

TUCOWS INC /PA/  
Form 10-Q  
November 13, 2013  
**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2013**

**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 1-32600**

**TUCOWS INC.**

(Exact Name of Registrant as Specified in Its Charter)

<b>Pennsylvania</b>	<b>23-2707366</b>
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

**96 Mowat Avenue,**

**Toronto, Ontario M6K 3M1, Canada**

(Address of Principal Executive Offices) (Zip Code)

**(416) 535-0123**

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of November 13, 2013, there were 43,610,423 outstanding shares of common stock, no par value, of the registrant.

**TUCOWS INC.**

**Form 10-Q Quarterly Report**

**INDEX**

**PART I**

**FINANCIAL INFORMATION**

Item 1.	Consolidated Financial Statements	1
	Consolidated Balance Sheets as of September 30, 2013 (unaudited) and December 31, 2012	1
	Consolidated Statements of Operations and Comprehensive Income (unaudited) for the three and nine months ended September 30, 2013 and 2012	2
	Consolidated Statements of Cash Flows (unaudited) for the three and nine months ended September 30, 2013 and 2012	3
	Notes to Consolidated Financial Statements (unaudited)	4
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	34
Item 4.	Controls and Procedures	35

**PART II**

**OTHER INFORMATION**

Item 1.	Legal Proceedings	36
Item 1A.	Risk Factors	36
Item 4.	Mine Safety Disclosures	36
Item 6.	Exhibits	37
	Signatures	38

**TRADEMARKS, TRADE NAMES AND SERVICE MARKS**

Tucows®, Butterscotch®, EPAG®, Hover®, OpenSRS®, Platypus®, Ting® and YummyNames® are registered trademarks of Tucows Inc. or its subsidiaries. Other service marks, trademarks and trade names of Tucows Inc. or its subsidiaries may be used in this Quarterly Report on Form 10-Q (this “Quarterly Report”). All other service marks, trademarks and trade names referred to in this Quarterly Report are the property of their respective owners. Solely for convenience, any trademarks referred to in this Quarterly Report may appear without the ® or TM symbol, but such references are not intended to indicate, in any way, that we or the owner of such trademark, as applicable, will not assert, to the fullest extent under applicable law, our or its rights, or the right of the applicable licensor, to these trademarks.

---

**PART I.****FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****Tucows Inc.****Consolidated Balance Sheets****(Dollar amounts in U.S. dollars)**

	<b>September 30, 2013 (unaudited)</b>	<b>December 31, 2012</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 11,549,948	\$ 6,415,679
Accounts receivable, net of allowance for doubtful accounts of \$89,981 as of September 30, 2013 and \$73,970 as of December 31, 2012	4,869,466	4,413,265
Inventory	338,110	587,104
Prepaid expenses and deposits	4,241,402	5,081,408
Derivative instrument asset, current portion (note 4)	258,188	412,944
Prepaid domain name registry and ancillary services fees, current portion	45,801,683	45,170,167
Deferred tax asset, current portion	672,175	-
Income taxes recoverable	311,470	1,730,631
Total current assets	68,042,442	63,811,198
Derivative instrument asset, long-term portion (note 4)	208,221	31,838
Prepaid domain name registry and ancillary services fees, long-term portion	12,031,926	12,318,723
Property and equipment	1,833,258	1,352,144
Deferred tax asset, long-term portion (note 7)	5,417,075	5,970,462
Intangible assets (note 5)	15,630,479	16,415,651
Goodwill	18,873,127	18,873,127
Total assets	\$ 122,036,528	\$ 118,773,143
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 2,631,198	\$ 1,928,459
Accrued liabilities	3,187,213	2,522,229
Customer deposits	4,072,325	4,955,671
Derivative instrument liability, current portion (note 4)	310,865	-

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Loan payable, current portion (note 6)	6,900,000	3,700,000
Deferred revenue, current portion	56,188,897	54,997,887
Accreditation fees payable, current portion	497,404	512,847
Deferred tax liability, current portion (note 7)	-	914,429
Income taxes payable (note 7)	923,280	1,255,108
Total current liabilities	74,711,182	70,786,630
Deferred revenue, long-term portion	15,801,411	16,002,464
Accreditation fees payable, long-term portion	137,117	145,592
Deferred rent, long-term portion	71,898	54,150
Deferred tax liability, long-term portion (note 7)	5,158,000	5,234,100
Stockholders' equity (note 11)		
Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding	-	-
Common stock - no par value, 250,000,000 shares authorized; 43,576,861 shares issued and outstanding as of September 30, 2013 and 44,322,159 shares issued and outstanding as of December 31, 2012	11,797,362	10,084,417
Additional paid-in capital	28,520,120	33,931,529
Deficit	(14,252,274 )	(17,509,843 )
Accumulated other comprehensive income	91,712	44,104
Total stockholders' equity	26,156,920	26,550,207
Total liabilities and stockholders' equity	\$ 122,036,528	\$ 118,773,143

Commitments and contingencies (note 10)

See accompanying notes to unaudited consolidated financial statements

**Tucows Inc.****Consolidated Statements of Operations and Comprehensive Income****(Dollar amounts in U.S. dollars)****(unaudited)**

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
	<b>(unaudited)</b>		<b>(unaudited)</b>	
Net revenues (note 9)	\$35,637,085	\$29,246,069	\$96,795,464	\$84,935,989
Cost of revenues (note 9):				
Cost of revenues	24,268,961	21,446,084	69,354,366	60,833,420
Network expenses (*)	1,192,450	1,158,885	3,716,471	3,629,639
Depreciation of property and equipment	164,283	157,203	452,711	460,259
Amortization of intangible assets (note 5)	11,970	35,910	83,790	107,730
Total cost of revenues	25,637,664	22,798,082	73,607,338	65,031,048
Gross profit	9,999,421	6,447,987	23,188,126	19,904,941
Expenses:				
Sales and marketing (*)	2,998,419	2,037,338	8,792,091	6,287,702
Technical operations and development (*)	1,215,327	1,010,949	3,097,294	3,229,669
General and administrative (*)	1,869,668	1,486,323	5,266,997	5,018,178
Depreciation of property and equipment	52,972	46,981	158,833	139,918
Amortization of intangible assets (note 5)	219,030	219,030	657,090	657,090
Loss (gain) on currency forward contracts (note 4)	(28,068 )	(615,245 )	353,209	(793,516 )
Total expenses	6,327,348	4,185,376	18,325,514	14,539,041
Income from operations	3,672,073	2,262,611	4,862,612	5,365,900
Other income (expense):				
Interest expense, net	(78,966 )	(50,228 )	(271,756 )	(145,710 )
Other income, net	-	-	-	529,711
Total other income (expense)	(78,966 )	(50,228 )	(271,756 )	384,001
Income before provision for income taxes	3,593,107	2,212,383	4,590,856	5,749,901
Provision for income taxes (note 7)	999,747	577,383	1,333,287	1,755,284
Net income	2,593,360	1,635,000	3,257,569	3,994,617

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Other comprehensive income net of tax of \$257,505 for the three months ended September 30, 2013, and \$24,800 for the nine months ended September 30, 2013	494,334	-	47,608	-
Comprehensive income for the period	\$3,087,694	\$1,635,000	\$3,305,177	\$3,994,617
Basic earnings per common share (note 8)	\$0.06	\$0.04	\$0.08	\$0.09
Shares used in computing basic earnings per common share (note 8)	43,183,583	45,094,678	41,289,876	46,362,261
Diluted earnings per common share (note 8)	\$0.06	\$0.03	\$0.07	\$0.08
Shares used in computing diluted earnings per common share (note 8)	45,639,900	48,411,429	44,749,232	49,603,870
(*) Stock-based compensation has been included in operating expenses as follows:				
Network expenses	\$8,755	\$5,979	\$22,813	\$18,354
Sales and marketing	\$32,681	\$24,116	\$93,000	\$67,047
Technical operations and development	\$21,549	\$15,600	\$57,166	\$43,490
General and administrative	\$99,801	\$120,676	\$155,904	\$163,041

See accompanying notes to consolidated financial statements



**Tucows Inc.****Consolidated Statements of Cash Flows****(Dollar amounts in U.S. dollars)****(unaudited)**

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
	<b>(unaudited)</b>		<b>(unaudited)</b>	
Cash provided by:				
Operating activities:				
Net income for the period	\$2,593,360	\$1,635,000	\$3,257,569	\$3,994,617
Items not involving cash:				
Depreciation of property and equipment	217,255	204,184	611,544	600,177
Amortization of deferred financing charges	-	100	-	2,300
Amortization of intangible assets	231,000	254,940	740,880	764,820
Deferred income taxes (recovery)	(99,786 )	228,169	(78,103 )	333,111
Excess tax benefits on share-based compensation expense	(1,056,014 )	-	(1,056,014 )	-
Deferred rent	7,872	8,258	17,748	21,458
Acquisition of domain names	-	-	-	(3,664 )
Disposal of domain names	8,923	15,142	44,292	38,181
Gain on disposition of intangible assets	-	-	-	(508,800 )
(Gain) loss on change in the fair value of forward contracts	(204,341 )	(698,781 )	361,646	(1,155,147)
Stock-based compensation	162,786	166,371	328,883	291,932
Change in non-cash operating working capital:				
Accounts receivable	758,089	90,239	(456,201 )	(946,592 )
Inventory	(150,686 )	-	248,994	-
Prepaid expenses and deposits	543,111	636,756	840,006	(1,254,712)
Prepaid domain name registry and ancillary services fees	1,038,268	905,807	(344,719 )	(3,392,387)
Income taxes recoverable/payable	980,969	226,304	1,087,333	466,885
Accounts payable	92,473	43,173	700,194	648,250
Accrued liabilities	163,300	(279,427 )	664,984	244,738
Customer deposits	(595,776 )	(2,781 )	(883,346 )	62,817
Deferred revenue	(986,779 )	(1,144,779)	989,957	4,139,869
Accreditation fees payable	(39,835 )	(51,839 )	(23,918 )	(26,660 )
Net cash provided by operating activities	3,664,189	2,236,836	7,051,729	4,321,193
Financing activities:				
Proceeds received on exercise of stock options	1,136,061	14,186	1,454,255	363,898
Excess tax benefits on share-based compensation expense	1,056,014	-	1,056,014	-
Repurchase of common stock	-	(1,630,643)	(6,537,616 )	(9,115,833)
Proceeds received on loan payable	-	-	5,200,000	4,000,000

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Repayment of loan payable	(600,000 )	-	(2,000,000 )	(850,000 )
Net cash provided by (used in) financing activities	1,592,075	(1,616,457)	(827,347 )	(5,601,935)
Investing activities:				
Additions to property and equipment	(171,442 )	(162,207 )	(1,090,113 )	(666,534 )
Proceeds on disposal of intangible assets	-	-	-	508,800
Net cash used in investing activities	(171,442 )	(162,207 )	(1,090,113 )	(157,734 )
Increase (decrease) in cash and cash equivalents	5,084,822	458,172	5,134,269	(1,438,476)
Cash and cash equivalents, beginning of period	6,465,126	4,511,561	6,415,679	6,408,209
Cash and cash equivalents, end of period	\$11,549,948	\$4,969,733	11,549,948	4,969,733
Supplemental cash flow information:				
Interest paid	\$92,610	\$50,511	289,483	146,342
Supplementary disclosure of non-cash investing and financing activities:				
Property and equipment acquired during the period not yet paid for	\$99,060	\$167,998	99,060	167,998

See accompanying notes to unaudited consolidated financial statements

## **NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

### **1. ORGANIZATION OF THE COMPANY:**

Tucows Inc., a Pennsylvania corporation (referred to throughout this report as the “Company”, “Tu cows”, “we”, “us” or through similar expressions), together with our consolidated subsidiaries, is a global distributor of Internet services, including domain name registration, security and identity products through digital certificates, email and mobile telephony services through its global Internet-based network of Internet Service Providers, web hosting companies and other providers of Internet services to end-users.

