

Crexendo, Inc.  
Form 10-Q  
May 14, 2012

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 001-32277

\_\_\_\_\_ ®

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

Delaware  
(State or other jurisdiction of  
incorporation or organization)

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

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

85281  
(Zip Code)

(602) 714-8500  
(Registrant's telephone number, including area code)

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

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

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required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

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

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

The number of shares outstanding of the registrant's common stock as of May 10, 2012 was 10,623,081.

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PART I - FINANCIAL INFORMATION  
ITEM FINANCIAL STATEMENTS.

1.

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

|  | March 31,<br>2012 | December<br>31,<br>2011 |
|--|-------------------|-------------------------|
| Assets   |                   |                         |
| Current Assets:  |                   |                         |
| Cash and cash equivalents  | \$8,723           | \$8,658                 |
| Restricted cash  | 1,965             | 1,965                   |
| Trade receivables, net of allowance for doubtful accounts of \$1,626<br>as of March 31, 2012 and \$3,512 as of December 31, 2011         | 9,012             | 9,420                   |
| Inventories  | 263               | 232                     |
| Income taxes receivable  | 534               | 552                     |
| Prepaid expenses and other   | 590               | 725                     |
| Total Current Assets   | 21,087            | 21,552                  |
| Certificate of deposit   | 500               | 500                     |
| Long-term trade receivables, net of allowance for doubtful accounts of \$814<br>as of March 31, 2012 and \$1,949 as of December 31, 2011 | 3,326             | 6,097                   |
| Property and equipment, net  | 3,863             | 4,055                   |
| Deferred income tax assets, net  | 272               | 279                     |
| Intangible assets  | 61                | 79                      |
| Goodwill   | 265               | 265                     |
| Other long-term assets   | 231               | 233                     |
| Total Assets   | \$29,605          | \$33,060                |
| Liabilities and Stockholders' Equity   |                   |                         |
| Current Liabilities:   |                   |                         |
| Accounts payable   | \$1,059           | \$1,153                 |
| Accrued expenses and other   | 1,676             | 2,240                   |
| Dividend payable   | 211               | 211                     |
| Deferred income tax liability  | 272               | 279                     |
| Deferred revenue, current portion  | 8,870             | 9,288                   |
| Total Current Liabilities  | 12,088            | 13,171                  |
| Deferred revenue, net of current portion   | 3,344             | 6,123                   |
| Other long-term liabilities  | 251               | 419                     |
| Total Liabilities  | 15,683            | 19,713                  |
| Commitments and contingencies (Note 7)   |                   |                         |

## Stockholders' Equity:

|   |           |           |
|---|-----------|-----------|
| Preferred stock, par value \$0.001 per share - authorized 5,000,000 shares; none issued   | -         | -         |
| Common stock, par value \$0.001 per share - authorized 100,000,000 shares; 10,623,081 shares outstanding as of March 31, 2012 and 10,523,078 shares outstanding as of December 31, 2011 | 11        | 11        |
| Additional paid-in capital  | 49,316    | 48,938    |
| Accumulated deficit   | (35,405 ) | (35,602 ) |
| Total Stockholders' Equity  | 13,922    | 13,347    |
| Total Liabilities and Stockholders' Equity  | \$29,605  | \$33,060  |

See accompanying notes.

## CREXENDO, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations  
(In thousands, except per share and share data)  
(unaudited)

|   | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2012                            | 2011       |
| Revenue                                     | \$5,255                         | \$14,568   |
| Operating expenses:                         |                                 |            |
| Cost of revenue                             | 1,421                           | 6,305      |
| Selling and marketing                       | 933                             | 8,763      |
| General and administrative                  | 3,033                           | 2,759      |
| Research and development                    | 594                             | 872        |
| Total operating expenses                    | 5,981                           | 18,699     |
| Loss from operations                        | (726 )                          | (4,131 )   |
| Other income (expense):                     |                                 |            |
| Interest income                             | 742                             | 1,153      |
| Interest expense                            | -                               | (1 )       |
| Other income, net                           | 28                              | 6          |
| Total other income, net                     | 770                             | 1,158      |
| Income (loss) before income tax benefit     | 44                              | (2,973 )   |
| Income tax benefit                          | 153                             | 1,122      |
| Net income (loss)                           | \$197                           | \$(1,851 ) |
| Net income (loss) per common share:         |                                 |            |
| Basic                                       | \$0.02                          | \$(0.17 )  |
| Diluted                                     | \$0.02                          | \$(0.17 )  |
| Dividends per common share:                 | \$0.02                          | \$0.02     |
| Weighted average common shares outstanding: |                                 |            |
| Basic                                       | 10,530,066                      | 10,638,597 |
| Diluted                                     | 10,566,273                      | 10,638,597 |

See accompanying notes.

## CREXENDO, INC. AND SUBSIDIARIES

## Condensed Consolidated Statement of Stockholders' Equity

Three Months Ended March 31, 2012

(In thousands, except share data)

(unaudited)

|   | Common Stock |        | Additional | Accumulated  | Total         |
|---|--------------|--------|------------|--------------|---------------|
|   | Shares       | Amount | Paid-in    | Deficit      | Stockholders' |
|   |              |        | Capital    |              | Equity        |
| Balance, December 31, 2011                                | 10,523,078   | \$11   | \$48,938   | \$ (35,602 ) | \$ 13,347     |
| Expense for stock options granted to employees            |              |        | 253        |              | 253           |
| Stock issued under stock award plans (net of forfeitures) | 100,003      |        | 336        |              | 336           |
| Dividends declared  |              |        | (211 )     |              | (211 )        |
| Net income  |              |        |            | 197          | 197           |
| Balance, March 31, 2012                                   | 10,623,081   | \$11   | \$49,316   | \$ (35,405 ) | \$ 13,922     |

See accompanying notes.

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

Three Months Ended  
March 31,  
2012                      2011

**CASH FLOWS FROM OPERATING ACTIVITIES**

|  |          |            |
|--|----------|------------|
| Net income (loss)  | \$ 197   | \$(1,851 ) |
| Adjustments to reconcile net income to net cash provided by (used for) operating activities: |          |            |
| Depreciation and amortization  | 391      | 349        |
| Expense for stock options issued to employees  | 253      | 174        |
| Deferred income tax benefit  | -        | (1,103 )   |
| Change in uncertain tax positions  | (167 )   | -          |
| Changes in assets and liabilities:   |          |            |
| Trade receivables  | 3,179    | (1,725 )   |
| Inventories  | (31 )    | 27         |
| Income taxes receivable  | 18       | 641        |
| Prepaid expenses and other   | 135      | (831 )     |
| Other long-term assets   | 2        | 2          |
| Accounts payable, accrued expenses and other   | (128 )   | (1,351 )   |
| Deferred revenue   | (3,197 ) | 2,397      |
| Other long-term liabilities  | -        | (36 )      |
| Net cash provided by (used for) operating activities   | 652      | (3,307 )   |

