

Crexendo, Inc.  
Form 10-K  
March 04, 2015

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UNITED STATES

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-K

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☐ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2014:

Or

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

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Crexendo, Inc.

(Exact name of registrant as specified in its charter)

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Delaware (State or Other Jurisdiction of Incorporation or Organization)	001-32277 (Commission File Number)	87-0591719 (I.R.S. Employer Identification No.)
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1615 South 52nd Street, Tempe, AZ 85281  
(Address of Principal Executive Office) (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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Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value \$0.001 per share	OTCQX Marketplace

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the common stock held by non-affiliates of the registrant as of December 31, 2014 was approximately \$9,917,000.

The number of shares of the registrant's common stock outstanding as of February 24, 2015 was 12,700,624.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Registrant's 2015 Annual Meeting of Stockholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

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## PART I

Throughout this Annual Report, we refer to Crexendo, Inc., together with its subsidiaries, as “we,” “us,” “our Company” or “the Company.” As used in this Annual Report, “StoresOnline™” and “Ride The Cloud” are registered trademarks of our Company in the United States and other countries. All other product names are or may be trademarks of, and are used to identify the products and services of, their respective owners.

THIS ANNUAL REPORT ON FORM 10-K CONTAINS FORWARD-LOOKING STATEMENTS. THESE STATEMENTS RELATE TO FUTURE EVENTS OR OUR FUTURE FINANCIAL PERFORMANCE. IN SOME CASES, YOU CAN IDENTIFY FORWARD-LOOKING STATEMENTS BY TERMINOLOGY SUCH AS “MAY,” “WILL,” “SHOULD,” “EXPECT,” “PLAN,” “INTEND,” “ANTICIPATE,” “BELIEVE,” “ESTIMATE,” “PROJECT,” “PREPARE,” “POTENTIAL” OR “CONTINUE” (INCLUDING THE NEGATIVE OF SUCH TERMS), OR OTHER SIMILAR TERMINOLOGY. THESE STATEMENTS ARE ONLY ESTIMATIONS, AND ARE BASED UPON VARIOUS ASSUMPTIONS THAT MAY NOT BE REALIZED. ACTUAL EVENTS OR RESULTS MAY DIFFER MATERIALLY. IN EVALUATING THESE STATEMENTS, YOU SHOULD SPECIFICALLY CONSIDER VARIOUS FACTORS, INCLUDING, BUT NOT LIMITED TO, THE RISKS OUTLINED BELOW UNDER ITEM 1A. THESE FACTORS MAY CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM ANY FORWARD-LOOKING STATEMENT.

ALTHOUGH WE BELIEVE THAT THE ESTIMATIONS REFLECTED IN THE FORWARD-LOOKING STATEMENTS ARE REASONABLE, WE CANNOT GUARANTEE FUTURE RESULTS, LEVELS OF ACTIVITY, PERFORMANCE OR ACHIEVEMENTS. MOREOVER, NEITHER WE NOR ANY OTHER PERSON ASSUMES RESPONSIBILITY FOR THE ACCURACY AND COMPLETENESS OF THE FORWARD-LOOKING STATEMENTS. WE DO NOT INTEND TO UPDATE ANY OF THE FORWARD-LOOKING STATEMENTS AFTER THE DATE OF THIS ANNUAL REPORT TO CONFORM SUCH STATEMENTS TO ACTUAL RESULTS OR TO CHANGES IN OUR EXPECTATIONS, UNLESS REQUIRED BY LAW.

### ITEM 1. BUSINESS

#### OVERVIEW

We are a hosted services company that provides website hosting, hosted telecommunications 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 Telecommunications Services and Web Services.

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

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

the lease, as appropriate.

Web Services segment –We generate website hosting revenue and professional services revenue primarily from search engine optimization services, link building, paid search management services, conversion rate optimization services, and website design and development. These services are typically billed on a fixed price basis or on a monthly recurring basis with an initial term of six to twelve months. During the quarter ended September 30, 2013, the Company made a strategic decision to limit our provision of web services to our enterprise sized customers.

## OUR SERVICES AND PRODUCTS

Our goal is to provide a broad range of Cloud-based products and services that nearly eliminate the cost of a businesses' technology infrastructure and enable businesses of any size to more efficiently run their business. By providing a variety of comprehensive and scalable solutions, we are able to provide these solutions on a monthly basis to businesses and entrepreneurs 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:

Hosted Telecommunications Services - Our hosted telecommunications service offering includes hardware and 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, 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 hosted telecommunications services are powered by our proprietary implementation of standard Internet, Web and IP or cloud technologies. Our services also use our complex infrastructure that we build and manage based on industry standard best practices to achieve greater efficiencies and customer satisfaction. Our infrastructure comprises of computing, storage, network technologies, 3rd party products and vendor relationships. We also develop end user portals for account management, license management, billing and customer support and adopt other cloud technologies through our partnerships.

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

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

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

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

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

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

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

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

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

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

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

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

Hosted Website Services - Our website hosting services allows businesses and entrepreneurs to host their websites in our data center for a monthly fee.

Search Engine Optimization (SEO) - There are two general aspects to Search Engine Optimization ("SEO"). First, the tactical level, that includes conditioning a website and/or its pages to be relevant and search-engine friendly. Second, we help businesses strategically select keywords and keyword phrases. The popularity of a site plays a role in what keyword phrases a business can compete on versus what keyword phrases might be "out of their league". We focus on the strategic selection of keywords and prioritize keywords that have healthy search volumes and high 'win' capability. Our experience coupled with our software allow us to strategically select the best choices for keyword phrases to target which provide the highest probability of getting high search engine positions and draws maximum traffic to the website. Our SEO packages include a keyword interview, strategic keyword research, baseline ranking report, search engine optimization plan, and comparison ranking report.

**Link Building** - Link building is a critical component of off-page SEO. To be effective, a link building campaign must be done manually. Search engines can detect links obtained via automated submission. Also, links need to come from many different types of sites, not just one or two. Link building is closely related to search engine optimization, as such; we carefully synchronize all our link building efforts and anchor text with our search engine optimization efforts.

An effective link building effort is labor intensive, with no real shortcuts. We use a broad based approach for link building that follows search engine webmaster guidelines. We use strategies that include, but aren't limited to: Web 2.0 sites, social media and social bookmarking sites, vertical portals, local directories, live directories, and others.

**Paid Search Management** - We offer paid search management services, such as management of Google® AdWords™, Yahoo and Microsoft Advertising adCenter™ accounts for our customers.

Modern paid search networks are incredibly sophisticated and require a tremendous amount of experience and expertise to avoid the many potential pitfalls of paid search. We assist customers by taking a conservative approach to paid search management. By using a combination of proprietary automation tools, split test dedicated landing pages, as well as the practiced eye of an expert monitoring our customer accounts on a daily basis, we are able to consistently raise conversion rates and lower the cost of pay-per-click (PPC) acquisition.

Website Design and Development - Using our proprietary software and processes we design and develop websites with “conversion” in mind. The term conversion means different things to different websites. To a lead-generation website, it means getting prospects to submit their contact information so the sales team can contact them. For an e-commerce website, conversion means getting an online customer to complete an order.

Our website design packages range from a semi-custom template based design package to a completely custom design package. We incorporate analytics into every website we build. Proper analytics allow identification of weak spots in the conversion process. Once weak spots are identified, the site can be adjusted to smooth out the process and help turn more prospects into customers.

Once the site is complete, we provide tutorials and tools to allow customers to make changes to their sites as often as necessary without having to pay additional programming fees. Alternatively, customers can elect to have us manage the changes to their websites for an additional fee.

## SEGMENT INFORMATION

The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. Effective April 1, 2014, the Company changed its reporting segments to reflect changes in how the Chief Operating Decision Maker (CODM) internally measures performance and allocates resources. Segment operating results for the prior year have been revised to conform to current year segment operating results presentation. Segment revenue and income (loss) before income tax provision was as follows (in thousands):

	Year Ended December 31,	
	2014	2013
Revenue:		
Hosted Telecommunications Services	\$4,297	\$2,370
Web Services	3,297	7,958
Consolidated revenue	\$7,594	\$10,328
	Year Ended December 31,	
	2014	2013
Income (loss) before income tax provision:		
Hosted Telecommunications Services	\$(5,689)	\$(5,429)
Web Services	(610)	209
Loss before income tax provision	\$(6,299)	\$(5,220)

## TECHNOLOGY

We believe our proprietary implementation of standard Web, IP, Cloud, Mobile and Internet technologies represent a key component of our business model. We believe these technologies and how we deliver them to our customers distinguish our services and products from the services and products offered by our competitors. Our technology infrastructure and virtual network operation center, all of which is built and managed on industry standard computing, storage, data and platforms offers us greater efficiencies. The synergies between Web and Telecommunication protocols such as TCP/IP, HTTP, XML, SIP and innovations in computing, load balancing, redundancy and high availability of Web and Telecommunications technologies offers us a unique advantage in delivering these services to our customers seamlessly from our data center.





Our Hosted Telecommunications technology is continuously being enhanced with additional features and software functionality. Our current functionality includes:

High-end desktop telephony devices such as Gigabit, PoE, 6 Line Color Phone with 10 programmable buttons and lower end Monochrome 2 Line wall mountable device

Basic Business Telephony Features such as those offered in a traditional private branch exchange (“PBX”) systems like extension dialing, Direct Inward Dialing (DID), Hold/Resume, Music-On-Hold, Call Transfer (Attended and Unattended), Conferencing, Local, Long Distance, Toll-Free and International Dialing, Voicemail, Auto-Attendant and traditional faxing

Advanced telephony features such as Call Park, Call Pickup, Paging (through the phones), Overhead paging, Call Recording

Call Center Functionality such as Agent Log In/Log Out, Whisper, Barge and Call center reporting

Unified Communications features like Simultaneous Ring, Sequential Ring, Status based Routing (Find-Me-Follow-Me), 10-party instant conference, and Mobile application (CrexMo)

Crexendo Mobile Application (CrexMo), which allows users to place and receive extension calls using Crexendo’s network, transfer and conference other users right from their mobile device as if they were in the office. It also provided users instant access to visual voicemail and call logs

End User Portal and Unified Messaging with Voicemail, Call Recording and eFax inbox.

Our web software platform is continuously being enhanced and is an innovative website-building environment. Features and functions of our software include:

during website development, our customers can experience the look and feel of their websites as if they were their own customers. They can shop, navigate, order products, track orders, and more. If they want to change or add more elements, they can edit, rearrange, add, and delete the elements all within a dynamic, point-and-click environment;

designs that are customized based on the customers’ choices and arrangements. Customers can modify the look and feel of the design to complement their services or products. In addition, design modification and arrangement are executed within a streamlined, point-and-click environment;

blogs, online journals, message boards, and forums that are easily integrated into the content of the website. As administrators, the customers have full control in terms of filtering content, allowing images, and other blog, message board, and forum permissions;

customizable forms that address customer-specific needs. By using customized forms, our customers can set up secure, encrypted forms with improved ease to collect sensitive information from their customers. This is especially useful for service-based businesses, as these forms can be used for job, loan, applications, questionnaires, bids, quotes, lead generation, etc.;

advanced out of the box eCommerce features include: shopping cart, ordering rules setup for shipping, sales tax, discount codes, UPS integration, inventory control system, gift certificate and gift card purchasing and redemption, integration with Amazon® Checkout and/or Google® Checkout, Google® Base integration, eBay® auctions

integration, shopping cart supporting multiple currencies and price sets, automatic sitemap generation used by search engines, and advanced website product search using filters to quickly narrow down the product offering based on product attributes.

We continue to invest and develop on our Web platform to make it more easy-to-use, enable larger mobile and 3rd party integration features thus enabling our web customers to drive more traffic to their web-sites.

#### RESEARCH AND DEVELOPMENT

We invested \$1,604,000 and \$1,692,000 for the years ended December 31, 2014 and 2013, respectively, in the research and development of our technologies and data center. The majority of these expenditures were for our hosted telecommunications products and services and website development software.

#### COMPETITION

Our markets are increasingly competitive. Our competitors include hosted telecommunications providers and traditional telephone service providers, application service providers, software vendors, systems integrators, direct providers, and information technology consulting services providers, and hosted service providers.

Most of these competitors, however, do not yet offer the full range of website hosting and telecommunications services we believe our target market requires. These competitors could elect to focus additional resources in our target markets, which could adversely affect our business prospects, financial position and results of operations materially. Many of our current and potential competitors have longer operating histories, larger customer bases, and longer relationships with customers as well as significantly greater financial, technical, marketing and public relations resources than we do.

Additionally, should we determine to pursue acquisition opportunities, we may compete with other companies with similar growth strategies. Some of these competitors may be larger and have greater financial resources than we do. Competition for these acquisition targets could also result in increased prices of acquisition targets and a diminished pool of companies available for acquisition.

There are relatively low barriers to entry into our business. Our proprietary technology does not preclude or inhibit competitors from entering our markets. In particular, we anticipate new entrants will attempt to develop competing products and services or new forums for conducting e-commerce and telecommunications services which could be deemed competition. Additionally, if e-commerce or Internet based enterprises and telecommunications service providers with more resources and name recognition were to enter our markets, they may redefine our industry and make it difficult for us to compete.

Expected technology advances associated with the Cloud, increasing use of the Cloud, and new software products are welcome advancements that we believe will broaden the Cloud's viability. We anticipate that we can compete successfully by relying on our infrastructure, marketing strategies and techniques, systems and procedures, and by adding additional products and services in the future. We believe we can continue the operation of our business by periodic review and revision to our product offerings and marketing approach.

## INTELLECTUAL PROPERTY

Our success depends in part on using and protecting our proprietary technology and other intellectual property. Furthermore, we must conduct our operations without infringing on the proprietary rights of third parties. We also rely upon trade secrets and the know-how and expertise of our key employees. To protect our proprietary technology and other intellectual property, we rely on a combination of the protections provided by applicable copyright, trademark and trade secret laws, as well as confidentiality procedures and licensing arrangements. Although we believe we have taken appropriate steps to protect our intellectual property rights, including requiring employees and third parties who are granted access to our intellectual property to enter into confidentiality agreements, these measures may not be sufficient to protect our rights against third parties. Others may independently develop or otherwise acquire unpatented technologies or products similar or superior to ours.

We license from third parties certain software and Internet tools which we include in our services and products. If any of these licenses were terminated, we could be required to seek licenses for similar software and Internet tools from other third parties or develop these tools internally. We may not be able to obtain such licenses or develop such tools in a timely fashion, on acceptable terms, or at all.

Companies participating in the software, Internet technology, and telecommunication industries are frequently involved in disputes relating to intellectual property. We may be required to defend our intellectual property rights against infringement, duplication, discovery and misappropriation by third parties or to defend against third-party claims of infringement. Likewise, disputes may arise in the future with respect to ownership of technology developed by employees who were previously employed by other companies. Any such litigation or disputes could be costly and divert our attention from our business. An adverse determination could subject us to significant liabilities to third parties, require us to seek licenses from, or pay royalties to, third parties, or require us to develop appropriate alternative technology. Some or all of these licenses may not be available to us on acceptable terms, or at all. In addition, we may be unable to develop alternate technology at an acceptable price, or at all. Any of these events could have a material adverse effect on our business prospects, financial position, or results of operations.

## EMPLOYEES

As of December 31, 2014, we had 56 employees; 55 full-time and 1 part-time, including 5 executives, 7 sales representatives, 5 in sales management and administration, 11 engineer and IT support in the development of our cloud services solutions, 13 in Hosted Telecommunications Services fulfillment, 3 in customer support, and 12 in finance, legal and business development, collections, marketing, and other general administration.

#### CORPORATE INFORMATION

Crexendo, Inc. was incorporated as a Nevada corporation under the name "Netgateway, Inc." on April 13, 1995. In November 1999, we were reincorporated under the laws of Delaware. In July 2002, we changed our corporate name to "iMergent, Inc.". In May 2011, our stockholders approved an amendment to our Certificate of Incorporation to change our name from "iMergent, Inc." to "Crexendo, Inc." The name change was effective May 18, 2011. Our ticker symbol "IIG" on the New York Stock Exchange was changed to "EXE" on May 18, 2011. We changed the name to better reflect the scope and direction of our business activities of assisting and providing web-based technology solutions to entrepreneurs and small businesses who are seeking to take advantage of the benefits of conducting business on the cloud.

We are headquartered at 1615 South 52nd Street, Tempe, AZ, 85281, and our telephone number is (602) 714-8500. Our website is [www.crexendo.com](http://www.crexendo.com). Our website and the information contained therein or connected thereto shall not be deemed to be incorporated into this Annual Report.

We make available free of charge on or through our Internet website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities Exchange and Commission ("SEC").

You may read and copy this Annual Report at the SEC's public reference room at 450 Fifth Street, NW, Washington D.C. 20549. Information on the operation of the public reference room can be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding our filings at [www.sec.gov](http://www.sec.gov).

## GOVERNMENTAL REGULATION

We are subject to regulations generally applicable to all businesses. We are also subject to an increasing number of laws and regulations directly applicable to telecom, internet access and commerce. The adoption of any such additional laws or regulations may decrease the rate of growth of the Internet, which could in turn decrease the demand for our products and services. Such laws may also increase our costs of doing business or otherwise have an adverse effect on our business prospects, financial position or results of operations. Moreover, the applicability to the Internet of existing laws governing issues such as property ownership, libel, and personal privacy is uncertain. In particular, one channel we use to initially contact our customers is e-mail. The use of e-mail for this purpose has become the subject of a number of recently adopted and proposed laws and regulations. Future federal or state legislation or regulation could have a material adverse effect on our business prospects, financial condition and results of operations.

### ITEM 1A.

### RISK FACTORS.

In addition to factors discussed elsewhere in this Annual Report, the following are important risks which could adversely affect our future results. If any of the risks we describe below materialize, or if any unforeseen risk develops, our operating results may suffer, our financial condition may deteriorate, the trading price of our common stock may decline and our investors could lose all or part of their investment.