We were incorporated under the laws of the Commonwealth of Pennsylvania in November 1992 under the name Infonautics, Inc. In August 2001, we completed our acquisition of Tucows Inc., a Delaware corporation, and we changed our name from Infonautics, Inc. to Tucows Inc. Our principal executive office is located in Toronto, Ontario and we have other offices in the Netherlands, Germany and the United States.

### **2. BASIS OF PRESENTATION:**

The accompanying unaudited interim consolidated balance sheets, and the related consolidated statements of operations and comprehensive income and cash flows reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position of Tucows and its subsidiaries as at September 30, 2013 and the results of operations and cash flows for the interim periods ended September 30, 2013 and 2012. The results of operations presented in this Quarterly Report on Form 10-Q are not necessarily indicative of the results of operations that may be expected for future periods.

The accompanying unaudited interim consolidated financial statements have been prepared by Tucows in accordance with the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosure normally included in the Company's annual audited consolidated financial statements and accompanying notes have been condensed or omitted. These interim consolidated financial statements and accompanying notes follow the same accounting policies and methods of application used in the annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended December 31, 2012 included in Tucows' 2012 Annual Report on Form 10-K filed with the SEC on March 15, 2013.

There have been no material changes to our significant accounting policies during the three and nine months ended September 30, 2013 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

The Company recognizes the effects of events or transactions that occur after the balance sheet date but before financial statements are issued (“subsequent events”) if there is evidence that conditions related to the subsequent event existed at the date of the balance sheet date, including the impact of such events on management's estimates and assumptions used in preparing the financial statements. Other significant subsequent events that are not recognized in the financial statements, if any, are disclosed in the notes to the unaudited interim consolidated financial statements.

### **3. NEW ACCOUNTING POLICIES:**

#### *Recent Accounting Pronouncements Adopted*

#### *Testing Indefinite-Lived Intangible Assets for Impairment*

On January 1, 2013, the Company adopted Accounting Standards Update No. 2012-02, Intangibles —Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment (“ASU 2012-02”) which allows entities to use a qualitative approach to test indefinite-lived intangible assets for impairment. ASU 2012-02 allows an entity to first perform a qualitative assessment to determine whether it is more likely than not that the indefinite-lived intangible asset is impaired. If an entity concludes that this is the case, it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount. The adoption of ASU 2012-02 did not materially impact the carrying value of our recorded indefinite-lived intangible assets. The Company will perform its next annual indefinite-lived intangible asset impairment test on December 31, 2013.

### ***Reclassification Out of Accumulated Other Comprehensive Income***

The Company adopted Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220): “Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income.” (“ASU 2013-02”), effective January 1, 2013. ASU 2013-02 was applied prospectively, which requires expanded disclosures for amounts reclassified out of accumulated other comprehensive income by component. The guidance requires the presentation of amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, a cross-reference to other disclosures that provide additional detail about those amounts is required. The adoption of ASU 2013-02 did not materially impact the Company’s consolidated financial statements.

### ***Recent Accounting Pronouncements Not Yet Adopted***

On July 18, 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (“ASU 2013-11”). ASU 2013-11, which is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013, is expected to reduce diversity in practice by providing guidance on the presentation of unrecognized tax benefits and will better reflect the manner in which an entity would settle at the reporting date any additional income taxes that would result from the disallowance of a tax position when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist. We are currently evaluating the impact of our pending adoption of ASU 2013-11 on our Consolidated Financial Statements.

## **4. Derivative instruments and hedging activities:**

### ***Foreign currency forward contracts***

In October 2012, the Company entered into a hedging program with a Canadian chartered bank to limit the potential foreign exchange fluctuations in its future cash flows related to a portion of payroll, rent and payments to a Canadian domain name registry supplier that are denominated in Canadian dollars and are expected to be paid by its Canadian operating subsidiary. As part of its risk management strategy, the Company uses derivative instruments to hedge a portion of the foreign exchange risk associated with these costs. The Company does not use these forward contracts for trading or speculative purposes. These forward contracts typically mature between one and eighteen months.

The Company has designated these transactions as cash flow hedges of forecasted transactions under ASC Topic 815 “Derivatives and Hedging” (ASC Topic 815). As the critical terms of the hedging instrument, and of the entire hedged forecasted transaction, are the same, in accordance with ASC Topic 815, the Company has been able to conclude that changes in fair value or cash flows attributable to the risk of being hedged are expected to completely offset at inception and on an ongoing basis. Accordingly, quarterly unrealized gains or losses on the effective portion of these contracts have been included within other comprehensive income. The fair value of the contracts, as of September 30, 2013, is recorded as derivative instrument assets and liabilities.

As of September 30, 2013, the notional amount of forward contracts that the Company held to sell U.S. dollars in exchange for Canadian dollars was \$32.8 million, of which \$25.5 million met the requirements of ASC Topic 815 and were designated as hedges (September 30, 2012 - \$15.1 million of which none were designated as hedges). In addition, as of September 30, 2013, the Company has forward contracts with a notional amount of \$7.3 million, which are not accounted for as a hedge. The change in fair value of \$16,000 for these contracts is recorded on the statement of operations.

*Fair value of derivative instruments and effect of derivative instruments on financial performance*

The effect of these derivative instruments on our consolidated financial statements as of, and for the nine months ended September 30, 2013, were as follows (amounts presented do not include any income tax effects).

*Fair value of derivative instruments in the consolidated balance sheets*

<u>Derivatives</u>	<u>Balance Sheet</u> <u>Location</u>	<u>As of</u>	<u>As of</u>
		<u>September</u> <u>30,</u> <u>2013</u>	<u>December</u> <u>31,</u> <u>2012</u>
		<u>Fair Value</u> <u>Asset</u> <u>(Liability)</u>	<u>Fair Value</u> <u>Asset</u> <u>(Liability)</u>
Foreign currency forward contracts designated as cash flow hedges	Derivative instruments	\$ 139,487	\$ 377,703
Foreign currency forward contracts not designated as cash flow hedges	Derivative instruments	\$ 16,057	\$ 67,079
Total foreign currency forward contracts	Derivative instruments	\$ 155,544	\$ 444,782

*Effects of derivative instruments on income and other comprehensive income (OCI) for the three and nine months ended September 30, 2013 is as follows:*

<b>Derivatives in Cash Flow</b>	<b>Amount of</b>	<b>Location of</b>	<b>Amount of</b>
---------------------------------	------------------	--------------------	------------------

Hedging Relationship	Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)	Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative (ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Income on Derivative (ineffective Portion and Amount Excluded from Effectiveness Testing)
Foreign currency forward contracts for the three months ended September 30, 2013	\$ 506,509	Operating expenses Cost of revenues	\$( 140,893 ) \$ 500	—	—
Foreign currency forward contracts for the nine months ended September 30, 2013	\$ 63,942	Operating expenses Cost of revenues	\$( 179,609 ) \$( 1,741 )	—	—

In addition to the above, for those foreign currency forward contracts not designated as hedged, the Company has recorded a loss (gain) of (28,000) and \$(0.6) million for the three months ended September 30, 2013 and September 30, 2012 respectively, and a loss (gain) of \$0.4 million and \$(0.8) million for the nine months ended September 30, 2013 and September 30, 2012 respectively, in the consolidated statement of operations and comprehensive income.



**5. INTANGIBLE ASSETS:**

Intangible assets consist of acquired technology, brand, customer relationships, surname domain names and our portfolio of domain names. As reflected in the table below, these balances are being amortized on a straight-line basis over the life of the intangible assets, except for the surname domain names and portfolio domain names, which have been determined to have an indefinite life and which are tested annually for impairment.

A summary of acquired intangible assets for the three months ended September 30, 2013 is as follows:

	<b>Technology</b>	<b>Brand</b>	<b>Customer relationships</b>	<b>Surname domain names indefinite life</b>	<b>Direct navigation domain names indefinite life</b>	<b>Total</b>
	<b>2 – 7 years</b>	<b>7 years</b>	<b>4 – 7 years</b>			
Net book value, June 30, 2013	\$ 11,970	\$ 311,470	\$ 1,458,940	\$ 12,102,878	\$ 1,985,144	\$ 15,870,402
Sales of domain names	—	—	—	(4,218 )	(4,705 )	(8,923 )
Amortization expense	(11,970 )	(43,410 )	(175,620 )	—	—	(231,000 )
Net book value, September 30, 2013	\$ —	\$ 268,060	\$ 1,283,320	\$ 12,098,660	\$ 1,980,439	\$ 15,630,479

A summary of acquired intangible assets for the nine months ended September 30, 2013 is as follows:

<b>Technology</b>	<b>Brand</b>	<b>Customer relationships</b>	<b>Surname domain names indefinite life</b>	<b>Direct navigation domain names indefinite life</b>	<b>Total</b>
<b>2 – 7 years</b>	<b>7 years</b>	<b>4 – 7 years</b>			

	<b>life</b>					
Net book value, December 31, 2012	\$ 83,790	\$ 398,290	\$ 1,810,180	\$ 12,110,017	\$ 2,013,374	\$ 16,415,651
Sales of domain names	—	—	—	(11,357 )	(32,935 )	(44,292 )
Amortization expense	(83,790 )	(130,230)	(526,860 )	—	—	(740,880 )
Net book value, September 30, 2013	\$ —	\$ 268,060	\$ 1,283,320	\$ 12,098,660	\$ 1,980,439	\$ 15,630,479

As of September 30, 2013, the accumulated amortization for the definite life intangibles was \$4.9 million.

## 6. LOAN PAYABLE:

The Company has credit agreements (collectively the “Amended Credit Facility”) with the Bank of Montreal (the “Bank”) that were amended on November 19, 2012, and which provide it with access to two revolving demand loan facilities (the “2012 Demand Loan Facilities”), a treasury risk management facility and an operating demand loan.

### *Two Revolving Demand Loan Facilities*

The 2012 Demand Loan Facilities are governed by the terms of the Offer Letter, dated November 19, 2012, between the Company and the Bank.