**CASH FLOWS FROM INVESTING ACTIVITIES**

|  |        |        |
|--|--------|--------|
| Acquisition of property and equipment  | (711 ) | (54 )  |
| Investment in subsidiary               | -      | (56 )  |
| Net cash used for investing activities | (711 ) | (110 ) |

**CASH FLOWS FROM FINANCING ACTIVITIES**

|  |        |        |
|--|--------|--------|
| Proceeds from exercise of stock options and related income tax benefit | 336    | 25     |
| Repurchase of common stock   | -      | (89 )  |
| Payments made on contingent consideration                              | (1 )   | -      |
| Dividend payments  | (211 ) | (214 ) |
| Net cash provided by (used for) financing activities                   | 124    | (278 ) |

|   |           |                 |
|---|-----------|-----------------|
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b> | <b>65</b> | <b>(3,695 )</b> |
|---|-----------|-----------------|

|  |       |        |
|--|-------|--------|
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 8,658 | 14,207 |
|--|-------|--------|

|  |         |          |
|--|---------|----------|
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$8,723 | \$10,512 |
|--|---------|----------|

## Supplemental disclosure of cash flow information:

## Cash paid (received) during the period:

|          |   |   |
|----------|---|---|
| Interest | - | 1 |
|----------|---|---|



|              |    |   |      |   |
|--------------|----|---|------|---|
| Income taxes | (4 | ) | (618 | ) |
|--------------|----|---|------|---|

See accompanying notes.

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

|  | Three Months<br>Ended March 31, |       |
|--|---------------------------------|-------|
|  | 2012                            | 2011  |
| Supplemental disclosure of non-cash investing and financing information: |                                 |       |
| Dividends declared   | \$211                           | \$213 |
| Purchase of property and equipment included in accounts payable          | 125                             | 57    |

See accompanying notes.

CREXENDO, INC. AND SUBSIDIARIES

Notes to the Condensed Consolidated Financial Statements (unaudited)

(1) Description of Business, Basis of Presentation and Summary of Significant Accounting Policies

Description of Business - Crexendo, Inc. is incorporated in the state of Delaware. As used hereafter in this Form 10-Q, we refer to Crexendo, Inc. and its wholly-owned subsidiaries, as “we,” “us,” or “our Company.” We are a hosted services company that provides e-commerce software, website development, web hosting, search engine optimization, link building and hosted telecom services that include integration of e-mail, fax, and phone with e-commerce for businesses and entrepreneurs. Our services are designed to make enterprise-class hosting services available to small and medium-sized businesses at affordable monthly rates. Our unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“US GAAP”) and pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). These unaudited consolidated financial statements reflect the results of operations, financial position, changes in stockholders’ equity, and cash flows of our Company.

Basis of Presentation – These unaudited condensed consolidated financial statements include the financial statements of Crexendo, Inc. and its wholly-owned subsidiaries. We have eliminated all intercompany balances and transactions in consolidation. We have included all adjustments, consisting only of normal recurring items, which we consider necessary for a fair presentation of our financial results for interim periods presented. These unaudited condensed consolidated financial statements and accompanying notes should be read together with the audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011. Results of the three months ended March 31, 2012 do not necessarily indicate the results we expect for the twelve month period ending December 31, 2012, or any other period. Due to our revenue recognition policies and the rapidly evolving nature of our business and the markets we serve, we believe period-to-period comparisons of our operating results, including operating expenses as a percentage of revenue and cash flows, are not necessarily meaningful and should not be relied upon as an indication of future performance. In the second quarter of 2011, we announced the suspension of our direct mail seminar sales channel in our StoresOnline division. As a result, we have shifted our focus toward growing our Crexendo Web Services and Crexendo Network Services divisions. We plan to fund this growth through operating cash flows. If operating cash flows prove to be insufficient to fund future growth, we may need to raise additional capital through financing. There can be no assurances that such additional capital, if needed, would be available on acceptable terms or at all, which would adversely affect our Company’s ability to achieve its business objectives.

Seasonality - Our StoresOnline revenue has historically been subject to seasonal fluctuations as responses to our marketing for Preview Training Sessions and Internet Training Workshops are historically lower during the period from June through Labor Day, and during the holiday season from Thanksgiving Day through the middle of January. As a result of the restructuring announced on July 5, 2011 that resulted in the suspension of our seminar sales model, which included Preview Training Sessions and Internet Training Workshops, we believe that seasonality will have less of an impact on our operating and financial results going forward.

Significant Accounting Policies – We described our significant accounting policies in Note 1 to our consolidated financial statements set forth in Item 8 of our Annual Report on Form 10-K for the period ended December 31, 2011.

Recently Adopted Accounting Guidance – In May 2011, the Financial Accounting Standards Board (“FASB”) issued ASU 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards ("IFRSs")." Under ASU 2011-04, the guidance amends certain accounting and disclosure requirements related to fair value measurements to

ensure that fair value has the same meaning in U.S. GAAP and in IFRSs and that their respective fair value measurement and disclosure requirements are the same. ASU 2011-04 is effective for public entities during interim and annual periods beginning after December 15, 2011. This adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

In June 2011, the FASB issued ASU No. 2011-05, "Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income," ("ASU 2011-05") which amends current comprehensive income guidance. This accounting update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. Instead, we must report comprehensive income in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. ASU 2011-05 will be effective for public companies during the interim and annual periods beginning after December 15, 2011 with early adoption permitted. Our adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

In September 2011, the FASB issued ASU No. 2011-08, "Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment," ("ASU 2011-08") which simplifies how entities test goodwill for impairment. This accounting update permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step good will impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. ASU 2011-08 will be effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 with early adoption permitted. Our adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

In December 2011, the FASB issued ASU No. 2011-12, "Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05" ("ASU 2011-12"). ASU 2011-12 defers changes in Update 2011-05 that relate to the presentation of reclassification adjustments. ASU 2011-12 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Our adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

Other Comprehensive Income (Loss) – Our unaudited condensed consolidated financial statements for the three months ended March 31, 2012 and 2011 did not reflect any components of other comprehensive income (loss) other than net income (loss).

Significant Customers – No customer accounted for 10% or more of our total net revenue or total accounts receivable for the three months ended March 31, 2012 or 2011.