The Company has transformed into a start-up company with the inherent risks and uncertainties of funding operations until profitability is achieved. We currently plan to fund our operations during the next twelve months using our cash and cash equivalents of \$2,906,000. However, after considering the Company's historical negative cash flow from operating activities as well as internal forecasts, such amount does not appear adequate to fund our anticipated cash needs for the next twelve months. Accordingly, the Company will be required to obtain additional debt or equity financing such as that available from its CEO to sustain operations. The company has the ability to call outstanding warrants to provide additional liquidity for approximately \$690,000, if needed. In addition, the Company received a commitment from the CEO, and major shareholder, in February 2015 that, if needed, he would provide up to \$1,000,000 of financial support to enable the Company to fund its operations through March 31, 2016. As such, the Company believes it will have sufficient funds to pay its obligations as they come due during the next twelve months as a result of the sources of funding detailed above.

Changes in laws and regulations and the interpretation and enforcement of such laws and regulations could adversely impact our financial results or ability to conduct business.

We are subject to a variety of federal and state laws and regulations as well as oversight from a variety of governmental agencies and public service commissions. The laws governing our business may change in ways that harm our business. Federal or state governmental agencies administering and enforcing such laws may also choose to interpret and apply them in ways that harm our business. These interpretations are also subject to change. Regulatory action could materially impair or force us to change our business model and may adversely affect our revenue, increase our compliance costs, and reduce our profitability. In addition, governmental agencies such as the Securities and Exchange Commission (SEC), Internal Revenue Service (IRS), Federal Trade Commission (FTC), Federal Communication Commission (FCC) and state taxing authorities may conclude that we have violated federal laws, state laws or other rules and regulations, and we could be subject to fines, penalties or other actions that could adversely impact our financial results or our ability to conduct business.

Changes in our business model and product strategies may adversely impact revenue.

Revenues from the discontinued seminar sale model continue to decrease. Extended Payment Term Agreements (EPTA's) have almost completed. Hosting fees from websites have continued to decline since the cessation of direct seminar sales. The Company has not actively marketed its website development software and new hosting fees from websites have been minimal.

From time to time we had been the subject of governmental inquiries and investigations related to our discontinued seminar sales model and business practices that could require us pay refunds, damages or fines, which could negatively impact our financial results or ability to conduct business.

From time to time, we received inquiries from federal, national, state, city and local government officials in the various jurisdictions in which we operated. These inquiries had historically been related to our discontinued seminar sales practices. 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. There is still the potential of review of past sales and sales of our current web and telecom services. 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. See Part I, Item 3, Legal Proceedings, for a discussion of some of these pending matters. The ultimate resolution of these or other inquiries or investigations may have a material adverse effect on our business or operations, or a formal complaint could be initiated. During the ordinary course of business we also receive a number of complaints and inquiries from customers, governmental and private entities. In some cases these complaints and inquiries have ended up in civil court. While we attempt to resolve these matters on a mutually satisfactory basis, 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 are also subject to various claims and legal proceedings covering matters which arise in the ordinary course of business. We believe the resolution of these other cases will not have a material adverse effect on our business, financial position, or results of operations.

We face risks in our strategy of developing new desktop telephones (end points).

We currently are developing new Crexendo ® branded end points. The development is being manufactured by a third party vendor. The end points include Crexendo design, technology and processes. The acceptance of the end points is not guaranteed and is contingent on factors including but not limited to our meeting certain industry standards, the availability of our vendors to meet agreed terms, supply from vendors being sufficient to meet demand, industry acceptance of the end points, end points meeting the needs of our customers, competitive pricing of the end points, feature set of the end points being up to competitive standards, regulatory approval as required of the end points and competitor claims relating to the end points. Our failure to be able to fully implement the sale of the Crexendo end points or the inability to have end points manufactured to meet our supply needs may cause us damage as well as require us to have to purchase end points from other suppliers at a higher price which could affect sales and margins.

Our Telecommunications services are required to comply with industry standards, FCC regulations as well as certain State and local jurisdiction specific regulations which may require us to modify existing products and/or services.

The acceptance of telephony services and network services are dependent upon our meeting certain industry standards. Our VoIP telephony products are not currently sold to work with other competitors' or vendors' equipment. There is currently a lack of agreement among industry leaders about whether there should be an industry standard or a preferred standard. Our inability to operate with competitor's equipment or services may impact our competitiveness. We do comply with certain rules and regulations of the FCC regarding safety standards. Standards are continuously being modified and replaced. As standards evolve, we may be required to modify our existing products or develop and support new versions of our products. We must comply with certain federal, state, and local requirements regarding how we interact with our customers, including marketing practices, consumer protection, privacy, and billing issues, the provision of 9-1-1 emergency service and the quality of service we provide to our customers. The failure of our products and services to comply, or delays in compliance, with various existing and evolving standards could delay future offerings and impact our sales, margins, and profitability.



Changes to Universal Service Fund programs could increase the cost of our service to our customers diminishing or eliminating our pricing advantage.

The FCC and a number of states are considering reform or other modifications to Universal Service Fund programs. The way we calculate our contribution may therefore change. The changes if not able to be passed on to our customers could substantially reduce our revenues, margins, and profitability.

States are adding regulation for VoIP carriers which could increase our costs and change certain aspects of our service.

Certain states take the position that offerings by VoIP companies are intrastate and therefore subject to state regulation. We have registered as a CLEC in most states however our rates are not regulated in the same manner as traditional telephone service providers. Some states are also requiring that we register as a seller of VoIP services even though we have registered as a CLEC. Some states argue that if the beginning and end points of communications are known, and if some of these communications occur entirely within the boundaries of a state, the state can regulate that offering and may therefore add additional taxes or surcharges or regulate rates in a similar matter to traditional telephone service providers. We believe that the FCC has pre-empted states from regulating VoIP offerings in the same manner as providers of traditional telecommunications services. We cannot predict how this issue will be resolved or its impact on our business at this time.

Our ability to offer services outside the U.S. is subject to different regulations which may be unknown and uncertain.

Regulatory treatment of VoIP telephony outside the United States varies from country to country, and local jurisdictions. Many times the laws are vague, unclear and regulations are not enforced uniformly. We are licensed as a VoIP seller in Canada, and are considering expanding to other countries. We also cannot control if our customers take their devices out of the United States and use them abroad. Our resellers may sell to customers who maintain facilities outside the United States. The failure by us or our customers and resellers to comply with laws and regulations could reduce our revenue and profitability. As we expand to additional Countries there may be additional regulations that we are required to comply with, the failure to comply or properly assess regulations may subject us to penalties, fines and other actions which could materially affect our business.

From time to time we are and have been the subject of customer complaints and lawsuits relating to our business practices which could require us to pay damages or fines, and could negatively impact our financial results.

Primarily from our discontinued seminar sales practices, we receive complaints and inquiries from both customers and governmental and non-governmental bodies on behalf of customers and, in some cases, these customer complaints have resulted in litigation. Some of these matters are pending. The ultimate resolution of these matters may have a material adverse effect on our financial position or results of operations.

Changes to rates by our suppliers, competitors and increasing regulatory charges may diminish or eliminate our competitive pricing advantage.

Pricing in the telecommunications industry is very fluid and competitive. Our competitors may reduce their rates which may diminish or eliminate the competitive pricing advantage of our services or otherwise require us to reduce our rates which would affect our margins and revenues. Our upstream carriers, suppliers and vendors may increase their rates thus directly impacting our service cost, which may affect our margins. In addition, increased regulation and additional regulatory funding obligations at various levels of government could require us to either increase our prices or absorb the cost or raise our prices which could make us less competitive. Continued rate decreases could require us to lower our rates to remain competitive which could substantially reduce our revenues, margins, and profitability.

We may be required to reduce our prices in order to compete which could negatively impact our profitability.

As competition with our Web Services and Hosted VoIP (Voice over Internet Protocol) services continues to expand, we may be required to respond to additional competition which could require us to engage in price competition. If intense price competition occurs, we may be forced to lower prices, which could result in lower revenue and gross margins.

The telecommunications industry is highly competitive. We face intense competition from traditional telephone companies, wireless companies, cable companies and alternative voice communication providers.

Our Hosted VoIP telecommunication product competes with other VoIP providers. In addition, we also compete with traditional telephone service providers which provide telephone service based on the public switched telephone network. Some of these traditional service providers also provide internet service to their customers. Our VoIP offering is not fully compatible with such customers. Some of these traditional providers have also added VoIP services. There is also competition from cable providers, which have added VoIP services to their existing cable customers. The telecommunications industry is highly competitive. We face intense competition from traditional

telephone companies, wireless companies, cable companies, and alternative voice communication providers.

Most traditional wire line and wireless telephone service providers, cable companies, and some VoIP providers are substantially larger and better capitalized than we are and have the advantage of a large existing customer base. Because most of our target customers are already purchasing communications services from one or more of these providers, our success is dependent upon our ability to attract target customers away from their existing providers. Our competitors' financial resources may allow them to offer services at prices below cost or even for free in order to maintain and gain market share or otherwise improve their competitive positions.

The market for our products and services is evolving and our position in that market is uncertain. We may not have the resources to compete with other companies within our industry.

The markets for our products and services are continuing to evolve and are increasingly competitive. Demand and market acceptance for recently introduced and proposed new products and services and sales of such products and services are subject to a high level of uncertainty and risk. Our business may suffer if the market develops in an unexpected manner, develops more slowly than in the past or becomes saturated with competitors, if any new products and services do not sustain market acceptance.

Many of our direct competitors offer a range of products and services comparable to those offered by us. These competitors at any time could elect to focus additional resources in our target markets, which could materially and adversely affect us. Many of our current and potential competitors have stronger brand recognition, longer operating histories, larger customer bases, longer relationships with customers, and significantly greater financial, technical, operational, marketing and public relations resources than we do. We believe our competitors may be able to adapt more quickly to new technologies and customer needs, devote greater resources to the promotion or sale of their products and services, initiate or withstand substantial price competition, take advantage of acquisition or other opportunities more readily or develop and expand their product and service offerings more quickly.

There are low barriers to entry into the e-commerce services and Hosted VoIP telecommunication markets and, as a result, we face significant competition in a rapidly evolving industry.

We currently do not have patented technology, and only a limited amount of other proprietary technology, that would preclude or inhibit competitors from entering our business. Although we have patents pending, we currently do not have any registered patents. In addition, the costs to develop and provide e-commerce and VoIP services are relatively low. Therefore, we expect that we will continually face additional competition from new entrants into the market in the future. There is also the risk that our employees or independent contractors may leave and start competing businesses. The emergence of these enterprises could have a material adverse effect on us. Existing or future competitors may better address new developments or react more favorably to changes within our industry and may develop or offer e-commerce and Hosted VoIP telecommunication services providing significant technological, creative, performance, price, or other advantages over the services that we offer.

Increased competition, including the entry of new competitors, the introduction of new products by new and existing competitors, or price competition, could have a materially adverse effect on operating results and financial condition.

A number of very large, well-capitalized, high profile companies serve the e-commerce, VoIP and Cloud technology markets. If any of these companies entered our markets in a focused and concentrated fashion, we could lose customers, particularly more sophisticated and financially stable customers, and our revenue and profitability would suffer. These potential competitors could likely offer a broad array of products and services that would compete favorably with our product offerings. They could also likely offer these products at prices that would be difficult for us to match.

The rates we pay to underlying telecommunications carriers are subject to change and may impact our operations.

Interconnected VoIP traffic may be subject to increased charges. Should this occur, the rates paid to our underlying carriers may increase which could reduce our profitability. Changes in our underlying rates may change rates we charge our customers which could impact our sales and retention of customers as well as make us less competitive.

FCC Regulations regarding payments between regulated carriers may increase our costs.

The FCC adopted changes regarding repayments between regulated carriers that we partner with to interface with the public switch telephone network. The rates we pay for the services performed by these carriers may increase as a result of the FCC's reform order. As a result, we may increase rates for service, making our offerings less competitive with others in the marketplace, or reduce our profitability. The FCC further reformed the system under which regulated providers of telecommunications services compensate each other for various types of traffic, including VoIP traffic that terminates on the PSTN and applied new call signaling requirements to VoIP and other service provider. This may also affect our cost structure and our competitiveness.

Congress and the FCC have imposed regulations that require carriers to protect customer information which if not complied with could subject us to fines, penalties and lawsuits.

We are subject to Federal laws and FCC regulations that require us to protect customer information. While we have protections in place to protect customer information there is no assurance that our systems will not be subject to failure or intentional fraudulent attack. The failure to protect the following information could subject us to penalties and diminish the confidence our customers have in our systems which could negatively affect results. We have (i) a general duty to protect the confidentiality of our customer information and release information in the following circumstances: (1) as required by law; (2) with customer approval; and (3) in providing the service from which the

customer information is derived; (ii) regulations prohibiting us from releasing customer information except when a password is provided (we would be required to by sending it to the customer address of record or calling the customer at the phone number of record and (iii) a responsibility not to use customer information for marketing purposes without providing a specific opt out or opt in mechanism;

The FCC has approved net neutrality rules. We cannot predict the effect of this rulemaking or predict whether any new rules will be subject to a legal appeal.

We believe interference with access to our products and services is unlikely, broadband Internet access provider interference has occurred in limited circumstances in the United States and could result in a loss of existing users and increased costs, and could impair our ability to attract new users, thereby negatively impacting our revenue and growth. The FCC has implemented network neutrality rules in the past legal challenges and congressional action may change current rules which could result in, interference with our service or higher charges. If that occurs it could cause us to lose existing customers, impair our ability to attract new customers, and harm our revenue and growth. These problems could also arise in international markets. Most foreign countries have not adopted formal net neutrality rules like those adopted by the FCC.

We have incurred operating losses.

We sustained operating losses in the current and prior years. Our ability to obtain positive cash flows from operating activities will depend on many factors including, but not limited to, our ability to (i) reduce costs, (ii) improve sales and marketing efficiencies, (iii) reach more highly qualified prospects, and (iv) achieve operational improvements.

Our new lines of business have not been profitable.

We recorded operating losses on our Hosted Telecommunications Services and Web Services segments for the period ending December 31, 2013 and 2014 of \$5,220,000 and \$6,299,000, respectively. We have incurred operating losses in each of the three prior years and may incur operating losses in the foreseeable future.

If the market for our new products does not develop as we anticipate, our revenue may decline or fail to grow, which would adversely affect our operating results.

We market our Web Services and Hosted Telecommunications Services. The market for these products is still evolving and it is uncertain whether these products and services will achieve and sustain high levels of demand and market acceptance. If potential customers do not perceive the benefits of our product lines, sales may not develop or may develop more slowly than we expect, either of which would adversely affect our operations. Because the market for new product development is difficult to predict, we may make errors in predicting and reacting to relevant business trends, which may have a material adverse effect on our consolidated financial position, results of operations, and cash flows.

Our ability to use our net operating loss carry-forwards may be reduced in the event of an ownership change, and could adversely affect our financial results.

As of December 31, 2014, we had net operating loss (“NOL”) carry-forwards of approximately \$18,861,000, of which \$5,761,000 is subject to Section 382 limitations. Section 382 of the Internal Revenue Code, as amended (the “Code”) imposes limitations on a corporation’s ability to utilize its NOL carry-forwards. In general terms, an ownership change results from transactions increasing the ownership of certain stockholders in the stock of a corporation by more than 50% over a three-year period. Since our formation, we have issued a significant number of shares, and purchasers of those shares have sold some of them, resulting in two ownership changes, as defined by Code Section 382. As a result of the most recent ownership change, utilization of our NOL is subject to an annual limitation determined by multiplying the value of our stock at the time of the ownership change by the applicable federal long-term tax-exempt rate. The annual limitation is approximately \$461,000. Any limited amounts may be carried over into later years, and the amount of the limitation may, under certain circumstances, be increased by the “recognized built-in gains” that occur during the five-year period after the ownership change (the recognition period). Future changes in ownership of more than 50% may also limit the use of these remaining NOL carry-forwards. Our earnings, if any, and cash resources would be materially and adversely affected if we cannot receive the full benefit of the remaining NOL carry-forwards. An ownership change could occur as a result of circumstances that are not within our control.

We are subject to the risk of future disruptive technologies. If new technologies develop that are able to deliver competing voice and messaging services at lower prices, better or more conveniently, it could have a material adverse effect on us.

Our VoIP service competes against established alternative voice communication providers, (such as 8x8 and Ring Central). While we believe the technology we employ provides substantially better quality, changes in technology could allow these alternative providers to deliver comparable quality at a substantially lower price. In addition, as we continue providing VoIP services, we are likely to face competition from emerging competitors focused on newer,

less costly technology. In order to compete with such service providers, we may have to reduce our prices, which would impair our profitability, or offer additional features that may cause us to incur additional costs without commensurate price increases.

If we fail to adapt to changes in the market then our products and services could become obsolete.

The market for our products and services is constantly and rapidly evolving. There is substantial competition for our e-commerce services and our Hosted VoIP telecommunications products and services. As competitors introduce new and enhanced products and services, we may not be able to develop or acquire new products and services that compete effectively. New products based on new technologies or new industry standards could render our existing products obsolete and unmarketable. Any technical flaws in products we release could have a negative effect on customer adoption and our reputation.

Fluctuations in our operating results may affect our stock price and ability to raise capital.

