SECURITIES & EXCHANGE COMMISSION EDGAR FILING

Crexendo, Inc.

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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 **September 30, 2020**

OR

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

For the transition period from ________ to ________.

Commission file number 001-32277

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

Nevada	**87-0591719**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
1615 South 52nd Street, Tempe, AZ	**85281**
(Address of Principal Executive Offices)	*(Zip Code)*

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

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

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

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

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

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

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

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

The number of shares outstanding of the registrant's common stock as of October 31, 2020 was 17,963,234.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	September 30, 2020	December 31, 2019
Assets		
Current assets:		
Cash and cash equivalents	$ 15,353	$ 4,180
Restricted cash	100	100
Trade receivables, net of allowance for doubtful accounts of $50 as of September 30, 2020 and $14 as of December 31, 2019	632	380
Contract assets	94	22
Inventories	263	382
Equipment financing receivables	253	143
Contract costs	403	379
Prepaid expenses	332	141
Income tax receivable	-	4
Total current assets	17,430	5,731
Long-term trade receivables, net of allowance for doubtful accounts of $0 as of September 30, 2020 and December 31, 2019	2	6
Long-term equipment financing receivables, net	846	561
Property and equipment, net	2,772	155
Operating lease right-of-use assets	1	51
Intangible assets, net	275	465
Goodwill	272	272
Contract costs, net of current portion	512	436
Other long-term assets	152	106
Total Assets	$ 22,262	$ 7,783
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 214	$ 86
Accrued expenses	1,570	1,754
Finance leases	31	30
Notes payable	1,071	-
Operating lease liabilities	-	50
Income tax payable	5	-
Contigent consideration	-	175
Contract liabilities	783	791
Total current liabilities	3,674	2,886
Contract liabilities, net of current portion	450	423
Finance leases, net of current portion	63	86
Notes payable, net of current portion	1,891	-
Operating lease liabilities, net of current portion	1	1
Total liabilities	6,079	3,396
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, 17,536,891 shares issued and outstanding as of September 30, 2020 and 14,884,755 shares issued and outstanding as of December 31, 2019	18	15
Additional paid-in capital	73,414	62,400
Accumulated deficit	(57,249)	(58,028)
Total stockholders' equity	16,183	4,387
Total Liabilities and Stockholders' Equity	$ 22,262	$ 7,783

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Service revenue	$ 3,654	$ 3,259	$ 10,747	$ 9,414
Product revenue	489	343	1,317	1,294
Total revenue	4,143	3,602	12,064	10,708
Operating expenses:				
Cost of service revenue	946	836	2,824	2,587
Cost of product revenue	314	172	797	664
Selling and marketing	1,051	1,003	3,151	2,865
General and administrative	1,351	1,040	3,585	3,051
Research and development	326	215	840	624
Total operating expenses	3,988	3,266	11,197	9,791
Income from operations	155	336	867	917
Other income/(expense):				
Interest income	1	1	3	4
Interest expense	(23)	(1)	(54)	(9)
Other income/(expense), net	1	(2)	(28)	6
Total other income/(expense), net	(21)	(2)	(79)	1
Income before income tax	134	334	788	918
Income tax provision	(3)	0	(9)	(7)
Net income	$ 131	$ 334	$ 779	$ 911
Earnings per common share:				
Basic	$ 0.01	$ 0.02	$ 0.05	$ 0.06
Diluted	$ 0.01	$ 0.02	$ 0.05	$ 0.06
Weighted-average common shares outstanding:				
Basic	15,244,804	14,663,151	15,058,192	14,507,696
Diluted	17,249,035	15,629,647	16,793,896	15,444,063

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

CREXENDO, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Stockholders' Equity
Nine Months Ended September 30, 2020 and 2019
(Unaudited, in thousands, except share data)

	Common Stock				
	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance, January 1, 2020	14,884,755	$ 15	$ 62,400	$ (58,028)	$ 4,387
Share-based compensation	-	-	105	-	105
Vesting of restricted stock units	7,498	-	-	-	-
Issuance of common stock for exercise of stock options	49,200	-	84	-	84
Net income	-	-	-	140	140
Balance, March 31, 2020	14,941,453	$ 15	$ 62,589	$ (57,888)	$ 4,716
Share-based compensation	-	-	136	-	136
Vesting of restricted stock units	15,363	-	-	-	-
Issuance of common stock for exercise of stock options	143,448	-	414	-	414
Net income	-	-	-	508	508
Balance, June 30, 2020	15,100,264	$ 15	$ 63,139	$ (57,380)	$ 5,774
Share-based compensation	-	-	136	-	136
Vesting of restricted stock units	14,372	-	-	-	-
Issuance of common stock for exercise of stock options	672,255	1	1,509	-	1,510
Issuance of common stock in connection with an offering	1,750,000	2	8,631	-	8,633
Net income	-	-	-	131	131
Balance, September 30, 2020	17,536,891	$ 18	$ 73,415	$ (57,249)	$ 16,184

	Common Stock				
	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance, January 1, 2019	14,394,113	$ 14	$ 61,153	$ (59,167)	$ 2,000
Share-based compensation	-	-	91	-	91
Vesting of restricted stock units	2,494	-	-	-	-
Net income	-	-	-	239	239
Balance, March 31, 2019	14,396,607	$ 14	$ 61,244	$ (58,928)	$ 2,330
Share-based compensation	-	-	95	-	95
Vesting of restricted stock units	7,498	-	-	-	-
Issuance of common stock for exercise of stock options	177,379	1	271	-	272
Net income	-	-	-	338	338
Balance, June 30, 2019	14,581,484	$ 15	$ 61,610	$ (58,590)	$ 3,035
Share-based compensation	-	-	107	-	107
Vesting of restricted stock units	7,496	-	-	-	-
Issuance of common stock for exercise of stock options	122,494	-	175	-	175
Net income	-	-	-	334	334
Balance, September 30, 2019	14,711,474	$ 15	$ 61,892	$ (58,256)	$ 3,651

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

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

	Nine Months Ended September 30, 2020	Nine Months Ended September 30, 2019
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 779	$ 911
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	197	69
Share-based compensation	377	293
Changes in assets and liabilities:		
Trade receivables	(248)	(11)
Contract assets	(72)	(2)
Equipment financing receivables	(395)	(342)
Inventories	119	108
Contract costs	(100)	(68)
Prepaid expenses	(191)	(157)
Income tax receivable	4	(2)
Other assets	(46)	14
Accounts payable and accrued expenses	(25)	224
Income tax payable	5	-
Contract liabilities	19	120
Net cash provided by operating activities	423	1,157
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(745)	(72)
Acquisition of customer relationship assets	(176)	-
Net cash used for investing activities	(921)	(72)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payment of contingent consideration	(54)	-
Repayments made on finance leases	(22)	(21)
Proceeds from notes payable	1,001	-
Repayments made on notes payable	(39)	(52)
Proceeds from exercise of options	2,007	447
Proceeds from issuance of common stock in connection with an offering	8,778	-
Net cash provided by financing activities	11,671	374
NET INCREASE IN CASH, CASH EQUIVALENTS, AND RESTRICTED CASH	11,173	1,459
CASH, CASH EQUIVALENTS, AND RESTRICTED CASH AT THE BEGINNING OF THE PERIOD	4,280	1,949
CASH, CASH EQUIVALENTS, AND RESTRICTED CASH AT THE END OF THE PERIOD	$ 15,453	$ 3,408
Cash used during the year for:		
Income taxes, net	$ -	$ (9)
Interest expense	$ (54)	$ (9)
Supplemental disclosure of non-cash investing and financing information:		
Purchase of property and equipment with a note payable	$ 2,000	$ -
Adjustment to intangible assets and contingent consideration of customer relationship asset acquisition	$ (121)	$ -
Deferred offering costs, in accounts payable and accrued expenses but not yet paid	$ (145)	$ -

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

1. Significant Accounting Policies

Description of Business – Crexendo, Inc. is incorporated in the state of Nevada. 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.” Crexendo is an award-winning premier provider of cloud communications, UCaaS, call center, collaboration services, and other cloud business services that are designed to provide enterprise-class cloud services to any size business at affordable monthly rates. The Company has two operating segments, which consist of Cloud Telecommunications and Web Services.

Basis of Presentation – The consolidated financial statements include the accounts and operations of Crexendo, Inc. and its wholly owned subsidiaries, which include Crexendo Business Solutions, Inc. and Crexendo International, Inc. All intercompany account balances and transactions have been eliminated in consolidation. The 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 September 30, 2020 and December 31, 2019, we had cash and cash equivalents in financial institutions in excess of federally insured limits in the amount of $15,414,000 and $4,004,000, respectively.

Restricted Cash – We classified $100,000 and $100,000 as restricted cash as of September 30, 2020 and December 31, 2019, respectively. Cash is restricted for compensating balance requirements on purchasing card agreements. As of September 30, 2020 and December 31, 2019, we had restricted cash in financial institutions in excess of federally insured limits in the amount of $100,000 and $100,000, respectively.

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

	September 30, 2020	September 30, 2019
Cash and cash equivalents	$ 15,353	$ 3,308
Restricted cash	100	100
Total cash, cash equivalents, and restricted cash shown in the condensed consolidated statement of cash flows	$ 15,453	$ 3,408

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

Allowance for Doubtful Accounts – The allowance represents estimated losses resulting from customers’ failure to make required payments. The allowance estimate is based on historical collection experience, specific identification of probable bad debts based on collection efforts, aging of trade receivables, customer payment history, and other known factors, including current economic conditions. We believe that the allowance for doubtful accounts is adequate based on our assessment to date, however, actual collection results may differ materially from our expectations.

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

Contract Costs – Contract costs primarily relate to incremental commission costs paid to sales representatives and sales leadership as a result of obtaining telecommunications contracts which are recoverable. The Company capitalized contract costs in the amount of $915,000 and $815,000 at September 30, 2020 and December 31, 2019, respectively. Capitalized commission costs are amortized based on the transfer of goods or services to which the assets relate which typically range from thirty-six to sixty months, and are included in selling and marketing expenses. During the three months ended September 30, 2020 and 2019, the Company amortized $123,000 and $127,000 respectively, and there was no impairment loss in relation to the costs capitalized. During the nine months ended September 30, 2020 and 2019, the Company amortized $368,000 and $376,000 respectively, and there was no impairment loss in relation to the costs capitalized.

Inventory – Finished goods telecommunications equipment inventory is stated at the lower of cost or net realizable value (first-in, first-out method). In accordance with applicable accounting guidance, we regularly evaluate whether inventory is stated at the lower of cost or net realizable value. If net realizable value is less than cost, the write-down is recognized as a loss in earnings in the period in which the excess occurs.

Property and Equipment – Depreciation and amortization expense is computed using the straight-line method in amounts sufficient to allocate the cost of depreciable assets over their estimated useful lives ranging from two to thirty-nine 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. Land is not depreciable. Depreciable lives by asset group are as follows:

Computer and office equipment	2 to 5 years
Computer software	3 years
Furniture and fixtures	4 years
Building	39 years
Leasehold improvements	2 to 5 years

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

Asset Acquisitions – Periodically we acquire customer relationships that we account for as an asset acquisition and record a corresponding intangible asset that is amortized over its estimated useful life. Any excess of the fair value of the purchase price over the fair value of the identifiable assets and liabilities is allocated on a relative fair value basis. No goodwill is recorded in an asset acquisition. If the fair value of the assets acquired exceeds the initial consideration paid as of the date of acquisition but includes a contingent consideration arrangement and ASC 450 and ASC 815 do not apply to contingent consideration, we analogize to the guidance in ASC 323 on recognizing contingent consideration in the acquisition of an equity method investment. The Company recognizes a liability equal to the lesser of, the maximum amount of contingent consideration or the excess of the fair value of the net assets acquired over the initial cost measurement. In accordance with the requirements of ASC 323 for equity method investments, the Company recognizes any excess of the contingent consideration issued or issuable, over the amount that was initially recognized as a liability, as an additional cost of the asset acquisition. If the amount initially recognized as a liability exceeds the contingent consideration issued or issuable, the entity recognizes that amount as a reduction of the cost of the asset acquisition. During the year ended December 31, 2019, the Company acquired customer relationships for an estimated aggregate purchase price of $351,000. During the nine month period ended September 30, 2020, the Company determined that the contingent consideration payable was $121,000 less than initially recorded and recognized a reduction in the cost of the asset acquired. The assets acquired were not material to our consolidated financial statements.