Under the terms of the Amended Credit Facility, our prior demand loan facilities have been amended to provide an aggregate of \$14 million in funds available through the 2012 Demand Loan Facilities, which consist of a demand loan revolving facility (the “2012 DLR Loan”) and a demand loan revolving reducing facility (the “2012 DLRR Loan”). The 2012 DLR Loan accrues interest at the Bank’s U.S. Base Rate plus 1.25%. The Company may elect to pay interest on the 2012 DLRR Loan either at the Bank’s U.S. Base Rate plus 1.25% or LIBOR plus 2.50%. Aggregate advances under the 2012 Demand Loan Facilities may not exceed \$14.0 million and no more than \$2.0 million of such advances may be used to finance repurchases of Company common stock. This facility also provided that a one-time repurchase of Company Common Stock of up to US\$10,000,000 may be made via Dutch Auction prior to March 31, 2013. The 2012 Demand Loan Facilities are subject to an undrawn aggregate standby fee of 0.20% following the first draw, which such fee is payable quarterly in arrears.

Repayment of advances under the 2012 DLR Loan consist of interest only payments made monthly in arrears and prepayment is permitted without penalty. The outstanding balance under the 2012 DLR Loan as of December 31st of each year is to be fully repaid within 30 days of December 31st through an equivalent advance made under the 2012 DLRR Loan. Advances under the 2012 DLRR Loan will be made annually and solely for such purpose. Each advance under the 2012 DLRR Loan is to be repaid in equal monthly principal payments plus interest, over a period of four years from the date of such advance.

At December 31, 2012, the outstanding balance under the 2012 DLR Loan was \$3.7 million. In accordance with the terms of the Amended Credit Facility, on January 1, 2013, the outstanding balance under the 2012 DLR Loan was fully repaid through an equivalent advance made under the 2012 DLRR Loan. Under the terms of the 2012 DLRR Loan this balance is to be repaid in equal monthly principal payments plus interest through December 31, 2016. At September 30, 2013, the outstanding balance under the 2012 DLRR Loan was \$1.7 million.

On January 7, 2013, the Company successfully concluded a modified “Dutch auction tender offer”, which was funded from available cash and an advance under the 2012 DLR Loan in the amount of \$5.2 million. Under the terms of the offer, the Company repurchased an aggregate of 4,114,121 shares of its common stock at a purchase price of \$1.50 per share, for a total of \$6,171,656, excluding transaction costs of approximately \$106,000. At September 30, 2013, the outstanding balance under the 2012 DLR Loan was \$5.2 million.

#### *Treasury Risk Management Facility*

The Amended Credit Facility also provides for a \$3.5 million settlement risk line to assist the Company with hedging Canadian dollar exposure through foreign exchange forward contracts and/or currency options. Under the terms of the Amended Credit Facility, the Company may enter into such agreements at market rates with terms not to exceed 18 months. As of September 30, 2013, the Company held contracts in the amount of \$32.8 million to trade U.S. dollars in exchange for Canadian dollars.

### *Operating Demand Loan*

The Amended Credit Facility also provides the Company with a \$1.0 million operating demand loan facility to assist in meeting its operational needs (the "Operating Demand Loan"). The Operating Demand Loan accrues interest at the Bank's U.S. Base Rate plus 1.25%. Interest is payable monthly in arrears with any borrowing under the Operating Demand Loan fluctuating widely with periodic clean-up, at a minimum on an annual basis. The Company has also agreed to pay to the Bank a monthly monitoring fee of US\$500 with respect to this loan. The Operating Demand Loan is payable on demand at any time, at the sole discretion of the Bank, with or without cause, and the Bank may terminate the Operating Demand Loan at any time. As of September 30, 2013, the Company had no amounts outstanding under its Operating Demand Loan.

### *General Terms*

The Company's Amended Credit Facility contains customary representations and warranties, affirmative and negative covenants, and events of default. The Company's obligations under the Amended Credit Facility are guaranteed and secured by a security interest in substantially all of its assets. The Amended Credit Facility also requires that the Company comply with certain non-financial covenants and restrictions. In addition, the Company has agreed to comply with the following financial covenants at all times, which are to be calculated on a rolling four quarter basis: (i) Maximum Total Funded Debt to EBITDA of 2.00:1; and (ii) Minimum Fixed Charge Coverage of 1.20:1. Further, its Maximum Annual Capital Expenditures cannot exceed \$3.6 million per year, which limit will be reviewed on an annual basis. As of September 30, 2013, the Company was in compliance with these covenants.

Scheduled principal loan repayments are as follows:

Remainder of 2013	250,000
2014	2,300,000
2015	1,750,000
2016	1,300,000
2017	1,300,000

## 7. INCOME TAXES

For the nine months ended September 30, 2013, the Company recorded a provision for income taxes of \$1.3 million on income before income taxes of \$4.6 million, using an estimated effective tax rate for its 2013 fiscal year adjusted for certain minimum state taxes. Comparatively, for the nine months ended September 30, 2012, the Company recorded a provision for income taxes of \$1.8 million on income before taxes of \$5.7 million, using an estimated effective tax rate for its 2012 fiscal year.

In assessing the realizability of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the years in which those temporary differences become deductible. The Company considers projected future taxable income, uncertainties related to the industry in which we operate, and tax planning strategies in making this assessment.

The Company follows the provisions of FASB ASC Topic 740, Income Taxes to account for income tax exposures. The application of this interpretation requires a two-step process that separates recognition of uncertain tax benefits from measurement thereof.

The Company had approximately \$0.1 million of total gross unrecognized tax benefit as of September 30, 2013 and \$0.4 million of total gross unrecognized tax benefit as of December 31, 2012, which if recognized would favorably affect its income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes. The decrease of \$0.3 million from December 31, 2012 relates to the finalization of prior year German income tax returns and the Company completing its 2012 scientific and research and development claim. The Company recognizes accrued interest and penalties related to income taxes in income tax expense. The Company did not have significant interest and penalties accrued at September 30, 2013 and December 31, 2012, respectively. The Company believes that it is reasonably possible that all of the unrecognized tax benefits will decrease in the next twelve months as it is anticipated that the tax authorities will finalize their review of prior taxes owing in Pennsylvania.

**8. BASIC AND DILUTED EARNINGS PER COMMON SHARE:**

Basic earnings per common share has been calculated by dividing net income for the period by the weighted average number of common shares outstanding during each period. Diluted earnings per share has been calculated by dividing net income for the period by the weighted average number of common shares and potentially dilutive common shares outstanding during the period. In computing diluted earnings per share, the treasury stock method is used to determine the number of shares assumed to be purchased from the conversion of common shares equivalents or the proceeds of option exercises.

The following table is a summary of the basic and diluted earnings per common share:

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Numerator for basic and diluted earnings per common share:				
Net income for the period	\$2,593,360	\$1,635,000	\$3,257,569	\$3,994,617
Denominator for basic and diluted earnings per common share:				
Basic weighted average number of common shares outstanding	43,183,583	45,094,678	41,289,876	46,362,261
Effect of outstanding stock options	2,456,317	3,316,751	3,459,356	3,241,609
Diluted weighted average number of shares outstanding	45,639,900	48,411,429	44,749,232	49,603,870
Basic earnings per common share	\$0.06	\$0.04	\$0.08	\$0.09
Diluted earnings per common share	\$0.06	\$0.03	\$0.07	\$0.08

For the three months ended September 30, 2013, outstanding options to purchase 404,000 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

For the nine months ended September 30, 2013, outstanding options to purchase 563,000 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

During the nine months ended September 30, 2013, 4,114,121 common shares were repurchased and cancelled under the terms of a modified Dutch auction tender offer announced in December 2012.

During the nine months ended September 30, 2013, 143,073 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in March 2013.

During the three months ended June 30, 2012, 1,115,304 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in November 2011.

During the three months ended March 31, 2012, 7,570,236 common shares were repurchased and cancelled under the terms of a modified Dutch auction tender offer announced in December 2011.

The computation of earnings per share and diluted earnings per share for the three and nine months ended September 30, 2013 and 2012 include reductions in the number of shares outstanding due to these repurchases.

**9. SUPPLEMENTAL INFORMATION:**

(a) The following is a summary of the Company's revenue earned from each significant revenue stream:

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Wholesale				
Domain Services	\$22,002,858	\$22,267,806	\$65,698,859	\$65,043,412
Value Added Services	2,606,151	2,603,513	7,854,268	7,881,213
Total Wholesale	24,609,009	24,871,319	73,553,127	72,924,625
Retail	6,860,921	2,964,943	16,862,957	7,112,823
Portfolio	4,167,155	1,409,807	6,379,380	4,898,541
	\$35,637,085	\$29,246,069	\$96,795,464	\$84,935,989

During the three and nine months ended September 30, 2013 and 2012, no customer accounted for more than 10% of total revenue. As at September 30, 2013, no customer accounted for more than 10% of accounts receivable, while as at September 30, 2012, one customer accounted for 13% of accounts receivable.

(b) The following is a summary of the Company's cost of revenues from each significant revenue stream:

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Wholesale				
Domain Services	\$18,580,828	\$18,644,315	\$55,519,797	\$54,275,405
Value Added Services	484,619	532,296	1,567,113	1,576,228
Total Wholesale	19,065,447	19,176,611	57,086,910	55,851,633
Retail	4,543,084	2,064,448	11,176,620	4,350,722
Portfolio	660,430	205,025	1,090,836	631,065
Network, other costs	1,192,450	1,158,885	3,716,471	3,629,639
Network, depreciation and amortization costs	176,253	193,113	536,501	567,989



\$25,637,664 \$22,798,082 \$73,607,338 \$65,031,048

(c) The following is a summary of the Company's property and equipment by geographic region:

	<b>September 30,</b>	<b>December 31,</b>
	<b>2013</b>	<b>2012</b>
Canada	\$1,320,572	\$1,026,570
United States	498,734	306,679
Germany	13,952	18,895
	<b>\$1,833,258</b>	<b>\$1,352,144</b>

(d) The following is a summary of the Company's amortizable intangible assets by geographic region:

	<b>September 30,</b>	<b>December 31,</b>
	<b>2013</b>	<b>2012</b>
Canada	\$499,000	\$1,062,100
Germany	1,052,380	1,230,160
	<b>\$1,551,380</b>	<b>\$2,292,260</b>

(e) The following is a summary of the Company's deferred tax asset, net of valuation allowance, by geographic region:

	<b>September 30,</b>	<b>December 31,</b>
	<b>2013</b>	<b>2012</b>
Canada	\$6,089,250	\$5,970,462
	\$6,089,250	\$5,970,462

#### 10. COMMITMENTS AND CONTINGENCIES:

The Company is involved in various legal claims and lawsuits in connection with its ordinary business operations. The Company intends to vigorously defend these claims. While the final outcome with respect to any actions or claims outstanding or pending as of September 30, 2013 cannot be predicted with certainty, management does not believe that the resolution of these claims, individually or in the aggregate, will have a material adverse effect on the Company's financial position.