Our operating results for any given quarter or fiscal year should not be relied upon as an indication of future performance. Quarter to quarter comparisons of our results of operations may not be meaningful as a result of (i) our limited operating history relating to Web Services and Hosted Telecommunications Services and (ii) the emerging nature of the markets in which we compete. Our future results will fluctuate, and those results may fall below the expectations of investors and may cause the trading price of our common stock to fall. This may impair our ability to raise capital, should we seek to do so. Our quarterly results may fluctuate based on, but not limited to, the following factors:

Our ability to attract and retain customers;

FCC or other regulatory charges which we may not be able to “pass on”;

Competition from other telecommunication offerings;

Negative publicity about our industry, events, or products;

Fluctuations in collections of our extended payment term agreements;

Changes in pricing policies;

Regulatory actions and legal proceedings;

Internet and online services usage levels and the rate of market acceptance of these services for transacting commerce;

Our ability to timely and effectively upgrade and develop our systems and infrastructure;

Changes to our business model resulting from regulatory requirements;

Our ability to control certain costs;

Our ability to attract, train and retain skilled management, as well as sales, strategic, technical, and creative professionals;

The availability of working capital and the amount and timing of costs relating to our expansion; and

General economic conditions and economic conditions that are specific to internet technology usage and e-commerce.

Future sales of our common stock by our existing stockholders and stock options granted by us could adversely affect our stock price.

The market price of our common stock could decline as a result of sales of a large number of shares of our common stock in the market or the perception that these sales could occur. These sales also might make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate. As of February 24, 2015, we had outstanding 12,700,624 shares of common stock.

Additional dilution will result if outstanding options to acquire shares of our common stock are exercised.. In addition, in the event future financings are required they could be convertible into or exchangeable for our equity securities, investors may experience additional dilution.

Our Chief Executive Officer owns a significant amount of our common stock and could exercise substantial corporate control.

Steven G Mihaylo, our Chief Executive Officer (“CEO”), owns over 50% of the outstanding shares of our common stock based on the number of shares outstanding as of March 3, 2015. As a result, Mr. Mihaylo may have the ability to determine the outcome of matters submitted to our stockholders for approval, including the election of directors and



any merger, amalgamation, consolidation or sale of all or substantially all of our assets. Mr. Mihaylo may have the ability to control the management and affairs of our Company. As a “control company” it may not be required that the company maintains an independent board. As a director and officer, Mr. Mihaylo owes a fiduciary duty to our stockholders. As a stockholder, Mr. Mihaylo is entitled to vote his shares, in his own interests, which may not always be in the interests of our stockholders generally. Accordingly, even though certain transactions may be in the best interests of other stockholders, this concentration of ownership may harm the market price of our common stock by, among other things, delaying, deferring or preventing a change in control of our Company, impeding a merger, amalgamation, consolidation, takeover or other business combination involving our Company, or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of our Company.

In addition, sales or other dispositions of our shares by Mr. Mihaylo may depress our stock price. Sales of a significant number of shares of our common stock in the public market could harm the market price of our common stock. As additional shares of our common stock become available for resale in the public market, the supply of our common stock will increase, which could result in a decrease in the market price of our common stock.

An active trading market in our equity securities may cease to exist, which would adversely affect the market price and liquidity of our common stock.

Our common stock is traded exclusively in the over-the-counter market. We cannot predict the actions of market makers, investors or other market participants, and can offer no assurances that the market for our securities will be stable. If there is no active trading market in our equity securities, the market price and liquidity of the securities will be adversely affected.

Lack of sufficient stockholder equity or continued losses from operations could subject us to fail to comply with the listing requirements of the OTC.QX, if that occurred, the price of our common stock and our ability to access the capital markets could be negatively impacted, and our business will be harmed.

Our common stock is currently listed on OTC.QX. We have had annual losses from continuing operations for the last four years with the possibility of continued losses. It is possible we may not remain in compliance with the minimum condition of OTC.QX continued listing standards. Delisting from the OTC.QX could negatively affect the trading price of our stock and could also have other negative results, including the potential loss of confidence by suppliers and employees, the failure to attract the interest of institutional investors, and fewer business development opportunities.

OTC.QX disclosure requirements are different than NYSE.MKT requirements.

Our common stock is traded exclusively in the over-the-counter market. The Company previously traded on the NYSE.MKT. The OTC.QX does not maintain the same level of required disclosure and communications required by the NYSE.MKT. For example an annual proxy statement may not be required. We are still required to meet all SEC filing requirements, and intend to continue to make disclosures in the same manner we did while being listed by the NYSE.MKT there is no requirement to do so, and based upon certain circumstances the Company may choose to make only the minimally required disclosures.

Our stock price could decline further because of the activities of short sellers.

The activities of short sellers could further reduce the price of our stock or inhibit increases in our stock price.

Our business could be materially and adversely affected as a result of general economic and market conditions.

We are subject to the effects of general global economic and market conditions. Unfavorable changes in economic conditions, including inflation, recession, or other changes in economic conditions may cause businesses and entrepreneurs to curtail or eliminate spending for our products and services. An adverse change in economic conditions may adversely affect our business.

If we do not successfully expand our sales including our dealer program, direct sales and sales channels, we may be unable to substantially increase our sales.

We sell our products primarily through direct sales, inside sales and our telecommunications dealer program, and we must substantially expand the number of dealers and producing direct sales personnel to increase revenue substantially. If we are unable to expand our dealer network and the sales per dealer and hire and retain qualified sales personnel or if new sales personnel fail to develop the necessary skills to be productive, or if they reach productivity more slowly than anticipated, our ability to increase our revenue and grow our business could be compromised. Our sales personnel may require a long period of time to become productive. The time required in achieving efficiency, as well as the challenge of attracting, training, and retaining qualified candidates, may make it difficult to grow revenue.

We face risks in our direct sales strategy to sell larger enterprises and, if we do not manage these efforts effectively, our business and results of operations could be materially and adversely affected.

We have attempted to increase our sales through our direct sales model to mid-market and larger enterprises. Penetrating these markets is essential to our future growth. The sales cycle for larger customers is more time-consuming, engendering involvement for customization with much company collaborative issues. The sales cycle is also more expensive. There is additional pricing pressure and revenue recognition may be delayed for some complex transactions which can make substantial difference in quarterly results and could harm our businesses and operating results (as larger multi-site orders take longer to install and may require additional engineering support), In addition, larger customers may demand more features, integration services and customization. We do not have substantial experience selling our services to larger businesses which could affect sales, sales issues, engineering

issues, implementation issue and acceptance of our services. If a customer is not satisfied with the quality of work performed by us or a third party we might incur additional costs to address the situation, the profitability of that work might be impaired, and the customer's dissatisfaction with our services could damage our ability to obtain additional work from that customer.

We face risks in our sales to certain market segments including but not limited to sales subject to HIPPA Regulations.

We have sold and will continue to attempt to sell to certain customer segments which may have certain requirements for additional privacy or security. In addition sales may be made to enterprises which are subject to additional security requirements and or HIPPA requirements. Selling into segments with additional requirements increases potential liability which in some instances may be unlimited. While the Company believes it meets or exceeds all requirements for sales into such segments there is no assurance that the Company systems fully comply with all requirements. In addition there are risks associated with third party system failure, or parties illegally hacking into the Company systems.

Our customers can use our services to store contact and other personal or identifying information, and to process, transmit, receive, store and retrieve a variety of communications and messages, including information about their own customers and other contacts. In addition, customers may use our services to store protected health information, or PHI, that is protected under the Health Insurance Portability and Accountability Act, or HIPAA, Noncompliance with laws and regulations relating to privacy and HIPAA may lead to significant fines, penalties or liabilities. Our actual compliance, our customers' perception of our compliance, costs of compliance with such regulations and customer concerns regarding their own compliance obligations (whether factual or in error) may limit the use and adoption of our service and reduce overall demand. Furthermore, privacy concerns, including the inability or impracticality of providing advance notice to customers of privacy issues related to the use of our services, may cause our customers' customers to resist providing the personal data necessary to allow our customers to use our services effectively. Even the perception of privacy concerns, whether or not valid, may inhibit market adoption of our service in certain industries.

In addition to government activity, privacy advocacy groups and industry groups have adopted and are considering the adoption of various self-regulatory standards and codes of conduct that may place additional burdens on us and our customers, which may further reduce demand for our services and harm our business.

While we try to comply with all applicable data protection laws, regulations, standards, and codes of conduct, as well as our own posted privacy policies and contractual commitments to the extent possible, any failure by us to protect our users' privacy and data, including as a result of our systems being compromised by hacking or other malicious or surreptitious activity, could result in a loss of user confidence in our services and ultimately in a loss of users, which could materially and adversely affect our business. Our customers may also accidentally disclose their passwords or store them on a mobile device that is lost or stolen, creating the perception that our systems are not secure against third-party access. Additionally, our third-party contractors in the Canada, Philippines, India, Singapore, Australia, and other parts of the world may have access to customer data. If these or other third-party vendors violate applicable laws or our policies, such violations may also put our customers' information at risk and could in turn have a material and adverse effect on our business.

If we do not successfully expand our infrastructure and build diverse geo redundant locations which require large investments we may be unable to substantially increase our sales and retain customers

Our ability to provide telecommunications services are dependent upon on Data center, facilities and equipment in our single Data Center. While most of our equipment required for operating these services are redundant in nature and offer high availability, certain types of failures or malfunctioning of critical hardware/software equipment, including but not limited to fire, water or other physical damage may impact our ability to deliver continuous service to our customers which may impact our revenue, profitability and retaining of customer and acquiring new customers.

Our ability to provide telecommunication services due to loss of physical facilities in our only data center from act of God or terrorism or vandalism or gross negligence of person(s) currently or formerly associated with the company

may result in loss of revenue and future business.

Our ability to recover from disasters, if and when they occur is paramount to offer continued service to our existing customers. While we have adequate equipment and procedures to handle disaster recovery including but not limited to offsite data storage; recovery from such scenarios may cause excessive delays in restoration of service and may result in some data loss. This may severely impact our revenue and may lead to loss of customers.

Our ability to provide telecommunications services is dependent upon third-party facilities and equipment, the failure of which could cause delays or interruptions of our service and impact our revenue and profitability.

Our ability to provide quality and reliable telephony service is in part dependent upon the proper functioning of facilities and equipment owned and operated by third parties and is, therefore, beyond our control. Our VoIP service (and to a lesser extent our e-commerce services) requires our customers to have an operative broadband Internet connection and an electrical power supply, which are provided by the customer's Internet service provider and electric utility company and not by us. The quality of some broadband Internet connections may be too poor for customers to use our services properly. In addition, if there is any interruption to a customer's broadband Internet service or electrical power supply, that customer will be unable to make or receive calls, including emergency calls (our E-911 service), using our service. We outsource several of our network functions to third-party providers. If our third-party service providers fail to maintain these facilities properly, or fail to respond quickly to problems, our customers may experience service interruptions. The failure of any of these third party service providers to properly maintain services may be subject to factors including but not limited to the following: (i) cause a loss of customers, (ii) adversely affect our reputation, (iii) cause negative publicity, (iv) negatively impact our ability to acquire customers, (v) negatively impact our revenue and profitability, (vi) potential law suits for not reaching E-911 services, and (vii) potential law suits for loss of business and loss of reputation.

We rely on third parties to provide a portion of our customer service responses, initiate local number portability for our customers, deliver calls to and from PSTN and other public telephone VoIP/Wireless service providers and provide aspects of our E-911 service.

We offer our telephony customers support 24 hours a day, seven days a week. We rely on third parties (sometimes outside of the U.S) to provide some services that respond to customer inquiries. These third-party providers generally represent us without identifying themselves as independent parties. The ability of third-party providers to provide these representatives may be disrupted due to issues outside our control.

We also maintain an agreement with an E-911 provider to assist us in routing emergency calls directly to an emergency service dispatcher at the PSAP in the area of the customer's registered location and terminating E-911 calls. We also contract with a provider for the national call center that operates 24 hours a day, seven days a week to receive certain emergency calls and with several companies that maintain PSAP databases for the purpose of deploying and operating E-911 services. The dispatcher will have automatic access to the customer's telephone number and registered location information. If a customer moves their Crexendo service to a new location, the customer's registered location information must be updated and verified by the customer. Until that takes place, the customer will have to verbally advise the emergency dispatcher of his or her actual location at the time of an emergency 9-1-1 call. This can lead to delays in the delivery of emergency services

Interruptions in service from these vendors could also cause failures in our customers' access to E-911 services and expose us to liability.

We also have agreements with companies that initiate our local number portability, which allow new customers to retain their existing telephone numbers when subscribing to our services. We will need to work with these companies to properly port numbers. The failure to port numbers may subject us to loss of customers or regulatory review.

If any of these third parties do not provide reliable, high-quality service, our reputation and our business will be harmed. In addition, industry consolidation among providers of services to us may impact our ability to obtain these services or increase our expense for these services.

Our dependence on outside contractors and third-party agents for fulfillment of certain items and critical manufacturing services could result in product or delivery delays and/or damage our customer relations.

We outsource the manufacturing of certain products we sell and products we provide. We submit purchase orders to agents or the companies that manufacture the products. We describe, among other things, the type and quantities of products or components to be supplied or manufactured and the delivery date and other terms applicable to the products or components. Our suppliers or manufacturers potentially may not accept any purchase order that we submit. Our reliance on outside parties involves a number of potential risks, including: (i) the absence of adequate capacity, (ii) the unavailability of, or interruptions in access to, production or manufacturing processes, (iii) reduced control over delivery schedules, (iv) errors in the product, and (v) claims of third party intellectual infringement or defective merchandise. If delays, problems or defects were to occur, it could adversely affect our business, cause claims for damages to be filed against us, and negatively impact our consolidated operations and cash flows.

Our success depends in part upon the capacity, reliability, and performance of our network infrastructure, including the capacity provided by our Internet bandwidth suppliers.

We depend on these companies to provide uninterrupted and error-free service. Some of these providers are also our competitors. We do not have control over these providers. We may be subject to interruptions or delays in network service. If we fail to maintain reliable bandwidth or performance that could significantly reduce customer demand for

our services and damage our business.

Our success depends in part upon the capacity, reliability, and performance of our telecom carriers, and their network infrastructure, including the capacity provided by our Tier 1 and non-Tier 1 Telecom suppliers for Telecom Origination and Termination Services

We depend on these companies to provide uninterrupted and error-free service telecom services, sourcing of DIDs, porting of numbers and delivering telephone calls from and to endpoints and devices on our network. Some of these providers are also our competitors. We do not have control over these providers. We may be subject to interruptions or delays in their service. If we fail to maintain reliable connectivity or performance with our upstream carriers it could then significantly reduce customer demand for our services and damage our business.

Increased costs of third party suppliers may adversely affect our operating results.

Our contracts do not contain provisions allowing certain costs to be passed on to our customers. These include but are not limited to; power to our data center and capacity leased from our Internet bandwidth suppliers, security breaches and fraud. We are not in control of costs for these services, or the reliability of these services. Failure of these providers could cause substantial harm to our costs and our ability to retain current customers and acquire new customers. A catastrophic failure of any of these systems could potentially subject us to liability.

Errors in our technology or technological issues outside our control could cause delays or interruptions to our customers.

Our services (including e-commerce and VoIP) may be disrupted by problems with our technology and systems such as malfunctions in our software or facilities. In addition there may be service interruptions for reasons outside our control. Our customers and potential customers subscribing to our services have experienced interruptions in the past and may experience interruptions in the future as a result of these types of problems. Interruptions could cause us to lose customers and offer customer credits, which could adversely affect our revenue and profitability. Network and Telecommunication interruptions may also impair our ability to sign-up new customers. In addition since our systems and our customers' ability to use our services are Internet-dependent, our services may be subject to "cyber attacks" from the Internet, which could have a significant impact on our systems and services. Our customers' ability to use our services is dependent on third-party internet providers which may suffer service disruptions. If service interruptions adversely affect the perceived reliability of our service, we may have difficulty attracting and retaining customers and our growth may suffer.

Our operations could be hurt by a natural disaster, network security breach, or other catastrophic event.

We maintain a fully redundant network infrastructure in our data center in Tempe, Arizona. Currently, we do not have multiple site capacity if any catastrophic event occurs, although we expect to attain multiple site redundancy sometime in the future. This system does not guarantee continued reliability if a catastrophic event occurs. Despite implementation of network security measures, our servers may be vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems including, but not limited to, denial of service attacks. In addition, if there is a breach or alleged breach of security or privacy involving our services including but not limited to data loss, or if any third party undertakes illegal or harmful actions using our communications or e-commerce services, our business and reputation could suffer substantial adverse publicity and impairment. We have experienced interruptions in service in the past. While we do not believe that we have lost customers as a consequence, the harm to our reputation is difficult to assess. We have taken and continue to take steps to improve our infrastructure to prevent service interruptions.

Failure in our data center or services could lead to significant costs and disruptions.

All data centers, including ours, are subject to various points of failure. Problems with cooling equipment, generators, uninterruptible power supply, routers, switches, or other equipment, whether or not within our control, could result in service interruptions for our customers as well as equipment damage. Any failure or downtime could affect a significant percentage of our customers. The total destruction or severe impairment of our data center facilities could result in significant downtime of our services and the loss of customer data.

Internet security issues and growing Cyber threats pose risks to the development of e-commerce and our business.

Security and privacy concerns may inhibit the growth of the Internet and other online services generally, especially as a means of conducting commercial transactions.

We could experience security breaches in the transmission and analysis of confidential and proprietary information of the consumer, the merchant, or both, as well as our own confidential and proprietary information.

Anyone able to circumvent security measures could misappropriate proprietary information or cause interruptions in our operations, as well as the operations of the merchant. We may be required to expend significant capital and other resources to protect against security breaches or to minimize problems caused by security breaches. To the extent that we experience breaches in the security of proprietary information which we store and transmit, our reputation could be damaged and we could be exposed to a risk of loss or litigation.

We depend on our senior management and other key personnel, and a loss of these individuals could adversely impact our ability to execute our business plan and grow our business.

We depend on the continued services of our key personnel, including our Officers and certain engineers. Each of these individuals have acquired specialized knowledge and skills with respect to our operations. The loss of one or more of these key personnel could negatively impact our performance. In addition, we expect to hire additional personnel as we continue to execute our strategic plan, particularly if we are successful in expanding our operations. Competition for the limited number of qualified personnel in our industry is intense. At times, we have experienced difficulties in hiring personnel with the necessary training or experience.