Goodwill – Goodwill is tested for impairment using a fair-value-based approach on an annual basis (December 31) and between annual tests if indicators of potential impairment exist.

Intangible Assets – Our intangible assets consist of customer relationships. The intangible assets are amortized following the patterns in which the economic benefits are consumed. We periodically review the estimated useful lives of our intangible assets and review these assets for impairment whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. The determination of impairment is based on estimates of future undiscounted cash flows. If an intangible asset is considered to be impaired, the amount of the impairment will be equal to the excess of the carrying value over the fair value of the asset.

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

Use of Estimates – In preparing the consolidated financial statements, management makes assumptions, estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of net sales and expenses during the reported periods. Specific estimates and judgments include valuation of goodwill and intangible assets in connection with business acquisitions and asset acquisitions, allowances for doubtful accounts, uncertainties related to certain income tax benefits, valuation of deferred income tax assets, valuations of share-based payments, annual incentive bonuses accrual, recoverability of long-lived assets and product warranty liabilities. 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.

Contingencies – The Company accrues for claims and contingencies when losses become probable and reasonably estimable. As of the end of each applicable reporting period, the Company reviews each of its matters and, where it is probable that a liability has been or will be incurred, it accrues for all probable and reasonably estimable losses. Where the Company can reasonably estimate a range of losses it may incur regarding such a matter, it records an accrual for the amount within the range that constitutes its best estimate. If the Company can reasonably estimate a range but no amount within the range appears to be a better estimate than any other, it uses the amount that is the low end of such range.

Product and Service Revenue Recognition – Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration we expect to receive in exchange for those products or services and excludes any amounts collected on behalf of third parties. We enter into contracts that can include various combinations of products and services, which are generally capable of being distinct and accounted for as separate performance obligations. We recognize revenue for delivered elements only when we determine there are no uncertainties regarding customer acceptance. Changes in the allocation of the sales price between delivered and undelivered elements can impact the timing of revenue recognized but does not change the total revenue recognized on any agreement. Revenue is recognized net of any taxes collected from customers, which are subsequently remitted to governmental authorities. For more detailed information about revenue, see Note 2.

Cost of Service Revenue – Cost of service includes Cloud Telecommunications and Web Services cost of service revenue. Cloud Telecommunications cost of service revenue primarily consists of fees we pay to third-party telecommunications and broadband Internet providers, costs of other third-party services we resell, personnel and travel expenses related to system implementation, and customer service. Web Services cost of service revenue consists primarily of customer service costs and outsourcing fees related to fulfillment of our professional web management services.

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

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

Contingent Consideration – Contingent consideration represents deferred asset acquisition consideration to be paid out at some point in the future, typically over a one-year period or less from the acquisition date. Contingent consideration is recorded at the asset acquisition date fair value. Contingent consideration recorded in connection with an asset acquisition is not derecognized until the related contingency is resolved and the consideration is paid or becomes payable. If the amount initially recorded as contingent consideration exceeds the amount paid or payable, the Company recognizes that excess amount as a reduction in the cost of the related intangible assets. During the nine month period ended September 30, 2020, the Company determined that the contingent consideration payable was $121,000 less than initially recorded and recognized a reduction in the cost of the asset acquired.

Public Offering – On September 28, 2020, the Company completed a public offering in which it issued and sold 1,750,000 shares of common stock at a price to the public of $5.50 per share. The shares sold and issued in the public offering resulted in an aggregate gross offering price of $9,625,000. The Company received net proceeds of $8,633,000 after deducting underwriting discounts and commissions of $674,000 and offering expenses of $318,000.

Deferred Offering Costs – Deferred offering costs of $145,000, primarily consisting of certain legal, accounting and other third-party fees that were directly associated with the offering, were recorded in stockholders' equity as a reduction of additional paid-in capital generated upon closing of the offering on September 28, 2020.

Research and Development – Research and development costs are expensed as incurred. Costs related to internally developed software are expensed as research and development expense until technological feasibility has been achieved, after which the costs are capitalized.

Fair Value Measurements – The fair value of our financial assets and liabilities was determined based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

Level 1 — Unadjusted quoted prices that are available in active markets for the identical assets or liabilities at the measurement date.

Level 2 — Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets in non-active markets;
- Inputs other than quoted prices that are observable for the asset or liability; and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 — Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

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

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

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

Notes Payable – We record notes payable net of any discounts or premiums. Discounts and premiums are amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.

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

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

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

Comprehensive Income – There were no other components of comprehensive income other than net income for the three and nine months ended September 30, 2020 and 2019.

Operating Segments – Accounting guidance establishes standards for the way public business enterprises are to report information about operating segments in annual financial statements and requires enterprises to report selected information about operating segments in financial reports issued to stockholders. The Company has two operating segments, which consist of Cloud Telecommunications and Web Services. Research and development expenses are allocated to Cloud Telecommunications and Web Services segments based on the level of effort, measured primarily by wages and benefits attributed to our engineering department. Indirect sales and marketing expenses are allocated to the Cloud Telecommunications and Web Services segments based on level of effort, measured by month-to-date contract bookings. General and administrative expenses are allocated to both segments based on revenue recognized for each segment. Accounting guidance also establishes standards for related disclosure about products and services, geographic areas and major customers. We generate over 90% of our total revenue from customers within North America (United States and Canada) and less than 10% of our total revenues from customers in other parts of the world.

Significant Customers – No customer accounted for 10% or more of our total revenue for the three and nine months ended September 30, 2020 and 2019. No customer accounted for 10% or more of our total trade accounts receivable as of September 30, 2020 and one telecommunications services customer accounted for 11% of total trade accounts receivable as of December 31, 2019.

Recently Adopted Accounting Pronouncements – In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-13, which removes, modifies and adds to the disclosure requirements on fair value measurements in Topic 820. The amendments on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption. All other amendments should be applied retrospectively to all periods presented upon their effective date. An entity is permitted to early adopt any removed or modified disclosures upon issuance of this updated guidance and delay adoption of the additional disclosures until their effective date. We adopted this guidance effective January 1, 2020. The adoption of this guidance did not have a material impact on our consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU 2017-04, *Intangibles - Goodwill and Other (Topic 350):* Simplifying the Test for Goodwill Impairment, which eliminates Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The Company adopted ASU 2017-04 effective January 1, 2020. The adoption of this ASU did not have an impact on our condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases* (Topic 842), and in December 2018, ASU No. 2018-20, *Narrow-Scope Improvements for Lessors*, and in July 2018, ASU No. 2018-10, *Codification Improvements to Topic 842, Leases*, and ASU 2018-11, *Leases (Topic 842) - Targeted Improvements* (collectively, "the new lease standard" or "ASC 842"). The new standard requires lessees to record assets and liabilities on the balance sheet for all leases with terms longer than 12 months. This ASU does not significantly change the previous lease guidance for how a lessee should recognize, measure, and present expenses and cash flows arising from a lease. Additionally, the criteria for classifying a finance lease versus an operating lease are substantially the same as the previous guidance. We adopted Topic 842 as of January 1, 2019, using the alternative transition method that allowed us to recognize a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the period of adoption. We used the package of practical expedients permitted under the transition guidance that allowed us to not reassess: (1) whether any expired or existing contracts are or contain leases, (2) lease classification for any expired or existing leases and (3) initial direct costs for any expired or existing leases. We elected the practical expedient that allows lessees to treat the lease and non-lease components of leases as a single lease component. Additionally, we elected the hindsight practical expedient to determine the reasonably certain lease terms for existing leases. The adoption of Topic 842 did not have a material adjustment to the opening balance of retained earnings. The adoption of Topic 842 had a material impact on our condensed consolidated balance sheet due to the recognition of right-of-use ("ROU") assets and lease liabilities. As a result of the adoption of the standard, the Company recognized ROU assets and lease liabilities of $1,088,000 as of January 1, 2019. The adoption of Topic 842 did not have a material impact on our condensed consolidated statement of operations or our condensed consolidated statement cash flows.

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

Recently Issued Accounting Pronouncements – In June 2016, the FASB issued ASU 2016-13, which requires measurement and recognition of expected credit losses for financial assets held. Following the effective date philosophy for all other entities in ASU 2019-10, which includes smaller reporting companies (SRCs), this guidance is effective for fiscal years beginning after December 15, 2022 including interim periods within those fiscal years. The standard is to be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. We do not plan to early adopt this ASU. We are in the process of evaluating the potential impact of adopting this new accounting standard on our consolidated financial statements and related disclosures.

In December 2019, the FASB issued ASU 2019-12 to simplify the accounting in ASC 740, *Income Taxes*. This guidance removes certain exceptions related to the approach for intra-period tax allocation, the methodology for calculating income taxes in an interim period, and the recognition of deferred tax liabilities for outside basis differences. This guidance also clarifies and simplifies other areas of ASC 740. This ASU will be effective beginning in the first quarter of the Company's fiscal year 2021. Early adoption is permitted. Certain amendments in this update must be applied on a prospective basis, certain amendments must be applied on a retrospective basis, and certain amendments must be applied on a modified retrospective basis through a cumulative-effect adjustment to retained earnings/(deficit) in the period of adoption. The Company is currently evaluating the impact this ASU will have on the financial statements and related disclosures, as well as the timing of adoption.

2. Revenue

Revenue is measured based on a consideration specified in a contract with a customer, and excludes any sales incentives and amounts collected on behalf of third parties. The Company recognizes revenue when it satisfies a performance obligation by transferring control over a product or service to a customer. Taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction, that are collected by the Company from a customer, are excluded from revenue. The following is a description of principal activities – separated by reportable segments – from which the Company generates its revenue. For more detailed information about reportable segments, see Note 15.

Cloud Telecommunications Segment

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

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

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

Cloud Telecommunications Services **–** Cloud telecommunication services include voice, data, collaboration software, broadband Internet access, and interest generated from equipment financing revenue. The Company recognizes revenue as services are provided in service revenue. Fees generated from reselling broadband Internet access are recognized as revenue net of the costs charged by the third-party service providers. Cloud telecommunications services are billed and paid on a monthly basis. Our telecommunications services contracts typically have a term of thirty-six to sixty months.

Fees, Commissions, and Other, Recognized over Time **–** Includes contracted and non-contracted items such as:

- Contracted activation and flash fees – The Company generally allocates a portion of the activation fees to the desktop devices, which is recognized at the time of the installation or customer acceptance, and a portion to the service, which is recognized over the contract term using the straight-line method.
- Non-contracted carrier cost recovery fee – This fee recovers the various costs and expenses that the Company incurs in connection with complying with legal, regulatory, and other requirements, including without limitation federal, state, and local reporting and filing requirements. This fee is assessed as a set percentage of our monthly billing and is recognized monthly.
- Non-contracted administrative fees – Administrative fees are recognized as revenue on a monthly basis.