#### 11. STOCKHOLDERS' EQUITY:

The following unaudited table summarizes stockholders' equity transactions for the three month period ended September 30, 2013:

				<b>Accumulated</b>	
				<b>Other</b>	<b>Total</b>
<b>Common stock</b>		<b>Additional</b>			
<b>Number</b>	<b>Amount</b>	<b>paid in</b>	<b>Deficit</b>	<b>Comprehensivestockholders'</b>	
		<b>capital</b>	<b>Income equity</b>		

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Balances, June 30, 2013	40,641,488	\$9,755,391	\$28,207,230	\$(16,845,634)	\$ (402,622 )	\$ 20,714,365
Exercise of stock options	2,935,373	2,041,971	(905,910 )	—	—	1,136,061
Stock-based compensation	—	—	162,786	—	—	162,786
Excess tax benefit from stock based payment arrangements	—	—	1,056,014	—	—	1,056,014
Net income for the period	—	—	—	2,593,360	—	2,593,360
Unrealized loss on foreign currency forward contracts treated as hedges	—	—	—	—	506,509	506,509
Reclassification to net income due to settlement of foreign currency forward contracts treated as hedges	—	—	—	—	(12,175 )	(12,175 )
Balances, September 30, 2013	43,576,861	\$11,797,362	\$28,520,120	\$(14,252,274)	\$ 91,712	\$ 26,156,920

The following unaudited table summarizes stockholders' equity transactions for the nine month period ended September 30, 2013:

	Common stock		Additional paid in capital		Accumulated Other Comprehensive Income		Total stockholders' equity
	Number	Amount		Deficit			
Balances, December 31, 2012	44,322,159	\$10,084,417	\$33,931,529	\$(17,509,843)	\$ 44,104		\$ 26,550,207
Exercise of stock options	3,511,946	2,564,447	(1,110,192 )	—	—		1,454,255
Repurchase and retirement of shares	(4,114,121 )	(822,887 )	(5,454,854 )	—	—		(6,277,741 )
Normal Course Issuer Bid	(143,073 )	(28,615 )	(231,260 )	—	—		(259,875 )
Cancellation of restricted stock	(50 )	—	—	—	—		—
Stock-based compensation	—	—	328,883	—	—		328,883
Excess tax benefit from stock based payment arrangements	—	—	1,056,014	—	—		1,056,014
Net income for the period	—	—	—	3,257,569	—		3,257,569
Unrealized loss on foreign currency forward contracts treated as hedges	—	—	—	—	63,942		63,942
Reclassification to net income due to settlement of foreign currency forward contracts treated as hedges	—	—	—	—	(16,334 )		(16,334 )
Balances, September 30, 2013	43,576,861	\$11,797,362	\$28,520,120	\$(14,252,274)	\$ 91,712		\$ 26,156,920

On January 7, 2013, the Company announced that it successfully concluded a modified “Dutch auction tender offer” that was previously announced on November 21, 2012. Under the terms of the offer, the Company repurchased an aggregate of 4,114,121 shares of its common stock at a purchase price of \$1.50 per share, for a total of \$6,171,656, excluding transaction costs of approximately \$106,000. The purchase price and all transaction costs were funded from available cash and an additional advance under our Amended Credit Facility from the Bank in the amount of \$5.2 million. All shares purchased in the tender offer received the same price and all shares repurchased were immediately retired. As a result of the completion of the tender offer, as of January 31, 2013, the Company had 40,226,875 shares issued and outstanding.

On March 1, 2013, the Company announced a stock buyback program. Under this buyback program, the Company may repurchase up to \$10 million of the Company's common stock over the 12-month period that commenced on March 1, 2013. The Company repurchased 143,073 shares under this program during the three months ended March 31, 2013 for a total of \$259,875.

## 12. SHARE-BASED PAYMENTS

### (a) Stock options

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model, consistent with the guidance on stock compensation. Because option-pricing models require the use of subjective assumptions, changes in these assumptions can materially affect the fair value of the options. The assumptions presented in the table below represent the weighted average of the applicable assumption used to value stock options at their grant date. The Company calculates expected volatility based on historical volatility of the Company's common shares. The expected term, which represents the period of time that options granted are expected to be outstanding, is estimated based on historical exercise experience. The Company evaluated historical exercise behavior when determining the expected term assumptions. The risk-free rate assumed in valuing the options is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. The Company determines the expected dividend yield percentage by dividing the expected annual dividend by the market price of our common shares at the date of grant.

During the three months ended September 30, 2013, stock options to purchase 90,000 common shares were granted. During the three months ended September 30, 2012, stock options to purchase 220,000 common shares were granted.

During the nine months ended September 30, 2013, stock options to purchase 571,500 common shares were granted. During the nine months ended September 30, 2012, stock options to purchase 769,000 common shares were granted.

Details of stock option transactions for the three months ended September 30, 2013 and September 30, 2012 are as follows:

	<b>Three months ended</b>		<b>Three months ended</b>	
	<b>September 30, 2013</b>		<b>September 30, 2012</b>	
	<b>Weighted</b>		<b>Weighted</b>	
<b>Number of</b>	Average	<b>Number of</b>	Average	
<b>Shares</b>	exercise price	<b>Shares</b>	exercise price	
				per share
Outstanding, beginning of period	8,468,485	\$ 0.71	8,524,499	\$ 0.62
Granted	90,000	2.23	220,000	1.38
Exercised	(2,935,373)	0.39	(20,187 )	0.70
Forfeited	(75,624 )	1.22	(56,689 )	0.83
Expired	(4,750 )	0.36	(3,000 )	0.44
Outstanding, end of period	5,542,738	\$ 0.91	8,664,623	\$ 0.64
Options exercisable, end of period	4,199,238	\$ 0.78	7,160,766	\$ 0.57

The stock options granted during the three and nine months ended September 30, 2013 expire in 2018 and 2020.

Details of stock option transactions for the nine months ended September 30, 2013 and September 30, 2012 are as follows:

	<b>Nine months ended</b>		<b>Nine months ended</b>	
	<b>September 30, 2013</b>		<b>September 30, 2012</b>	
	<b>Weighted</b>		<b>Weighted</b>	
<b>Number of</b>	Average	<b>Number of</b>	Average	
<b>Shares</b>	exercise price	<b>Shares</b>	exercise price	
				per share
Outstanding, beginning of period	8,592,686	\$ 0.64	8,746,041	\$ 0.57
Granted	571,500	1.97	769,000	1.36
Exercised	(3,511,946)	0.41	(693,340 )	0.52

Forfeited	(104,752 )	1.21	(154,064 )	0.80
Expired	(4,750 )	0.36	(3,014 )	0.44
Outstanding, end of period	5,542,738	\$ 0.91	8,664,623	\$ 0.64
Options exercisable, end of period	4,199,238	\$ 0.78	7,160,766	\$ 0.57

As of September 30, 2013, the exercise prices, weighted average remaining contractual life and intrinsic values of outstanding options were as follows:

Exercise price	Options outstanding			Options exercisable			
	Outstanding Number	Weighted average exercise price per share	Weighted Average remaining contractual life (years)	Aggregate intrinsic value	Number exercisable	Weighted average exercise price per share	Aggregate intrinsic value
\$ 0.38	1,349,125	\$ 0.58	1.2	\$ 2,440,266	1,349,125	\$ 0.58	\$ 2,440,266
\$ 0.62	1,531,550	\$ 0.69	3.2	2,606,519	1,223,550	\$ 0.69	2,086,000
\$ 0.73	1,383,813	\$ 0.80	2.2	2,196,030	1,182,438	\$ 0.82	1,861,747
\$ 1.05	1,278,250	\$ 1.62	5.6	986,623	444,125	\$ 1.54	378,379
	5,542,738	\$ 0.91	3.0	\$ 8,229,438	4,199,238	\$ 0.78	\$ 6,766,392

Total unrecognized compensation cost relating to unvested stock options at September 30, 2013, prior to the consideration of expected forfeitures, was approximately \$833,000 and is expected to be recognized over a weighted average period of 2.4 years.

The Company recorded stock-based compensation of \$162,786 and \$166,371 for the three months ended September 30, 2013 and 2012, respectively.

The Company recorded stock-based compensation of \$328,883 and \$291,932 for the nine months ended September 30, 2013 and 2012, respectively.

The Company has not capitalized any stock-based compensation expense as part of the cost of an asset.

**13. FAIR VALUE MEASUREMENT**

ASC Topic 820, “*Fair Value Measurements and Disclosures*” establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides a summary of the fair values of the Company's derivative instrument assets and liabilities measured at fair value on a recurring basis at September 30, 2013:

	September 30, 2013			
	Fair Value Measurements Using		Assets at	
	Level 1	Level 2	Level 3	Fair Value
Derivative instrument asset	\$—	\$466,409	\$ —	\$466,409
Total Assets	\$—	\$466,409	\$ —	\$466,409
Derivative instrument liability	\$—	\$310,865	\$ —	\$310,865
Total Liabilities	\$—	\$310,865	\$ —	\$310,865

The following table provides a summary of the fair values of the Company's derivative instrument assets measured at fair value on a recurring basis as at December 31, 2012:

	December 31, 2012			
	Fair Value Measurements Using		Assets at	
	Level 1	Level 2	Level 3	Fair Value
Derivative instrument asset	\$—	\$444,782	\$ —	\$444,782
Total Assets	\$—	\$444,782	\$ —	\$444,782



The carrying values of cash and cash equivalents, accounts receivable, accounts payable, accreditation fees payable, customer deposits, loan payable and accrued liabilities approximate their fair values due to the relatively short periods to maturity of the instruments.