Evolving regulation of the Internet, including the use of e-mail as a marketing tool, may harm our business.



As e-commerce and VoIP continue to evolve, they are subject to increasing regulation by federal and state agencies. Areas subject to regulation include, but may not be limited to, the use of e-mail, user privacy, pricing, content, quality of products and services, taxation, advertising, intellectual property rights, and information security. In particular, our initial contact with some of our customers is through e-mail. The use of e-mail for this purpose has become the subject of a number of recently adopted and proposed laws and regulations. In addition, laws and regulations applying to the solicitation, collection, or processing of personal or consumer information could negatively affect our activities. The perception of security and privacy concerns, whether or not valid, may inhibit market acceptance of our products. In addition, legislative or regulatory requirements may heighten these concerns if businesses must notify website users that the data captured after visiting websites may be used by marketing entities to unilaterally direct product promotion and advertising to that user. Moreover, the applicability to the Internet of existing laws governing issues such as intellectual property ownership and infringement, copyright, trademark, trade secret, obscenity, and libel is uncertain and developing. Furthermore, any regulation imposing fees or assessing taxes for Internet use could result in a decline in the use of the Internet and the viability of e-commerce. Any new legislation or regulation, or the application or interpretation of existing laws or regulations, may decrease the growth in the use of the Internet, may impose additional burdens on e-commerce or may require us to alter how we conduct our business. This could decrease the demand for our products and services increase our cost of doing business, increase the costs of products sold through the Internet, or otherwise have a negative effect on our business, results of operations, and financial position.

We depend upon our proprietary intellectual property rights, none of which can be completely safeguarded against infringement.

We rely upon copyright law, trade secret protection, and confidentiality or license agreements with our employees, customers, business partners, and others to protect our proprietary rights, but we cannot guarantee that the steps we have taken to protect our proprietary rights will be adequate. Although we have patents pending, we currently do not have any registered patents. Effective copyright, trademark, patent, and trade secret protections may not be able to be adequately protected in all Countries in which we operate source products or have an Internet presence.

We depend upon Industry standard protocols, best practices, solutions, third-party software, technology, tools including but not limited to Open Source software.

We rely on non-proprietary third party licensing and software some of which may be Open Source and protected under various licensing agreements. We may be subject to additional royalties, license or trademark infringement costs or other unknown costs when one or more of these third party technologies are affected or need to be replaced due to end-of-support or end-of-sale of such third parties.

We may incur substantial expenses in defending against third-party patent and trademark infringement claims regardless of their merit.

From time to time, parties may assert patent infringement claims against us in the form of letters, lawsuits, and other forms of communication. Third parties may also assert claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights or alleging unfair competition. If there is a determination that we have infringed third-party proprietary rights, we could incur substantial monetary liability and be prevented from using the rights in the future.

Some provisions of our certificate of incorporation and bylaws may deter takeover attempts that may limit the opportunity of our stockholders to sell their shares at a favorable price.

Some of the provisions of our certificate of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so might be beneficial to our stockholders by providing them with the opportunity to sell their shares at a premium to the then market price. Our bylaws contain provisions regulating the introduction of business at annual stockholders' meetings by anyone other than the board of directors. These provisions may have the effect of making it more difficult, delaying, discouraging, preventing or rendering more costly an acquisition or a change in control of our Company.

In addition, our corporate charter provides for a staggered board of directors divided into two classes. Provided that we have at least four directors, it will take at least two annual meetings to effectuate a change in control of the board of directors because a majority of the directors cannot be elected at a single meeting. This extends the time required to effect a change in control of the board of directors and may discourage hostile takeover bids. We currently have five directors.

Further, our certificate of incorporation authorizes the board of directors to issue up to 5,000,000 shares of preferred stock, which may be issued in one or more series, the terms of which may be determined at the time of issuance by the board of directors without further action by stockholders. Such terms may include voting rights, including the right to vote as a series on particular matters, preferences as to dividends and liquidation, conversion and redemption rights and sinking fund provisions. No shares of preferred stock are currently outstanding and we have no present plans for the issuance of any preferred stock. However, the issuance of any preferred stock could materially adversely affect the

rights of holders of our common stock, and therefore could reduce its value. In addition, specific rights granted to future holders of preferred stock could be used to restrict our ability to merge with, or sell assets to, a third party. The ability of the board of directors to issue preferred stock could make it more difficult, delay, discourage, prevent, or make it more costly to effect a change in control, thereby preserving the current stockholders' control.

Our publicly filed SEC reports are reviewed by the SEC from time to time and any significant changes required as a result of any such review may result in material liability to us and have a material adverse impact on the trading price of our common stock.

The reports of publicly-traded companies are subject to review by the SEC from time to time for the purpose of assisting companies in complying with applicable disclosure requirements and to enhance the overall effectiveness of companies' public filings. Comprehensive reviews by the SEC of such reports are now required at least every three years under the Sarbanes-Oxley Act of 2002. SEC reviews often occur at the time companies file registration statements, but reviews may be initiated at any time by the SEC. While we believe that our previously filed SEC reports comply, and we intend that all future reports will comply, in all material respects with the published rules and regulations of the SEC, we could be required to modify or reformulate information contained in prior filings as a result of an SEC review. Any modification or reformulation of information contained in such reports could be significant and result in a material liability to us and have a material adverse impact on the trading price of our common stock.

Examinations by relevant tax authorities may result in material changes in related tax reserves for tax positions taken in previously filed tax returns or may impact the valuation of certain deferred income tax assets, such as net operating loss carry-forwards.

Based on the outcome of examinations by relevant tax authorities, or as a result of the expiration of statutes of limitations for specific jurisdictions, it is reasonably possible that the related tax reserves for tax positions taken regarding previously filed tax returns will materially change from those recorded in our financial statements. In addition, the outcome of examinations may impact the valuation of certain deferred income tax assets (such as net operating loss carry-forwards) in future periods. It is not possible to estimate the impact of the amount of such changes, if any, to previously recorded uncertain tax positions.

We may undertake acquisitions, mergers or change to our capital structure to expand our business, which may pose risks to our business and dilute the ownership of our existing stockholders.

As part of a potential growth strategy we may attempt to acquire or merge with certain businesses. Whether we realize benefits from any such transactions will depend in part upon the integration of the acquired businesses, the performance of the acquired products, services and capacities of the technologies acquired, as well as the personnel hired in connection therewith. Accordingly, our results of operations could be adversely affected from transaction-related charges, amortization of intangible assets, and charges for impairment of long-term assets. While we believe that we have established appropriate and adequate procedures and processes to mitigate these risks, there can be no assurance that any potential transaction will be successful.

In addition, the financing of any acquisition may require us to raise additional funds through public or private sources. Additional funds may not be available on terms that are favorable to us and, in the case of equity financings, may result in dilution to our stockholders. Future acquisitions by us could also result in large and immediate write-offs or assumptions of debt and contingent liabilities, any of which may have a material adverse effect on our consolidated financial position, results of operations, and cash flows.

We collect personal and credit card information from our customers and employees could misuse this information.

We maintain credit card and other personal information in our systems. Due to the sensitive nature of retaining such information we have implemented policies and procedures to preserve and protect our data and our customers' data against loss, misuse, corruption, misappropriation caused by systems failures, unauthorized access, or misuse. Notwithstanding these policies, we could be subject to liability claims by individuals and customers whose data resides in our databases for the misuse of that information. While the Company believes its systems meet or exceed industry standards the Company does not believe it is required to meet PCI level 1 Compliance and has not recertified under that level. Failure to meet PCI compliance levels could negatively impact the Company's ability to collect and store credit card information which could cause substantial disruption to our business.

## ITEM 2.

## PROPERTIES

Our corporate offices consist of approximately 22,000 square feet of office space in Tempe, Arizona owned by our CEO and approximately 1,300 square feet of office space in Reno, NV which is leased from an unaffiliated third party. Our corporate office is located at 1615 South 52nd Street, Tempe, Arizona 85281. We maintain tenant fire and casualty insurance on our assets located in these buildings in an amount that we deem adequate.

## ITEM 3.

## LEGAL PROCEEDINGS

From time to time we receive inquiries from federal, state, city and local government officials as well as the FCC and taxing authorities in the various jurisdictions in which we operate. These inquiries and investigations related primarily to our discontinued seminar operations and concern compliance with various city, county, state, and/or federal regulations involving sales, representations made, customer service, refund policies, services 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 our 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.

On November 4, 2013, the Company received a motion for leave to file an amended complaint and a request for scheduling conference (including a request for extending discovery) in the case entitled Information Technology Customer Care, Inc., Plaintiff v StoresOnline, Inc., Defendant; filed in In The Fourth District Court, Utah County, and State Of Utah Case No. 090401169. In the original Complaint, Plaintiff ITCCI claimed that StoresOnline breached a contract with ITCCI by improperly moving its Philippine support to a new support center. ITCCI also alleged an action for tortious interference claiming that StoresOnline caused former employees of ITCCI to leave to work for that support center. There was also a claim for “civil conspiracy”. The original Complaint sought actual and punitive damages.

The parties had completed discovery and filed various motions, including a motion for Summary Judgment by StoresOnline. The Company believes there was no evidence to support any of the claims raised by the Plaintiff, and that there was no contractual obligation which would have prohibited a change of support centers.

The Plaintiff has filed motions to substitute new counsel, amend its Complaint and re-open discovery. The allegations included in the proposed Amended Complaint are that former officers and executives of StoresOnline acted fraudulently and secretly to improperly move support centers. The Company strongly disputes the allegations against it under both the original Complaint and the proposed Amended Complaint. Moreover, even if any of the allegations regarding former employees in the proposed Amended Complaint were true, the Company believes that it would have no liability for those alleged actions.

In November 2014 the parties attended a mediation where the case was settled. The Plaintiffs have dismissed the case with prejudice.

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.

#### ITEM 4.

#### MINE SAFETY DISCLOSURES

The disclosure required by this item is not applicable

### PART II

#### ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND 5. ISSUER PURCHASES OF EQUITY SECURITIES

##### MARKET INFORMATION

Our common stock began trading on the NYSE - MKT on August 16, 2004 under the symbol "IIG." In May 2011, our stockholders approved an amendment to our Certificate of Incorporation to change our name from "iMergent, Inc." to "Crexendo, Inc." The name change was effective May 18, 2011. Our ticker symbol "IIG" on the New York Stock Exchange was changed to "EXE" on May 18, 2011. On January 13, 2015, the Company moved to the OTCQX Marketplace and our ticker symbol was changed to "CXDO". The following table sets forth the range of high and low sales prices as reported on the NYSE – MKT for the periods indicated.

	High	Low
Year Ended December 31, 2014		
October to December 2014	\$3.05	\$1.10
July to September 2014	3.35	2.66
April to June 2014	3.58	3.01
January to March 2014	3.80	3.00
Year Ended December 31, 2013		
October to December 2013	\$3.25	\$2.82
July to September 2013	3.30	2.80
April to June 2013	3.31	2.41
January to March 2013	3.15	2.40

## SECURITY HOLDERS

There were 242 holders of record of our shares of common stock as of February 24, 2015. The number of holders does not include individual participants in security positions listings.

## DIVIDENDS

There are no contractual restrictions on dividends declared for the year ended December 31, 2014 and 2013.

## ISSUER PURCHASES OF EQUITY SECURITIES

None

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## RECENT SALES OF UNREGISTERED SECURITIES

On December 23, 2014, we issued 1,449,275 shares of common stock and 500,000 warrants to Steven G. Mihaylo, Chief Executive Officer of the Company at a price of \$1.38 per share. The financing resulted in gross proceeds to us of \$2.0 million. We expect to use the net proceeds from the sale of the shares to fund our operations and for general corporate purposes. The warrants will be exercisable for 500,000 shares of common stock until the fifth anniversary of the date of issuance of the warrants. The warrants have a strike price of \$1.38 per share.

The securities were offered and sold to Steven G. Mihaylo an accredited investor without registration under the Securities Act or state securities laws, in reliance on the exemptions provided by Section 4(2) of the Securities Act and Regulation D promulgated thereunder and in reliance on similar exemptions under applicable state laws.

## ITEM 6. SELECTED FINANCIAL DATA

Not required.

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

### SAFE HARBOR

In addition to historical information, this Annual Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Actual results could differ materially from those projected in the forward-looking statements as a result of a number of factors, risks and uncertainties, including the risk factors set forth in Item 1A. above and the risk factors set forth in this Annual Report. Generally, the words "anticipate", "expect", "intend", "believe" and similar expressions identify forward-looking statements. The forward-looking statements made in this Annual Report are made as of the filing date of this Annual Report with the SEC, and future events or circumstances could cause results that differ significantly from the forward-looking statements included here. Accordingly, we caution readers not to place undue reliance on these statements. We expressly disclaim any obligation to update or alter our forward-looking statements, whether, as a result of new information, future events or otherwise after the date of this document.

### OVERVIEW

We are a hosted services company that provides website hosting, hosted telecommunications 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 Telecommunications Services and Web Services.

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



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

On June 1, 2014, we acquired certain assets from One Stop Tech Solutions, LLC, dba One Stop Voice (OSV), a privately held provider of IP Telecom and Cloud communications located in Scottsdale, Arizona. The aggregate purchase price of approximately \$540,000 consisted of \$195,000 of cash paid at closing and 40,521 shares of our common stock with an estimated fair value of approximately \$134,000 at the time of the acquisition. In addition, the Company recorded as part of the purchase price approximately \$211,000 of contingent consideration it estimates will be paid during the earn-out period, at a split of 60% cash and 40% stock. The historical results of operations of OSV were not significant to the Company's consolidated results of operations for the periods presented.

On June 4, 2013 we acquired certain assets from PBX Holdings, LLC., dba PBX Central, a privately-held provider of IP Telecom and Cloud communications located in Austin, Texas. The purchase price of approximately \$770,000 consisted of \$387,000 of cash and 153,901 shares of our common stock with an estimated fair value of approximately \$383,000 at the time of the acquisition. Our consolidated financial statements include the results of operations of PBX Central from the date of acquisition. The historical results of operations of PBX Central were not significant to our consolidated results of operations for the periods presented.

Our Hosted Telecommunications Services revenue increased 81% or \$1,927,000 to \$4,297,000 for the year ended December 31, 2014 as compared to \$2,370,000 for the year ended December 31, 2013. As of December 31, 2014 and 2013, our backlog was \$9,763,000 and \$7,019,000, respectively.

Web Services segment – We generate website hosting revenue and professional services revenue primarily from search engine optimization services, link building, paid search management services, conversion rate optimization services, and website design and development. These services are typically billed on a fixed price basis or on a monthly recurring basis with an initial term of six to twelve months. During the quarter ended September 30, 2013, the Company made a strategic decision to limit our provision of web services to our enterprise sized customers.

Our typical EPTA agreement has a term of two to three years. As such, while we no longer plan to offer EPTAs to our customers as a result of the suspension of our direct mail seminar sales, we will continue to recognize revenue from those EPTA contracts executed prior to July 2011 as cash is collected from those contracts.

Our Web Services revenue decreased 59% or \$4,661,000 to \$3,297,000 for the year ended December 31, 2014 as compared to \$7,958,000 for the year ended December 31, 2013. As of December 31, 2014 and 2013, our backlog was \$28,000 and \$553,000, respectively.

#### 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, 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 March 3, 2015 earnings press release, as furnished on Form 8-K, we included Non-GAAP net loss, EBITDA and Adjusted EBITDA. The terms Non-GAAP net loss, EBITDA, and Adjusted EBITDA are not defined under U.S. GAAP, and are not measures of operating income, operating performance or liquidity presented in analytical tools, and when assessing our operating performance, Non-GAAP net loss, EBITDA, and Adjusted EBITDA should not be considered in isolation, or as a substitute for net loss or other consolidated income statement data prepared in accordance with U.S. GAAP. Some of these limitations include, but are not limited to:

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

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

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

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

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

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

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

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

## Reconciliation of Non-GAAP Financial Measures

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

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

	Year Ended December 31,	
	2014	2013
	(In thousands)	
U.S. GAAP net loss	\$(6,376 )	\$(4,963 )
Share-based compensation	1,049	808
Amortization of rent expense paid in stock	268	-
Amortization of intangible assets	248	117
Non-GAAP net loss	\$(4,811 )	\$(4,038 )

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

	Year Ended December 31,	
	2014	2013
	(In thousands)	
U.S. GAAP net loss	\$(6,376 )	\$(4,963 )
Depreciation and amortization	663	1,145
Interest expense	3	-
Interest and other (income) expense	(303 )	(525 )
Income tax provision/(benefit)	77	(257 )
EBITDA	\$(5,936 )	\$(4,600 )
Share-based compensation	1,049	808
Amortization of rent expense paid in stock	268	-
Adjusted EBITDA	\$(4,619 )	\$(3,792 )

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our consolidated financial statements have been prepared in accordance with US GAAP and necessarily included certain estimates and judgments made by management. The following is a list of accounting policies that we believe are the most critical in understanding our consolidated financial position, results of operations or cash flows, and that may require management to make subjective or complex judgments about matters that are inherently uncertain.

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

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

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

**Cost of Revenue** – Our cost of Hosted Telecommunications Service revenue primarily consists of fees we pay to third-party telecommunications and business internet providers, personnel costs related to system implementation, customer service and travel costs related to system implementation, and the costs associated with the purchase of phones and other third party equipment.

**Cost of Web Services** revenue consists primarily of salaries and outsourcing fees related to fulfillment of our web services and customer service costs.

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 Telecommunications 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.

Income Taxes -- In preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating current income tax liabilities together with assessing temporary differences resulting from differing treatment of items for tax and financial reporting purposes. These temporary differences result in deferred income tax assets and liabilities. Our deferred income tax assets consist primarily of the future benefit of net operating loss carry-forwards, certain deferred revenue, accrued expenses and tax credit carry-forwards. 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.