One-Time Fees, Commissions, and Other **–** Includes contracted and non-contracted items such as:

- Contracted professional service revenue – Professional service revenue includes professional installation services, custom integration, and other professional services. The Company typically bills and collects professional service revenue upon entering into a contract with a customer. Professional service revenue is recognized as revenue when the performance obligations are completed.
- Non-contracted cancellation fees – These cancellation fees relate to remaining contractual term buyout payments in connection with early cancellation and are billed and recognized as revenue upon receipt.
- Other non-contracted fees – These fees include disconnect fees, shipping fees, restocking fees, and porting fees. Other non-contracted fees are recognized as revenue upon receipt of payment.

Web Services Segment

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

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

Disaggregation of Revenue

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

Three Months Ended September 30, 2020

(In thousands)	Cloud Telecommunications Segment	Web Services Segment	Total Reportable Segments
Major products/services lines			
Desktop devices	$ 489	$ -	$ 489
Equipment financing revenue	59	-	59
Telecommunications services	3,182	-	3,182
Fees, commissions, and other, recognized over time	244	-	244
One time fees, commissions and other	40	-	40
Website hosting services	-	117	117
Website management services and other	-	12	12
	$ 4,014	$ 129	$ 4,143
Timing of revenue recognition			
Products and fees recognized at a point in time	$ 529	$ -	$ 529
Services and fees transferred over time	3,485	129	3,614
	$ 4,014	$ 129	$ 4,143

Three Months Ended September 30, 2019

(In thousands)	Cloud Telecommunications Segment	Web Services Segment	Total Reportable Segments
Major products/services lines			
Desktop devices	$ 343	$ -	$ 343
Equipment financing revenue	30	-	30
Telecommunications services	2,813	-	2,813
Fees, commissions, and other, recognized over time	176	-	176
One time fees, commissions and other	81	-	81
Website hosting services	-	146	146
Website management services and other	-	13	13
	$ 3,443	$ 159	$ 3,602
Timing of revenue recognition			
Products and fees recognized at a point in time	$ 424	$ -	$ 424
Services and fees transferred over time	3,019	159	3,178
	$ 3,443	$ 159	$ 3,602

Nine Months Ended September 30, 2020

(In thousands)	Cloud Telecommunications Segment	Web Services Segment	Total Reportable Segments
Major products/services lines			
Desktop devices	$ 1,317	$ -	$ 1,317
Equipment financing revenue	156	-	156
Telecommunications services	9,321	-	9,321
Fees, commissions, and other, recognized over time	726	-	726
One time fees, commissions and other	123	-	123
Website hosting services	-	372	372
Website management services and other	-	49	49
	$ 11,643	$ 421	$ 12,064
Timing of revenue recognition			
Products and fees recognized at a point in time	$ 1,440	$ -	$ 1,440
Services and fees transferred over time	10,203	421	10,624
	$ 11,643	$ 421	$ 12,064

Nine Months Ended September 30, 2019

(In thousands)	Cloud Telecommunications Segment	Web Services Segment	Total Reportable Segments
Major products/services lines			
Desktop devices	$ 1,294	$ -	$ 1,294
Equipment financing revenue	79	-	79
Telecommunications services	7,949	-	7,949
Fees, commissions, and other, recognized over time	575	-	575
One time fees, commissions and other	309	-	309
Website hosting services	-	444	444
Website management services and other	-	58	58
	$ 10,206	$ 502	$ 10,708
Timing of revenue recognition			
Products and fees recognized at a point in time	$ 1,603	$ -	$ 1,603
Services and fees transferred over time	8,603	502	9,105
	$ 10,206	$ 502	$ 10,708

Contract balances

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

(In thousands)	September 30, 2020	December 31, 2019
Receivables, which are included in trade receivables, net of allowance for doubtful accounts	$ 634	$ 386
Contract assets	94	22
Contract liabilities	1,233	1,214

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

(In thousands)	Nine Months Ended September 30, 2020		For the Year Ended December 31, 2019	
	Contract Assets	Contract Liabilities	Contract Assets	Contract Liabilities
Revenue recognized that was included in the contract liability balance at the beginning of the period	$ -	$ (942)	$ -	$ (882)
Increase due to cash received, excluding amounts recognized as revenue during the period	-	923	-	1,033
Transferred to receivables from contract assets recognized at the beginning of the period	(12)	-	(13)	-
Increase due to additional unamortized discounts	84	-	23	-

Transaction price allocated to the remaining performance obligations

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

	2020	2021	2022	2023	2024	2025	Total
Desktop devices	$ 304	-	-	-	-	-	$ 304
Telecommunications service	$ 3,166	9,937	7,057	4,752	2,598	499	$ 28,009
All consideration from contracts with customers is included in the amounts presented above							

3. Earnings Per Common Share

Basic net income per common share is computed by dividing the net income for the period by the weighted-average number of common shares outstanding during the period. Diluted net income per common share is computed giving effect to all dilutive common stock equivalents, consisting of common stock options. The following table sets forth the computation of basic and diluted net income per common share:

	Three Months Ended September 30, 2020	Three Months Ended September 30, 2019	Nine Months Ended September 30, 2020	Nine Months Ended September 30, 2019
Net income (in thousands) (A)	$ 131	$ 334	$ 779	$ 911
Weighted-average share reconciliation:				
Weighted-average basic shares outstanding (B)	15,244,804	14,663,151	15,058,192	14,507,696
Dilutive effect of stock-based awards	2,004,231	966,496	1,735,704	936,367
Diluted weighted-average outstanding shares of common stock (C)	17,249,035	15,629,647	16,793,896	15,444,063
Earnings per common share:				
Basic (A/B)	$ 0.01	$ 0.02	$ 0.05	$ 0.06
Diluted (A/C)	$ 0.01	$ 0.02	$ 0.05	$ 0.06

For the three and nine months ended September 30, 2020 and 2019, the following potentially dilutive common stock, including awards granted under our equity incentive compensation plans, were excluded from the computation of diluted net income per share because including them would be anti-dilutive.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Stock options	18,685	1,271,559	91,845	1,662,311

4. Acquisitions

DoubleHorn, LLC Asset Acquisition

On December 31, 2019, the Company acquired certain assets from DoubleHorn, LLC. The aggregate purchase price of approximately $351,000 consisted of $176,000 of cash payable at closing and $175,000 of contingent consideration it estimates will be paid during the six month earn-out period. The Company concluded that the DoubleHorn acquisition met the definition of an asset acquisition under ASU 2017-01, "Clarifying the Definition of a Business", and the cost was allocated to the individual assets acquired and liabilities assumed based on their relative fair values. The customer relationships intangible asset will be amortized over a six year estimated useful life following the pattern of the economic benefits.

During the nine month period ended September 30, 2020, $54,000 of contingent consideration was paid in cash and the Company determined that the contingent consideration payable was $121,000 less than initially recorded and recognized a reduction in the cost of the asset acquired. The following table presents the cost of the acquisition and the allocation to assets acquired based upon their relative fair value:

Consideration:		
Cash	$	230
Total consideration	$	230
Recognized amounts of identifiable assets acquired and liabilities assumed:		
Customer relationships	$	230
Net assets acquired	$	230

5. Trade Receivables, net

Our trade receivables balance consists of traditional trade receivables. Below is an analysis of our trade receivables as shown on our balance sheet (in thousands):

	September 30, 2020		December 31, 2019	
Gross trade receivables	$	684	$	400
Less: allowance for doubtful accounts		(50)		(14)
Trade receivables, net	$	634	$	386
Current trade receivables, net	$	632	$	380
Long-term trade receivables, net		2		6
Trade receivables, net	$	634	$	386

6. Prepaid Expenses

Prepaid expenses consisted of the following (in thousands):

	September 30, 2020	December 31, 2019
Prepaid corporate insurance	$ 87	$ 48
Prepaid software services and support	80	27
Prepaid inventory deposits	90	-
Other prepaid expenses	75	66
Total prepaid expenses	$ 332	$ 141

7. Property and Equipment

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

	September 30, 2020	December 31, 2019
Building	$ 2,000	$ -
Land	500	-
Computer and office equipment	1,407	1,388
Computer software	526	346
Internal software	14	-
Furniture and fixtures	29	-
Leasehold improvements	-	85
Less: accumulated depreciation	(1,704)	(1,664)
Total property and equipment, net	$ 2,772	$ 155

Depreciation and amortization expense is included in general and administrative expenses and totaled $34,000 and $12,000 for the three months ended September 30, 2020 and 2019, respectively and $128,000 and $29,000 for the nine months ended September 30, 2020 and 2019, respectively.

8. Intangible Assets

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

	September 30, 2020	December 31, 2019
Customer relationships	$ 1,171	$ 1,292
Less: accumulated amortization	(896)	(827)
Total	$ 275	$ 465

Amortization expense is included in general and administrative expenses and totaled $23,000 and $13,000 for the three months ended September 30, 2020 and 2019, respectively, and $69,000 and $40,000 for the nine months ended September 30, 2020 and 2019, respectively. During the nine months ended September 30, 2020, we reduced customer relationships by $121,000 due to an adjustment to the total consideration payable under the DoubleHorn customer relationships asset purchase agreement.

9. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	September 30, 2020	December 31, 2019
Accrued wages and benefits	$ 384	$ 538
Accrued accounts payable	607	566
Accrued sales and telecommunication taxes	393	529
Product warranty liability	47	37
Other	139	84
Total accrued expenses	$ 1,570	$ 1,754

The changes in aggregate product warranty liabilities for the year ended December 31, 2019 and nine months ended September 30, 2020 were as follows (in thousands):

	Warranty Liabilities
Balance at January 1, 2019	$ 16
Accrual for warranties	37
Adjustments related to pre-existing warranties	7
Warranty settlements	(23)
Balance at December 31, 2019	37
Accrual for warranties	29
Warranty settlements	(19)
Balance at September 30, 2020	$ 47

Product warranty expense is included in cost of product revenue expense and totaled $11,000 and $4,000 for the three months ended September 30, 2020 and 2019, respectively, and $29,000 and $14,000 for the nine months ended September 30, 2020 and 2019, respectively.

10. Notes Payable

Notes payable consists of a short and long-term financing arrangements:

	September 30, 2020	December 31, 2019
Notes payable	$ 2,962	$ -
Less: current notes payable	(1,071)	-
Notes payable, net of current portion	$ 1,891	$ -

On January 27, 2020, we entered into a Fixed Rate Term Loan Agreement with Bank of America, N.A. to finance Two Million Dollars ($2,000,000) to purchase our corporate office building. The Loan Agreement has a term of seven (7) years with monthly payments of Eleven Thousand Eight Hundred Forty-One and 15/100 Dollars ($11,841.15), including interest at 3.67%, beginning on March 1, 2020, secured by the office building.

On April 21, 2020, we received a loan from Infinity Bank in the aggregate principal amount of One Million, Six Hundred and Twenty-Six Dollars ($1,000,626), pursuant to the Paycheck Protection Program (the “PPP”) under the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”), which was enacted March 27, 2020. The loan bears interest at a rate of 1.00% per annum, payable monthly commencing on November 21, 2020, following an initial deferral period as specified under the PPP. The notes may be prepaid by the applicable Borrower at any time prior to maturity with no prepayment penalties. Proceeds from the loan will be available to fund designated expenses, including certain payroll costs, group health care benefits and other permitted expenses, in accordance with the PPP. Under the terms of the PPP, up to the entire amount of principal and accrued interest may be forgiven to the extent loan proceeds are used for qualifying expenses as described in the CARES Act and applicable implementing guidance issued by the U.S. Small Business Administration under the PPP. The Company will use the entire loan amount for designated qualifying expenses and believes forgiveness will be granted of the respective loan in accordance with the terms of the PPP.