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

### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains, in addition to historical information, forward-looking statements by us with regard to our expectations as to financial results and other aspects of our business that involve risks and uncertainties and may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as “may,” “should,” “anticipate,” “believe,” “plan,” “estimate,” “expect”, “intend ” and other expressions are intended to identify forward-looking statements. The forward-looking statements contained in this report include statements regarding, among other things, the Company's foreign currency requirements, specifically for the Canadian dollar; the number of new, renewed and transferred-in domain names we register as our business develops and competes; the effect of a potential global top level domain (“gTLD”) expansion by the Internet Corporation for Assigned Names and Numbers (“ICANN”) on the number of domains we register and the impact it may have on related revenues; our belief that the market for domain name registration will trend upward gradually and may be affected by market volatility; our belief that, by increasing the number of services we offer, we will be able to generate higher revenues; the revenue that our parked page vendor relationships may generate in the future; the effectiveness of our intellectual property protection, including our ability to license proprietary rights to network partners and to register additional trademarks and service marks; the potential impact of current and pending claims on our business; our valuations of certain deferred tax assets; our expectation to collect our outstanding receivables, net of our allowance for doubtful accounts; our expectation regarding fluctuations in certain expense and cost categories; our expectations regarding future revenue from our patent assignments; our expectations regarding our unrecognized tax benefit and the timing or completion of certain audits of our US, Canadian and German tax returns; our expectations regarding cash from operations to fund our business; our expectation regarding increased competition due to the introduction of new gTLDs by ICANN; the impact of cancellations of or amendments to market development fund programs under which we receive funds; and our belief that a slowing economy may lead to a decrease in advertising spending. These statements are based on management's current expectations and are subject to a number of uncertainties and risks that could cause actual results to differ materially from those described in the forward-looking statements. Many factors affect our ability to achieve our objectives and to successfully develop and commercialize our services including:

Our ability to continue to generate sufficient working capital to meet our operating requirements;

Our ability to maintain a good working relationship with our vendors and customers;

The ability of vendors to continue to supply our needs;

Actions by our competitors;

Our ability to achieve gross profit margins at which we can be profitable;

Our ability to attract and retain qualified personnel in our business;

Our ability to effectively manage our business;

Our ability to obtain and maintain approvals from regulatory authorities on regulatory issues;

Pending or new litigation; and

Factors set forth under the caption “Item 1A Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

This list of factors that may affect our future performance and financial and competitive position and also the accuracy of forward-looking statements is illustrative, but it is by no means exhaustive. Accordingly, all forward-looking statements should be evaluated with the understanding of their inherent uncertainty. All forward-looking statements included in this document are based on information available to us as of the date of this document, and we assume no obligation to update these cautionary statements or any forward-looking statements except to the extent of any obligations under the Securities Exchange Act of 1934 or the Securities Act of 1933. These statements are not guarantees of future performance.

We qualify all the forward-looking statements contained in this Quarterly Report on Form 10-Q by the foregoing cautionary statements.

## OVERVIEW

Our mission is to provide simple useful services that help people unlock the power of the Internet. We accomplish this by reducing the complexity our customers' experience as they acquire, deliver or use Internet services such as domain name registration, email and other Internet services.

Our primary distribution channel is a global network of more than 13,000 resellers in more than 100 countries who typically provide their customers, the end-users of the Internet, with a critical component for establishing and maintaining an online presence. Our primary focus is serving the needs of this network of resellers by providing superior services, easy-to-use interfaces, proactive and attentive customer service, reseller-oriented technology and agile design and development processes. We seek to provide superior customer service to our resellers by anticipating their business needs and technical requirements. This includes providing easy-to-use interfaces that enable resellers to quickly and easily integrate our services into their individual business processes, and offering brandable end-user interfaces that emphasize simplicity and visual appeal. We also provide "second tier" support to our resellers by email and phone in the event resellers experience issues or problems with our services. In addition, our Network Operating Center provides proactive support to our resellers by monitoring all services and network infrastructure to address deficiencies before customer services are impacted.

We believe that the underlying platforms for our services are one of the most mature, reliable and functional reseller-oriented provisioning and management platforms in our industry, and we continue to refine, evolve and improve these services for both resellers and end-users.

Our principal place of business is located in Canada. We report our financial results as one operating segment. Our chief operating decision maker regularly reviews our operating results on a consolidated basis, principally to make decisions about how we utilize our resources and to measure our consolidated operating performance. To assist us in forecasting growth and to help us monitor the effectiveness of our operational strategies, our chief operating decision maker regularly reviews revenue for each of our service offerings in order to gain more depth and understanding of the key business metrics driving our business. Accordingly, we report revenue in the following service areas:

Wholesale, primarily branded as OpenSRS, derives revenue from its Domain Service and from providing Value-Added Services. The OpenSRS Domain Service manages over 14 million domain names under the Tucows ICANN registrar accreditation and for other registrars under their own accreditations. Value-Added Services include hosted email which provides email delivery and webmail access to millions of mailboxes, Internet security services, publishing tools and reseller billing services. All of these services are made available to end-users through a network of over 13,000 web hosts, Internet service providers ("ISPs"), and other resellers around the world. In addition, we also derive revenue from the bulk sale of domain names and advertising from the OpenSRS Domain Expiry Stream and the

Marketing Development Funds we receive from vendors from time-to-time to expand or maintain the market position for their services.

Retail, primarily our Hover and Ting websites, derives revenues from the sale of domain name registration, email services and mobile phone service to individuals and small businesses. Retail also includes our Personal Names Service – based on over 40,000 surname domains – that allows roughly two-thirds of Americans to purchase an email address based on their last name.

Portfolio generates advertising revenue from our domain name portfolio and from our two large advertising-supported websites, butterscotch.com and tucows.com. We also generate revenue by offering names in our domain portfolio for resale via our reseller network and other channels. In addition, we generate revenue from the payments for the sale of rights to gTLD strings under the New gTLD program.

Our business model is characterized primarily by non-refundable, up-front payments, which lead to recurring revenue and positive operating cash flow.

For the three months ended September 30, 2013 and 2012, we reported revenue of \$35.6 million and \$29.2 million, respectively. For the three months ended September 30, 2013 and 2012, our OpenSRS domain service offering accounted for 62% and 76% of our total revenue, respectively.

For the nine months ended September 30, 2013 and 2012, we reported revenue of \$96.8 million and \$84.9 million, respectively. For the nine months ended September 30, 2013 and 2012, our OpenSRS domain service offering accounted for 68% and 77% of our total revenue, respectively.

**KEY BUSINESS METRICS**

We regularly review a number of business metrics, including the following key metrics to, assist us in evaluating our business, measure the performance of our business model, identify trends impacting our business, determine resource allocations, formulate financial projections and make strategic business decisions. The following table sets forth, the key business metrics which we believe are the primary indicators of our performance for the periods presented:

Total new, renewed and transferred-in domain name registrations:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013 (1)</b>	<b>2012 (1)</b>	<b>2013 (1)</b>	<b>2012 (1)</b>
	<b>(in 000's)</b>		<b>(in 000's)</b>	
Total new, renewed and transferred-in domain name registrations	2,240	2,253	7,005	7,138

(1) For a discussion of these period to period changes in the domains provisioned and how they impacted our financial results see the Net Revenue discussion below.

Domain names under management:

	<b>September 30,</b>	
	<b>2013(1)</b>	<b>2012(1)</b>
	<b>(in 000's)</b>	
Domain names under management:		
Registered using the Tucows Registrar Accreditation	10,713	10,773
Registered using our Resellers' Registrar Accreditations	3,529	3,392
Total domain names under management	14,242	14,165

(1) For a discussion of these period to period changes in domains under management and how they impacted our financial results see the Net Revenue discussion below.

**OPPORTUNITIES, CHALLENGES AND RISKS**

The increased competition in the market for Internet services in recent years, which the Company expects will continue to intensify in the short and long term, poses a material risk for the Company. As new registrars are introduced, existing competitors expand service offerings and competitors offer price discounts to gain market share, the Company faces pricing pressure, which can adversely impact its revenues and profitability. To address these risks, the Company has focused on leveraging the scalability of its infrastructure and its ability to provide proactive and attentive customer service to aggressively compete to attract new customers and to maintain existing customers.

Our direct costs to register domain names on behalf of our customers are almost exclusively controlled by registries such as Verisign and by ICANN. Verisign provides all the registry services operations for the .com, .net, .cc, .tv and .name domain names. ICANN is a private sector, not-for-profit corporation formed to oversee a number of Internet related tasks, including domain registrations for which it collects fees. The market for wholesale registrar services is both price sensitive and competitive, particularly for large volume customers, such as large web hosting companies and owners of large portfolios of domain names. We have a relatively limited ability to increase the pricing of domain name registrations without negatively impacting our ability to maintain or grow our customer base.

We are still participating in ICANN's New gTLD program to own and/or operate two New gTLD strings. The New gTLD Program's goals include enhancing competition and consumer choice, and enabling the benefits of innovation via the introduction of a wide range of new gTLDs. On October 23, 2013 ICANN announced that the first four new gTLDs from its New gTLD Program had been delegated. The newly delegated gTLDs are in Arabic, Chinese and Cyrillic scripts. We believe that such expansion, once completed, will result in an increase in the number of domains we register and related revenues commencing in 2014. In addition, while the delegation of New gTLDs could substantially change the domain name industry in unexpected ways, we believe that the New gTLD Program will provide us with new revenue opportunities commencing in 2014.

Under the terms of the New gTLD program, in April 2012 we paid the required \$1.1 million application fee in support of our application for six domain strings under ICANN's new gTLD Program. A declining percentage of these evaluation fees are refundable if any application is withdrawn prior to our executing a registry agreement with ICANN. In May 2012 we withdrew two of our applications and under the terms of the New gTLD application process have received a full refund of \$0.4 million against these applications.

In March 2013, we entered into an alliance with Directi and Namecheap to jointly work together to manage the contested .online registry. In May 2013, in accordance with our alliance with Directi and Namecheap, we withdrew our .online application and under the terms of the New gTLD application process have received a partial refund of \$0.1 million against this application.

In addition, in a series of private arrangements that were completed in July 2013, we have negotiated agreements that have changed our interest in the remaining three applications - .group, .media and .marketing. We have withdrawn our applications for .media and .marketing and the gross amounts received for the domain related rights have been recorded as portfolio revenue in the three months ended September 30, 2013. With .group, we have exchanged a majority interest in our .group application for a minority stake in two other contested new gTLD strings, .tech and .store. As all these strings are contested, there can be no assurance that we will be part of a successful bid for any of these new gTLD strings.

While there can be no assurance that we will be awarded any gTLDs, we intend to continue to pursue contested gTLD operator rights and in order to prevail, may incur significant additional costs to acquire such rights. Any such additional costs will be capitalized and included in prepaid expenses and deposits until such time as the relevant gTLD is delegated by ICANN. Other costs incurred by the Company as part of its gTLD initiative not directly attributable to the acquisition of gTLD operator rights are expensed as incurred.

To the extent we elect to sell or dispose of any of our rights under the New gTLD Program, any gains realized on the sale of our interest will be recognized as portfolio revenue, while losses will be recognized when deemed probable. Should we be successful in acquiring any contested gTLD operator rights, any capitalized gTLD costs will be reclassified as finite lived intangible assets and amortized on a straight-line basis over their estimated useful life.

From time-to-time certain of our vendors provide us with Market Development Funds to expand or maintain the market position for their services. Any decision by these vendors to cancel or amend these programs for any reason, may result in payments in future periods not being commensurate with what we have achieved during past periods.

Sales of domain names from our domain portfolio have a negative impact on our advertising revenue as these names are no longer available for advertising purposes. In addition, the timing of larger domain names portfolio sales is



unpredictable and may lead to significant quarterly and annual fluctuations in our Portfolio revenue.

Our revenue is primarily realized in U.S. dollars and a major portion of our operating expenses are paid in Canadian dollars. Fluctuations in the exchange rate between the U.S. dollar and the Canadian dollar may have a material effect on our business, financial condition and results from operations. In particular, we may be adversely affected by a significant weakening of the U.S. dollar against the Canadian dollar on a quarterly and an annual basis. Our policy with respect to foreign currency exposure is to manage our financial exposure to certain foreign exchange fluctuations with the objective of neutralizing some or all of the impact of foreign currency exchange movements by entering into foreign exchange forward contracts to mitigate the exchange risk on a portion of our Canadian dollar exposure. We may not always enter into such forward contracts and such contracts may not always be available and economical for us. Additionally, the forward rates established by the contracts may be less advantageous than the market rate upon settlement.