(2) Dividends

During the three months ended March 31, 2012 and 2011, our Board of Directors declared the following cash dividends:

| Declaration Date | Per Share Dividend | Record Date    | Total Amount | Payment Date  |
|------------------|--------------------|----------------|--------------|---------------|
| March 14, 2012   | \$ 0.02            | March 28, 2012 | \$ 211,000   | April 4, 2012 |
| March 22, 2011   | \$ 0.02            | March 31, 2011 | \$ 213,000   | April 7, 2011 |



## (3) Net Income (Loss) Per Common Share

Basic net income (loss) per common share is computed by dividing the net income (loss) for the period by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share is computed giving effect to all dilutive common stock equivalents, consisting of common stock options. Diluted net loss per common share for the three months ended March 31, 2011 was the same as basic net loss per common share because the common share equivalents were anti-dilutive. Diluted net income per common share for the three months ended March 31, 2012 included 29,207 common share equivalents related to shares to be purchased under our Company's employee stock option plan and 7,000 restricted shares held in escrow. The following table sets forth the computation of basic and diluted net income (loss) per common share:

|   | Three Months<br>Ended March 31,<br>2012 | 2011        |
|---|---|-------------|
| Net income (loss) (in thousands)                  | \$ 197                                  | \$ (1,851 ) |
| Weighted-average share reconciliation:            |   |             |
| Weighted-average shares outstanding               | 10,537,066                              | 10,652,597  |
| Weighted-average restricted shares held in escrow | (7,000 )                                | (14,000 )   |
| Weighted-average basic shares outstanding         | 10,530,066                              | 10,638,597  |
| Dilutive employee stock options                   | 29,207                                  | -           |
| Dilutive restrictive shares held in escrow        | 7,000                                   | -           |
| Diluted shares outstanding                        | 10,566,273                              | 10,638,597  |
| Net income (loss) per common share:               |   |             |
| Basic   | \$ 0.02                                 | \$ (0.17 )  |
| Diluted   | \$ 0.02                                 | \$ (0.17 )  |

The following table includes the number of common stock equivalent shares that are not included in the computation of diluted income (loss) per share.

|                                  | March 31,<br>2012 | 2011    |
|----------------------------------|-------------------|---------|
| Outstanding stock options        | 1,051,321         | 539,367 |
| Restricted shares held in escrow | -                 | 14,000  |
| Total                            | 1,051,321         | 553,367 |

## (4) Trade Receivables

Our trade receivables balance primarily consists of Extended Payment Term Agreements sold through our workshop seminars. Below is an analysis of the days outstanding of our trade receivables as shown on our balance sheet (in thousands):

|                                      | March 31,<br>2012 | December<br>31,<br>2011 |
|--------------------------------------|-------------------|-------------------------|
| Current                              | \$ 12,184         | \$ 16,065               |
| 1 - 30 days                          | 1,132             | 2,121                   |
| 31 - 60 days                         | 766               | 1,626                   |
| 61 - 90 days                         | 696               | 1,166                   |
| 91 days and over                     | -                 | -                       |
| Gross trade receivables              | 14,778            | 20,978                  |
| Less allowance for doubtful accounts | (2,440 )          | (5,461 )                |
| Trade receivables, net               | \$ 12,338         | \$ 15,517               |
| Current trade receivables, net       | \$ 9,012          | \$ 9,420                |
| Long-term trade receivables, net     | 3,326             | 6,097                   |
| Trade receivables, net               | \$ 12,338         | \$ 15,517               |

## (5) Income Taxes

Our effective tax rate for the three months ended March 31, 2012 and 2011 was 348% and 38%, respectively, which resulted in a benefit for income taxes of \$153,000 and \$1,122,000, respectively. The benefit for the three months ended March 31, 2012 was primarily due to the statute of limitations expiring for a few uncertain tax positions.

Significant management judgment is required in determining our provision for income taxes and in determining whether deferred tax assets will be realized in full or in part. During the three months ended June 30, 2011, we placed a full valuation allowance on net deferred tax assets. In assessing the recovery of the deferred tax assets, we considered whether it is more likely than not that some portion or all of our deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income in the periods in which those temporary differences become deductible. We considered the scheduled reversals of future deferred tax assets, projected future taxable income, the suspension of the sale of product and services through the seminar sales channel for our StoresOnline division, the restructuring of the StoresOnline 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; accordingly, we recorded a full valuation allowance in the three months ended June 30, 2011. Subsequent to placing a full valuation allowance on our net deferred tax assets, adjustments impacting our tax rate have been and are expected to continue to be insignificant.



## (6) Fair Value Measurements

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.

Liabilities measured at fair value on a recurring basis are summarized below as of March 31, 2012 and December 31, 2011 (in thousands):

| Description              | As of<br>March 31,<br>2012 | Fair value measurement at reporting date |         |         |
|--------------------------|----------------------------|--|---------|---------|
|                          |                            | Level 1                                  | Level 2 | Level 3 |
| Contingent consideration | \$ (5 )                    | -  | -       | \$ (5 ) |

| Description              | As of<br>December 31,<br>2011 | Fair value measurement at reporting date |         |         |
|--------------------------|-------------------------------|--|---------|---------|
|                          |                               | Level 1                                  | Level 2 | Level 3 |
| Contingent consideration | \$ (6 )                       | -  | -       | \$ (6 ) |

The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs (Level 3) (in thousands):

|                                       | Acquisition<br>Contingent<br>Consideration |
|---------------------------------------|--|
| Balances as of December 31, 2011      | \$ 6                                       |
| Purchases, sales and settlements, net | (1 )                                       |
| Transfers in and/or (out) of Level 3  | -  |
| Balances as of March 31, 2012         | \$ 5                                       |

The fair values of the trade receivables and certificate of deposits were computed using a discounted cash flow model using estimated market rates as of March 31, 2012 and December 31, 2011 (in thousands):

|                           | March 31, 2012    |                         | December 31, 2011 |                         |
|---------------------------|-------------------|-------------------------|-------------------|-------------------------|
|                           | Carrying<br>Value | Estimated<br>Fair Value | Carrying<br>Value | Estimated<br>Fair Value |
| Cash and cash equivalents | \$8,723           | \$8,723                 | \$8,658           | \$8,658                 |
| Restricted cash           | 1,965             | 1,965                   | 1,965             | 1,965                   |
| Trade receivables         | 12,388            | 12,173                  | 15,517            | 15,178                  |
| Certificate of deposit    | 500               | 500                     | 500               | 500                     |

The carrying amount of cash and cash equivalents and trade payables approximates fair value because of the immediate, short-term maturity of these financial instruments. The carrying amount of certificate of deposits approximates fair value, as determined by certificates of deposits with similar terms and conditions. The fair values of the trade receivables and certificate of deposit were computed using a discounted cash flow model using estimated market rates. The fair value of assets and liabilities whose carrying value approximates fair value is determined using Level 2 inputs, with the exception of cash and cash equivalents (Level 1).

Our disclosure of the estimated fair value of our financial instruments is made in accordance with generally accepted accounting guidance. The estimated fair value amounts have been determined by us using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data in order to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts we could realize in a current market exchange. The use of different market assumptions and estimation methodologies may have a material effect on the estimated fair value amounts. The fair value estimates presented herein are based on pertinent information available to management as of March 31, 2012 and December 31, 2011.