As of September 30, 2020, future principal payments are scheduled as follows (in thousands):

Year ending December 31,		
2020 remaining	$	1,018
2021		71
2022		74
2023		76
2024		79
Thereafter		1,644
Total	$	2,962

11. Fair Value Measurements

We have financial instruments as of September 30, 2020 and December 31, 2019 for which the fair value is summarized below (in thousands):

	September 30, 2020		December 31, 2019	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets:				
Trade receivables, net	$ 634	$ 634	$ 386	$ 386
Equipment financing receivables	1,099	1,099	704	704
Liabilities:				
Finance lease obligations	$ 94	$ 94	$ 116	$ 116
Notes payable	2,962	2,962	-	-
Asset acquisition contigent consideration	-	-	175	175

Liabilities for which fair value is recognized in the balance sheet on a recurring basis are summarized below as of September 30, 2020 and December 31, 2019 (in thousands):

		Fair value measurement at reporting date		
Description	As of September 30,2020	Level 1	Level 2	Level 3
Liabilities:				
Asset acquisition contingent consideration	$ -	$ -	$ -	$ -

Description	As of December 31,2019	Level 1	Level 2	Level 3
Liabilities:				
Asset acquisition contingent consideration	$ 175	$ -	$ -	$ 175

The recurring Level 3 measurement of our asset acquisition contingent consideration liability includes the following significant unobservable inputs at December 31, 2019 (in thousands):

Contingent consideration liability	Fair Value at December 31, 2019	Valuation technique	Unobservable inputs	Range
Revenue - based payments	$ 175	Discounted cash flow	Discount Rate	3.67%
			Probability of milestone payment	100%
			Projected year of payments	2020

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.

During the nine month period ended September 30, 2020, the Company reduced the contingent consideration to be paid based on the completion of the earn-out period by $121,000 and recognized a reduction in the cost of the assets acquired. The progression of the Company's Level 3 instruments fair valued on a recurring basis for the nine months ended September 30, 2020 and the year ended December 31, 2019 are shown in the table below (in thousands):

	Asset Acquisition Contingent Consideration
Balance at January 1, 2019	$ -
Additions	175
Balance at December 31, 2019	$ 175
Cash payments	(54)
Adjustment	(121)
Balance at September 30, 2020	$ -

12. Income Taxes

Our effective tax rate for the three months ended September 30, 2020 and 2019 was 2.2% and 0.1%, respectively, which resulted in an income tax provision of $(3,000) and $0, respectively. Our effective tax rate for the nine months ended September 30, 2020 and 2019 was 1.1% and 0.7%, respectively, which resulted in an income tax provision of $(9,000) and $(7,000), respectively. The tax provision is due to state tax payments made with extensions filed.

Significant management judgment is required in determining our provision for income taxes and in determining whether deferred tax assets will be realized in full or in part. 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 reduce the carrying amounts of deferred tax assets by a valuation allowance if, based on the evidence available, it is more-likely-than-not that such assets will not be realized. In making the assessment under the more-likely-than-not standard, appropriate consideration must be given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carry-forward periods by jurisdiction, unitary versus stand-alone state tax filings, our experience with loss carryforwards expiring unutilized, and all tax planning alternatives that may be available. Based on the significant negative evidence of cumulative losses and history of loss carryforwards expiring unutilized, the positive evidence of forecasts of future profitability was not sufficient to overcome the negative evidence. As a result, we determined it was more likely than not that the deferred tax assets would not be realized as of September 30, 2020 and December 31, 2019; accordingly, we recorded a full valuation allowance.

13. Leases

Lessee Accounting

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

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

We previously leased the corporate office building in Tempe, Arizona from a Company that is owned by the major shareholder and CEO of the Company. Effective March 1, 2017, the lease agreement was renewed for a three year term with monthly rent payments of $25,000. There was a renewal option for another three year term at the end of the lease that was considered in valuing the ROU asset as we were reasonably certain we would exercise the renewal option. Amortization of the ROU assets and operating lease liabilities for the three months ended September 30, 2020 and 2019 was $0 and $59,000, respectively, and for the nine months ended September 30, 2020 and 2019 was $50,000 and $174,000, respectively. Rental expense incurred on operating leases for the three months ended September 30, 2020 and 2019 was approximately $0 and $75,000, respectively, and for the nine months ended September 30, 2020 and 2019 was approximately $25,000 and $225,000, respectively.

As of December 31, 2019 we initiated the process to purchase the corporate office building back from our lessor and gave notice that we will not be exercising our option to renew for another three year term. The ROU asset and associated lease liabilities were revalued as of December 31, 2019 for the remaining two months of the lease term. This resulted in an adjustment of approximately $804,000 for the associated ROU, $250,000 for the operating lease liability, current portion, and $554,000 for the operating lease liability, net of current portion.

We have lease agreements with lease and non-lease components, and we account for the lease and non-lease components as a single lease component. Our lease agreements do not contain any material residual value guarantees or material restrictive covenants. The Company leases equipment and support under a finance lease agreement which extends through 2023. The outstanding balance for finance leases was $94,000 and $116,000 as of September 30, 2020 and December 31, 2019, respectively. The Company recorded assets classified as property and equipment under finance lease obligations of $129,000 and $129,000 as of September 30, 2020 and December 31, 2019, respectively. Related accumulated depreciation totaled $60,000 and $34,000 as of September 30, 2020 and 2019, respectively. The $25,000 support contract was classified as a prepaid expense and is being amortized over the service period of 3 years. Amortization expense is included in general and administrative expenses and totaled $2,000 and $2,000 for the three months ended September 30, 2020 and 2019, respectively, and $6,000 and $6,000 for the nine months ended September 30, 2020 and 2019, respectively. The interest rate on the finance lease obligation is 6.7% and interest expense was $2,000 and $1,000 for the three months ended September 30, 2020 and 2019, respectively and $5,000 and $7,000 for the nine months ended September 30, 2020 and 2019, respectively.

The maturity of operating leases and finance lease liabilities as of September 30, 2020 are as follows:

Year ending December 31,	**Operating Leases**	**Finance Leases**
2020 remaining	$ -	$ 9
2021	1	36
2022	-	37
2023	-	21
Total minimum lease payments	1	103
Less: amount representing interest	-	(9)
Present value of minimum lease payments	$ 1	$ 94

Lease term and discount rate	**September 30, 2020**
Weighted-average remaining lease term (years)	
Operating leases	3.5
Finance leases	2.8
Weighted-average discount rate	
Operating leases	6.7%
Finance leases	6.7%

	Nine Months Ended September 30, 2020
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash flows from operating leases	$ 25
Operating cash flows from finance leases	5
Financing cash flows from finance leases	22

Lessor Accounting

Lessor accounting remained substantially unchanged with the adoption of ASC Topic 842. Crexendo offers its customers lease financing for the lease of our cloud telecommunication equipment (IP or cloud telephone desktop devices). We account for these transactions as sales-type leases. The vast majority of our leases that qualify as sales-type leases are non-cancelable and include cancellation penalties approximately equal to the full value of the lease receivables. Leases that do not meet the criteria for sales-type lease accounting are accounted for as operating leases. Revenue from sales-type leases is recognized upon installation and the interest portion is deferred and recognized as earned. Revenue from operating leases is recognized ratably over the applicable service period.

Equipment finance receivables arising from the rental of our cloud telecommunications equipment through sales-type leases, were as follows (in thousands):

	September 30, 2020	December 31, 2019
Gross financing receivables	$ 1,650	$ 1,086
Less: unearned income	(551)	(382)
Financing receivables, net	1,099	704
Less: current portion of finance receivables, net	(253)	(143)
Finance receivables due after one year	$ 846	$ 561

Future minimum lease payments as of September 30, 2020, consisted of the following:

Year ending December 31,	Lease Receivables
2020 remaining	$ 126
2021	485
2022	431
2023	338
2024	214
2025	56
Gross equipment financing receivables	1,650
Less: unearned income	(551)
Equipment financing receivables, net	$ 1,099

14. Commitments and Contingencies

Annual Incentive Bonuses Accrual

We utilize incentive bonuses to reward performance achievements and have in place annual target incentive bonuses, payable either in whole or in part, depending on the extent to which the financial performance goals set by the Compensation Committee are achieved. Under our 2020 Profit Sharing Plan, incentive bonuses for all of the participants, including the participating officers excluding the CEO, are determinable based upon four measures of corporate financial performance. The four performance target are; (a) The revenue for the year ended December 31, 2020 must exceed the budgeted revenue approved by the Board; (b) adjusted EBITDA must exceed the budgeted adjusted EBITDA approved by the board; (c) sales bookings for the year ended December 31, 2020 must exceed budgeted Sales Bookings approved by the board; and (d) completion of an asset or business acquisition during the year ended December 31, 2020. If the requirements of (a-c) are met individually, there shall be an award pool of sixty thousand ($60,000) for each performance target achieved during the year ended December 31, 2020, to be allocated to participants based on the participant's proportionate share. If the requirement of (d) is met, there shall be an award pool based on the acquired annual revenue for each asset or business combination completed during the year ended December 31, 2020. An amount of $20,000 per $1M of acquired annualized revenue up to $5 million of acquired annualized revenue; plus $10,000 per $1M of acquired annualized revenue above $5M will be placed in the award pool to be allocated to participating executives based on the participant's proportionate share. Based on our financial performance as of September 30, 2020, it is reasonably possible that one or multiple of the performance targets may be achieved, however a reasonable estimate of liability cannot be made at this time.

15. Segments

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Revenue:				
Cloud telecommunications	$ 4,014	$ 3,443	$ 11,643	$ 10,206
Web services	129	159	421	502
Consolidated revenue	4,143	3,602	12,064	10,708
Income from operations:				
Cloud telecommunications	124	276	739	692
Web services	31	60	128	225
Total operating income	155	336	867	917
Other income/(expense), net:				
Cloud telecommunications	(20)	2	(47)	(2)
Web services	(1)	(4)	(32)	3
Total other income/(expense), net	(21)	(2)	(79)	1
Income before income tax provision:				
Cloud telecommunications	104	278	692	690
Web services	30	56	96	228
Income before income tax provision	$ 134	$ 334	$ 788	$ 918

Depreciation and amortization was $55,000 and $24,000 for the Cloud Telecommunications segment for the three months ended September 30, 2020 and 2019, respectively. Depreciation and amortization was $190,000 and $66,000 for the Cloud Telecommunications segment for the nine months ended September 30, 2020 and 2019, respectively. Depreciation and amortization was $2,000 and $1,000 for the Web Services segment for the three months ended September 30, 2020 and 2019, respectively. Depreciation and amortization was $7,000 and $3,000 for the Web Services segment for the nine months ended September 30, 2020 and 2019, respectively.

Interest income was $1,000 and $1,000 for the Web Services segment for the three months ended September 30, 2020 and 2019, respectively. Interest income was $3,000 and $4,000 for the Web Services segment for the nine months ended September 30, 2020 and 2019, respectively.

Interest expense was $22,000 and $1,000 for the Cloud Telecommunications segment for the three months ended September 30, 2020 and 2019, respectively. Interest expense was $52,000 and $9,000 for the Cloud Telecommunications segment for the nine months ended September 30, 2020 and 2019, respectively. Interest expense was $1,000 and $0 for the Web Services segment for the three months ended September 30, 2020 and 2019. Interest expense was $2,000 and $0 for the Web Services segment for the nine months ended September 30, 2020 and 2019, respectively.