Stock Based Compensation -- We account for our share-based compensation awards using the fair-value method. The grant date fair value was determined using the Black-Scholes-Merton pricing model. The Black-Scholes-Merton valuation calculation requires us to make key assumptions such as future stock price volatility, expected terms, risk-free rates, and dividend yield. Our expected volatility is derived from our volatility rate as a publicly traded company. The risk-free interest factor is based on the United States Treasury yield curve in effect at the time of the grant for zero coupon United States Treasury notes with maturities of approximately equal to each grant’s expected term.

We develop an estimate of the number of share-based awards that will be forfeited due to employee turnover. Annual changes in the estimated forfeiture rate may have a significant effect on share-based payments expense, as the effect of adjusting the rate is recognized in the period the forfeiture estimate is changed. If the actual forfeiture rate is higher than the estimated forfeiture rate, then an adjustment is made to increase the estimated forfeiture rate, which will result in a decrease to the expense recognized in the financial statements. If the actual forfeiture rate is lower than the estimated forfeiture rate, then an adjustment is made to decrease the estimated forfeiture rate, which will result in an increase to the expense recognized in the financial statements.



We will continue to use judgment in evaluating the expected term, volatility, and forfeiture rate related to our own share-based awards on a prospective basis, and in incorporating these factors into the model. If our actual experience differs significantly from the assumptions used to compute our share-based compensation cost, or if different assumptions had been used, we may have recorded too much or too little share-based compensation cost.

## RESULTS OF OPERATIONS

### Results of Consolidated Operations

The following discussion of financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto and other financial information included herein this Annual Report.

## Results of Consolidated Operations (in thousands, except for per share amounts)

	Year Ended December 31,	
	2014	2013
Revenue	\$7,594	\$10,328
Loss before income taxes	(6,299 )	(5,220 )
Income tax benefit (provision)	(77 )	257
Net loss	(6,376 )	(4,963 )
Basic/diluted net loss per share	\$(0.57 )	\$(0.46 )

## Year Ended December 31, 2014 Compared to Year Ended December 31, 2013

## Revenue

Revenue decreased 26% or \$2,734,000, to \$7,594,000 for the year ended December 31, 2014 as compared to \$10,328,000 for the year ended December 31, 2013. The decrease in revenue from the prior year is primarily related to the decrease in cash collected on EPTAs of \$2,495,000 and our shift in focus to only providing Web Services to enterprise-sized customers, resulting in a decrease of \$1,420,000. Web Services revenue decreased 59% or \$4,661,000 to \$3,297,000 during the year ended December 31, 2014 compared to \$7,958,000 for the year ended December 31, 2013. Web Services revenue was offset by an increase in our Hosted Telecommunications Services revenue of 81% or \$1,927,000 to \$4,297,000 during the year ended December 31, 2014 compared to \$2,370,000 for the year ended December 31, 2013.

## Loss Before Income Taxes

Loss before income tax increased 21% or \$1,079,000, to \$6,299,000 for the year ended December 31, 2014 as compared to \$5,220,000 for the year ended December 31, 2013 primarily due to a decrease in EPTA collections and outstanding balances segment in Web Services revenue along with a decrease in other income of \$225,000 to \$300,000 for year ended December 31, 2014 as compared to \$525,000 for year ended December 31, 2013 primarily due to interest income from EPTAs. This was offset by an increase in our Hosted Telecommunications revenue of \$1,927,000 and a decrease in total operating expenses of \$1,880,000 to \$14,193,000 for the year ended December 31, 2014 as compared to \$16,073,000 for the year ended December 31, 2013.

## Income Tax Provision

We had an income tax provision of \$77,000 for the year ended December 31, 2014 compared to an income tax benefit of \$257,000 for the year ended December 31, 2013. We had a pre-tax loss for the years ended December 31, 2014 and 2013 of \$6,299,000 and \$5,220,000, respectively, and a full valuation allowance on all of our deferred tax assets for the years ended December 31, 2014 and 2013.

## Segment Operating Results

The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. Effective April 1, 2014, the Company changed its reporting segments to reflect changes in how the Chief Operating Decision Maker (CODM) internally measures performance and allocates resources. Segment operating results for the prior year have been modified to conform to current year segment operating results presentations. The information below is organized in accordance with our two reportable segments. Segment operating income (loss) is equal to segment net revenue less segment cost of revenue, sales and marketing, research and development, and

general and administrative expenses.

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

Hosted Telecommunications Services	Year Ended December 31,	
	2014	2013
Revenue	\$4,297	\$2,370
Operating expenses:		
Cost of revenue	2,847	2,160
Research and development	934	987
Selling and marketing	2,215	2,242
General and administrative	4,077	2,413
Total operating expenses	10,073	7,802
Operating loss	(5,776 )	(5,432 )
Other income	87	3
Loss before tax provision	\$(5,689 )	\$(5,429 )

## Quarterly Financial Information

Hosted Telecommunications Services	Year ended December 31, 2014			
	For the three months ended			
		September	December	
	March 31, 2014	June 30, 2014	30, 2014	31, 2014
	(In thousands, except per share data)			
Revenue	\$955	\$963	\$1,035	\$1,344
Operating expenses:				
Cost of revenue	663	708	630	846
Selling and marketing	618	488	536	573
General and administrative	937	885	955	1,300
Research and development	245	258	214	214
Goodwill impairment	-	-	-	-
Total operating expenses	2,463	2,339	2,335	2,933
Loss from operations	(1,508 )	(1,376 )	(1,300 )	(1,589 )
Total other income	20	21	24	22
Loss before income taxes	\$(1,488 )	\$(1,355 )	\$(1,276 )	\$(1,567 )

Hosted Telecommunications Services	Year ended December 31, 2013			
	For the three months ended			
		September	December	
	March 31, 2013	June 30, 2013	30, 2013	31, 2013
	(In thousands, except per share data)			
Revenue	\$385	\$491	\$696	\$798
Operating expenses:				
Cost of revenue	448	498	580	634
Selling and marketing	522	490	564	666
General and administrative (1)	358	506	698	851
Research and development	291	248	223	225
Goodwill impairment	-	-	-	-

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Total operating expenses	1,619	1,742	2,065	2,376
Loss from operations	(1,234 )	(1,251 )	(1,369 )	(1,578 )
Total other income	3	-	-	-
Loss before income taxes	\$(1,231 )	\$(1,251 )	\$(1,369 )	\$(1,578 )

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(1) During the first quarter of the year ended December 31, 2013, we entered into a settlement and released \$606,000 of the lease abandonment accrual.

## Year Ended December 31, 2014 Compared to Year Ended December 31, 2013

## Revenue

Hosted Telecommunications Services segment revenue increased 81% or \$1,927,000, to \$4,297,000 for the year ended December 31, 2014 as compared to \$2,370,000 for the year ended December 31, 2013. In January 2012 our direct sales representatives began selling our Hosted Telecommunications Services products and services. A substantial portion of Hosted Telecommunications Services segment revenue is generated through 36 to 60 month service contracts. As such, we believe growth in Hosted Telecommunications Services segment will initially be seen through increases in our backlog. Backlog represents future revenue on contracts signed with no service or payment provided at December 31, 2014 and December 31, 2013.

Hosted Telecommunications Services backlog as of December 31, 2014	\$9,763
Hosted Telecommunications Services backlog as of December 31, 2013	\$7,019

## Cost of Revenue

Cost of revenue consists primarily of fees we pay to third-party telecommunications and business internet providers, personnel costs related to system implementation, customer service, travel costs related to system implementation, and the costs associated with the purchase of phones and other third party equipment. Cost of revenue increased 32% or \$687,000, to \$2,847,000 for the year ended December 31, 2014 as compared to \$2,160,000 for the year ended December 31, 2013. These direct costs increased due to an increase in revenue.

## Research and Development

Research and development expenses primarily consist of payroll and related expenses, related to the development of new hosted telecommunications products. Research and development expenses decreased 5% or \$53,000, to \$934,000 for the year ended December 31, 2014 as compared to \$987,000 for the year ended December 31, 2013. The decrease was primarily attributed to a decrease in payroll costs, as the average monthly number of engineers decreased to 14 from 15 for the years ended December 31, 2014 and 2013, respectively.

## Selling and Marketing

Selling and marketing expenses consist primarily of direct sales representative salaries and benefits and the production of marketing materials. Selling and marketing expenses decreased 1% or \$27,000, to \$2,215,000 for the year ended December 31, 2014 as compared to \$2,242,000 for the year ended December 31, 2013. The decrease was primarily attributable to a decrease in the sales representative's salary and benefit expenses with an offsetting increase in dealer channel commissions.

## General and Administrative

General and administrative expenses consist primarily of payroll and related expenses for rent, professional fees, and administrative personnel. General and administrative expenses increased 69% or \$1,664,000, to \$4,077,000 for the year ended December 31, 2014 as compared to \$2,413,000 for the year ended December 31, 2013. General and administrative expenses for the year ended December 31, 2014 were higher than the year ended December 31, 2013, primarily due to an increased allocation of corporate expenses being allocated at a higher rate resulting from increased revenue in the Hosted Telecommunications Services segment. As Web Services revenue decreased significantly for the year ended December 31, 2014 compared to 2013, we allocated less of the general and administrative expenses to the Web Services segment and more expenses to the Hosted Telecommunications Services segment.

Other Income

Other income primarily relates to the allocated portion of sublease rental income. Other income increased \$84,000, to \$87,000 for the year ended December 31, 2014 as compared to \$3,000 for the year ended December 31, 2013. This increase is primarily due to the decrease in Web Revenue and increase in Hosted Telecommunications revenue, which led to a higher allocation for the year ended December 31, 2014 as compared to the year ended December 31, 2013.

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## Operating Results of our Web Services Segment (in thousands)

	Year Ended December 31,	
	2014	2013
Web Services		
Revenue	\$3,297	\$7,958
Operating expenses:		
Cost of revenue	735	1,931
Research and development	670	705
Selling and marketing	65	813
General and administrative	2,650	4,822
Total operating expenses	4,120	8,271
Operating loss	(823 )	(313 )
Other income	213	522
Income/(loss) before income taxes	\$(610 )	\$209

## Quarterly Financial Information

	Year ended December 31, 2014			
	For the three months ended			
	March 31,	June 30,	September	December
	2014	2014	30,	31,
			2014	2014
Web Services	(In thousands, except per share data)			
Revenue	\$1,117	\$845	\$690	\$645
Operating expenses:				
Cost of revenue	267	176	160	132
Selling and marketing	35	16	10	4
General and administrative	813	663	594	580
Research and development	169	177	180	147
Goodwill impairment	-	-	-	-
Total operating expenses	1,284	1,032	944	863
Loss from operations	(167 )	(187 )	(254 )	(218 )
Total other income	57	61	37	58
Loss before income taxes	\$(110 )	\$(126 )	\$(217 )	\$(160 )

	Year ended December 31, 2013			
	For the three months ended			
	March 31,	June 30,	September	December
	2013	2013	30,	31,
			2013	2013
Web Services	(In thousands, except per share data)			
Revenue	\$2,637	\$2,246	\$1,732	\$1,343
Operating expenses:				
Cost of revenue	594	472	464	401
Selling and marketing	386	227	148	52
General and administrative (1)	1,080	1,346	1,312	1,084
Research and development	190	166	173	176
Goodwill impairment	-	-	-	-
Total operating expenses	2,250	2,211	2,097	1,713



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Income/(loss) from operations	387	35	(365 )	(370 )
Total other income	209	120	98	95
Income/(loss) before income taxes	\$596	\$155	\$(267 )	\$(275 )

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(1) During the first quarter of the year ended December 31, 2013, we entered into a settlement and released \$606,000 of the lease abandonment accrual.

Year Ended December 31, 2014 Compared to Year Ended December 31, 2013

#### Revenue

Web Services segment revenue decreased 59% or \$4,661,000, to \$3,297,000 for the year ended December 31, 2014 as compared to \$7,958,000 for the year ended December 31, 2013. The decrease in revenue from the prior year is primarily related to the decrease in cash collected on EPTAs of \$2,495,000 and our shift in focus to only providing web services to enterprise-sized customers, resulting in a decrease of \$1,420,000, a decrease in hosting revenue of \$480,000, and a decrease in other revenue of \$266,000. Revenue from Web Services is generated primarily through website hosting and Search Engine Optimization (“SEO”) services, link building, search engine management services, conversion rate optimization services, and website design and development services. A substantial portion of Web Services revenue is generated through three to twelve month service contracts. Our typical EPTA agreement has a term of two to three years. As such, while we no longer offer EPTAs to our customers as a result of the suspension of our direct mail seminar sales, we will continue to recognize revenue from those EPTA contracts executed prior to July 2011 as cash is collected from those contracts.

Below is a table which displays the Web Services revenue backlog as of December 31, 2014 and 2013, which is expected to be recognized as revenue within the next twelve months (in thousands):

Web Services backlog as of December 31, 2014	\$28
Web Services backlog as of December 31, 2013	\$553

Revenue related to cash collected under EPTA agreements decreased 78% or \$2,495,000 to \$694,000 for the year ended December 31, 2014, compared to \$3,189,000 for the year ended December 31, 2013. Our typical EPTA agreement has a term of two to three years. As such, while we no longer offer EPTAs to our customers as a result of the suspension of our direct mail seminar sales, we will continue to recognize revenue from those EPTA contracts executed prior to July 2011 as cash is collected from those contracts. EPTAs were originally recognized in our balance sheet, net of an allowance for doubtful accounts, through our deferred revenue balance. The remaining deferred revenue balance is expected to be recognized as revenue, however, at a decreasing rate over the next twelve months. The following table summarizes the activity within deferred revenue for the years ended December 31, 2014 and 2013 (in thousands):

EPTA deferred revenue as of January 1, 2014	\$545
Cash collected on Principal of EPTA Contracts	(694 )
Adjustments of EPTA deferred revenue	335
EPTA deferred revenue as of December 31, 2014	\$186
EPTA deferred revenue as of January 1, 2013	\$3,173
Cash collected on Principal of EPTA Contracts	(3,189 )
Adjustments of EPTA deferred revenue	561
EPTA deferred revenue as of December 31, 2013	\$545

Revenue related to cash collected on previously written off bad debt decreased 22% or \$88,000, to \$326,000 for the year ended December 31, 2014 as compared to \$414,000 for the year ended December 31, 2013.

#### Cost of Revenue

Cost of revenue consists primarily of salaries and outsourcing fees related to fulfillment of our web services and customer service costs. Cost of revenue decreased 62% or \$1,196,000, to \$735,000 for the year ended December 31,

2014 as compared to \$1,931,000 for the year ended December 31, 2013. The decrease is primarily related to the reduction in salaries and benefits associated with the fulfillment of website management services of \$966,000 and reduction in customer service costs for website hosting of \$230,000.

### Research and Development

Research and development expenses primarily consist of payroll and related expenses which are attributable to the development of our website development software products. Research and development expenses decreased 5% or \$35,000, to \$670,000 for the year ended December 31, 2014 as compared to \$705,000 for the year ended December 31, 2013. The decrease was due to decreased salaries and expenses related to the continued development of our website development software.

### Selling and Marketing

Selling and marketing expenses consist primarily of salaries and benefits, commissions as well as advertising expenses. Selling and marketing expense decreased 92% or \$748,000, to \$65,000 for the year ended December 31, 2014 as compared to \$813,000 for the year ended December 31, 2013. The decrease was primarily attributable to discontinuing the sale of web products in 2013, thus there was no allocation of salaries and expenses in 2014 and a reduction in web commissions in 2014 to a minimal amount.

### General and Administrative

General and administrative expenses consist of salaries and related expenses for executives, administrative personnel, legal, rent, accounting and other professional services, and other general corporate expenses. General and administrative expenses decreased 45% or \$2,172,000, to \$2,650,000 for the year ended December 31, 2014 as compared to \$4,822,000 for the year ended December 31, 2013. The decrease in general and administrative expenses is primarily due to less of an allocation of corporate general and administrative expenses resulting from the 59% decrease in revenue for the year ended December 31, 2014 compared to the year ended December 31, 2013, and a company-wide reduction in general and administrative expenses as we continue to cut unnecessary expenses.

### Other Income

Other income primarily relates to interest earned on EPTA contracts, which generally carry an 18% simple interest rate. Other income decreased 59% or \$309,000, to \$213,000 for the year ended December 31, 2014 as compared to \$522,000 for the year ended December 31, 2013. This decrease is primarily due to the decrease in outstanding EPTA receivables as cash is collected and uncollectable accounts are written off.

## LIQUIDITY AND CAPITAL RESOURCES

The Company has transformed into a start-up company with the inherent risks and uncertainties of funding operations until profitability is achieved. We currently plan to fund our operations during the next twelve months using our cash and cash equivalents of \$2,906,000. However, after considering the Company's historical negative cash flow from operating activities as well as internal forecasts, such amount does not appear adequate to fund our anticipated cash needs for the next twelve months. Accordingly, the Company will be required to obtain additional debt or equity financing such as that available from its CEO to sustain operations. The company has the ability to call outstanding warrants to provide additional liquidity for approximately \$690,000, if needed. In addition, the Company received a commitment from the CEO, and major shareholder, in February 2015 that, if needed, he would provide up to \$1,000,000 of financial support to enable the Company to fund its operations through March 31, 2016. As such, the Company believes it will have sufficient funds to pay its obligations as they come due during the next twelve months as a result of the sources of funding detailed above.

### Working Capital

Working capital decreased 24% or \$695,000 to \$2,154,000 as of December 31, 2014 as compared to \$2,849,000 as of December 31, 2013. The decrease in working capital is primarily due to a decrease in cash and restricted cash of \$524,000 from December 31, 2013 to December 31, 2014.

#### Cash and Cash Equivalents

Cash and cash equivalents decreased 6% or \$170,000, to \$2,906,000 as of December 31, 2014 as compared to \$3,076,000 as of December 31, 2013. During the year ended December 31, 2014, we used cash flows for operating activities of \$4,338,000, investing activities provided \$2,152,000, and financing activities provided \$2,016,000.