(7) Commitments and Contingencies

Legal Proceedings

From time to time we receive inquiries from federal, state, city and local government officials in the various jurisdictions in which we operate. These inquiries and investigations generally concern compliance with various city, county, state and/or federal regulations involving sales, representations made, customer service, refund policies, and marketing practices. We respond to these inquiries and have generally been successful in addressing the concerns of these persons and entities, without a formal complaint or charge being made, although there is often no formal closing of the inquiry or investigation. There can be no assurance that the ultimate resolution of these or other inquiries or investigations will not have a material adverse effect on our business or operations, or that a formal complaint will not be initiated. We also receive complaints and inquiries in the ordinary course of business from both customers and governmental and non-governmental bodies on behalf of customers, and in some cases these customer complaints have risen to the level of litigation. There can be no assurance that the ultimate resolution of these matters will not have a material adverse effect on our business or results of operations. There have been no material changes to current legal events as outlined in our Annual Report on Form 10-K for the year ended December 31, 2011.

As of March 31, 2012 and December 31, 2011, we had liabilities relating to legal proceedings of \$241,000 and \$381,080, respectively. 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.

(8) Restricted Cash

We classified \$1,965,000 as restricted cash as of March 31, 2012 and December 31, 2011, due to acquiring a letter of credit related to our telecom registration in Arizona, and the compensating balance requirement for our merchant accounts, and purchasing card agreements.

(9) Segment Information

Management has chosen to organize the Company around differences in products and services. Crexendo Web Services generates revenue from managing e-commerce or lead generation offerings, web-sites, search engine optimization/management and online promotional needs for small, medium, and large businesses. Crexendo Network Services generates revenue by selling telecommunication and data services. We believe StoresOnline will continue to generate revenue by offering businesses a continuum of services and technology providing tools and training to establish a successful website on the Internet for entrepreneurs and small office/home office (SOHO) customers.

Segment revenue and operating income (loss) was as follows (in thousands):

|  | Three Months<br>Ended March 31, |             |
|--|---------------------------------|-------------|
|  | 2012                            | 2011        |
| Revenue:                                 |                                 |             |
| StoresOnline                             | \$ 4,410                        | \$ 14,089   |
| Crexendo Web Services                    | 770                             | 479         |
| Crexendo Network Services                | 75                              | -           |
| Consolidated revenue                     | 5,255                           | 14,568      |
| Income (Loss) from Operations:           |                                 |             |
| StoresOnline                             | 3,186                           | (785 )      |
| Crexendo Web Services                    | (563 )                          | (670 )      |
| Crexendo Network Services                | (688 )                          | (486 )      |
| Unallocated corporate items              | (2,661 )                        | (2,190 )    |
| Total operating loss                     | (726 )                          | (4,131 )    |
| Other Income, net:                       |                                 |             |
| StoresOnline                             | 764                             | 1,158       |
| Unallocated corporate items              | 6                               | -           |
| Total other income                       | 770                             | 1,158       |
| Income (loss) before income tax benefit: |                                 |             |
| StoresOnline                             | 3,950                           | 373         |
| Crexendo Web Services                    | (563 )                          | (670 )      |
| Crexendo Network Services                | (688 )                          | (486 )      |
| Unallocated corporate items              | (2,655 )                        | (2,190 )    |
| Income (loss) before income tax benefit  | \$ 44                           | \$ (2,973 ) |

## ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF 2. OPERATIONS

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as “anticipates,” “expects,” “believes,” “plans,” “predicts,” and similar terms. Forward-looking statements are not guarantees of future performance and our Company’s actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part II, Item 1A, “Risk Factors,” which are incorporated herein by reference. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011 (the “2011 Form 10-K”) filed with the SEC and the Condensed Consolidated Financial Statements and notes thereto included in the 2011 Form 10-K and elsewhere in this Form 10-Q. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.

### OVERVIEW

We provide a variety of cloud-based infrastructure services to entrepreneurs and small and medium-sized businesses. Our services include high-quality voice and messaging services over broadband networks, Do-It-For-Me and Do-It-Yourself content management and website building tools, online marketing, online lead generation, e-commerce technology, and training solutions that enable entrepreneurs and small and medium-sized businesses to build and maintain an effective online presence. Our web services are designed to help increase the predictability of success for our customers.

Our primary web service offerings are designed to meet the needs of entrepreneurs and small and medium-sized businesses anywhere along their lifecycles. Our Do-It-Yourself package includes our robust content management and website building solution, fully enabled e-commerce package, online marketing tools, and educational training modules. In addition to our primary service offerings for the Do-It-Yourself customer base, we also offer a variety of premium services to the Do-It-Yourself customer such as initial site design and build, logo design, drop-shipper/supplier integration, and a variety of search engine optimization and link building packages.

Our Do-It-For-Me services are comprehensive and flexible, allowing us to meet the needs of a wide variety of customers ranging from those just establishing their online presence to those wanting to enhance their existing online presence. These services include custom website design and development, search engine optimization, link building, conversion rate optimization, paid search management, and social media management. Additionally, as the online space continues to evolve, we intend to modify our product and service offerings in an effort to keep our customers on the cutting edge of the online space.

In addition to web services, we offer a suite of high quality voice and messaging services over broadband networks. Our small and home office services are portable and allow our customers to make and receive phone calls almost anywhere a broadband Internet connection is available. We transmit these calls using VoIP technology, which converts voice signals into digital data packets for transmission over the Internet. At a cost effective rate, 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.

We rely heavily on our network, which is a flexible, scalable Session Initiation Protocol (“SIP”) based VoIP network that rides on top of the Internet. This platform enables a user via a single “identity” to access and utilize services and features regardless of how the user is connected to the Internet. As a result, with one identity, either a number or user name, customers have access to Crexendo voice, messaging, features, and personal profile information regardless of location, device, or how they access the Internet.



## SOURCES OF REVENUE

We derive our revenue from sales of a variety of services to entrepreneurs, small and medium-sized businesses, including website builder software subscriptions, web design, SEO, paid search management, hosting, link building, hosted telecom subscriptions, and commissions from third parties. Leads are generated primarily through direct mail marketing campaigns, online advertising campaigns, and strategic partnerships.

## LICENSE REVENUE

We have historically derived a substantial portion of our revenue from cash collected on the sale of our content management and web building software licenses at workshop events held throughout the year, as well as principal collected on the sale of software licenses sold through extended payment term arrangements (“EPTAs”). As a result of the restructuring plan we initiated in July 2011, we will no longer generate revenue from cash collected on the sale of our content management and web building software licenses at workshop events. We believe we will, however, continue to generate revenue from principal collected on our EPTA contracts for the next eighteen months to two years at a decreasing rate over that time period.

## PROFESSIONAL SERVICES REVENUE

We generate professional services revenue primarily from website design and development, search engine optimization services, link building, paid search management services, conversion rate optimization services, and telecom installation services. 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.