16. Subsequent Events

On October 21, 2020, the underwriters of the Company's public offering exercised their option to purchase additional shares of the Company's common stock to cover sales by the underwriters of a greater number of shares than the total set forth in the filed prospectus for the public offering. The underwriters purchased an additional 420,000 shares of common stock from the Company. The gross proceeds to the Company of the issuance were $2,310,000, and the Company received net proceeds of $2,148,000 after deducting underwriting discounts and commissions.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as "anticipates," "expects," "believes," "plans," "predicts," and similar terms. Forward-looking statements are not guarantees of future performance and our Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part II, Item 1A, "Risk Factors," which are incorporated herein by reference. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2019 (the "2019 Form 10-K") filed with the SEC and the Condensed Consolidated Financial Statements and notes thereto included in the 2019 Form 10-Qs and elsewhere in this Form 10-Q. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.

OVERVIEW

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

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

We generate recurring revenue from our cloud telecommunications and broadband Internet services. Our cloud telecommunications contracts typically have a thirty-six to sixty month term. We may also charge activation and flash fees and the Company generally allocates a portion of the activation fees to the desktop devices, which is recognized at the time of the installation or customer acceptance, and a portion to the service, which is recognized over the contract term using the straight-line method. We also charge other various contracted and non-contracted fees.

We generate product revenue and equipment financing revenue from the sale and lease of our cloud telecommunications equipment. Revenues from the sale of equipment, including those from sales-type leases, are recognized at the time of sale or at the inception of the lease, as appropriate.

Our Cloud Telecommunications service revenue increased 14% or $425,000 to $3,525,000 for the three months ended September 30, 2020 as compared to $3,100,000 for the three months ended September 30, 2019. Cloud Telecommunications service revenue increased 16% or $1,414,000 to $10,326,000 for the nine months ended September 30, 2020 as compared to $8,912,000 for the nine months ended September 30, 2019. Our Cloud Telecommunications product revenue increased 43% or $146,000 to $489,000 for the three months ended September 30, 2020 as compared to $343,000 for the three months ended September 30, 2019. Cloud Telecommunications product revenue increased 2% or $23,000 to $1,317,000 for the nine months ended September 30, 2020, as compared to $1,294,000 for the nine months ended September 30, 2019. As of September 30, 2020 and 2019, our backlog was $28,313,000 and $25,335,000, respectively.

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

Our Web Services revenue decreased 19% or $30,000 to $129,000 for the three months ended September 30, 2020 as compared to $159,000 for the three months ended September 30, 2019. Our Web Services revenue decreased 16% or $81,000 to $421,000 for the nine months ended September 30, 2020 as compared to $502,000 for the nine months ended September 30, 2019.

OUR SERVICES AND PRODUCTS

Our goal is to provide a broad range of cloud-based products and services that nearly eliminate the cost of a businesses' technology infrastructure and enable businesses of any size to more efficiently run their business. By providing a variety of comprehensive and scalable solutions, we are able to cater to businesses of all sizes on a monthly subscription basis without the need for expensive capital investments, regardless of where their business is in its lifecycle. Our products and services can be categorized in the following offerings:

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

Crexendo's cloud telecommunication service offers a wide variety of essential and advanced features for businesses of all sizes. Many of these features included in the service offering are:

- Business Productivity Features such as dial-by extension and name, transfer, conference, call recording, Unlimited calling to anywhere in the US and Canada, International calling, Toll free (Inbound and Outbound)
- Individual Productivity Features such as Caller ID, Call Waiting, Last Call Return, Call Recording, Music/Message-On-Hold, Voicemail, Unified Messaging, Hot-Desking
- Group Productivity Features such as Call Park, Call Pickup, Interactive Voice Response (IVR), Individual and Universal Paging, Corporate Directory, Multi-Party Conferencing, Group Mailboxes, Web and mobile devices based collaboration applications
- Call Center Features such as Automated Call Distribution (ACD), Call Monitor, Whisper and Barge, Automatic Call Recording, One way call recording, Analytics
- Advanced Unified Communication Features such as Find-Me-Follow-Me, Sequential Ring and Simultaneous Ring, Voicemail transcription
- Mobile Features such as extension dialing, transfer and conference and seamless hand-off from WiFi to/from 3G and 4G, LTE, as well as other data services. These features are also available on CrexMo, an intelligent mobile application for iPhones and Android smartphones, as well as iPads and Android tablets
- Traditional PBX Features such as Busy Lamp Fields, System Hold. 16-48 Port density Analog Devices
- Expanded Desktop Device Selection such as Entry Level Phone, Executive Desktop, DECT Phone for roaming users
- Advanced Faxing solution such as Cloud Fax (cFax) allowing customers to send and receive Faxes from their Email Clients, Mobile Phones and Desktops without having to use a Fax Machine simply by attaching a file
- Web based online portal to administer, manage and provision the system.
- Asynchronous communication tools like SMS/MMS, chat and document sharing to keep in pace with emerging communication trends.

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

Website Services – Our website services segment allows businesses to host their websites in our data center for a recurring monthly fee.

RESULTS OF OPERATIONS

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Service revenue	$ 3,654	$ 3,259	$ 10,747	$ 9,414
Product revenue	489	343	1,317	1,294
Total revenue	$ 4,143	$ 3,602	$ 12,064	$ 10,708
Income before income taxes	134	334	788	918
Income tax provision	(3)	-	(9)	(7)
Net income	131	334	779	911
Basic earnings per share	$ 0.01	$ 0.02	$ 0.05	$ 0.06
Diluted earnings per share	$ 0.01	$ 0.02	$ 0.05	$ 0.06

Three months ended September 30, 2020 compared to three months ended September 30, 2019

Service revenue

Service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, reselling broadband Internet services, administrative fees, website hosting, and web management services. Service revenue increased 12% or $395,000, to $3,654,000 for the three months ended September 30, 2020 as compared to $3,259,000 for the three months ended September 30, 2019. Cloud Telecommunications service revenue increased 14% or $425,000, to $3,525,000 for the three months ended September 30, 2020 as compared to $3,100,000 for the three months ended September 30, 2019. Web service revenue decreased 19% or $30,000, to $129,000 for the three months ended September 30, 2020 as compared to $159,000 for the three months ended September 30, 2019.

Product Revenue

Product revenue consists primarily of fees collected from the sale of desktop phone devices and third-party equipment. Product revenue increased by 43% or $146,000, to $489,000 for the three months ended September 30, 2020 as compared to $343,000 for the three months ended September 30, 2019. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30-60 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence.

Income Before Income Taxes

Income before income taxes decreased 60% or $200,000, to $134,000 for the three months ended September 30, 2020 as compared to $334,000 for the three months ended September 30, 2019. The decrease in income before income tax is primarily due to an increase in operating expenses of $722,000 and an increase in interest expense and other expense of $19,000, offset by an increase in revenue of $541,000.

Income Tax Provision

We had an income tax provision of $3,000 for the three months ended September 30, 2020 compared to an income tax provision of $0 for the three months ended September 30, 2019. We had pre-tax income for the three months ended September 30, 2020 and 2019 of $134,000 and $334,000, respectively, and a full valuation allowance on all of our deferred tax assets for the three months ended September 30, 2020 and 2019.

Nine months ended September 30, 2020 compared to nine months ended September 30, 2019

Service revenue

Service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, broadband Internet services, administrative fees, website hosting, and web management services. Service revenue increased 14% or $1,333,000, to $10,747,000 for the nine months ended September 30, 2020 as compared to $9,414,000 for the nine months ended September 30, 2019. Cloud Telecommunications service revenue increased 16% or $1,414,000, to $10,326,000 for the nine months ended September 30, 2020 as compared to $8,912,000 for the nine months ended September 30, 2019. Web service revenue decreased 16% or $81,000, to $421,000 for the nine months ended September 30, 2020 as compared to $502,000 for the nine months ended September 30, 2019.

Product Revenue

Product revenue consists primarily of fees collected from the sale of desktop phone devices and third-party equipment. Product revenue increased by 2% or $23,000, to $1,317,000 for the nine months ended September 30, 2020 as compared to $1,294,000 for the nine months ended September 30, 2019. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30-60 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence.

Income Before Income Taxes

Income before income tax decreased 14% or $130,000, to $788,000 for the nine months ended September 30, 2020 as compared to $918,000 for the nine months ended September 30, 2019. The decrease in income before income tax is primarily due to an increase in operating expenses of $1,406,000 and an increase in interest expense of $45,000 and other expense of $35,000, offset by an increase in revenue of $1,356,000.

Income Tax Provision

We had an income tax provision of $9,000 for the nine months ended September 30, 2020 compared to an income tax provision of $7,000 for the nine months ended September 30, 2019. We had pre-tax income for the nine months ended September 30, 2020 and 2019 of $788,000 and $918,000, respectively, and a full valuation allowance on all of our deferred tax assets for the nine months ended September 30, 2020 and 2019.

USE OF NON-GAAP FINANCIAL MEASURES

To evaluate our business, we consider and use non-generally accepted accounting principles (“Non-GAAP”) net income 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 to be an important indicator of overall business performance because it allows us to evaluate results without the effects of share-based compensation and amortization of intangibles. We define EBITDA as U.S. GAAP net income 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. We use Adjusted EBITDA as a supplemental measure to review and assess operating performance. We also believe use of Adjusted EBITDA facilitates investors’ use of operating performance comparisons from period to period, as well as across companies.

In our November 10, 2020 earnings press release, as furnished on Form 8-K, we included Non-GAAP net income, EBITDA and Adjusted EBITDA. The terms Non-GAAP net income, EBITDA, and Adjusted EBITDA are not defined under U.S. GAAP, and are not measures of operating income, operating performance or liquidity presented in analytical tools, and when assessing our operating performance, Non-GAAP net income, EBITDA, and Adjusted EBITDA should not be considered in isolation, or as a substitute for net income 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, EBITDA, and Adjusted EBITDA only as supplemental support for management’s analysis of business performance. Non-GAAP net income, EBITDA and Adjusted EBITDA are calculated as follows for the periods presented.

RECONCILIATION OF NON-GAAP FINANCIAL MEASURES

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
	(In thousands)		(In thousands)	
U.S. GAAP net income	$ 131	$ 334	$ 779	$ 911
Share-based compensation	136	107	377	293
Amortization of intangible assets	23	13	69	40
Non-GAAP net income	$ 290	$ 454	$ 1,225	$ 1,244
Non-GAAP earnings per common share:				
Basic	$ 0.02	$ 0.03	$ 0.08	$ 0.09
Diluted	$ 0.02	$ 0.03	$ 0.07	$ 0.08
Weighted-average common shares outstanding:				
Basic	15,244,804	14,663,151	15,058,192	14,507,696
Diluted	17,249,035	15,629,647	16,793,896	15,444,063

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
	(In thousands)		(In thousands)	
U.S. GAAP net income	$ 131	$ 334	$ 779	$ 911
Depreciation and amortization	57	25	197	69
Interest expense	23	1	54	9
Interest and other expense/(income)	(2)	1	25	(10)
Income tax provision	3	-	9	7
EBITDA	212	361	1,064	986
Share-based compensation	136	107	377	293
Adjusted EBITDA	$ 348	$ 468	$ 1,441	$ 1,279

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing our financial statements, we make estimates, assumptions and judgments that can have a significant impact on our revenue, operating income or loss and net income or loss, as well as on the value of certain assets and liabilities on our balance sheet. Please see Note 1 of Part I, Item 1 of this quarterly report on Form 10-Q for a summary of significant accounting policies. In addition, the estimates, assumptions and judgments involved in our accounting policies described in critical accounting policies and estimates are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2019.