#### Trade Receivables

Current and long-term trade receivables, net of allowance for doubtful accounts, decreased 50% or \$599,000, to \$607,000 as of December 31, 2014 as compared to \$1,206,000 as of December 31, 2013. Long-term trade receivables, net of allowance for doubtful accounts, decreased 45% or \$52,000, to \$64,000 as of December 31, 2014 as compared to \$116,000 as of December 31, 2013. We offered our customers an installment contract with payment terms between 24 and 36 months (EPTAs), as one of several payment options. The payments that become due more than 12 months after the end of the fiscal period are classified as long-term trade receivables. Trade receivables will continue to decline as cash is collected on EPTA contracts.

## Accounts Payable

Accounts payable decreased 77% or \$154,000, to \$47,000 as of December 31, 2014 as compared to \$201,000 as of December 31, 2013. The aging of accounts payable as of December 31, 2014 and 2013 was generally within our vendors' terms of payment. The decrease is primarily related to the decrease in operating costs as a result of cost cutting measures and the timing of vendor payments.

## Capital

Total stockholders' equity decreased 32% or \$2,157,000, to \$4,544,000 as of December 31, 2014 as compared to \$6,701,000 as of December 31, 2013. The decrease as of December 31, 2014 in total stockholders' equity was attributable to net loss of \$6,376,000 offset by an increase in Additional Paid-in-Capital of \$784,000 for options granted, \$265,000 for warrants granted, \$70,000 for proceeds from stock options exercised, \$134,000 for issuance of common stock in connection with a business acquisition (Note 3), \$2,000,000 from sale of common stock and \$966,000 for issuance of common stock related to the prepayment of rent on the corporate headquarters (Note 15).

## OFF BALANCE SHEET ARRANGEMENTS

As of December 31, 2014, we are not involved in any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

## 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.

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

In August 2014, the FASB issued ASU 2014-15. This ASU requires management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing

standards. Specifically, the ASU (1) provides a definition of the term substantial doubt, (2) requires an evaluation every reporting period including interim periods, (3) provides principles for considering the mitigating effect of management's plans, (4) requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) requires an express statement and other disclosures when substantial doubt is not alleviated, and (6) requires an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). This standard is effective for the fiscal years ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The Company is currently evaluating the new guidance to determine the impact it will have on its consolidated financial statements.

#### 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. The section entitled "Business" above in Part I, Item 1 of this Annual Report also includes forward-looking statements. 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, 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 to succeed by periodic review and revisions to 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, fluctuations in weather patterns, interest rate fluctuations, and the factors set forth in the section entitled, “Risk Factors,” under Part I, Item 1A of this Annual Report. We also advise readers not to place any undue reliance on the forward-looking statements contained in this report, 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 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Not required



ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CREXENDO, INC. AND SUBSIDIARIES

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
Crexendo, Inc.

We have audited the accompanying consolidated balance sheets of Crexendo, Inc. and subsidiaries (the "Company") as of December 31, 2014 and 2013, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2014. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Crexendo, Inc. and subsidiaries at December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/DELOITTE & TOUCHE LLP

Salt Lake City, Utah

March 3, 2015

## CREXENDO, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(In thousands, except par value and share data)

	December 31,	
	2014	2013
Assets		
Current assets:		
Cash and cash equivalents	\$2,906	\$3,076
Restricted cash	133	487
Trade receivables, net of allowance for doubtful accounts of \$49 as of December 31, 2014 and \$163 as of December 31, 2013	543	1,090
Inventories	72	217
Equipment financing receivables	171	94
Income tax receivable	-	55
Prepaid expenses and other	1,032	620
Total current assets	4,857	5,639
Certificate of deposit	251	250
Long-term trade receivables, net of allowance for doubtful accounts of \$19 as December 31, 2014 and \$37 as of December 31, 2013	64	116
Long-term equipment financing receivables	455	398
Property and equipment, net	68	2,195
Deferred income tax assets, net	381	244
Intangible assets, net	676	571
Goodwill	272	75
Long-term prepaid rent	376	-
Other long-term assets	114	119
Total Assets	\$7,514	\$9,607
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$47	\$201
Accrued expenses	1,331	1,095
Income tax payable	7	-
Contingent consideration	211	51
Deferred income tax liability	381	244
Deferred revenue, current portion	726	1,199
Total current liabilities	2,703	2,790
Deferred revenue, net of current portion	64	116
Other long-term liabilities	203	-
Total liabilities	2,970	2,906
Commitments and contingencies		

## 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, 12,681,617 shares outstanding as of December 31, 2014 and 10,801,315 shares outstanding as of December 31, 2013	13	11
Additional paid-in capital	55,413	50,998
Contingent consideration	-	198
Accumulated deficit	(50,882 )	(44,506 )
Total stockholders' equity	4,544	6,701
Total Liabilities and Stockholders' Equity	\$7,514	\$9,607

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

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

	Year Ended December 31,	
	2014	2013
Revenue	\$7,594	\$10,328
Operating expenses:		
Cost of revenue	3,582	4,091
Selling and marketing	2,280	3,055
General and administrative	6,727	6,970
Research and development	1,604	1,692
Goodwill impairment	-	265
Total operating expenses	14,193	16,073
Loss from operations	(6,599 )	(5,745 )
Other income:		
Interest income	150	501
Other income, net	150	24
Total other income, net	300	525
Loss before income tax	(6,299 )	(5,220 )
Income tax benefit/(provision)	(77 )	257
Net loss	\$(6,376 )	\$(4,963 )
Net loss per common share:		
Basic	\$(0.57 )	\$(0.46 )
Diluted	\$(0.57 )	\$(0.46 )
Weighted-average common shares outstanding:		
Basic	11,163,592	10,714,353
Diluted	11,163,592	10,714,353

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

CREXENDO, INC. AND SUBSIDIARIES  
Consolidated Statements of Stockholders' Equity  
Years Ended December 31, 2014 and December 31, 2013  
(In thousands, except share data)

	Common Stock		Additional	Contingent	Accumulated	Total
	Shares	Amount	Paid-in Capital	Consideration	Deficit	Stockholders' Equity
Balance, January 1, 2013	10,669,201	\$ 11	\$49,824	\$ -	\$ (39,543 )	\$ 10,292
Expense for stock options granted to employees	-	-	808	-	-	808
Stock issued under stock award plans	67,832	-	181	-	-	181
Issuance of common stock in connection with a business acquisition	38,516	-	107	-	-	107
Contingent consideration	-	-	-	276	-	276
Issuance of common stock from contingent consideration	25,766	-	78	(78 )	-	-
Net loss	-	-	-	-	(4,963 )	(4,963 )
Balance, December 31, 2013	10,801,315	11	50,998	198	(44,506 )	6,701
Expense for stock options granted to employees	-	-	784	-	-	784
Stock issued under stock award plans	28,418	-	70	-	-	70
Issuance of common stock for rent	300,000	-	966	-	-	966
Issuance of common stock in connection with a business acquisition	40,521	-	134	-	-	134
Issuance of common stock from contingent consideration	62,088	-	198	(198 )	-	-
Issuance of common stock in connection with stock purchase agreement	1,449,275	2	1,998	-	-	2,000
Issuance of common stock warrants in connection with stock purchase agreement	-	-	265	-	-	265
Net loss	-	-	-	-	(6,376 )	(6,376 )
Balance, December 31, 2014	12,681,617	\$ 13	\$55,413	\$ -	\$ (50,882 )	\$ 4,544

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

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

	Year Ended December 31,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$(6,376 )	\$(4,963 )
Adjustments to reconcile net loss to net cash used for operating activities:		
Goodwill impairment	-	265
Lease abandonment	-	(606 )
Amortization of prepaid rent	268	-
Depreciation and amortization	663	1,145
Expense for warrants and stock options issued to employees	1,049	808
Change in uncertain tax positions	-	(253 )
Loss/(gain) on disposal of property and equipment	(1 )	3
Amortization of deferred gain	(78 )	-
Change in fair value of contingent consideration	3	(13 )
Changes in assets and liabilities, net of effects of acquisitions:		
Trade receivables	599	2,232
Equipment financing receivables	(134 )	(368 )
Inventories	145	(46 )
Income tax receivable	55	379
Prepaid expenses and other	(90 )	(287 )
Other long-term assets	5	(22 )
Accounts payable, accrued expenses and other	72	(1,520 )
Income tax payable	7	-
Deferred revenue	(525 )	(2,136 )
Net cash used for operating activities	(4,338 )	(5,382 )
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Acquisition of property and equipment	(8 )	(62 )
Proceeds from sale of property and equipment	2,002	15
(Acquisition)/Redemption of certificate of deposit	(1 )	250
Change in restricted cash	354	957
Business acquisitions	(195 )	(300 )
Net cash provided by investing activities	2,152	860
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from exercise of options	70	181
Payments of contingent consideration	(54 )	(23 )
Proceeds from sale of common stock and warrants	2,000	-
Net cash provided by financing activities	2,016	158
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(170 )</b>	<b>(4,364 )</b>
<b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR</b>	<b>3,076</b>	<b>7,440</b>

CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	\$2,906	\$3,076
Supplemental disclosure of cash flow information:		
Cash (used)/received during the year for:		
Income taxes	\$(14	) \$383
Supplemental disclosure of non-cash investing and financing information:		
Prepayment of rent with common stock	\$966	\$-
Business acquisition with stock (Note 3)	\$134	\$107
Contingent consideration related to acquisition (Note 3)	\$211	\$363
Exchange of property and equipment for services rendered	\$-	\$4

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



CREXENDO, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements

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 telecommunications 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 Telecommunications Services and Web Services.

The Company has transformed into a start-up company with the inherent risks and uncertainties of funding operations until profitability is achieved. We currently plan to fund our operations during the next twelve months using our cash and cash equivalents of \$2,906,000. However, after considering the Company’s historical negative cash flow from operating activities as well as internal forecasts, such amount does not appear adequate to fund our anticipated cash needs for the next twelve months. Accordingly, the Company will be required to obtain additional debt or equity financing such as that available from its CEO to sustain operations. The company has the ability to call outstanding warrants to provide additional liquidity for approximately \$690,000, if needed. In addition, the Company received a commitment from the CEO, and major shareholder, in February 2015 that, if needed, he would provide up to \$1,000,000 of financial support to enable the Company to fund its operations through March 31, 2016. As such, the Company believes it will have sufficient funds to pay its obligations as they come due during the next twelve months as a result of the sources of funding detailed above.

Basis of Presentation – The 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., Internet Training Group, Inc., Crexendo International, Inc., Crexendo Telecom, Inc., and Crexendo Property Management, LLC. All intercompany account balances and transactions have been eliminated in consolidation. The 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 consolidated financial statements reflect the results of operations, financial position, changes in stockholders’ equity, and cash flows of our Company.

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 December 31, 2014, we had cash and cash equivalents in financial institutions in excess of federally insured limits in the amount of \$2,487,000.

Restricted Cash – We classified \$133,000 and \$487,000 as restricted cash as of December 31, 2014 and 2013, respectively. Cash is restricted for state licensing letters of credit and compensating balance requirements on merchant accounts, and purchasing card agreements. As of December 31, 2014, we had restricted cash in financial institutions in excess of federally insured limits in the amount of \$133,000.

Trade Receivables – We have historically offered to our web site development software customers the option to finance, typically through 24 and 36-month extended payment term arrangements (“EPTAs”), purchases made at our suspended 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 cash basis beginning on the contract date. Trade

receivables from our hosted telecommunications and web services segments are recorded at invoiced amounts.

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 Telecommunications 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 interest income of \$150,000 and \$501,000 for the years ended December 31, 2014 and 2013, respectively.

Inventory - Telecommunications 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 \$251,000 certificate of deposit as collateral for merchant accounts, which automatically renews every 12 months. The certificate of deposit is classified as long-term in the consolidated balance sheets.

Property and Equipment - Depreciation and amortization expense is computed using the straight-line method in amounts sufficient to allocate the cost of depreciable assets over their estimated useful lives ranging from two to five years. The cost of leasehold improvements 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 \$415,000 and \$1,022,000 for the year ended December 31, 2014 and 2013, respectively. Depreciable lives by asset group are as follows:

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

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

Goodwill – Goodwill is tested for impairment using a fair-value-based approach on an annual basis (December 31) and between annual tests if indicators of potential impairment exist. During the quarter ended September 30, 2013, the Company made a strategic decision to limit the sale of web services to our enterprise sized customers. As this change significantly impacted revenue in our Web Services segment, the Company determined that the change was a triggering event requiring the Company to perform an impairment assessment to determine whether the carrying amount of the goodwill exceeded its fair value. In accordance with the accounting guidance, the Company performed the two-step goodwill impairment test and concluded that the goodwill related to CastleWave was impaired and recorded an impairment charge of \$265,000 to eliminate the carrying value of the CastleWave goodwill.

Intangible Assets - Our intangible assets consist primarily of assets acquired in the acquisition of PBX Central and OSV, which include customer relationships and developed technology. 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 \$248,000 and \$123,000 for the years ended December 31, 2014 and 2013, respectively.

We periodically review the estimated useful lives of our intangible assets and review these assets for impairment whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. The determination of impairment is based on estimates of future undiscounted cash flows. If an intangible asset is considered to be impaired, the amount of the impairment will be equal to the excess of the carrying value over the fair

value of the asset.

Use of Estimates - In preparing the consolidated financial statements, management makes assumptions, estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of net sales and expenses during the reported periods. Specific estimates and judgments include 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 Telecommunications 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 telecommunications services begin.

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

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

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

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. Prepaid sales commissions were as follows:

	December 31, 2014	December 31, 2013
Prepaid sales commissions	\$424,000	\$189,000
Accumulated amortization	(116,000 )	(13,000 )
Prepaid sales commissions, net	\$308,000	\$176,000

We amortized commission expense of \$103,000 and \$13,000 for the years ended December 31, 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.

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**Income Taxes** - We recognize a liability or asset for the deferred tax consequences of all temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements that will result in taxable or deductible amounts in future years when the reported amounts of the assets and liabilities are recovered or settled. Accruals for uncertain tax positions are provided for in accordance with accounting guidance. Accordingly, we may recognize the tax benefits from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Accounting guidance is also provided on de-recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in the financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial position, results of operations, and cash flows. In assessing the need for a valuation allowance, we evaluate all significant available positive and negative evidence, including historical operating results, estimates of future taxable income and the existence of prudent and feasible tax planning strategies. We have placed a full valuation allowance on net deferred tax assets, see Note 12.

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

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

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

**Comprehensive Loss** – There were no other components of comprehensive loss other than net loss for the years ended December 31, 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 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 or total accounts receivable as of and for the years ended December 31, 2014 and 2013.

Recently Adopted Accounting Guidance - 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.

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

In August 2014, the FASB issued ASU 2014-15. This ASU requires management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the ASU (1) provides a definition of the term substantial doubt, (2) requires an evaluation every reporting period including interim periods, (3) provides principles for considering the mitigating effect of management's plans, (4) requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (5) requires an express statement and other disclosures when substantial doubt is not alleviated, and (6) requires an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). This standard is effective for the fiscal years ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. 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 loss per common share is computed by dividing the net loss for the period by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share is computed giving effect to all dilutive common stock equivalents, consisting of common stock options and warrants. Diluted net loss per common share for the year ended December 31, 2014 and 2013 is the same as basic net loss per common share because the common share equivalents were anti-dilutive due to the net loss. The following table sets forth the computation of basic and diluted net loss per common share:

	Year Ended December 31,	
	2014	2013
Net loss (in thousands)	\$(6,376 )	\$(4,963 )
Weighted-average share reconciliation:		
Weighted-average shares outstanding	11,163,592	10,714,353
Weighted-average basic shares outstanding	11,163,592	10,714,353
Diluted shares outstanding	11,163,592	10,714,353
Net loss per common share:		
Basic	\$(0.57 )	\$(0.46 )
Diluted	\$(0.57 )	\$(0.46 )

Common stock equivalent shares 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. At December 31, 2014 and 2013, the common stock equivalent shares were, as follows:

	Year Ended December 31,	
	2014	2013
Shares of common stock issuable under equity incentive plans outstanding	2,147,561	2,130,239
Shares of common stock issuable upon conversion of warrants	500,000	-
Common stock equivalent shares excluded from diluted net loss per share	2,647,561	2,130,239

## 3. Acquisitions

## One Stop Tech Solutions, LLC Acquisition

On June 1, 2014, we acquired certain assets from One Stop Tech Solutions, LLC, dba One Stop Voice (OSV), a privately-held provider of IP Telecom and Cloud communications located in Scottsdale, Arizona. The aggregate purchase price of approximately \$540,000 consisted of \$195,000 of cash paid at closing and 40,521 shares of our common stock with an estimated fair value of approximately \$134,000. The fair value of the issuance of common stock issued as consideration for OSV was determined on the basis of the closing market price of the Company's common stock on the acquisition date. In addition, the Company recorded as part of the purchase price approximately \$211,000 of contingent consideration it estimates will be paid during the earn-out period. The contingent consideration of \$211,000 will be paid out in cash and stock at a split of 60% cash and 40% stock. The Company's consolidated financial statements include the results of operations of OSV from the date of acquisition. The historical results of operations of OSV were not significant to the Company's consolidated results of operations for the periods

presented. The total purchase consideration was allocated to the assets acquired and liabilities assumed at their estimated fair values as of the date of acquisition, as determined by management based on a valuation performed by an independent third party valuation firm. The excess of the purchase price over the amounts allocated to assets acquired and liabilities assumed has been recorded as goodwill. The goodwill arising from the acquisitions discussed above consists largely of the synergies and economies of scale we hope to achieve from combining the acquired assets and operations with our historical operations. In accordance with current accounting standards, goodwill associated with the OSV acquisition will not be amortized and will be tested for impairment at least annually.