## **Net Revenues**

### *Wholesale - OpenSRS Domain Service*

Historically, our OpenSRS Domain Service has constituted the largest portion of our business and encompasses all of our services as an accredited registrar related to the registration, renewal, transfer and management of domain names. In addition, this service fuels other revenue categories as it often is the initial service for which a reseller will engage us, enabling us to follow on with other services and allowing us to add to our portfolio by purchasing names registered through us upon their expiration.

With the acquisition of EPAG Domainservices GmbH (“EPAG”) in August 2011, we now offer registration services for over 200 TLDs.

With respect to the sale of domain registrations, our pricing structure for domain names provides visibility into the various fees that make up the cost of a domain name by breaking out the cost of the registry and ICANN fees separately from our management fee. In November 2012, Verisign renewed its agreement with ICANN to serve as the authoritative registry operator for the .com registry until November 2018. Under the terms of the renewal, Verisign agreed to continue the current pricing of \$7.85 per domain name registration throughout the term of the agreement and in December 2012, announced their intention, effective July 1, 2013, to increase the registry fee for .net to \$5.62 from \$5.11. The management fee provides our resellers with access to our provisioning and management tools to enable them to register and administer domain names and access to additional services like WHOIS privacy and DNS services, enhanced domain name suggestion tools and access to our premium domain names. We earn fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to resellers and registrars on a monthly basis. Domain registrations are generally purchased for terms of one to ten years, with a majority having a one-year term.

*Wholesale – OpenSRS Value-Added Services*

We derive revenue from our hosted email service through our global distribution network. Our hosted email service is offered on a per account, per month basis, and provides resellers with a reliable, scalable “white label” hosted email solution that can be customized to their branding and business model requirements. The hosted email service also includes spam and virus filtering on all accounts. End-users can access the hosted email service via a full-featured, multi-language AJAX-enabled web interface or through traditional desktop email clients, such as Microsoft Outlook or Apple Mail, using IMAP or POP/SMTP.

We also derive revenue from other Value-Added Services primarily from provisioning SSL and other trust certificates. In addition, we derive revenue from the bulk sale of domain names and advertising from the OpenSRS Domain Expiry Stream.

Other services included in Value-Added Services include web publishing tools, special discounts on 3rd party services and fees we receive from time-to-time from vendors to expand or maintain the market position for their services. In addition, we provide billing, provisioning and customer care software solutions to ISPs through our Platypus billing software.

*Retail – Hover*

We derive revenues from Hover's sale of retail Internet domain name registration and email services to individuals and small businesses.

*Retail - Ting*

We derive revenue from Ting's sale of retail mobile phones and services to individuals and small businesses.

*Portfolio*

We derive revenue from our portfolio of domain names by displaying advertising on the domains and by making them available for sale or lease. When a user types one of these domain names into a web browser, they are presented with dynamically generated links that are pay-per-click advertising. Every time a user clicks on one of these links, it generates revenue for us through our partnership with third-parties who provide syndicated pay-per-click advertising ("parked page vendors").

Our parked page vendor relationships may not continue to generate levels of revenue commensurate with what we have achieved during past periods. Our ability to generate online advertising revenue from parked page vendors depends on their advertising networks' assessment of the quality and performance characteristics of Internet traffic resulting from online advertisements rendered on their websites. We have no control over any of these quality assessments. Parked page vendors may from time to time change their existing, or establish new, methodologies and metrics for valuing the quality of Internet traffic and delivering pay-per-click advertisements. Any changes in these methodologies, metrics and advertising technology platforms could decrease the amount of revenue that we generate from online advertisements. In addition, parked page vendors may at any time change or suspend the nature of the service that they provide to online advertisers. These types of changes or suspensions would adversely impact our ability to generate revenue from pay-per-click advertising.

Portfolio names are sold through our premium domain name service, auctions or in negotiated sales. The size of our domain name portfolio varies over time, as we acquire and sell domains on a regular basis to maximize the overall value and revenue generation potential of our portfolio. In evaluating names for sale, we consider the potential foregone revenue from pay-per-click advertising, as well as other factors. The name will be offered for sale if, based on our evaluation, the name is deemed non-essential to our business and management believes that deriving proceeds from the sale is strategically more beneficial to the Company. In addition, we generate revenue from the payments for the sale of rights to gTLD strings under the New gTLD program.

Portfolio names that have been acquired from third-parties or through acquisition are included as intangible assets with indefinite lives on our consolidated balance sheet.

We also generate advertising and other revenue through two ad-supported content sites, butterscotch.com and tucows.com. These sites primarily derive revenue from banner and text advertising. In addition, their revenue is derived from software developers who rely on us as a primary source of distribution. Software developers use our Author Resource Center to submit their products for inclusion on our site and to purchase promotional placements of their software.

### **Critical Accounting Policies**

The following is a discussion of our critical accounting policies and methods. Critical accounting policies are defined as those that are both important to the portrayal of our financial condition and results of operations and are reflective of significant judgments and uncertainties made by management that may result in materially different results under different assumptions and conditions. Note 2 to the consolidated financial statements for the year ended December 31, 2012, includes further information on the significant accounting policies and methods used in the preparation of our consolidated financial statements.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate the application of these estimates, including those related to the recoverability of investments, useful lives and valuation of intangible assets, valuation of goodwill, fair value measurement of assets and liabilities, product development costs, revenue recognition and deferred revenue and accounting for income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual amounts could differ significantly from these estimates.

### **Revenue recognition policy**

We earn revenues from the following services:

Wholesale (Domain Service and other Value-Added Services);  
Retail (Hover and  
Ting)  
Portfolio (Domain Portfolio monetization and sales).

With respect to the sale of domain registrations and other Internet services, we earn registration fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to resellers and registrars on a monthly basis. We also enter into revenue arrangements in which a reseller may purchase a combination of services (multiple element arrangements). When a standalone selling price exists for each deliverable, we allocate revenue to each deliverable based on the relative selling price of each of the deliverables. The standalone selling price is established for each deliverable by the price charged when that deliverable is sold separately by the Company which is vendor specific objective evidence (“VSOE”). For arrangements where the Company does not sell the deliverable separately, the selling price is determined based on third party evidence (“TPE”), which is the price at which a competitor or third party sells the same or similar and largely interchangeable deliverable on a standalone basis. In instances where VSOE and TPE do not exist, the Company uses an estimated selling price for the deliverable, which is the price at which a company would transact if the deliverable were sold by the vendor regularly on a standalone basis. Payments for the full term of all services are received at the time of activation of service and where appropriate are recorded as deferred revenue and are recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

Revenue from domain portfolio monetization and sales consists primarily of amounts earned for the transfer of rights to domain names and domain related rights that are currently under the Company's control. Collectability of revenues generated is subject to a high level of uncertainty; accordingly revenues are recognized only when payment is received, except where a fixed contract has been negotiated, in which case revenues are recognized once all the terms of the contract have been satisfied.

We also generate advertising and other revenue through [tucows.com](http://tucows.com) and [butterscotch.com](http://butterscotch.com) as well as advertising revenue from our OpenSRS expired domain names and our domain name portfolio. Advertising and other revenue is recognized ratably over the period in which it is presented. To the extent that the minimum number of post-presentation impressions we guarantee to customers is not met, we defer recognition of the corresponding revenues until the guaranteed impressions are achieved. Revenue is also generated from vendors who are seeking to expand or maintain their services market position and is recognized once all the conditions have been met.

Changes to contractual relationships in the future could impact the amounts and timing of revenue recognition.

In those cases where payment is not received at the time of sale, additional conditions for recognition of revenue apply. The conditions are (i) that the collection of sales proceeds is reasonably assured and (ii) that we have no further performance obligations. We record expected refunds, rebates and credit card charge-backs as a reduction of revenues at the time of the sale based on historical experiences and current expectations. Should these expectations not be met, adjustments will be required in future periods.

We record provisions for possible uncollectible accounts receivable and contingent liabilities which may arise in the normal course of business. The allowance for doubtful accounts is calculated by taking into account factors such as our historical collection and write-off experience, the number of days the customer is past due and the status of the customer's account with respect to whether or not the customer is continuing to receive service. The contingent liability estimates are based on management's historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the reported amounts of liabilities and expenses that are not readily apparent from other sources. Historically, credit losses have been within our expectations and the reserves we have established have been appropriate. However, we have, on occasion, experienced issues which have led to accounts receivable not being fully collected. Should these issues occur more frequently, additional provisions may be required.

### **Valuation of intangible assets, goodwill and long-lived assets**

The excess of the fair value of purchase price over the fair values of the identifiable assets and liabilities from our acquisitions is recorded as goodwill. At September 30, 2013, we had \$18.9 million in goodwill related to our acquisitions and \$15.6 million in intangible assets. The goodwill recorded in relation to these acquisitions is not deductible for tax purposes. We report our financial results as one operating segment with three distinct service offerings, being Wholesale, Retail and Portfolio.

Finite life intangible assets, related to the acquisition of EPAG in August 2011, are being amortized on a straight-line basis over periods of two to seven years, and consist of technology, brand and customer relationships. Finite life intangible assets, related to the acquisition of Innerwise, Inc. in July 2007, are being amortized on a straight-line basis over periods of five to seven years, and consist of brand and customer relationships. Indefinite life intangible assets, acquired in the acquisition of Mailbank.com Inc. in June 2006, consist of surname domain names and direct navigation domain names.

We account for goodwill in accordance with FASB's authoritative guidance, which requires that goodwill and certain intangible assets are not amortized, but are subject to an annual impairment test. We complete our goodwill and

certain intangible assets impairment test on an annual basis, during the fourth quarter of our fiscal year, or more frequently, if changes in facts and circumstances indicate that impairment in the value of goodwill and certain intangible assets recorded on our balance sheet may exist.

With regards to property and equipment and definite life intangible assets, we continually evaluate whether events or circumstances have occurred that indicate the remaining estimated useful lives of our definite-life intangible assets may warrant revision or that the remaining balance of such assets may not be recoverable. We use an estimate of the related undiscounted cash flows over the remaining life of the asset in measuring whether the asset is recoverable. There was no impairment recorded on definite-life intangible assets and property and equipment during the three and nine months ended September 30, 2013 and 2012.

Our 2012 annual goodwill impairment analysis, which we performed for our reporting unit as of December 31, 2012, did not result in an impairment charge.

We determined the estimated fair value for our reporting unit using the market approach that is based on the publicly traded common shares of the Company to estimate fair value. The fair value was greater than the carrying value, therefore no impairment exists and the second step was not performed. The analysis was consistent with the approach we utilized in our analysis performed in prior years.