Segment Operating Results

The Company has two operating segments, which consist of Cloud Telecommunications and Web Services. The information below is organized in accordance with our two reportable segments. Segment operating income is equal to segment net revenue less segment cost of service revenue, cost of product revenue, sales and marketing, research and development, and general and administrative expenses.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
Cloud Telecommunications	2020	2019	2020	2019
Service revenue	$ 3,525	$ 3,100	$ 10,326	$ 8,912
Product revenue	489	343	1,317	1,294
Total revenue	$ 4,014	$ 3,443	$ 11,643	$ 10,206
Operating expenses:				
Cost of service revenue	$ 930	$ 811	$ 2,758	$ 2,515
Cost of product revenue	314	172	797	664
Research and development	318	207	816	600
Selling and marketing	1,051	1,003	3,151	2,865
General and administrative	1,277	974	3,382	2,870
Total operating expenses	3,890	3,167	10,904	9,514
Operating income	124	276	739	692
Other income/(expense)	(20)	2	(47)	(2)
Income before tax provision	$ 104	$ 278	$ 692	$ 690

Three months ended September 30, 2020 compared to three months ended September 30, 2019

Service Revenue

Cloud Telecommunications service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, administrative fees, and reselling broadband Internet services. Service revenue increased 14% or $425,000, to $3,525,000 for the three months ended September 30, 2020 as compared to $3,100,000 for the three months ended September 30, 2019. The increase in service revenue is due to an increase in contracted service revenue and usage charges of $369,000, an increase in fees, commissions, and other, recognized over time of $68,000, and an increase in sales-type lease interest of $29,000, offset by a decrease in one time fees, commissions and other of $41,000. A substantial portion of Cloud Telecommunications service revenue is generated through thirty-six to sixty month service contracts.

Product Revenue

Product revenue consists primarily of fees collected from the sale of desktop phone devices and third-party equipment. Product revenue increased 43% or $146,000, to $489,000 for the three months ended September 30, 2020 as compared to $343,000 for the three months ended September 30, 2019. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30-60 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence. Additionally, product revenue can fluctuate due to the allocation of discounts across the performance obligations, primarily due to sales promos.

Backlog

Backlog represents the total contract value of all contracts signed, less revenue recognized from those contracts as of September 30, 2020 and 2019. Backlog increased 12% or $2,978,000 to $28,313,000 as of September 30, 2020 as compared to $25,335,000 as of September 30, 2019. Below is a table which displays the Cloud Telecommunications segment revenue backlog as of July 1, 2020 and 2019, and September 30, 2020 and 2019, which we expect to recognize as revenue within the next thirty-six to sixty months (in thousands):

Cloud Telecommunications backlog as of July 1, 2020	$ 27,349
Cloud Telecommunications backlog as of September 30, 2020	$ 28,313
Cloud Telecommunications backlog as of July 1, 2019	$ 24,772
Cloud Telecommunications backlog as of September 30, 2019	$ 25,335

Cost of Service Revenue

Cost of service revenue consists primarily of fees we pay to third-party telecommunications carriers, broadband Internet providers, software providers, costs related to installations, credit card processing fees, shipping charges, customer support salaries and benefits, and share-based compensation. Cost of service revenue increased 15% or $119,000, to $930,000 for the three months ended September 30, 2020 as compared to $811,000 for the three months ended September 30, 2019. The increase in cost of service revenue was primarily due to an increase in salaries and benefits of $55,000 as a result of an increase in customer support and implementation headcount and temporary labor, an increase in bandwidth costs of $38,000 from an increase in service revenue, an increase in credit card processing fees of $8,000, an increase in share-based compensation of $5,000, an increase in shipping charges of $4,000, an increase in costs related to professional installation services of $4,000, and an increase in other cost of service revenue of $5,000. These increases are directly related to the growth in monthly recurring revenue.

Cost of Product Revenue

Cost of product revenue consists of the costs associated with desktop phone devices and third-party equipment. Cost of product revenue increased 83% or $142,000, to $314,000 for the three months ended September 30, 2020 as compared to $172,000 for the three months ended September 30, 2019. The increase is primarily due to the increase in product revenue, offset by an increase in device costs and an increase in product warranty costs.

Research and Development

Research and development expenses primarily consist of salaries and benefits, share-based compensation, and outsourced engineering services related to the development of new cloud telecommunications features and products. Research and development expenses increased 54% or $111,000, to $318,000 for the three months ended September 30, 2020 as compared to $207,000 for the three months ended September 30, 2019. There was an increase in salaries and benefits of $82,000 as a result of an increase in headcount as we continue to invest in our solution, an increase in costs for maintenance on our customer user interface, our Android and iPhone mobile phone applications, and Java development of $23,000, and an increase in share-based compensation of $6,000.

Selling and Marketing

Selling and marketing expenses consist primarily of direct and channel sales representative salaries and benefits, share-based compensation, partner channel commissions, amortization of costs to acquire contracts, travel expenses, lead generation services, trade shows, internal and third-party marketing costs, the production of marketing materials, and sales support software. Selling and marketing expenses increased 5% or $48,000, to $1,051,000 for the three months ended September 30, 2020 as compared to $1,003,000 for the three months ended September 30, 2019. The increase in selling and marketing expense is due to an increase in commission expense of $50,000 directly related to an increase in revenue, an increase in salaries and benefits of $38,000 primarily related to the addition of one sales rep and a new director of marketing, and an increase in share-based compensation of $2,000, offset by a decrease in travel related expenses of $27,000, a decrease in bad debt expense of $8,000, and a decrease in other sales and marketing expense of $7,000.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, equipment, accounting and other professional services, investor relations, and other administrative corporate expenses. General and administrative expenses increased 31% or $303,000, to $1,277,000 for the three months ended September 30, 2020 as compared to $974,000 for the three months ended September 30, 2019. Consolidated general and administrative expenses increased 30% or $311,000, to $1,351,000 for the three months ended September 30, 2020 as compared to $1,040,000 for the three months ended September 30, 2019. As Web Services segment revenue has decreased and Cloud Telecommunications segment revenue has increased, a higher percentage of general and administrative costs are being allocated to the Cloud Telecommunications segment. Therefore, we will discuss changes in our consolidated general and administrative expenses. The increase in consolidated general and administrative expenses is primarily due to an increase in stock exchange uplisting and annual fees of $89,000 related to our uplisting from the OTCQX marketplace to the Nasdaq Capital Markets, an increase in administrative salaries and benefits of $73,000, an increase in recruiting fees of $55,000, an increase in legal fees of $37,000, an increase in contractor costs of $33,000, an increase in telecommunication fees of $20,000, an increase in depreciation expense of $20,000, an increase in share-based compensation of $17,000, an increase in software expense of $14,000, an increase in computer, office equipment, and data center maintenance costs of $11,000, an increase in intangible amortization expense of $10,000 related to the DoubleHorn asset acquisition, and an increase in other administrative corporate expenses of $7,000, offset by a decrease in rent expense of $75,000 related to the purchase of our corporate office building.

Other Income/(Expense)

Other income/(expense) primarily relates to the allocated portions of interest expense offset by credit card cash back rewards. Other expenses increased 1,100%, or $22,000, to $(20,000) for the three months ended September 30, 2020 as compared to $2,000 of net other income for the three months ended September 30, 2019. The increase in other expenses is related to our increase in interest expense from our outstanding notes payables and a decrease in credit card cash back rewards of $2,000.

Nine months ended September 30, 2020 compared to nine months ended September 30, 2019

Service Revenue

Cloud Telecommunications service revenue consists primarily of fees collected for cloud telecommunications services, professional services, interest from sales-type leases, administrative fees, and broadband Internet services. Service revenue increased 16% or $1,414,000, to $10,326,000 for the nine months ended September 30, 2020 as compared to $8,912,000 for the nine months ended September 30, 2019. The increase in service revenue is due to an increase in contracted service revenue and usage charges of $1,372,000, an increase in fees, commissions, and other, recognized over time of $151,000, and an increase in sales-type lease interest of $77,000, offset by a decrease in one time fees, commissions and other of $186,000 related to a higher volume of site surveys and installation service revenue in the first quarter of 2019. A substantial portion of Cloud Telecommunications service revenue is generated through thirty-six to sixty month service contracts.

Product Revenue

Product revenue consists primarily of fees collected from the sale of desktop phone devices and third-party equipment. Product revenue increased 2% or $23,000, to $1,317,000 for the nine months ended September 30, 2020 as compared to $1,294,000 for the nine months ended September 30, 2019. Product revenue fluctuates from one period to the next based on timing of installations. Our typical customer installation is complete within 30-60 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations. Product revenue is recognized when products have been installed and services commence. Additionally, product revenue can fluctuate due to the allocation of discounts across the performance obligations, primarily due to sales promos.

Backlog

Backlog represents the total contract value of all contracts signed, less revenue recognized from those contracts as of September 30, 2020 and 2019. Backlog increased 12% or $2,978,000 to $28,313,000 as of September 30, 2020 as compared to $25,335,000 as of September 30, 2019. Below is a table which displays the Cloud Telecommunications segment revenue backlog as of January 1, 2020 and 2019, and September 30, 2020 and 2019, which we expect to recognize as revenue within the next thirty-six to sixty months (in thousands):

Cloud Telecommunications backlog as of January 1, 2020	$	26,110
Cloud Telecommunications backlog as of September 30, 2020	$	28,313
Cloud Telecommunications backlog as of January 1, 2019	$	23,029
Cloud Telecommunications backlog as of September 30, 2019	$	25,335

Cost of Service Revenue

Cost of service revenue consists primarily of fees we pay to third-party telecommunications carriers, broadband Internet providers, software providers, costs related to installations, credit card processing fees, shipping charges, customer support salaries and benefits, and share-based compensation. Cost of service revenue increased 10% or $243,000, to $2,758,000 for the nine months ended September 30, 2020 as compared to $2,515,000 for the nine months ended September 30, 2019. The increase in cost of service revenue is primarily due to an increase in bandwidth costs of $136,000, an increase in salaries and benefits of $123,000 as a result of an increase in customer support and implementation headcount and temporary labor, an increase in profit sharing costs of $33,000, an increase in credit card processing fees of $30,000, an increase in share-based compensation of $20,000, an increase in shipping charges of $9,000, an increase in other cost of service revenue of $6,000, and an increase in project management software costs of $4,000, offset by a decrease in costs related to professional installation services of $118,000. These increases are directly related to the growth in monthly recurring revenue.

Cost of Product Revenue

Cost of product revenue consists of the costs associated with desktop phone devices and third-party equipment. Cost of product revenue increased 20% or $133,000, to $797,000 for the nine months ended September 30, 2020 as compared to $664,000 for the nine months ended September 30, 2019. The increase is primarily due to the increase in product revenue, offset by an increase in device costs and an increase in product warranty costs.

Research and Development

Research and development expenses primarily consist of salaries and benefits, share-based compensation, and outsourced engineering services, related to the development of new cloud telecommunications features and products. Research and development expenses increased 36% or $216,000, to $816,000 for the nine months ended September 30, 2020 as compared to $600,000 for the nine months ended September 30, 2019. The increase is primarily due to an increase in costs for maintenance on our customer user interface, our Android and iPhone mobile phone applications, and Java development of $98,000, an increase of $97,000 in salaries and benefits as a result of an increase in headcount as we continue to invest in our solution, an increase in share-based compensation of $14,000, and an increase in allocated profit sharing costs of $7,000.