## SUBSCRIPTION AND HOSTING REVENUE

We generate revenue from monthly SaaS subscription fees on our website builder platform as well as monthly subscription fees on our hosted telecom offering and broadband services. We also derive revenue from monthly web hosting fees from our software license customers who utilize our hosting services. Revenue is recognized ratably on a daily basis over the life of the contract for all subscription and hosting services. The typical contract is a recurring monthly contract, although terms range up to 36 months.

## PRODUCT REVENUE

We generate product revenue from the sale of telephone equipment, as well as DVD training courses covering a host of online marketing topics, including affiliate marketing, Amazon® and eBay® training, comparison shopping engines, competitive reconnaissance, conversion rate optimization, keyword research, link building, localization and regionalization, paid search campaigns, permission marketing, search engine optimization, social media marketing, and Google® Analytics. These products are typically billed on a fixed price basis. These DVD training courses, which have historically been sold through our direct mail seminar channel, are now available for sale through our inside sales channel.

## COMMISSION REVENUE

We generate commissions from contracted third-party companies who telemarket complementary products and services to our customer base. This commission is typically paid as a percentage of revenue generated by these third-party companies on products and services sold to our customer base. As the lead source for the commission revenue has been our direct mail seminar events, which we discontinued in July 2011, we do not anticipate we will generate significant commission revenue in the future.

### Economic Factors

The tight credit markets in place over the past several years have adversely affected our StoresOnline business as consumers and businesses continued to be limited in their ability to obtain alternate sources of financing. The tight credit markets contributed to our decision to suspend the sale of our products and services through the seminar sales channel. The high unemployment rate has had a negative impact on our StoresOnline customer base and has continued to result in high default rates on our accounts receivable. While we have seen our collection rates stabilize and improve slightly over the past several quarters, our default rate remains high. As we recognize revenue when the cash is collected on our accounts receivable portfolio, an improvement in our collection rates will result in additional future revenue, while deterioration in our collection rate will decrease future revenue.

### Opportunities

Technological and product innovation is the foundation of our long-term growth strategy, and we intend to increase our commitment to invest in product development, engineering excellence, and delivering high-quality products and services to customers. We have organized Crexendo Web Services and Crexendo Network Services around our primary business objectives which are to help entrepreneurs and small and medium businesses increase the effectiveness and visibility of their online presence, as well as decreasing their infrastructure and communications costs. Crexendo Web Services offers a wide range of services, including content management, SaaS, SEO services, search engine management services, website and logo design services and conversion rate optimization services. Crexendo Network Services offers a suite of high-quality voice and messaging services over broadband networks.

We believe our long-term focus on investing in products and developing new and alternative sales channels is enabling us to build a foundation for growth by delivering innovative products, creating opportunities for potential channel partners, and improving customer satisfaction. Our focus continues to be to execute in key areas through ongoing innovation on our integrated content management software solution, responding effectively to customer and partner needs, and focusing internally on product excellence, business efficacy, and accountability across our Company.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing our financial statements, we make estimates, assumptions and judgments that can have a significant impact on our net revenue, operating income or loss and net income or loss, as well as on the value of certain assets and liabilities on our balance sheet. We believe that the estimates, assumptions and judgments involved in our accounting policies described in Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011 have the greatest potential impact on our financial statements, so we consider them to be our critical accounting policies and estimates. We believe that there were no significant changes to those critical accounting policies during the three months ended March 31, 2012. Our senior management has reviewed the development and selection of our critical accounting policies and estimates and their disclosure in this Form 10-Q with the Audit Committee of our Board of



Directors.

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## RESULTS OF OPERATIONS

## Results of Consolidated Operations

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

| Consolidated Operations             | Three Months<br>Ended March 31,          |            |
|-------------------------------------|--|------------|
|                                     | 2012                                     | 2011       |
|                                     | (in thousands, except per share amounts) |            |
| Revenue                             | \$ 5,255                                 | \$ 14,568  |
| Income (loss) before income taxes   | 44                                       | (2,973 )   |
| Income tax benefit                  | 153                                      | 1,122      |
| Net income (loss)                   | 197                                      | (1,851 )   |
| Diluted net income (loss) per share | \$ 0.02                                  | \$ (0.17 ) |

## Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

## Revenue

Total net revenue decreased 64% in the three months ended March 31, 2012 compared with the corresponding period of 2011, primarily due to a 29% decrease in principal collected on our accounts receivable balance, an 83% decrease in commissions from third parties and other revenue, following the suspension of our direct mail seminar sales, and a 100% decrease in seminar sales as we no longer conduct seminars. Crexendo Web Services generated revenue of \$770,000 during the three months ended March 31, 2012, compared with \$479,000 in the corresponding period in 2011.

## Income (Loss) Before Income Taxes

Income before income tax was \$44,000 in the three months ended March 31, 2012 compared with a loss of \$2,973,000 in the corresponding period of 2011. Revenue for the three months ended March 31, 2012 decreased \$9,313,000 compared to corresponding period of 2011. Total operating expenses decreased 68% to \$5,981,000 for the three months ended March 31, 2012, compared to \$18,699,000 in the corresponding period of 2011.

## Income Tax Provision

Our effective tax rate for the three months ended March 31, 2012 and 2011 was 348% and 38%, respectively, which resulted in a benefit for income taxes of \$153,000 and \$1,122,000, respectively. The benefit in the current year is primarily due to the statute of limitations expiring for a few uncertain tax positions.

Significant management judgment is required in determining our provision for income taxes and in determining whether deferred tax assets will be realized in full or in part. During the three months ended June 30, 2011, we placed a full valuation allowance on net deferred tax assets. In assessing the recovery of the deferred tax assets, we considered whether it is more likely than not that some portion or all of our deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income in the periods in which those temporary differences become deductible. We considered the scheduled reversals of future deferred tax assets, projected future taxable income, the suspension of the sale of product and services through the seminar sales channel for our StoresOnline division, the restructuring of the StoresOnline 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; accordingly, we recorded a full valuation allowance in the three months ended June 30, 2011. Subsequent to placing a full valuation allowance on our net deferred tax assets, adjustments impacting our tax rate have been and are expected to continue to be insignificant.

### Segment Operating Results

The information below is organized in accordance with our three reportable segments. Segment operating income (loss) is equal to segment net revenue less segment cost of revenue, sales and marketing, and general and administrative expenses. Segment expenses do not include certain costs, such as corporate general and administrative expenses and share-based compensation expenses, which are not allocated to specific segments.

#### Operating Results of our StoresOnline Division (in thousands)

|                            | Three Months<br>Ended March 31, |           |
|----------------------------|---------------------------------|-----------|
|                            | 2012                            | 2011      |
| StoresOnline               |                                 |           |
| Revenue                    | \$ 4,410                        | \$ 14,089 |
| Operating expenses:        |                                 |           |
| Cost of revenue            | 646                             | 5,758     |
| Selling and marketing      | 77                              | 8,047     |
| General and administrative | 501                             | 1,069     |
| Operating income (loss)    | 3,186                           | (785 )    |
| Other income               | 764                             | 1,158     |
| Income before taxes        | \$ 3,950                        | \$ 373    |

#### Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

##### Revenue

Revenue from our StoresOnline division for the three months ended March 31, 2012 decreased 69% to \$4,410,000, from \$14,089,000 for the three months ended March 31, 2011.