Any changes to our key assumptions about our businesses and our prospects, or changes in market conditions, could cause the fair value of our reporting unit to fall below its carrying value, resulting in a potential impairment charge. In addition, changes in our organizational structure or how our management allocates resources and assesses performance, could result in a change in our operating segments or reporting units, requiring a reallocation and updated impairment analysis of goodwill. A goodwill or intangible asset impairment charge could have a material effect on our consolidated financial statements because of the significance of goodwill and intangible assets to our consolidated balance sheet. There was no impairment of goodwill or intangible assets as a result of the annual impairment tests completed during the fourth quarters of 2012 and 2011.

## Accounting for income taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. We apply a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if on the weight of available evidence it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit that is more than 50% likely to be realized upon settlement.

Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate based on new information that may become available. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made.

As we account for income taxes under the asset and liability method, we recognize deferred tax assets or liabilities for the anticipated future tax effects of temporary differences between the financial statement basis and the tax basis of our assets and liabilities. We record a valuation allowance to reduce the net deferred tax assets when it is more likely than not that the benefit from the deferred tax assets will not be realized. In assessing the need for a valuation allowance, historical and future levels of income, expectations and risks associated with estimates of future taxable income and ongoing tax planning strategies are considered. In the event that it is determined that the deferred tax assets to be realized in the future would be in excess of the net recorded amount, an adjustment to the deferred tax asset valuation allowance would be recorded. This adjustment would increase income in the period that such determination was made. Likewise, should it be determined that all or part of a recorded net deferred tax asset would not be realized in the future, an adjustment to increase the deferred tax asset valuation allowance would be charged to income in the period that such determination would be made.

On a periodic basis, we evaluate the probability that our deferred tax asset balance will be recovered to assess its realizability. To the extent we believe it is more likely than not that some portion of our deferred tax assets will not be realized, we will increase the valuation allowance against the deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future taxable income. Our judgments regarding future profitability may change due to future market conditions, changes in U.S. or international tax laws and other factors. These changes, if any, may require possible material adjustments to these deferred tax assets, impacting net income or net loss in the period when such determinations are made.



**RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2013 AS COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012**

**NET REVENUES**

The following table presents our net revenues, by revenue source:

	<b>Three months ended September 30, 2013</b>		<b>Nine months ended September 30, 2013</b>	
	<b>2012</b>	<b>2012</b>	<b>2012</b>	<b>2012</b>
	<b>(unaudited)</b>		<b>(unaudited)</b>	
Wholesale				
Domain Services	\$22,002,858	\$22,267,806	\$65,698,859	\$65,043,412
Value Added Services	2,606,151	2,603,513	7,854,268	7,881,213
Total Wholesale	24,609,009	24,871,319	73,553,127	72,924,625
Retail	6,860,921	2,964,943	16,862,957	7,112,823
Portfolio	4,167,155	1,409,807	6,379,380	4,898,541
	\$35,637,085	\$29,246,069	\$96,795,464	\$84,935,989
Increase over prior period	\$6,391,016		\$11,859,475	
Increase - percentage	22	%	14%	

The following table presents our revenues, by revenue source, as a percentage of total revenues:

	<b>Three months ended September 30, 2013</b>		<b>Nine months ended September 30, 2012</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Wholesale				
Domain Services	62 %	76 %	68 %	77 %
Value Added Services	7 %	9 %	8 %	9 %
Total Wholesale	69 %	85 %	76 %	86 %
Retail	19 %	10 %	17 %	8 %

Portfolio	12 %	5 %	7 %	6 %
	100 %	100 %	100 %	100 %

Total net revenues for the three months ended September 30, 2013 increased by \$6.4 million or 22% to \$35.6 million when compared to the three months ended September 30, 2012.

Total net revenues for the nine months ended September 30, 2013 increased by \$11.9 million or 14% to \$96.8 million when compared to the nine months ended September 30, 2012.

Deferred revenue decreased to \$72.0 million at September 30, 2013 from \$73.3 million at September 30, 2012 and increased by \$1.0 million from \$71.0 million at December 31, 2012. Deferred revenue has been impacted by certain of our customers, who have acquired their own registrar accreditation, no longer registering new domain names on our platform.

No customer accounted for more than 10% of revenue during the three and nine months ended September 30, 2013 and September 30, 2012. At September 30, 2013, no customer accounted for more than 10% of accounts receivable, and as of September 30, 2012, one customer accounted for 13% of accounts receivable. Significant management judgment is required at the time revenue is recorded to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

### ***Wholesale***

For the three months ended September 30, 2013, Wholesale revenue remained relatively unchanged at \$24.6 million when compared to the three months ended September 30, 2012. For the nine months ended September 30, 2013, Wholesale revenue increased by \$0.7 million, or 1%, to \$73.6 million when compared to the nine months ended September 30, 2012. These results primarily reflect the result of customers who have acquired their own registrar accreditation no longer registering new domain names on our platform. In addition, certain marketing initiatives undertaken by both vendors and resellers in fiscal 2012 have either been significantly scaled back or cancelled for fiscal 2013.

Value-Added Services for the three and nine months ended September 30, 2013 remained relatively unchanged at \$2.6 million and \$7.9 million respectively, when compared to the three and nine months ended September 30, 2012.

During the three months ended September 30, 2013, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed decreased by 0.1 million transactions to 2.2 million when compared to the three months ended September 30, 2012. This result reflects the impact of certain of our customers now registering new transactions under their own accreditation on our platform.

During the nine months ended September 30, 2013, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed decreased by 0.1 million transactions to 7.0 million when compared to the nine months ended September 30, 2012. This result reflects the impact of certain of our customers now registering new transactions under their own accreditation on our platform.

As of September 30, 2013, the total domain names under our management remained relatively unchanged at 14.2 million when compared to September 30, 2012. Included in domains under management are 3.5 million (as of September 30, 2012 – 3.4 million) names we manage for other accredited registrars who use our provisioning platform to process domain registrations under their own accreditations.

### ***Retail***

Net revenues from Retail for the three months ended September 30, 2013 increased by \$3.9 million to \$6.9 million, when compared to the three months ended September 30, 2012. This increase resulted primarily from additional revenue of \$3.5 million in Ting's mobile device and service sales made during the quarter, as well as the success that our retail marketing initiatives and improved websites are having on our ability to attract new customers and retain existing ones.

Net revenues from Retail for the nine months ended September 30, 2013 increased by \$9.8 million to \$16.9 million, when compared to the nine months ended September 30, 2012. This increase resulted primarily from additional revenue of \$8.6 million in Ting's mobile device and service sales made during the quarter, as well as the success that our retail marketing initiatives and improved websites are having on our ability to attract new customers and retain existing ones.

As of September 30, 2013, Ting had 36,000 subscribers and 56,000 mobile devices under its management. During the three months ended September 30, 2013, Ting added 11,000 subscribers and 16,000 devices. During the nine months ended September 30, 2013, Ting added 26,000 subscribers and 41,000 devices.

### ***Portfolio***

For the three months ended September 30, 2013, Portfolio revenue increased by \$2.8 million to \$4.2 million when compared to the three months ended September 30, 2012, primarily as a result of the revenues from payments from our withdrawal for the domain related rights for our .media and .marketing new gTLD applications being partially offset by lower sales of big ticket domains, seasonality and certain of our vendors electing not to repeat market development programs that they undertook during fiscal 2012.

For the nine months ended September 30, 2013, Portfolio revenue increased by \$1.5 million to \$6.4 million when compared to the nine months ended September 30, 2012, primarily as a result of the revenues from payments from our withdrawal for the domain related rights for our .media and .marketing new gTLD applications being partially offset by lower sales of big ticket domains and certain of our vendors electing not to repeat market development programs that they undertook during fiscal 2012.

We have two primary buyers for our domain names - domain investors and businesses. While businesses domain sales continue to grow, we have begun to see evidence of domain investors interest slowing as they attempt to assess the impact the introduction of new gTLD's may have on their businesses. Accordingly, until the impact of new gTLD's can be appropriately assessed, we will be shifting our efforts towards appealing more to businesses while continuing to work with domain investors.

The market for monetization of domain names is rapidly evolving and is being impacted by uncertainty around the implementation of ICANN's new gTLD Program.

## **COST OF REVENUES**

### ***Wholesale***

#### *OpenSRS Domain Service*

Cost of revenues for domain registrations represents the amortization of registry fees on a basis consistent with the recognition of revenues from our customers, namely ratably over the term of provision of the service. Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered, and are initially recorded as prepaid domain registry fees. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the period. Market development funds that do not meet the criteria for revenue recognition under ASC 605-50 "Customer Payments and Incentives", are reflected as cost of goods sold and are recognized as earned.

*Value-Added Services*

Costs of revenues for Value-Added Services include licensing and royalty costs related to the provisioning of certain components of hosted email, fees paid to third-party service providers, primarily for trust certificates and for printing services in connection with Platypus. Fees payable for trust certificates are amortized on a basis consistent with the provision of service, generally one year, while email hosting fees and monthly printing fees are included in cost of revenues in the month they are incurred.

*Retail*

Costs of revenues for our provision and management of Internet services through our retail site, Hover.com, include the amortization of registry fees on a basis consistent with the recognition of revenues from our customers, namely ratably over the term of provision of the service. Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered, and are recorded as prepaid domain registry fees.

The costs of revenue for Ting's mobile phone service include hardware (the cost of devices sold to our customers) and network services (our customers' voice, messaging and data usage) provided by our Mobile Network Operator.

*Portfolio*

Costs of revenues for Portfolio represent the amortization of registry fees for domains added to our Portfolio over the renewal period, which is generally one year, the value attributed under intangible assets to any domain name sold and any impairment charges that may arise from our assessment of our domain name intangible assets. As the total names in our portfolio continue to grow, this cost will become a more significant component of our cost of revenues. Payments for domain registrations are payable for the full term of service at the time of activation of service and are recorded as prepaid domain registry fees and are expensed ratably over the renewal term.

Costs of revenues for our larger ad-supported content sites (tucows.com and butterscotch.com) include the fees paid to third-party service providers, primarily for digital certificates sold through our content sites and content license fees.

*Network costs*

Network costs include personnel and related expenses, depreciation and amortization, communication costs, equipment maintenance, stock-based compensation and employee and related costs directly associated with the management and maintenance of our network. Communication costs include bandwidth, co-location and provisioning costs we incur to support the supply of all our services.