Selling and Marketing

Selling and marketing expenses consist primarily of direct and channel sales representative salaries and benefits, share-based compensation, partner channel commissions, amortization of costs to acquire contracts, travel expenses, lead generation services, trade shows, third-party marketing services, the production of marketing materials, and sales support software. Selling and marketing expenses increased 10% or $286,000, to $3,151,000 for the nine months ended September 30, 2020 as compared to $2,865,000 for the nine months ended September 30, 2019. The increase in selling and marketing expense is due to an increase in commission expense of $155,000 directly related to an increase in revenue, an increase in salaries and benefits of $147,000 primarily related to the addition of one sales rep and a new director of marketing, an increase in bad debt expense of $19,000, an increase in tradeshow related expense of $18,000, and an increase in share-based compensation of $14,000, offset by a decrease in travel related expenses of $56,000 and a decrease in other sales and marketing expenses of $11,000.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, equipment, accounting and other professional services, investor relations, and other administrative corporate expenses. General and administrative expenses increased 18% or $512,000, to $3,382,000 for the nine months ended September 30, 2020 as compared to $2,870,000 for the nine months ended September 30, 2019. Consolidated general and administrative expenses increased 18%, or $534,000 to $3,585,000 for the nine months ended September 30, 2020 as compared to $3,051,000 for the nine months ended September 30, 2019. As Web Services segment revenue has decreased and Cloud Telecommunications segment revenue has increased, a higher percentage of general and administrative costs are being allocated to the Cloud Telecommunications segment. Therefore, we will discuss changes in our consolidated general and administrative expenses. The increase in consolidated general and administrative expenses is primarily due to an increase in administrative salaries and benefits of $143,000, an increase in depreciation expense of $98,000 from an acceleration of leasehold improvements amortization and depreciation of the corporate office building directly related to the purchase of the corporate office building and from depreciation of additional datacenter related licenses, an increase in stock exchange uplisting and annual fees of $94,000 related to our uplisting from the OTCQX marketplace to the Nasdaq Capital Markets, an increase in recruiting fees of $70,000, an increase in telecommunication fees of $55,000, an increase in contractor costs of $54,000, an increase in software expense of $48,000, an increase in legal fees of $43,000, an increase in share-based compensation of $36,000, an increase in computer, office equipment, and data center maintenance costs of $35,000, an increase in intangible amortization expense of $29,000 related to the DoubleHorn asset acquisition, an increase in profit sharing costs of $12,000, an increase in corporate insurance costs of $8,000, an increase in other administrative corporate expenses of $8,000, an increase in board of director fees of $6,000, an increase in closing and inspection fees related to the building purchase of $5,000, offset by a decrease in rent expense of $200,000 related to the purchase of our corporate office building and a decrease in accounting fees of $10,000.

Other Expense

Other expense primarily relates to the allocated portions of interest expense offset by credit card cash back rewards. Net other expense increased 2,250%, or $45,000, to $47,000 for the nine months ended September 30, 2020 as compared to $2,000 for the nine months ended September 30, 2019. The increase in other expense is due to an increase in allocated interest expense of $43,000 for interest paid on finance agreements and a decrease in credit card cash back rewards of $2,000.

Operating Results of Web Services segment (in thousands):

Web Services	Three Months Ended September 30, 2020	Three Months Ended September 30, 2019	Nine Months Ended September 30, 2020	Nine Months Ended September 30, 2019
Service revenue	$ 129	$ 159	$ 421	$ 502
Operating expenses:				
Cost of service revenue	16	25	66	72
Research and development	8	8	24	24
General and administrative	74	66	203	181
Total operating expenses	98	99	293	277
Operating income	31	60	128	225
Other income/(expense)	(1)	(4)	(32)	3
Income before tax provision	$ 30	$ 56	$ 96	$ 228

Three months ended September 30, 2020 compared to three months ended September 30, 2019

Service Revenue

Service revenue is generated primarily through website hosting and professional web management services. Web Services segment revenue decreased 19% or $30,000, to $129,000 for the three months ended September 30, 2020 as compared to $159,000 for the three months ended September 30, 2019. The decrease in service revenue is primarily due to a decrease in hosting revenue of $30,000.

Cost of Service Revenue

Cost of service revenue consists primarily of bandwidth, web domain registration fees, customer service salaries and benefits, temporary labor cost, and credit card processing fees. Cost of service revenue decreased 36% or $9,000, to $16,000 for the three months ended September 30, 2020 as compared to $25,000 for the three months ended September 30, 2019. The decrease in cost of service revenue is primarily related to a decrease in customer service salaries and benefits and temporary labor of $7,000, a decrease in web domain registration fees of $1,000, and a decrease in credit card fees of $1,000, directly related to the decrease in revenue.

Research and Development

Research and development expenses primarily consist of salaries and benefits, and related expenses which are attributable to the development of our website development software products. Research and development expenses were $8,000 for the three months ended September 30, 2020 as compared to $8,000 for the three months ended September 30, 2019.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, equipment, accounting and other professional services, investor relations, and other administrative corporate expenses. General and administrative expenses increased 12% or $8,000, to $74,000 for the three months ended September 30, 2020 as compared to $66,000 for the three months ended September 30, 2019. Consolidated general and administrative expenses increased 30% or $311,000, to $1,351,000 for the three months ended September 30, 2020 as compared to $1,040,000 for the three months ended September 30, 2019. As Web Services segment revenue has decreased and Cloud Telecommunications segment revenue has increased, a higher percentage of general and administrative costs are being allocated to the Cloud Telecommunications segment. Therefore, we will discuss changes in our consolidated general and administrative expenses. The increase in consolidated general and administrative expenses is primarily due to an increase in stock exchange uplisting and annual fees of $89,000 related to our uplisting from the OTCQX marketplace to the Nasdaq Capital Markets, an increase in administrative salaries and benefits of $73,000, an increase in recruiting fees of $55,000, an increase in legal fees of $37,000, an increase in contractor costs of $33,000, an increase in telecommunication fees of $20,000, an increase in depreciation expense of $20,000, an increase in share-based compensation of $17,000, an increase in software expense of $14,000, an increase in computer, office equipment, and data center maintenance costs of $11,000, an increase in intangible amortization expense of $10,000 related to the DoubleHorn asset acquisition, and an increase in other administrative corporate expenses of $7,000, offset by a decrease in rent expense of $75,000 related to the purchase of our corporate office building.

Other Expense

Other expense primarily relates to interest income, foreign exchange gains or losses, the allocated portions of interest expense, and credit card cash back rewards. Net other expense decreased 75% or $3,000, to $1,000 for the three months ended September 30, 2020 as compared to $4,000 for the three months ended September 30, 2019. The decrease in net other expense is due to a $5,000 decrease in foreign exchange losses offset by an increase in allocated interest expense of $1,000 for interest on finance agreements and a $1,000 decrease in interest income.

Nine months ended September 30, 2020 compared to nine months ended September 30, 2019

Service Revenue

Service revenue is generated primarily through website hosting and professional web management services. Web Services segment revenue decreased 16% or $81,000, to $421,000 for the nine months ended September 30, 2020 as compared to $502,000 for the nine months ended September 30, 2019. The decrease in service revenue is primarily due to a decrease in hosting revenue of $88,000 offset by an increase in professional web management services of $7,000.

Cost of Service Revenue

Cost of service revenue consists primarily of bandwidth, web domain registration fees, customer service salaries and benefits, temporary labor cost, and credit card processing fees. Cost of service revenue decreased 8% or $6,000, to $66,000 for the nine months ended September 30, 2020 as compared to $72,000 for the nine months ended September 30, 2019. The decrease in cost of service revenue is primarily related to a decrease in web domain registration fees of $3,000 and a decrease in credit card fees of $3,000, directly related to the decrease in revenue.

Research and Development

Research and development expenses primarily consist of salaries and benefits, and related expenses which are attributable to the development of our website development software products. Research and development expenses were $24,000 for the nine months ended September 30, 2020 as compared to $24,000 for the nine months ended September 30, 2019.

General and Administrative

General and administrative expenses consist of salaries and benefits for executives, administrative personnel, legal, rent, equipment, accounting and other professional services, investor relations, and other administrative corporate expenses. General and administrative expenses increased 12% or $22,000, to $203,000 for the nine months ended September 30, 2020 as compared to $181,000 for the nine months ended September 30, 2019. Consolidated general and administrative expenses increased 18%, or $534,000 to $3,585,000 for the nine months ended September 30, 2020 as compared to $3,051,000 for the nine months ended September 30, 2019. As Web Services segment revenue has decreased and Cloud Telecommunications segment revenue has increased, a higher percentage of general and administrative costs are being allocated to the Cloud Telecommunications segment. Therefore, we will discuss changes in our consolidated general and administrative expenses. The increase in consolidated general and administrative expenses is primarily due to an increase in administrative salaries and benefits of $143,000, an increase in depreciation expense of $98,000 from an acceleration of leasehold improvements amortization and depreciation of the corporate office building directly related to the purchase of the corporate office building and from depreciation of additional datacenter related licenses, an increase in stock exchange uplisting and annual fees of $94,000 related to our uplisting from the OTCQX marketplace to the Nasdaq Capital Markets, an increase in recruiting fees of $70,000, an increase in telecommunication fees of $55,000, an increase in contractor costs of $54,000, an increase in software expense of $48,000, an increase in legal fees of $43,000, an increase in share-based compensation of $36,000, an increase in computer, office equipment, and data center maintenance costs of $35,000, an increase in intangible amortization expense of $29,000 related to the DoubleHorn asset acquisition, an increase in profit sharing costs of $12,000, an increase in corporate insurance costs of $8,000, an increase in other administrative corporate expenses of $8,000, an increase in board of director fees of $6,000, an increase in closing and inspection fees related to the building purchase of $5,000, offset by a decrease in rent expense of $200,000 related to the purchase of our corporate office building and a decrease in accounting fees of $10,000.

Other Income/(Expense)

Other income/(expense) primarily relates to interest income, foreign exchange gains or losses, the allocated portions of interest expense, and credit card cash back rewards. Net other income decreased 1,167% or $35,000, to $(32,000) of net other expense for the nine months ended September 30, 2020 as compared to $3,000 of net other income for the nine months ended September 30, 2019. The decrease in net other income is due to an increase in net foreign exchange losses of $32,000 and an increase in allocated interest expense of $3,000 for interest on finance agreements.

Liquidity and Capital Resources

As of September 30, 2020 and December 31, 2019, we had cash and cash equivalents of $15,453,000 and $4,280,000, respectively. Changes in cash and cash equivalents are dependent upon changes in, among other things, working capital items such as contract liabilities, contract costs, accounts payable, accounts receivable, prepaid expenses, and various accrued expenses, as well as purchases of property and equipment, asset acquisitions, and changes in our capital and financial structure due to debt repayments and issuances, stock option exercises, sales of equity investments and similar events. We believe that our operations along with existing liquidity sources will satisfy our cash requirements for at least the next 12 months.

Working Capital

Working capital increased 384% or $10,911,000 to $13,756,000 as of September 30, 2020 as compared to $2,845,000 at December 31, 2019. The increase in working capital was primarily related to an increase in cash and cash equivalents of $11,173,000, an increase in trade receivables, net of allowance for doubtful accounts of $252,000, an increase in contract assets of $72,000, an increase in equipment financing receivables of $110,000, an increase in contract costs of $24,000, an increase in prepaid expenses of $191,000, a decrease in accrued expenses of $184,000, a decrease in operating lease liabilities of $50,000, a decrease in contingent consideration of $175,000, and a decrease in contract liabilities of $8,000, offset by a decrease in inventories of $119,000, a decrease in income tax receivable of $4,000, an increase in accounts payable of $128,000, an increase in finance leases of $1,000, an increase in notes payable of $1,071,000, and an increase in income tax payable of $5,000 during the nine months ended September 30, 2020.