The following table presents the purchase price allocation of OSV (in thousands):

Consideration (including estimated unpaid contingent consideration):	
Cash	\$ 195
Common stock	134
Contingent consideration	211
Total consideration	\$540
Recognized amounts of identifiable assets acquired and liabilities assumed:	
Identifiable intangible assets	\$353
Commission liability	(10 )
Total identifiable net assets	343
Goodwill	197
Total consideration	\$540

The following were the identified intangible assets acquired and the respective estimated periods over which such assets will be amortized (in thousands):

Intangible Assets:	Amount	Weighted Average useful life (in years)
Customer relationships	\$335	7
Technology	18	3
Total intangible assets	\$353	

In determining the purchase price allocation, the Company considered, among other factors, its intention to use the acquired assets and the historical and estimated future demand for One Stop Voice services. The estimated fair value of customer relationships was based upon the income approach. The income approach relies on an estimation of the present value of the future monetary benefits expected to flow to the owner of an asset during its remaining economic life. This approach requires a projection of the cash flow that the asset is expected to generate in the future. The projected cash flow is discounted to its present value using a rate of return, or discount rate that accounts for the time value of money and the degree of risk inherent in the asset. The income approach may take the form of a “relief from royalty” methodology, a cost savings methodology, a “with and without” methodology, or excess earnings methodology, depending on the specific asset under consideration.

The relief from royalty approach was used to determine the fair value of the technology license acquired from One Stop Voice. The relief from royalty approach estimates the value of the intangible asset by quantifying the aggregate expenditures that would be required to replace the intangible asset. The customer relationships were valued using a form of the income approach known as the multi-period excess earnings method. Inherent in the multi-period excess earnings method is the recognition that, in most cases, all of the assets of the business, both tangible and intangible, contribute to the generation of the cash flow of the business and the net cash flows attributable to the subject asset must recognize the support of the other assets which contribute to the realization of the cash flows. This future cash flow was then discounted using an estimated required rate of return for the asset to determine the present value of the future cash flows attributable to the asset. The key assumptions used in valuing the customer relationships acquired 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 total weighted average amortization period for the identified intangible assets acquired from One Stop Voice is 7 years. The goodwill resulting from the One Stop Voice acquisition is not currently deductible for income tax purposes.

## PBX Holdings, LLC. Acquisition

On June 4, 2013 we acquired certain assets from PBX Holdings, LLC., dba PBX Central, a privately-held provider of IP Telecom and Cloud communications located in Austin, Texas. The aggregate purchase price of approximately \$770,000 consisted of \$300,000 of cash paid at closing and 38,516 shares of our common stock with an estimated fair value of approximately \$107,000. The fair value of the issuance of common stock issued as consideration for PBX Central was determined on the basis of the closing market price of the Company's common stock on the acquisition date. In addition, the Company recorded as part of the purchase price approximately \$363,000 of contingent consideration. The estimated additional payment obligation is comprised of approximately \$87,000 of cash consideration and 115,385 shares of the Company's common stock with an estimated value of approximately \$276,000 at the time of the acquisition. The Company's consolidated financial statements include the results of operations of PBX Central from the date of acquisition and were accounted for as an acquisition of a business. The historical results of operations of PBX Central were not significant to the Company's consolidated results of operations for the periods presented. The total purchase consideration was allocated to the assets acquired and liabilities assumed at their estimated fair values as of the date of acquisition. The excess of the purchase price over the amounts allocated to assets acquired and liabilities assumed has been recorded as goodwill. In accordance with current accounting standards, goodwill associated with the PBX Central acquisition will not be amortized and will be tested for impairment at least annually.

During the third quarter of 2013, the Company completed the valuation of the intangible assets acquired. The final assessment resulted in no changes to the amounts recorded. The following table presents the final allocation of the purchase price for PBX Central (in thousands):

Consideration (including estimated unpaid contingent consideration):	
Cash	\$300
Common stock	107
Contingent consideration	363
Total consideration	\$770
Recognized amounts of identifiable assets acquired and liabilities assumed:	
Property and equipment	\$7
Identifiable intangible assets	688
Total identifiable net assets	695
Goodwill	75
Total consideration	\$770

The following were the identified intangible assets acquired and the respective estimated periods over which such assets will be amortized (in thousands):

	Amount	Weighted Average useful life (In years)
Technology	\$180	2
Customer relationships	508	10
Total	\$688	

In determining the purchase price allocation, the Company considered, among other factors, its intention to use the acquired assets and the historical and estimated future demand for PBX Central services. The estimated fair value of

customer relationships was based upon the income approach. The income approach relies on an estimation of the present value of the future monetary benefits expected to flow to the owner of an asset during its remaining economic life. This approach requires a projection of the cash flow that the asset is expected to generate in the future. The projected cash flow is discounted to its present value using a rate of return, or discount rate that accounts for the time value of money and the degree of risk inherent in the asset. The income approach may take the form of a “relief from royalty” methodology, a cost savings methodology, a “with and without” methodology, or excess earnings methodology, depending on the specific asset under consideration.

The cost approach was used to determine the fair value of the technology acquired from PBX Central. The cost approach estimates the value of the intangible asset by quantifying the aggregate expenditures that would be required to replace the intangible asset. Such expenditures include the developers’ time and materials. The underlying assumption is that the cost to purchase or develop an asset is commensurate with the economic benefits the asset is expected to generate over its remaining economic life. Management has estimated the cost to develop a similar product with current technology. The key assumptions used in valuing the technology acquired are developers’ time and salary.

The customer relationships were valued using a form of the income approach known as the multi-period excess earnings method. Inherent in the multi-period excess earnings method is the recognition that, in most cases, all of the assets of the business, both tangible and intangible, contribute to the generation of the cash flow of the business and the net cash flows attributable to the subject asset must recognize the support of the other assets which contribute to the realization of the cash flows. This future cash flow was then discounted using an estimated required rate of return for the asset to determine the present value of the future cash flows attributable to the asset. The key assumptions used in valuing the customer relationships acquired 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.



The total weighted average amortization period for the identified intangible assets acquired from PBX Central is 6 years. The goodwill resulting from the PBX Central acquisition is not currently deductible for income tax purposes.

At December 31, 2013, the Company updated the cash flow forecast using actual results for the period June 1, 2013 through December 31, 2013, and determined a re-measurement was necessary to adjust the fair value of the contingent consideration. The contingent consideration comprised of 25% cash and 75% common stock. The cash contingent consideration recorded as a liability at the acquisition date fair value of \$87,000 was reduced by \$14,000. As the common stock contingent consideration was recorded as equity at the acquisition date fair value of \$276,000, no re-measurement was necessary. During the quarter ended September 30, 2014, management finalized the earn-out calculation for the final payout of contingent consideration. The cash contingent consideration classified as liability was increased by \$3,000 and the stock consideration was increased by \$2,000. The liability change in fair value was recognized in general and administrative expenses. The stock contingent consideration change in fair value was accounted for within equity. The sellers received cash of \$76,000 and stock of \$278,000 for total contingent consideration of \$354,000.

#### 4. Trade Receivables, net

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

	December 31,	
	2014	2013
Trade receivables	\$433	\$688
Conforming EPTAs	192	577
Non-Conforming EPTAs:		
1 - 30 days	19	68
31 - 60 days	28	30
61 - 90 days	3	43
Gross trade receivables	675	1,406
Less: allowance for doubtful accounts	(68 )	(200 )
Trade receivables, net	\$607	\$1,206
Current trade receivables, net	\$543	\$1,090
Long-term trade receivables, net	64	116
Trade receivables, net	\$607	\$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 \$158,000 and \$1,027,000 of EPTAs during the years ended December 31, 2014 and 2013 respectively, of which, all had original contract terms of greater than one year.

#### 5. Equipment Financing Receivables

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



	December 31,	
	2014	2013
Gross financing receivables	\$1,610	\$1,369
Less unearned income	(984 )	(877 )
Financing receivables, net	626	492
Less: Current portion of finance receivables, net	(171 )	(94 )
Finance receivables due after one year	\$455	\$398

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

## 6. Property and Equipment

Property and equipment consisted of the following (in thousands):

	December 31,	
	2014	2013
Software	\$1,183	\$1,180
Computers and office equipment	1,790	1,785
Land	-	877
Building	-	765
Building improvements	-	758
Leasehold improvements	8	8
Furniture and fixtures	4	124
Less accumulated depreciation and amortization	(2,917 )	(3,302 )
Total property and equipment, net	\$68	\$2,195

## 7. Intangible Assets

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

	December 31,	
	2014	2013
Customer relationships	\$941	\$606
Technical know-how	60	60
Non-compete	60	60
Developed technology	198	180
Less accumulated amortization		
Customer relationships	(316 )	(163 )
Technical know-how	(60 )	(60 )
Non-compete	(60 )	(60 )
Developed technology	(147 )	(52 )
Total	\$676	\$571

The following table outlines the estimated future amortization expense related to intangible assets held at December 31, 2014 (in thousands):

Year ending December 31,	
2015	\$209
2016	131
2017	97
2018	72
2019	53
Thereafter	114
Total	\$676

#### 8. Goodwill

The Company has recorded goodwill as a result of its business acquisitions. Goodwill is recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. In each of the Company's acquisitions, the objective of the acquisition was to expand the Company's product offerings and customer base and to achieve synergies related to cross selling opportunities, all of which contributed to the recognition of goodwill

The Company tests goodwill for impairment on an annual basis or more frequently if events or changes in circumstances indicate that goodwill might be impaired. The changes in the carrying amount of goodwill for the years ended December 31, 2014 and 2013 were as follows:

	Acquisition Related Goodwill
Balance at December 31, 2012	\$265
Goodwill impairment - CastleWave	(265 )
Additions - PBX Central	75
Balance at December 31, 2013	\$75
Additions - OSV	197
Balance at December 31, 2014	\$272

#### 9. Fair Value Measurements

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

	December 31, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets:				
Trade receivables, net	\$607	\$607	\$1,206	\$1,190
Equipment financing receivables	626	626	492	492
Certificate of deposit	251	251	250	250
Liabilities:				
Acquisition related contingent consideration	\$211	\$211	\$51	\$51

Assets and liabilities for which fair value is recognized in the balance sheet on a recurring basis are summarized below as of December 31, 2014 and 2013 (in thousands):

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Description	As of December 31, 2014	Fair value measurement at reporting date		
		Level 1	Level 2	Level 3
<b>Assets:</b>				
Certificate of deposit	\$251	\$-	\$251	\$-
<b>Liabilities:</b>				
Acquisition related contingent consideration	211	-	-	211

  

Description	As of December 31, 2013	Fair value measurement at reporting date		
		Level 1	Level 2	Level 3
<b>Assets:</b>				
Certificate of deposit	\$250	\$-	\$250	\$-
<b>Liabilities:</b>				
Acquisition related contingent consideration	51	-	-	51

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

The recurring Level 3 measurement of our contingent consideration liability includes the following significant unobservable inputs at December 31, 2014 and 2013, respectively (in thousands):

Contingent consideration liability	Fair Value at December 31, 2014	Valuation technique	Unobservable inputs	Range	
Revenue - based payments	\$ 211	Discounted cash flow	Discount Rate	12.5	%
			Probability of milestone payment	90	%
			Projected year of payments	2014 - 2015	

  

Contingent consideration liability	Fair Value at December 31, 2013	Valuation technique	Unobservable inputs	Range	
Revenue - based payments	\$51	Discounted cash flow	Discount Rate	17.9	%
			Probability of milestone payment	90	%
			Projected year of payments	2014	

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

The progression of the Company's Level 3 instruments fair valued on a recurring basis for the year ended December 31, 2014 are shown in the table below (in thousands):

	Acquisition Related Contingent Consideration
Balance at December 31, 2012	\$ -
Purchases, sales and settlements, net	87
Cash payments	(23 )
Fair value adjustment	(13 )
Balance at December 31, 2013	\$ 51
Change in fair value	3
Cash payments	(54 )
Additions	211
Balance at December 31, 2014	\$ 211

## 10. Equity

## Common Stock

In July 2013, the Company's Certificate of Incorporation with the State of Delaware was amended to reduce the aggregate number of shares authorized for issuance from 100,000,000 to 25,000,000. Shares of common stock reserved for future issuance as of December 31, 2014 were as follows:

Common stock warrants	500,000
Stock-based compensation plans:	
Outstanding option awards	2,147,561
Available for future grants	3,555,434
	6,202,995

## Warrants

On December 23, 2014, the Company entered into a stock purchase agreement with a major shareholder and CEO of the Company, whereby 1,449,275 shares of the Company's common stock were sold at an aggregate purchase price of \$2,000,000. In connection with the Stock Purchase Agreement, warrants to purchase 500,000 shares of the Company's common stock at a price of \$1.38 per share were provided to the purchaser. The warrants contain standard limitations and representations and are exercisable for a period of five years from the date of the stock purchase agreement. Further, for a period of two years from the date of the agreement, the Company shall be entitled to require the purchaser to exercise up to 500,000 of the warrants, upon it determining that it requires cash to meet liquidity needs. The warrants are legally detachable and separately exercisable. In addition, the warrants require the Company to transfer a fixed number of shares at the stated price at inception of the contract and the holder is exposed to risk and rewards similar to those of an owner. As a result, the proceeds from the stock purchase agreement were allocated to stockholders' equity and the warrants based on the relative fair value of the instruments, resulting in stock option expense of \$265,000 being recorded, with a corresponding increase to additional paid-in-capital as part of stockholders' equity. Fair value of the warrants was calculated using the Black-Scholes option-pricing model with the following assumptions:

Expected volatility	55	%
Expected life (in years)	5.00	
Risk-free interest rate	1.76	%
Expected dividend yield	0.00	%

## 11. Stock-Based Compensation

We have various incentive stock-based compensation plans that provide for the grant of stock options, restricted stock, and other share-based awards of up to 5,702,995 shares to eligible employees, consultants, and directors. As of December 31, 2014, we had 3,555,434 shares remaining in the plans available to grant.

The following table summarizes the statement of operations effect of stock-based compensation for the years ended December 31, 2014 and 2013 (in thousands):

	Year Ended December 31,	
	2014	2013
Share based compensation expense by financial statement line item:		
Cost of revenue	\$25	\$12



Research and development	129	105
Selling and marketing	64	76
General and administrative	566	615
Total cost related to share-based compensation expense	\$784	\$808

Total cost allocated to share-based compensation expense related to warrants issued during the year ended December 31, 2014 was \$265,000 (Note 10).

There is no tax benefit related to stock compensation expense due to a full valuation allowance on net deferred tax assets at December 31, 2014 and 2013, respectively.

### Stock Options

The weighted-average fair value of stock options on the date of grant and the assumptions used to estimate the fair value of stock options granted during the years ended December 31, 2014 and 2013 using the Black-Scholes option-pricing model were as follows:

	Year Ended December 31, 2014	Year Ended December 31, 2013
Weighted-average fair value of options and warrants granted	\$ 1.01	\$ 1.13
Expected volatility	55 %	59 %
Expected life (in years)	4.60	4.00
Risk-free interest rate	1.65 %	0.85 %
Expected dividend yield	0.00 %	0.00 %

The expected volatility of the options is determined using historical volatilities based on historical stock prices. The expected life of the options granted is based on our historical share option exercise experience. The risk-free interest rate is determined using the yield available for zero-coupon U.S. government issues with a remaining term equal to the expected life of the option. Expected dividend yield is based on our announced dividends each period during the term of the option.

The following table summarizes the stock option activity for all plans for the years ended December 31, 2014 and 2013:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Life	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2013	1,738,860	\$ 4.61	8.4 years	\$ 52
Granted	745,000	2.49		
Exercised	(67,832)	2.69		
Cancelled/forfeited	(285,789)	4.45		
Outstanding at December 31, 2013	2,130,239	3.96	8.0 years	482
Granted	498,000	3.18		
Exercised	(28,418)	2.44		
Cancelled/forfeited	(452,260)	4.05		
Outstanding at December 31, 2014	2,147,561	3.78	6.9 years	-
Shares vested and expected to vest	1,949,592	3.78	6.9 years	-
Exercisable as of December 31, 2014	1,351,894	4.18	6.6 years	-
Exercisable as of December 31, 2013	1,080,589	4.67	7.3 years	113

The total intrinsic value of options exercised during the years ended December 31, 2014 and 2013, was \$21,000 and \$133,000 respectively.

As of December 31, 2014, the total future compensation expense related to non-vested options not yet recognized in the consolidated statements of operations was approximately \$1,045,000 and the weighted-average period over which these awards are expected to be recognized is approximately 1.9 years.

## 12. Income Taxes

The income tax benefit consisted of the following for the years ended December 31, 2014 and 2013 (in thousands):

	Year Ended December 31, 2014	Year Ended December 31, 2013
Current income tax expense/(benefit):		
Federal	\$-	\$(259 )
State and local	77	59
Foreign	-	(57 )
Current income tax expense/(benefit)	\$77	\$(257 )

There was no deferred income tax expense (benefit) for the years ended December 31, 2014 and 2013.

