30, 2013	2014	2013
Net loss (in thousands)	\$(1,494)	\$(1,070)	\$(3,126)	\$(1,468)
Weighted-average share reconciliation:				
Weighted-average shares outstanding	11,173,762	10,682,393	11,043,770	10,675,990
Weighted-average basic shares outstanding	11,173,762	10,682,393	11,043,770	10,675,990
Dilutive employee stock options	-	-	-	-
Diluted shares outstanding	11,173,762	10,682,393	11,043,770	10,675,990
Net (loss) income per common share:				
Basic	\$(0.13)	\$(0.10)	\$(0.28)	\$(0.14)
Diluted	\$(0.13)	\$(0.10)	\$(0.28)	\$(0.14)

Outstanding stock options are not included in the computation of diluted loss per share because the Company has a net loss and the inclusion of such shares would be anti-dilutive due to the net loss. At June 30, 2014 and 2013, the outstanding stock options were 2,310,890 and 2,300,571, respectively.

(3) Trade Receivables, net

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

	June 30, 2014	December 31, 2013
Non-EPTA trade receivables	\$492	\$688
Conforming EPTAs	289	577
Non-Conforming EPTAs:		
1 - 30 days	15	68
31 - 60 days	10	30
61 - 90 days	10	43
Gross trade receivables	816	1,406
Less allowance for doubtful accounts	(71)	(200)
Trade receivables, net	\$745	\$1,206
Current trade receivables, net	\$651	\$1,090

Long-term trade receivables, net	94	116
Trade receivables, net	\$745	\$1,206

All current and long-term EPTAs in the table above had original contract terms of greater than one year. The Company wrote off \$46,000 of EPTAs during the six months ended June 30, 2014 and \$1,027,000 during the year ended December 31, 2013, of which, all had original contract terms of greater than one year.

(4) Equipment Financing Receivables

We rent our hosted telecom equipment (VoIP telephone devices) through leasing contracts that we classify as either operating leases or sale-type leases. Equipment finance receivables arising from the rental of our hosted telecom equipment through sales-type leases were as follows (in thousands):

	June 30, 2014	December 31, 2013
Gross financing receivables	\$1,665	\$1,369
Less unearned income	(1,051)	(877)
Financing receivables, net	614	492
Less: Current portion of finance receivables, net	(141)	(94)
Finance receivables due after one year	\$473	\$398

Equipment finance receivables are expected to be collected over the next thirty-six to sixty months.

(5) Income Taxes

Our effective tax rate for the three and six months ended June 30, 2014 was (0.9)% and (1.5)%, respectively, which resulted in a provision for income taxes of \$13,000 and \$47,000 respectively. The benefit for the six months ended June 30, 2014 was primarily due to the statute of limitations expiring on some uncertain tax positions.

Our effective tax rate for the three and six months ended June 30, 2013 was 2.4% and 15.5%, respectively, which resulted in a benefit for income taxes of \$26,000 and \$263,000 respectively. The benefit for the six months ended June 30, 2013 was primarily due to the statute of limitations expiring on some uncertain tax positions.

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.

(6) Fair Value Measurements

We have financial instruments as of June 30, 2014 and December 31, 2013 for which the fair value is summarized below (in thousands):

	June 30, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets:				
Trade receivables, net	\$745	\$704	\$1,206	\$1,190

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Certificate of deposit	251	251	250	250
Equipment financing receivable	614	614	492	492
Liabilities:				
Acquisition related contingent consideration	\$228	\$228	\$51	\$51

The carrying amount of certificates of deposit approximates fair value, as determined by certificates of deposit with similar terms and conditions. The trade receivables consist primarily of extended payment term agreements and the fair value is computed using a discounted cash flow model with an estimated market rate.

Liabilities measured at fair value on a recurring basis are summarized below as of June 30, 2014 and December 31, 2013, respectively (in thousands).