Cash, Cash Equivalents, and Restricted Cash

Cash, cash equivalents, and restricted cash increased 261% or $11,173,000 to $15,453,000 at September 30, 2020 as compared to $4,280,000 at December 31, 2019. During the nine months ended September 30, 2020, cash provided by operating activities was $423,000. Cash used for investing activities was $921,000, primarily for the purchase of our corporate office building, datacenter related assets, and a redesigned company website of $745,000 and an initial asset acquisition payment of $176,000 for customer relationships. Cash provided by financing activities was $11,671,000, primarily related to proceeds from notes payable of $1,001,000, proceeds from the exercise of options of $2,007,000, and proceeds from the issuance of common stock in connection with our public offering of $8,778,000, offset by $54,000 in contingent consideration payments for a customer relationship asset acquisition, repayments made on notes payable of $39,000, and repayments on finance leases of $22,000 during the period.

Inventories

Inventories decreased 31% or $119,000 to $263,000 at September 30, 2020 as compared to $382,000 at December 31, 2019. Inventory balances fluctuate based on timing of installations and inventory shipments. The decrease is primarily due to the timing of inventory shipments. We feel our inventory balance at September 30, 2020 is sufficient to fulfill future installations.

Prepaid Expenses

Prepaid expenses increased 135% or $191,000 to $332,000 at September 30, 2020 as compared to $141,000 at December 31, 2019. The increase is related to a $90,000 increase in inventory deposits, $53,000 increase in software services and support, a $39,000 increase in corporate insurance policies, and a $9,000 increase in other prepaid expense accounts.

Trade Receivables

Current and long-term trade receivables, net of allowance for doubtful accounts, increased 64% or $248,000, to $634,000 as of September 30, 2020 as compared to $386,000 as of December 31, 2019. Current trade receivables, net of allowance for doubtful accounts, increased 66% or $252,000, to $632,000 as of September 30, 2020 as compared to $380,000 as of December 31, 2019. The increase in current trade receivables can primarily be attributed to a number of customers carrying a balance as of September 30, 2020 related to a slowdown in collections resulting from COVID-19. The Company took the FCC's Keep Americans Connected Pledge in response to the COVID-19 pandemic to not shut off customers for non-payment. Long-term trade receivables, net of allowance for doubtful accounts, decreased 67% or $4,000, to $2,000 as of September 30, 2020 as compared to $6,000 as of December 31, 2019. The decrease is primarily due to the receipt of monthly installment payments.

Accounts Payable and Accrued Expenses

Accounts payable increased 149% or $128,000 to $214,000 at September 30, 2020 as compared to $86,000 at December 31, 2019. The aging of accounts payable as of September 30, 2020 were generally within our vendors' terms of payment. The increase is primarily related to the timing of check processing schedule.

Accrued expenses decreased 10% or $184,000 to $1,570,000 at September 30, 2020 as compared to $1,754,000 at December 31, 2019. The decrease is related to a $200,000 decrease in accrued bonuses due to the payout of the 2019 Profit Sharing Plan, a $176,000 decrease in accrued asset acquisition costs, a $108,000 decrease in accrued telecommunications and sales tax accrual, and a $62,000 decrease in accrued salaries, offset by a $179,000 increase in accrued invoices, an $89,000 increase in accrued paid time off, a $55,000 increase in partner commissions, a $12,000 increase in 401k accrued contributions, a $10,000 increase in warranty reserve, and a $17,000 increase in other accrued expenses.

Notes Payable

Notes payables increased $2,962,000 to $2,962,000 at September 30, 2020 as compared to $0 at December 31, 2019. The increase in notes payable is related to the $1,961,000 note payable for the purchase of the corporate office building, and a $1,001,000 note payable related to the Paycheck Protection Program loan.

Finance Lease

Finance lease obligations decreased 19% or $22,000, to $94,000 as of September 30, 2020 as compared to $116,000 at December 31, 2019. The decrease in finance lease obligations can be attributed to payments made on financing contracts of $22,000.

Contingent Consideration

Contingent consideration decreased 100% or $175,000 to $0 at September 30, 2020 as compared to $175,000 at December 31, 2019. The decrease is due to $54,000 in earn-out payments and a $121,000 adjustment to the total consideration payable under the customer relationships asset purchase agreement.

Operating Lease Liabilities

Operating lease liabilities decreased 98% or $50,000 to $1,000 at September 30, 2020 as compared to $51,000 at December 31, 2019. The decrease is related to the expiration of the corporate office lease due to the purchase of the building in January 2020.

Contract Liabilities

Contract liabilities increased 2% or $19,000 to $1,233,000 at September 30, 2020 as compared to $1,214,000 at December 31, 2019. The increase is from an increase in the prorated portion of monthly invoices with service dates in future periods for customers added during the period and an increase in down payments of uninstalled contracts. Our typical customer installation is complete within 30-60 days. However, larger enterprise customers can take multiple months, depending on size and the number of locations

Capital

Total stockholders' equity increased 269% or $11,796,000, to $16,183,000 as of September 30, 2020 as compared to $4,387,000 at December 31, 2019. The increase in total stockholders' equity was attributable to net income of $779,000, and increases in additional paid-in capital of $2,007,000 from stock option exercises, $8,633,000 from the issuance of common stock related to an offering, and $377,000 in share-based compensation for options issued to employees.

Off Balance Sheet Arrangements

As of, September 30, 2020, we are not involved in any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

RELATED PARTY TRANSACTIONS

We leased our corporate office building in Tempe, Arizona from a Company that is owned by the major shareholder and CEO of the Company, a related party. On March 1, 2017, the lease agreement was renewed for a three year term with monthly rent payments of $25,000. As of December 31, 2019, we initiated the process to purchase our corporate office building and gave notice that we will not be exercising our option to renew for another three year term. On January 27, 2020, the Company entered into an agreement to purchase our corporate office building located at 1615 S 52nd St, Tempe, AZ 85281 from a Company that is owned by the major shareholder and CEO of the Company for $2,500,000. The fair value of the building was established by an independent appraisal.

Impact of Recent Accounting Pronouncements

The information set forth under Note 1 to the condensed consolidated financial statements under the caption “Recent Accounting Pronouncements” is incorporated herein by reference.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not required

Item 4. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this Report, have concluded that, based on the evaluation of these controls and procedures, our disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the three months ended September 30, 2020 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are involved in lawsuits, claims, investigations and proceedings that arise in the ordinary course of business. There are no matters pending or threatened that we expect to have a material adverse impact on our business, results of operations, financial condition or cash flows.

Item 1A. Risk Factors

There are many risk factors that may affect our business and the results of our operations, many of which are beyond our control. Information on certain risks that we believe are material to our business is set forth in "Part I – Item 1A. Risk Factors" of the 2019 Form 10-K. Additional risk factors identified during the period are as follows:

Our results of operations may be negatively impacted by the coronavirus outbreak.

The novel coronavirus (COVID-19) has been declared a global emergency, the United States has enacted numerous "shelter in place orders" and many business have been severely adversely affect by the outbreak. The outbreak has also had substantial negative effect on global stock markets, as well as liquidity. The total impacts of the outbreak are unknown and rapidly evolving. We cannot fully gage which of our customers may be negatively affected and how that would impact their ability to pay, or their ability to stay in business which may impact our results. Office closures and distance requirements may further impact the ability of new and existing companies to engage in installing phone systems which may also impact our results. Market fluctuations may have a negative impact on our stock price, and our ability to raise funds if that were deemed necessary. The widespread health crisis has adversely affected the economy, resulting in an economic downturn that could impact demand for our products.

Further, we rely on third-party suppliers and manufacturers in China. This outbreak had resulted in the extended shutdown of certain businesses in China, and a recurrence could have further impact on our suppliers. It is possible that there may be disruptions or delays to our supply chain. These may include disruptions from the temporary closure of third-party supplier and manufacturer facilities, interruptions in product supply or restrictions on the export or shipment of our products. Any disruption of our suppliers and their contract manufacturers will likely impact our sales and operating results.

To date the outbreak has not had a material adverse impact on our operations. However, future impact of the outbreak is highly uncertain and cannot be predicted and there is no assurance that the outbreak will not have a material adverse impact on the future results of the Company. The extent of the impact, if any, will depend on future developments, including actions taken to contain the coronavirus.

This outbreak, as well as intensified measures undertaken to contain the spread of COVID-19, could decrease consumer spending, adversely affect demand for our technology and services, cause one or more of our customers and partners to file for bankruptcy protection or go out of business, cause one or more of our customers to fail to renew, terminate, or renegotiate their contracts, affect the ability of our sales team to travel to potential customers, impact expected spending from new customers, and negatively impact collections of accounts receivable, all of which could adversely affect our business, results of operations, and financial condition.

Further, the sales cycle for a new customer of our technology and services could lengthen, resulting in a potentially longer delay between increasing operating expenses and the generation of corresponding revenue, if any. We cannot predict with any certainty whether and to what degree the disruption caused by the COVID-19 pandemic and reactions thereto will continue, and expect to face difficulty accurately predicting our internal financial forecasts. The outbreak also presents challenges as our workforce is currently working remotely and shifting to assisting new and existing customers who are also generally working remotely. It is not possible for us to predict the duration or magnitude of the adverse results of the outbreak and its effects on our business, results of operations, or financial condition at this time.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 6. Exhibits

Exhibits

31.1	Certification of Chief Executive Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities and Exchange Act of 1934, as amended
31.2	Certification of Chief Financial Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities and Exchange Act of 1934, as amended
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101.INS*	XBRL INSTANCE DOCUMENT
101.SCH*	XBRL TAXONOMY EXTENSION SCHEMA DOCUMENT
101.CAL*	XBRL TAXONOMY EXTENSION CALCULATION LINKBASE DOCUMENT
101.DEF*	XBRL TAXONOMY EXTENSION DEFINITION LINKBASE DOCUMENT
101.LAB*	XBRL TAXONOMY EXTENSION LABEL LINKBASE DOCUMENT
101.PRE*	XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE DOCUMENT

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

SIGNATURES

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

Crexendo, Inc.

November 10, 2020	By:	/s/ STEVEN G. MIHAYLO
		Steven G. Mihaylo
		Chief Executive Officer
November 10, 2020	By:	/s/ RONALD VINCENT
		Ronald Vincent
		Chief Financial Officer

EXHIBIT 31.1

Certification Pursuant to
Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as Amended

I, Steven G. Mihaylo, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Crexendo, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 10, 2020

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

EXHIBIT 31.2

Certification Pursuant to
Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as Amended

I, Ronald Vincent, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Crexendo, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 10, 2020	By:	/s/ RONALD VINCENT
		Ronald Vincent Chief Financial Officer

EXHIBIT 32.1

CERTIFICATIONS PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the Quarterly Report of Crexendo, Inc., a Nevada corporation (the “Company”), on Form 10-Q for the quarter ended September 30, 2020, as filed with the Securities and Exchange Commission (the “Report”), Steven G. Mihaylo, Chief Executive Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: November 10, 2020	By:	/s/ Steven G. Mihaylo
		Steven G. Mihaylo
		Chief Executive Officer

EXHIBIT 32.2

CERTIFICATIONS PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)

In connection with the Quarterly Report of Crexendo, Inc., a Nevada corporation (the "Company"), on Form 10-Q for the quarter ended September 30, 2020, as filed with the Securities and Exchange Commission (the "Report"), Ronald Vincent, Chief Financial Officer of the Company, does hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: November 10, 2020	By:	/s/ RONALD VINCENT
		Ronald Vincent
		Chief Financial Officer