Following our decision to suspend our direct mail seminar sales in July 2011, revenue from our StoresOnline division has been generated primarily through principal amounts collected on historical sales of StoresOnline products and services sold through EPTAs. Fees for our StoresOnline products and services sold under EPTAs are recognized as revenue as cash payments are received from the customer and not at the time of sale.



Revenue related to cash collected under EPTA agreements decreased to \$3,120,000 for the three months ended March 31, 2012, compared to \$4,204,000 for the three months ended March 31, 2011. 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 these EPTA contracts as cash is collected. EPTAs are 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 at a decreasing quarterly rate over the next eighteen months to two years. The following table summarizes the activity within deferred revenue for the three months ended March 31, 2012 and 2011 (in thousands):

|  |          |
|--|----------|
| StoresOnline deferred revenue as of December 31, 2010            | \$23,229 |
| Cash collected on Principal of EPTA Contracts                    | (4,204 ) |
| Deferred revenue added during period (net of writeoffs)          | 6,592    |
| StoresOnline deferred revenue as of March 31, 2011               | \$25,617 |
| StoresOnline deferred revenue as of December 31, 2011            | \$15,196 |
| Cash collected on Principal of EPTA Contracts                    | (3,120 ) |
| Deferred revenue recognized during the period (net of writeoffs) | (38 )    |
| StoresOnline deferred revenue as of March 31, 2012               | \$12,038 |

Due to the suspension of our direct mail seminar sales channel in July 2011, we had no cash sales of StoresOnline Software licenses (“SOS licenses”) or other products at events during the three months ended March 31, 2012, compared to \$6,651,000 of cash sales at events in the three months ended March 31, 2011. Hosting revenue decreased to \$860,000 in the three months ended March 31, 2012 compared to \$1,326,000 in the three months ended March 31, 2011. The decrease in hosting revenue was primarily due to attrition in the StoresOnline customer base since March 2011, primarily as a result of the suspension of the direct mail seminar sales channel.

Commissions from third parties and other revenue decreased 83% to \$322,000 for the three months ended March 31, 2012, from \$1,908,000 for the three months ended March 31, 2011, due primarily to our decision to suspend our direct mail seminar sales channel. As a result of this decision, we no longer sent leads to these third parties, and as such, we do not expect this revenue source to be significant in the future.

#### Cost of Revenue

Cost of revenue consists primarily of the cost to conduct Internet Training Workshops, credit card fees, the cost of products sold, as well as customer support costs. Cost of revenue for the three months ended March 31, 2012 decreased 89% to \$646,000, from \$5,758,000 for the three months ended March 31, 2011. The decrease in cost of revenue was primarily due to suspension of our direct mail seminar sales channel in July 2011, as such, we no longer incurred the costs to conduct the Internet Training Workshops. The cost of revenue for the three months ended March 31, 2012 primarily related to the cost to fulfill products sold through our inside sales group, which is included in other revenue, as well as customer services costs.

#### Selling and Marketing

Selling and marketing expenses consist of payroll and related expenses for sales and marketing activities, advertising, and promotional expenses. Selling and marketing expenses for the three months ended March 31, 2012 decreased 99% to \$77,000, from \$8,047,000 for the three months ended March 31, 2011. The decrease was primarily related to the suspension of our direct mail sales seminars in July 2011, as such, we no longer incur the selling and marketing expenses associated with those seminars, which accounted for most of our selling and marketing expenses in 2011.



## General and Administrative

General and administrative expenses consist of payroll and related expenses for executive, accounting and administrative personnel, legal, accounting and other professionals, finance company service fees, and other general corporate expenses. General and administrative expenses for the three months ended March 31, 2012 decreased to \$501,000 from \$1,069,000 for the three months ended March 31, 2011. The decrease was primarily due to the suspension of our direct mail seminar sales channel, which resulted in decreases in head count and other general and administrative expenses.

## Other Income

Other income primarily relates to EPTA contracts, which generally carry an 18% simple interest rate. For the three months ended March 31, 2012 and 2011, other income was \$764,000 and \$1,158,000, respectively.

## Operating Results of Crexendo Web Services (in thousands)

|                            | Three Months<br>Ended March 31, |           |
|----------------------------|---------------------------------|-----------|
|                            | 2012                            | 2011      |
| Crexendo Web Services      |                                 |           |
| Revenue                    | \$ 770                          | \$ 479    |
| Operating Expenses:        |                                 |           |
| Cost of revenue            | 512                             | 408       |
| Selling and marketing      | 683                             | 681       |
| General and administrative | 138                             | 60        |
| Operating loss             | \$ (563 )                       | \$ (670 ) |

## Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

## Revenue

Crexendo Web Services revenue for the three months ended March 31, 2012 was \$770,000, compared to \$479,000 for the three months ended March 31, 2011. The increase in revenue was primarily due to the increase in our recurring revenue stream from the prior year as well as an increase in number of sales representatives. Revenue from Crexendo Web Services is generated primarily through on-page and off-page SEO services, search engine management services, conversion rate optimization services, and website design and development services. A substantial portion of Crexendo Web Services' revenue is generated through six to twelve-month service contracts. As such, we believe growth in Crexendo Web Services will initially be seen through increases in our backlog.

Below is a table which displays the Crexendo Web Services revenue backlog as of December 31, 2010 and 2011, and March 31, 2011 and 2012, which is expected to be recognized as revenue within the next twelve to eighteen months (in thousands):

|   |         |
|---|---------|
| Crexendo Web Services backlog as of December 31, 2010 | \$964   |
| Crexendo Web Services backlog as of March 31, 2011    | \$972   |
| Crexendo Web Services backlog as of December 31, 2011 | \$1,142 |
| Crexendo Web Services backlog as of March 31, 2012    | \$1,212 |

Cost of Revenue

Cost of revenue consists primarily of salaries related to fulfillment of our web services. Cost of revenue for the three months ended March 31, 2012 was \$512,000 compared to \$408,000 for the three months ended March 31, 2011. The increase in cost of revenue for the current period is related to an increase in headcount as we continue to increase our fulfillment capacity as revenue increases.



## Selling and Marketing

Selling and marketing expenses consist primarily of salaries and benefits, as well as advertising expenses. Selling and marketing expense was \$683,000 and \$681,000 for the three months ended March 31, 2012 and 2011, respectively. While the selling and marketing expense remained essentially flat, the composition of the expense changed as we increased the number of direct sales representatives to 21 in the current year from 12 in the prior year which resulted in an increase salaries and wages of \$127,000 from the prior year. This increase was off-set by a decrease in advertising spend of approximately \$175,000, as we have shifted our focus from an advertising sale primarily through paid search advertising to less expensive vertical specific lead channels.