The income tax provision attributable to loss before income tax benefit for the years ended December 31, 2014 and 2013 differed from the amounts computed by applying the U.S. federal statutory tax rate of 34.0% as a result of the following (in thousands):

	Year Ended December 31, 2014	Year Ended December 31, 2013
U.S. federal statutory income tax benefit	\$(2,142 )	\$(1,775 )
Increase (decrease) in income tax benefit resulting from:		
State and local income tax benefit, net of federal effect	104	130
Change in the valuation allowance for net deferred income tax assets	2,036	1,551
Uncertain tax positions	-	(253 )
Other, net	79	90
Income tax expense/(benefit)	\$77	\$(257 )

As of December 31, 2014 and 2013, significant components of net deferred income tax assets and liabilities were as follows (in thousands):

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	As of December 31, 2014		As of December 31, 2013	
	Current	Non-current	Current	Non-current
Deferred income tax assets:				
Accrued expenses	\$302	\$-	\$243	\$-
Deferred revenue	230	-	293	-
Net operating loss carry-forwards	-	7,132	-	5,182
Foreign tax credits	-	892	-	892
Stock-based compensation	-	2,895	-	2,568
Property and equipment	-	118	-	223
Other	-	708	-	706
Subtotal	532	11,745	536	9,571
Valuation allowance	(511 )	(11,364 )	(512 )	(9,327 )
Total deferred income tax assets	21	381	24	244
Deferred income tax liabilities:				
Property and equipment	-	-	-	-
Prepaid expenses and other	(402 )	-	(268 )	-
Total deferred income tax liabilities	(402 )	-	(268 )	-
Net deferred income tax assets (liabilities)	\$(381 )	\$381	\$(244 )	\$244

During the fiscal year ended June 30, 2002 (our fiscal year was subsequently changed to December 31), we experienced a change in ownership, as defined by the Internal Revenue Code, as amended (the "Code") under Section 382. A change of ownership occurs when ownership of a company increases by more than 50 percentage points over a three-year testing period of certain stockholders. As a result of this ownership change we determined that our annual limitation on the utilization of our federal net operating loss ("NOL") carry-forwards is approximately \$461,000 per year. We will only be able to utilize \$5,761,000 of our pre-ownership change NOL carry-forwards and will forgo utilizing \$14,871,000 of our pre-ownership change NOL carry-forwards as a result of this ownership change. We do not account for forgone NOL carryovers in our deferred tax assets and only account for the NOL carry-forwards that will not expire unutilized as a result of the restrictions of Code Section 382.

As of December 31, 2014, we had NOL, research and development, and foreign tax credit carry-forwards for U.S. federal income tax reporting purposes of approximately \$18,861,000, \$129,000 and \$892,000 respectively. The NOLs will begin to expire in 2020 through 2034, the research and development credits will begin to expire in 2019 through 2020, and the foreign tax credits will expire in 2017, if not utilized.

We also have state NOL and research and development credit carry-forwards of approximately \$7,695,000 and \$61,000 which expire on specified dates as set forth in the rules of the various states to which the carry-forwards relate.

We also have foreign NOL carry-forwards of approximately \$710,000 which expire on specified dates as set forth in the rules of the various countries in which the carry-forwards relate.

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 liabilities, projected future taxable income, the suspension of the sale of product and services through the direct mail seminar sales channel for our Web Services segment, the

restructuring of the Web Services division, 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 as of December 31, 2014 and 2013; accordingly, we recorded a full valuation allowance. The valuation allowance for deferred tax assets as of December 31, 2014 and 2013 was \$11,875,000 and \$9,839,000 respectively.

The net change in our valuation allowance was an increase of \$2,036,000 for the year ended December 31, 2014 and an increase of \$1,551,000 for the year ended December 31, 2013.

Accounting guidance clarifies the accounting for uncertain tax positions and requires companies to recognize the impact of a tax position in their financial statements, if that position is more likely than not of being sustained on audit, based on the technical merits of the position.

Although we believe our estimates are reasonable, there can be no assurance that the final tax outcome of these matters will not be different from that which we have reflected in our historical income tax provisions and accruals. Such difference could have a material impact on our income tax provision and operating results in the period in which it makes such determination.

The aggregate changes in the balance of unrecognized tax benefits during the years ended December 31, 2014 and 2013 were as follows:

Balance as of January 1, 2013	\$1,133
Reductions due to lapsed statute of limitations	(242 )
Balance as of December 31, 2013	\$891
Reductions due to lapsed statute of limitations	-
Balance as of December 31, 2014	\$891

As of December 31, 2014, we had unrecognized tax benefits of \$891,000, which if recognized, none would reduce our effective tax rate.

Estimated interest and penalties related to the underpayment or late payment of income taxes are classified as a component of income tax provision (benefit) in the consolidated statements of operations. No accrued interest and penalties were accrued as of December 31, 2014 and 2013.

Our U.S. federal income tax returns for fiscal 2011 through 2014 are open tax years. The IRS recently completed an audit of fiscal years 2005 through 2007. We also file in various state and foreign jurisdictions. With few exceptions, we are no longer subject to state and non-U.S. income tax examinations by tax authorities for years prior to fiscal 2010.

### 13. Prepaid Expenses and Other

Prepaid expenses consisted of the following (in thousands):

	December 31,	
	2014	2013
Current prepaid rent	\$322	\$-
Prepaid commissions	308	176
Other	402	444
Total current prepaids	\$1,032	\$620
Long-term prepaid rent	376	-
Total prepaid and other	\$1,408	\$620

## 14. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	December 31,	
	2014	2013
Accrued wages and benefits	\$345	\$473
Accrued accounts payable	318	70
Accrued legal costs	231	202
Accrued sales taxes	209	105
Other	228	245
Total accrued expenses	\$1,331	\$1,095

Certain amounts in the prior year accrued expenses in the table above have been reclassified to conform to the 2014 presentation.

## 15. Commitments and Contingencies

## Operating Leases

We lease certain of our equipment and corporate offices under non-cancelable operating lease agreements expiring at various dates through 2016. The operating leases for our Reno, NV and Draper, UT offices contain customary escalation clauses. Future aggregate minimum lease obligations under operating leases as of December 31, 2014, exclusive of taxes and insurance, are as follows (in thousands):

	Years ending December 31,	
	2015	2016
	119	92
Total	\$211	

Rental expense for the year ended December 31, 2014 and 2013 was approximately \$119,000 and \$119,000, respectively.

The following schedule shows the composition of total rental expense for all operating leases except those with terms of a month or less that were not renewed:

	Years ending December 31,	
	2015	2016
Minimum rentals	\$119	\$92
Less: Sublease rentals	(107 )	(92 )
Total	\$12	\$-



## Sale-Leaseback

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

Current prepaid rent	\$322,000
Long-term prepaid rent	376,000
Total prepaid rent, net	\$698,000

Rent expense incurred on the sale-leaseback, net of \$78,000 deferred gain amortization, during the year ended December 31, 2014 and 2013 was \$268,000 and \$0, respectively.

## Legal Proceedings

From time to time we receive inquiries from federal, state, city and local government officials as well as the FCC and taxing authorities in the various jurisdictions in which we operate. These inquiries and investigations related primarily to our discontinued seminar operations and concern compliance with various city, county, state, and/or federal regulations involving sales, representations made, customer service, refund policies, services 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 our 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.

On November 4, 2013, the Company received a motion for leave to file an amended complaint and a request for scheduling conference (including a request for extending discovery) in the case entitled Information Technology Customer Care, Inc., Plaintiff v StoresOnline, Inc., Defendant; filed in In The Fourth District Court, Utah County, and State Of Utah Case No. 090401169. In the original Complaint, Plaintiff ITCCI claimed that StoresOnline breached a contract with ITCCI by improperly moving its Philippine support to a new support center. ITCCI also alleged an action for tortious interference claiming that StoresOnline caused former employees of ITCCI to leave to work for that support center. There was also a claim for "civil conspiracy". The original Complaint sought actual and punitive damages.

The parties had completed discovery and filed various motions, including a motion for Summary Judgment by StoresOnline. The Company believes there was no evidence to support any of the claims raised by the Plaintiff, and that there was no contractual obligation which would have prohibited a change of support centers.



The Plaintiff has filed motions to substitute new counsel, amend its Complaint and re-open discovery. The allegations included in the proposed Amended Complaint are that former officers and executives of StoresOnline acted fraudulently and secretly to improperly move support centers. The Company strongly disputes the allegations against it under both the original Complaint and the proposed Amended Complaint. Moreover, even if any of the allegations regarding former employees in the proposed Amended Complaint were true, the Company believes that it would have no liability for those alleged actions.

In November 2014 the parties attended a mediation where the case was settled. The Plaintiffs have dismissed the case with prejudice.

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.

We have recorded liabilities of approximately \$231,000 and \$202,000 as of December 31, 2014 and 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.

#### 16. Employee Benefit Plan

We have established a retirement savings plan for eligible employees. The plan allows employees to contribute a portion of their pre-tax compensation in accordance with specified guidelines. For the year ended December 31, 2014 and 2013, we contributed approximately \$146,000 and \$169,000 to the retirement savings plan, respectively.

#### 17. Segments

Management has chosen to organize the Company around differences based on its products and services. Hosted Telecommunications Services segment generates revenue from selling hosted telecommunication services and broadband internet services. Web Services segment generates revenue from website hosting, managing e-commerce or lead generation offerings, websites, search engine optimization/management and online promotional needs for small, medium, and enterprise sized businesses. The Company has two operating segments, which consist of Hosted Telecommunications Services and Web Services. Effective April 1, 2014, the Company changed its reporting segments to reflect changes in how the Chief Operating Decision Maker (CODM) internally measures performance and allocates resources.

Historically, the Company reported StoresOnline as a separate segment which included cash collectives on extended payment term agreements (EPTA's) and website hosting services for those customers, Now that EPTA's are insignificant, the CODM reviews the website hosting services and web management services as one reportable segment, which is our web services segment.

Segment operating results for the prior year have been revised to conform to current year segment operating results presentation. Segment revenue and income (loss) before income tax provision was as follows (in thousands):

	December 31,	
	2014	2013
Revenue:		
Hosted Telecommunications Services	\$4,297	\$2,370

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Web Services	3,297	7,958
Consolidated revenue	7,594	10,328
<b>Loss from Operations:</b>		
Hosted Telecommunications Services	(5,776 )	(5,432 )
Web Services	(823 )	(313 )
Total operating loss	(6,599 )	(5,745 )
<b>Other Income, net:</b>		
Hosted Telecommunications Services	87	3
Web Services	213	522
Total other income	300	525
<b>Income/(Loss) before income tax provision</b>		
Hosted Telecommunications Services	(5,689 )	(5,429 )
Web Services	(610 )	209
Loss before income tax provision	\$(6,299 )	\$(5,220 )

Depreciation and amortization was \$400,000 and \$378,000 for the Hosted Telecommunications Services segment for the years ended December 31, 2014 and 2013, respectively. Depreciation and amortization was \$263,000 and \$767,000 for the Web Services segment for the years ended December 31, 2014 and 2013, respectively.

Interest income was \$152,000 and \$502,000 for the Web Services segment for the years ended December 31, 2014 and 2013, respectively.

Interest expense was \$3,000 and \$0 for the Hosted Telecommunications Services segment for the years ended December 31, 2014 and 2013, respectively.

## 18. Subsequent Events

On January 13, 2015, the Company voluntarily delisted from the New York Stock Exchange MKT Exchange and began trading on the OTCQX Marketplace and our ticker symbol was changed to “CXDO”. The Company previously traded on the NYSE MKT exchange under the ticker symbol “EXE”.

## 19. Quarterly Financial Information (unaudited)

	Year ended December 31, 2014			
	For the three months ended			
	March 31,	June 30,	September	December
	2014	2014	30,	31,
			2014	2014
	(In thousands, except per share data)			
Revenue	\$2,072	\$1,808	\$1,725	\$1,989
Operating expenses:				
Cost of revenue	930	884	790	978
Selling and marketing	653	504	546	577
General and administrative	1,750	1,548	1,549	1,880
Research and development	414	435	394	361
Goodwill impairment	-	-	-	-
Total operating expenses	3,747	3,371	3,279	3,796
Loss from operations	(1,675 )	(1,563 )	(1,554 )	(1,807 )
Total other income	77	82	61	80
Loss before income taxes	(1,598 )	(1,481 )	(1,493 )	(1,727 )
Income tax benefit (provision)	(34 )	(13 )	(9 )	(21 )
Net loss	\$(1,632 )	\$(1,494 )	\$(1,502 )	\$(1,748 )
Basic net loss per common share (1)	\$(0.15 )	\$(0.13 )	\$(0.13 )	\$(0.15 )
Diluted net loss per common share (1)	\$(0.15 )	\$(0.13 )	\$(0.13 )	\$(0.15 )

	Year ended December 31, 2013			
	For the three months ended			
	March 31,	June 30,	September	December
	2013	2013	30,	31,
			2013	2013
	(In thousands, except per share data)			
Revenue	\$3,022	\$2,737	\$2,428	\$2,141
Operating expenses:				
Cost of revenue	1,042	970	1,044	1,035
Selling and marketing	908	717	712	718
General and administrative (2)	1,438	1,852	1,745	1,935
Research and development	481	414	396	401
Goodwill impairment	-	-	265	-
Total operating expenses	3,869	3,953	4,162	4,089
Loss from operations	(847 )	(1,216 )	(1,734 )	(1,948 )
Total other income	212	120	98	95
Loss before income taxes	(635 )	(1,096 )	(1,636 )	(1,853 )
Income tax benefit (provision)	237	26	(23 )	17

Net loss	\$ (398 )	\$ (1,070 )	\$ (1,659 )	\$ (1,836 )
Basic net loss per common share (1)	\$ (0.15 )	\$ (0.13 )	\$ (0.13 )	\$ (0.17 )
Diluted net loss per common share (1)	\$ (0.15 )	\$ (0.13 )	\$ (0.13 )	\$ (0.17 )

(1) Net income (loss) per common share is computed independently for each of the quarters presented. Therefore, the sums of quarterly net income (loss) per common share amounts do not necessarily equal the total for the twelve month periods presented.

(2) During the first quarter of the year ended December 31, 2013, we entered into a settlement and released \$606,000 of the lease abandonment accrual.

CREXENDO, INC. AND SUBSIDIARIES  
 Schedule II- Valuation and Qualifying Accounts  
 Year Ended December 31, 2014 and 2013

	Balance at Beginning of Year	Additions (in thousands)	Deductions	Balance at End of Year
Year ended December 31, 2014				
Allowance for doubtful accounts receivable	\$200	\$-	\$(132 )	\$68
Deferred income tax asset valuation allowance	9,839	2,036	-	11,875
Year ended December 31, 2013				
Allowance for doubtful accounts receivable	\$1,522	\$-	\$(1,322 )	\$200
Deferred income tax asset valuation allowance	8,288	1,551	-	9,839

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

None

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13(a)-15(b) under the Exchange Act, as the end of the period covered by this annual report on Form 10-K.

Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of December 31, 2014 our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provided reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time period specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the year ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) of the Exchange Act. Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2014. Management reviewed the results of its assessment with our Audit Committee.

Limitations of Effectiveness of Control and Procedures

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

ITEM 9B. OTHER INFORMATION

None

PART III



ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information with respect to this item will be set forth in the definitive proxy statement to be delivered to stockholders in connection with the 2015 Annual Meeting of Stockholders (the “Proxy Statement”). Such information is incorporated herein by reference.

We have adopted a code of ethics that applies to all employees, including employees of our subsidiaries, as well as each member of our Board of Directors. The code of ethics is available at our website at [www.crexendo.com](http://www.crexendo.com).

ITEM 11. EXECUTIVE COMPENSATION

Information with respect to this item will be set forth in the Proxy Statement under the heading “Executive Compensation and Other Matters,” and is incorporated herein by reference.

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

Information with respect to this item will be set forth in the Proxy Statement under the heading “Beneficial Ownership of Shares,” and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information with respect to this item will be set forth in the Proxy Statement under the heading “Corporate Governance” and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information with respect to this item will be set forth in the Proxy Statement under the headings “Fees of Independent Registered Public Accounting Firm” and “Pre-Approval Policies and Procedures,” and is incorporated herein by reference.

## PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this Report:

1. Financial Statements – consolidated financial statements of Crexendo, Inc. and subsidiaries as set forth under Item 8 of this Report.
2. The Financial Statement Schedule on page 56 of this Annual Report.
3. Exhibit Index as seen below.

## EXHIBIT INDEX

Exhibit No.	Exhibit Description	Incorporated By Reference			Filed Herewith
		Form	Date	Number	
2.1	Agreement and Plan of Merger dated February 28, 2000 by and among Netgateway, Inc., Galaxy Acquisition Corp. and Galaxy Enterprises, Inc.	8-K	3/21/00	10.1	
3.1	Certificate of Incorporation	S-1	6/1/99	3.1	
3.2	Certificate of Amendment to Certificate of Incorporation	S-1	9/7/00	3.1	
3.3	Certificate of Amendment to Certificate of Incorporation	10-K	10/15/02	3.3	
3.4	Amended and Restated Bylaws	10-Q	11/20/01	3.2	
3.5	Certificate of Ownership and Merger (4)	S-1/A	11/12/99	3.3	
3.6	Articles of Merger	S-1/A	11/12/99	3.4	
4.1	Form of Common Stock Certificate	10-K	10/15/02	4.1	
4.2*	Form of Representatives' Warrant	S-1	6/1/99	4.1	
10.1*	1998 Stock Compensation Program	S-1	6/1/99	10.6	
10.2*	Amended and Restated 1998 Stock Option Plan for Senior Executives	10-K	9/29/03	10.2	
10.3*	Amended and Restated 1999 Stock Option Plan for Non-Executives	10-K	9/29/03	10.3	
10.5*	2003 Equity Incentive Plan	10-K	9/10/04	10.11	
10.6*	2013 Long-Term Incentive Plan	10-Q	5/6/08	10.1	
10.7	Deed of Sale, dated February 28, 2014, from Crexendo, Inc. to SGM EXE, LLC.	8-K	3/4/14	10.1	
10.8	Lease Agreement dated as of March 1, 2014 between Crexendo, Inc. and SGM EXE, LLC.	8-K	3/4/14	10.2	
10.9	Stock Purchase Agreement, dated December 24, 2014 between Crexendo, Inc. and CEO Steven G. Mihaylo	8-K	12/24/14	10.1	
21.1	Subsidiaries of Crexendo, Inc.				X
23.1	Consent of Independent Registered Public Accounting Firm (Deloitte & Touche LLP)				X

31.1	Certification Pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934 as amended	X
31.2	Certification Pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934 as amended	X
32.1	Certification Pursuant to 18 U.S.C. Section 1350	X
32.2	Certification Pursuant to 18 U.S.C. Section 1350	X
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	

\* Indicates a management contract or compensatory plan or arrangement.