Description	As of June	Fair value measurement at reporting date		
	30, 2014	Level 1	Level 2	Level 3
Liabilities:				
Acquisition related contingent consideration	\$228	\$-	\$-	\$228
Description	As of December 31,	Fair value measurement at reporting date		
	2013	Level 1	Level 2	Level 3
Liabilities:				
Acquisition related contingent consideration	\$ 51	\$ -	\$ -	\$ 51

Level 3 instruments are valued based on unobservable inputs that are supported by little or no market activity and reflect the Company's own assumptions in measuring fair value. The fair value of contingent consideration is measured using various types of income approach models which include; excess earnings, relief from royalty, and with and without methodology. The key assumptions used in valuing the OSV contingent consideration are as follows: discount rate of 12.5%, tax rate of 39.3%, contributory asset charges for technology license and tangible assets used to deliver services, assembled workforce, and estimated economic life of 7 years. The key assumptions used in valuing the PBX Central contingent consideration are as follows: discount rate of 18%, tax rate of 38.1%, contributory asset charges for technology license and tangible assets used to deliver services, and estimated economic life of 10 years. See additional details on the valuation approach approaches for both acquisitions in Note 9.

The progression of the Company's Level 3 instruments fair valued on a recurring basis for the six months ended June 30, 2014 are shown in the table below (in thousands):

	Acquisition Related Contingent Consideration
Balance at December 31, 2013	\$ 51
Cash payments	(37)
Change in fair value	3
Additions	211
Balance at June 30, 2014	\$ 228

(7) Commitments and Contingencies

Legal Proceedings

From time to time we receive inquiries from federal, state, city and local government officials in the various jurisdictions in which we operate. These inquiries and investigations generally concern compliance with various city, county, state and/or federal regulations involving sales, representations made, customer service, refund policies, and marketing practices. We respond to these inquiries and have generally been successful in addressing the concerns of these persons and entities, without a formal complaint or charge being made, although there is often no formal closing

of the inquiry or investigation. There can be no assurance that the ultimate resolution of these or other inquiries and investigations will not have a material adverse effect on our business or operations, or that a formal complaint will not be initiated. We also receive complaints and inquiries in the ordinary course of business from both customers and governmental and non-governmental bodies on behalf of customers, and in some cases these customer complaints have risen to the level of litigation. There can be no assurance that the ultimate resolution of these matters will not have a material adverse effect on our business or results of operations.

We have recorded liabilities of approximately \$193,000 and \$202,000 as of June 30, 2014 and December 31, 2013, respectively, for estimated losses resulting from various legal proceedings in which we are engaged. Attorney's fees associated with the various legal proceedings are expensed as incurred. We are also subject to various claims and legal proceedings covering matters that arise in the ordinary course of business. We believe that the resolution of these other cases will not have a material adverse effect on our business, financial position, or results of operations.

Sale-Leaseback

On February 28, 2014, the Company sold and leased back the land, building and furniture associated with the corporate headquarters in Tempe, Arizona for \$2.0 million in cash (Note 10). The Company recognized a deferred gain of \$281,000 on sale-leaseback, which will be amortized over the initial lease term of 36 months to offset rent expense. The net deferred gain is included in other long-term liabilities in the condensed consolidated balance sheets as of June 30, 2014.

The lease agreement called for rent payments for the initial three year term to be made in advance in the form of 300,000 shares of common stock of Crexendo, Inc. The fair value price per share at the time of the lease was \$3.22 per share, resulting in rent expense of \$322,000 per year for three years. Prepaid rent included in the condensed consolidated balance sheets as of June 30, 2014, is as follows:

Prepaid rent, current	\$322,000
Long-term prepaid rent	537,000
Total prepaid rent, net	\$859,000

Rent expense incurred on the sale-leaseback, including the effects of the deferred gain amortization, during the three months ended June 30, 2014 and 2013 was \$57,000 and \$0, respectively. Rent expense incurred on the sale-leaseback, including the effects of the deferred gain amortization, during the six months ended June 30, 2014 and 2013 was \$75,000 and \$0, respectively.

(8) Segment Information

Management has chosen to organize the Company around differences based on its products and services. Hosted Telecom Services segment generates revenue from selling hosted telecom services and broadband internet services. Web Services segment generates revenue from website hosting, managing e-commerce or lead generation offerings, websites, search engine optimization/management and online promotional needs for small, medium, and large sized businesses. The Company has two operating segments, which consist of Hosted Telecom Services and Web Services. Effective April 1, 2014, the Company changed its reporting segments to reflect changes in how the