## General and Administrative

General and administrative expenses consist of payroll and related expenses for administrative personnel. General and administrative expenses were \$138,000 and \$60,000 for the three months ended March 31, 2012 and 2011, respectively. The increase in general and administrative expenses is primarily due to an increase in the allocation of office space rent from the three months ended March 31, 2012.

## Operating Results of our Crexendo Network Services Division (in thousands)

|                            | Three Months<br>Ended March 31, |           |
|----------------------------|---------------------------------|-----------|
|                            | 2012                            | 2011      |
| Crexendo Network Services  |                                 |           |
| Revenue                    | \$ 75                           | \$ -      |
| Operating expenses:        |                                 |           |
| Cost of revenue            | 250                             | 107       |
| Selling and marketing      | 133                             | 22        |
| General and administrative | 139                             | 64        |
| Research and development   | 241                             | 293       |
| Operating loss             | \$ (688 )                       | \$ (486 ) |

## Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

### Revenue

Crexendo Network Services revenue for the three months ended March 31, 2012 was \$75,000 compared to no revenue for the three months ended March 31, 2011. We began selling our network services products through a limited launch during the first half of 2011 with no dedicated sales representatives, as such; we had no revenue during the three months ended March 31, 2011. As of March 31, 2012 we had seven dedicated telecom sales representatives. A substantial portion of Crexendo Network Services' revenue is generated through twenty-four to thirty-six month service contracts. As such, we believe growth in Crexendo Network Services will initially be seen through increases in our backlog.

Below is a table which displays the Crexendo Network Services revenue backlog as of December 31, 2010 and 2011, and March 31, 2011 and 2012, which we expect to recognize as revenue within the next twenty-four to thirty-six months (in thousands):

|   |       |
|---|-------|
| Crexendo Network Services backlog as of December 31, 2010 | \$-   |
| Crexendo Network Services backlog as of March 31, 2011    | \$-   |
| Crexendo Network Services backlog as of December 31, 2011 | \$155 |
| Crexendo Network Services backlog as of March 31, 2012    | \$965 |

#### Cost of Revenue

Cost of revenue consists primarily of product cost and customer support department salaries of our telecom services. Cost of revenue for the three months ended March 31, 2012 was \$250,000 compared to \$107,000 for the three months ended March 31, 2011. The increase in cost of revenue from the three months ended March 31, 2011 was primarily due to an increase in product costs due to more sales as well as an increase in customer support and provisioning personnel to support increased volume.

#### Selling and Marketing

Selling and marketing expenses consist primarily of salaries and benefits, as well as advertising expenses. Selling and marketing expenses for the three months ended March 31, 2012 was \$133,000 compared to \$22,000 for the three months ended March 31, 2011. The increase in selling and marketing expenses was primarily due to the increase in the number of sales representatives to seven in the current period from none in the prior period.

#### 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 were \$139,000 and \$64,000 for the three months ended March 31, 2012 and 2011, respectively. General and administrative expenses for the three months ended March 31, 2012 were higher than the three months ended March 31, 2011, due primarily to an increase in headcount and legal costs associated with governmental registrations in various states.

#### Research and Development

Research and development expenses consist primarily of payroll and related expenses which are attributable to the development of new telecom products. Research and development expenses were \$241,000 and \$293,000 for the three months ended March 31, 2012 and 2011, respectively. The decrease was primarily attributable to a decrease in our engineering head count.

## Results of our Corporate and Other Unallocated Operations (in thousands)

|                             | Three Months<br>Ended March 31, |             |
|-----------------------------|---------------------------------|-------------|
|                             | 2012                            | 2011        |
| Unallocated corporate items |                                 |             |
| Operating Expenses          |                                 |             |
| Cost of revenues            | \$ 13                           | \$ 32       |
| Selling and marketing       | 40                              | 13          |
| General and administrative  | 2,255                           | 1,566       |
| Research and development    | 353                             | 579         |
| Operating loss              | \$ (2,661 )                     | \$ (2,190 ) |
| Other Income                | 6                               | -           |
| Loss before taxes           | \$ (2,655 )                     | \$ (2,190 ) |

## Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

Unallocated corporate expenses, which are not allocated to specific segments of our operations, totaled \$2,655,000 and \$2,190,000 for the three months ended March 31, 2012 and 2011, respectively. Unallocated costs increased for the three months ended March 31, 2012 due primarily to an increase in unallocated costs for rent, option expense, accounting services and software license and maintenance expense. Following the suspension of the direct mail seminar sales channel, certain costs were reallocated back to corporate unallocated expenses.

## Cost of Revenue

Cost of revenue consists of share-based compensation expense of \$13,000 and \$32,000 for the three months ended March 31, 2012 and 2011, respectively.

## Selling and Marketing

Selling and marketing expenses consist of share-based compensation which was \$40,000 and \$13,000 for the three months ended March 31, 2012 and 2011, respectively.

## General and Administrative

Corporate general and administrative expenses consist of payroll, share-based compensation, rent, professional fees, and administrative personnel expenses which are not allocated to specific segments. Corporate general and administrative expenses were \$2,255,000 and \$1,566,000 for the three months ended March 31, 2012 and 2011, respectively. The increase was due primarily to higher rental expense primarily due to the favorable lease impairment adjustment in 2011 as well as an increase in unallocated option expense, accounting services, and software licenses and maintenance.

## Research and Development

Research and development expenses consist primarily of payroll and share-based compensation expenses, related to our engineering team, whose cost cannot be specifically allocated to any particular segment. Unallocated research and development expenses were \$353,000 and \$579,000 for the three months ended March 31, 2012 and 2011, respectively. The decrease was due primarily to a reduction in headcount in our engineering department.



## Liquidity and Capital Resources

### Working Capital

As of March 31, 2012, we had working capital of \$8,999,000, compared to \$8,381,000 as of December 31, 2011. As of March 31, 2012, we had working capital, excluding deferred revenue, of \$17,869,000, compared to \$17,669,000 as of December 31, 2011. Deferred revenue balances represent historical contract sales for which we cannot immediately recognize revenue. We currently anticipate that the costs and expenses we will incur as these deferred revenue amounts are recognized as revenue will be insignificant. Consequently, we do not consider deferred revenue to be a factor that impacts our liquidity or future cash requirements. The increase in working capital and working capital excluding deferred revenue is primarily attributable to the proceeds from exercise of stock options of \$336,000 in the current quarter which was offset by the payment of \$211,000 in dividends. We believe we have sufficient liquidity and capital resources to meet our needs for at least the next twelve months.

### Cash and Cash Equivalents

As of March 31, 2012, we had \$8,723,000 of cash and cash equivalents held primarily in operating accounts, compared to \$8,658,000 as of December 31, 2011. During the three months ended March 31, 2012, we generated \$652,000 in cash from operating activities and used \$711,000 in cash from investing activities. During the three months ended March 31, 2012, we generated cash from financing activities of \$124,000, primarily due to the exercise of stock options which was offset by the payment of dividends to stockholders.

### Trade Receivables

Current and long-term trade receivables, net of allowance for doubtful accounts, totaled \$12,338,000 as of March 31, 2012 compared to \$15,517,000 as of December 31, 2011. Long-term trade receivables, net of allowance for doubtful accounts, were \$3,326,000 as of March 31, 2012 compared to \$6,097,000 as of December 31, 2011. We offer our customers a contract with payment terms between 24 and 36 months, as one of several payment options. The payments that become due more than 12 months after the end of the fiscal period are classified as long-term trade receivables.

### Accounts Payable

Accounts payable as of March 31, 2012 totaled \$1,059,000, compared to \$1,153,000 as of December 31, 2011. Our accounts payable as of March 31, 2012 were generally within our vendors' terms of payment.

### Capital

As of March 31, 2012, total stockholders' equity was \$13,922,000, up from \$13,347,000 at December 31, 2011. In addition to net income of \$197,000, other significant changes in stockholders' equity during the first three months of fiscal year 2012 included an increase of additional paid-in capital of \$253,000 for options granted, \$336,000 for stock issued under stock award plans, and a decrease of \$211,000 for common stock dividends.

During the three months ended March 31, 2012, we declared cash dividends of \$0.02 per common share, which were paid on April 4, 2012 to stockholders of record as of March 28, 2012. The dividend payout ratio, representing dividends per share divided by basic and diluted income per share, was 107% for the three months ended March 31, 2012.



## Off Balance Sheet Arrangements

We have no off-balance sheet arrangements other than operating leases. We believe that these operating leases are immaterial to our current or future financial position, results of operations, revenues or expenses, liquidity, capital expenditures or capital resources.

## Impact of Recent Accounting Pronouncements

**Recently Adopted Accounting Guidance –** In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards ("IFRSs")." Under ASU 2011-04, the guidance amends certain accounting and disclosure requirements related to fair value measurements to ensure that fair value has the same meaning in U.S. GAAP and in IFRSs and that their respective fair value measurement and disclosure requirements are the same. ASU 2011-04 is effective for public entities during interim and annual periods beginning after December 15, 2011. Our adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

In June 2011, the FASB issued ASU No. 2011-05, "Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income," ("ASU 2011-05") which amends current comprehensive income guidance. This accounting update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. Instead, we must report comprehensive income in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. ASU 2011-05 will be effective for public companies during the interim and annual periods beginning after December 15, 2011 with early adoption permitted. Our adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

In September 2011, the FASB issued ASU No. 2011-08, "Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment," ("ASU 2011-08") which simplifies how entities test goodwill for impairment. This accounting update permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step good will impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. ASU 2011-08 will be effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 with early adoption permitted. Our adoption of this guidance effective January 1, 2012 did not have a material impact on our consolidated results of operations or financial condition.

In December 2011, the FASB issued ASU No. 2011-12, "Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05" ("ASU 2011-12"). ASU 2011-12 defers changes in Update 2011-05 that relate to the presentation of reclassification adjustments. ASU 2011-12 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Our adoption of this guidance, effective January 1, 2012, did not have a material impact on our consolidated results of operations or financial condition.

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

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

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

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

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

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

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

our belief that we operate in compliance with laws concerning sales practices and more particularly that we are not obligated to offer more than a three-day right of rescission;

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 belief that continuously testing and implementing changes to our business model may further reduce the level of investment necessary to get customers to attend our events and to increase our value proposition to these customers;

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 the 2011 Form 10-K. We also advise readers not to place any undue reliance on the forward-looking statements contained in this Form 10-Q, which reflect our beliefs and expectations only as of the date of this Report. We assume no obligation to update or revise these forward-looking statements to reflect new events or circumstances or any changes in our beliefs or expectations, other than as required by law.

#### ITEM QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

3.

Not required

#### ITEM CONTROLS AND PROCEDURES

4.

##### Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act) as of the end of the period covered by this report, have concluded that, based on the evaluation of these controls and procedures, our disclosure controls and procedures were effective.

##### Changes in Internal Control Over Financial Reporting

No changes in our internal control over financial reporting occurred during the three months ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM LEGAL PROCEEDINGS

1.

Information on certain legal proceedings that we believe may be material to our business is set forth in “Part I – Item 3. Legal Proceedings” to the 2011 Form 10-K. Other than the information regarding the legal proceedings set forth under “Legal Proceedings” in Note 8 of Notes to Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report, there were no material changes from the legal proceedings previously disclosed in on the 2011 Form 10-K. The information regarding legal proceedings as set forth under "Legal Proceedings" in Note 8 of Notes to Condensed Consolidated Financial Statements, included in Part I, Item 1 of this Report, is incorporated herein by reference.

### ITEM RISK FACTORS

1A.

There are many risk factors that may affect our business and the results of our operations, many of which are beyond our control. Information on certain risks that we believe are material to our business is set forth in “Part I – Item 1A. Risk Factors” of the 2011 Form 10-K.

### ITEM UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

2.

We have a share purchase program that authorizes us to purchase outstanding shares of our common stock. The aggregate dollar amount originally authorized in September 2006 for purchase was \$20,000,000 through September 2009. In September 2007, our Board of Directors authorized the purchase of an additional \$50,000,000 of our common stock through September 2012. We had no share purchases during the three months ended March 31, 2012.

### ITEM DEFAULTS UPON SENIOR SECURITIES

3.

None.

### ITEM MINE SAFETY DISCLOSURES

4.

Not applicable.

### ITEM OTHER INFORMATION

5.

None

ITEMEXHIBITS

6.

Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities and Exchange Act of 1934, as amended

31.2 Certification of Chief Financial Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities and Exchange Act of 1934, as amended

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

101.INS\* XBRL INSTANCE DOCUMENT

101.SCH\* XBRL TAXONOMY EXTENSION SCHEMA DOCUMENT

101.CAL\* XBRL TAXONOMY EXTENSION CALCULATION LINKBASE DOCUMENT

101.DEF\* XBRL TAXONOMY EXTENSION DEFINITION LINKBASE DOCUMENT

101.LAB\* XBRL TAXONOMY EXTENSION LABEL LINKBASE DOCUMENT

101.PRE\* XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE DOCUMENT

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

SIGNATURES

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

May 11, 2012

Crexendo, Inc.

By: /s/ Steven G. Mihaylo  
Steven G. Mihaylo  
Chief Executive Officer

May 11, 2012

By: /s/ Jonathan R. Erickson  
Jonathan R. Erickson  
Chief Financial Officer