The following table presents our cost of revenues, by revenue source:

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Wholesale				
Domain Services	\$18,580,828	\$18,644,315	\$55,519,797	\$54,275,405
Value Added Services	484,619	532,296	1,567,113	1,576,228
Total Wholesale	19,065,447	19,176,611	57,086,910	55,851,633
Retail	4,543,084	2,064,448	11,176,620	4,350,722
Portfolio	660,430	205,025	1,090,836	631,065
Network, other costs	1,192,450	1,158,885	3,716,471	3,629,639
Network, depreciation and amortization costs	176,253	193,113	536,501	567,989
	\$25,637,664	\$22,798,082	\$73,607,338	\$65,031,048
Increase over prior period	\$2,839,582		\$8,576,290	
Increase - percentage	12	%	13	%

The following table presents our cost of revenues, as a percentage of total revenues:

	<b>Three months ended September 30, 2013</b>		<b>Nine months ended September 30, 2012</b>	
Wholesale				
Domain Services	52 %	63 %	57 %	64 %
Value Added Services	1 %	2 %	2 %	2 %
Total Wholesale	53 %	65 %	59 %	66 %
Retail	13 %	7 %	12 %	5 %
Portfolio	2 %	1 %	1 %	1 %
Network, other costs	3 %	4 %	4 %	4 %

Network, depreciation and amortization costs	0 %	1 %	1 %	1 %
	71 %	78 %	77 %	77 %

Total cost of revenues for the three months ended September 30, 2013 increased by \$2.8 million, or 12%, to \$25.6 million when compared to the three months ended September 30, 2012.



Total cost of revenues for the nine months ended September 30, 2013 increased by \$8.6 million, or 13%, to \$73.6 million when compared to the nine months ended September 30, 2012.

Prepaid domain registration and other Internet services fees as of September 30, 2013 decreased by \$1.4 million to \$57.8 million from \$59.2 million at September 30, 2012. Prepaid domain registration and other Internet services fees have been impacted by certain of our customers, who have acquired their own registrar accreditation, no longer registering new domain names on our platform.

### ***Wholesale***

Costs for Wholesale for the three months ended September 30, 2013 decreased by \$0.1 million, or 1%, to \$19.1 million, when compared to the three months ended September 30, 2012.

Costs for Wholesale for the nine months ended September 30, 2013 increased by \$1.2 million, or 2%, to \$57.1 million, when compared to the nine months ended September 30, 2012, primarily the result of increases in registration fees paid to the registries that were implemented on January 15, 2012 and the fact that certain marketing initiatives undertaken by both vendors and resellers in fiscal 2012 have either been significantly scaled back or cancelled for fiscal 2013.

### ***Retail***

Costs for Retail for the three months ended September 30, 2013 increased by \$2.5 million, to \$4.5 million, when compared to the three months ended September 30, 2012. This increase resulted primarily from additional costs of \$2.2 million incurred as a result of increased Ting mobile device and services sales made during the quarter, as well as the increased cost resulting from the additional volume in Hover services.

Costs for Retail for the nine months ended September 30, 2013 increased by \$6.8 million, to \$11.2 million, when compared to the nine months ended September 30, 2012. This increase resulted primarily from additional costs of \$6.2 million incurred as a result of increased Ting mobile device and services sales made during the nine month period, as well as the increased cost resulting from the additional volume in Hover services.

### ***Portfolio***

Costs for Portfolio increased by \$0.5 million for both the three and nine months ended September 30, 2013, to \$0.7 million and \$1.1 million respectively, primarily the result of costs associated with our New gTLD applications.

### *Network Costs*

Network costs before depreciation and amortization remained relatively flat at \$1.2 million and \$3.7 million for the three and nine months ended September 30, 2013 as compared to the three and nine months ended September 30, 2012.

Network depreciation and amortization costs for the three and nine months ended September 30, 2013 remained relatively flat at \$0.2 million and \$0.5 million, respectively.

These results reflect our improved efficiency we have achieved in operating and managing our co-location facilities, which has also enabled us to decrease our capital spend on network equipment.

## **SALES AND MARKETING**

Sales and marketing expenses consist primarily of personnel costs. These costs include commissions and related expenses of our sales, product management, public relations, call center, support and marketing personnel. Other sales and marketing expenses include customer acquisition costs, advertising and other promotional costs.

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Sales and marketing	\$2,998,419	\$2,037,338	\$8,792,091	\$6,287,702
Increase over prior period	\$961,081		\$2,504,389	
Increase - percentage	47	%	40	%
Percentage of net revenues	8	%	7	%

Sales and marketing expenses for the three months ended September 30, 2013 increased by \$1.0 million, or 47%, to \$3.0 million, when compared to the three months ended September 30, 2012. This increase primarily related to

workforce and marketing expenses incurred in connection with our Ting mobile service offering in the amount of \$1.2 million. This was partially offset by a net decrease in non-Ting workforce related costs in the amount of \$0.2 million.

Sales and marketing expenses for the nine months ended September 30, 2013 increased by \$2.5 million, or 40%, to \$8.8 million, when compared to the nine months ended September 30, 2012. This increase primarily related to workforce and marketing expenses incurred in connection with our Ting mobile service offering in the amount of \$3.2 million. This was partially offset by a net decrease in non-Ting workforce related costs in the amount of \$0.9 million, offset by additional non-Ting marketing expenses in the amount of \$0.2 million.

## TECHNICAL OPERATIONS AND DEVELOPMENT

Technical operations and development expenses consist primarily of personnel costs and related expenses required to support the development of new or enhanced service offerings and the maintenance and upgrading of existing infrastructure. This includes expenses incurred in the research, design and development of technology that we use to register domain names, email, retail, domain portfolio and other Internet services, as well as to distribute our digital content services. Editorial costs relating to the rating and review of the software content libraries are included in the costs of product development. All technical operations and development costs are expensed as incurred.

	Three months ended		Nine months ended			
	September 30,		September 30,			
	2013	2012	2013	2012		
Technical operations and development	\$1,215,327	\$1,010,949	\$3,097,294	\$3,229,669		
Increase over prior period	\$204,378		\$(132,375 )			
Increase - percentage	20	%	(4	)%		
Percentage of net revenues	3	%	3	%	4	%

Technical operations and development expenses for the three months ended September 30, 2013 increased by \$0.2 million, or 20%, to \$1.2 million, when compared to the three months ended September 30, 2012. This increase primarily related to additional workforce costs of \$0.2 million, the result of a non-recurring cost of approximately \$0.1 million related to severance costs and an incremental accrual for incentive bonuses as we now believe that the annual incentive bonus target for the year ending December 31, 2013 will be achieved.

Technical operations and development expenses for the nine months ended September 30, 2013 decreased by \$0.1 million, or 4%, to \$3.1 million, when compared to the nine months ended September 30, 2012. This decrease resulted from payment received for a 2010 Ontario Interactive Digital Media Tax Credit (“OIDMTC”) of \$0.5 million, primarily related to eligible personnel costs, during the nine months ended September 30, 2013. This decrease was partially offset by the non-recurring cost of approximately \$0.1 million related to severance costs.

**GENERAL AND ADMINISTRATIVE**

	<b>Three months ended</b>		<b>Nine months ended</b>			
	<b>September 30,</b>		<b>September 30,</b>			
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>		
General and administrative	\$1,869,668	\$1,486,323	\$5,266,997	\$5,018,178		
Increase over prior period	\$383,345		\$248,819			
Increase - percentage	26	%	5	%		
Percentage of net revenues	5	%	5	%	6	%

General and administrative expenses for the three months ended September 30, 2013 increased by \$0.4 million, or 26%, to \$1.9 million, when compared to the three months ended September 30, 2012. This increase primarily related to additional workforce costs of \$0.4 million as we now believe that the annual incentive bonus target for the year ending December 31, 2013 will be achieved.

General and administrative expenses for the nine months ended September 30, 2013 increased by \$0.2 million, or 5%, to \$5.3 million as compared to the nine months ended September 30, 2012. This increase primarily related to additional costs incurred in processing a higher volume of credit cards in the amount of \$0.3 million and additional workforce costs of \$0.2 million. These increases were partially offset by a gain in foreign exchange of \$0.2 million for the nine months ended September 30, 2013.

**DEPRECIATION OF PROPERTY AND EQUIPMENT**

Property and equipment is depreciated on a straight-line basis over the estimated useful life of the assets.

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>			
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>		
Depreciation of property and equipment	\$52,972	\$46,981	\$158,833	\$139,918		
Increase over prior period	\$5,991		\$18,915			
Increase - percentage	13	%	14	%		
Percentage of net revenues	0	%	0	%	0	%

Depreciation costs remained relatively flat at \$0.05 million and \$0.2 million for the three and nine months ended September 30, 2013 as compared to the three and nine months ended September 30, 2012.

**AMORTIZATION OF INTANGIBLE ASSETS**

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>			
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>		
Amortization of intangible assets	\$219,030	\$219,030	\$657,090	\$657,090		
Decrease over prior period	\$-		\$-			
Decrease - percentage	-	%	-	%		
Percentage of net revenues	1	%	1	%	1	%

Amortization of intangible assets consists of amounts arising in connection with the acquisition of IYD in July 2007 and the acquisition of EPAG in July 2011.

Brand and customer relationships acquired in connection with the acquisitions of IYD and EPAG are amortized on a straight-line basis over seven years.

Technology acquired in connection with the acquisition of EPAG is amortized on a straight-line basis over two years.

## LOSS (GAIN) ON CURRENCY FORWARD CONTRACTS

Although our functional currency is the U.S. dollar, a major portion of our fixed expenses are incurred in Canadian dollars. Our goal with regard to foreign currency exposure is, to the extent possible; to achieve operational cost certainty, manage financial exposure to certain foreign exchange fluctuations and to neutralize some of the impact of foreign currency exchange movements. Accordingly, we enter into foreign exchange contracts to mitigate the exchange rate risk on portions of our Canadian dollar exposure.

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Loss (gain) on currency forward contracts	\$ (28,068 )	\$ (615,245 )	\$ 353,209	\$ (793,516 )
(Decrease) increase over prior period	\$ 587,177		\$ 1,146,725	
(Decrease) /increase - percentage	(95 )%		(145 )%	
Percentage of net revenues	(0 )%	(2 )%	0 %	(1 )%

We have entered into certain forward exchange contracts that do not comply with the requirements of hedge accounting to meet a portion of our future Canadian dollar requirements through December 2014. The impact of the fair value adjustment on outstanding contracts for the three months ended September 30, 2013 was a net gain of \$0.2 million, compared to a net gain of \$0.7 million for the three months ended September 30, 2012. The impact of the fair value adjustment on outstanding contracts was partially offset by a realized loss upon settlement of currency forward contracts of \$0.2 million for the three months ended September 30, 2013 and a realized loss of \$0.1 million for the three months ended September 30, 2012.

The impact of the fair value adjustment on outstanding contracts for the nine months ended September 30, 2013 was a net loss of \$0.4 million compared to a net gain of \$1.2 million for the nine months ended September 30, 2012. The impact of the fair value adjustment on outstanding contracts was partially offset by a realized gain upon settlement of currency forward contracts of \$8,000 for the nine months ended September 30, 2013 and a realized loss of \$0.4 million for the nine months ended September 30, 2012.

At September 30, 2013, our balance sheet reflects a net derivative instrument asset of \$0.2 million as a result of our existing foreign exchange contracts. At September 30, 2013 the value of our outstanding foreign exchange contracts amounted to \$32.8 million. Until their respective maturity dates, these contracts will fluctuate in value in line with movements in the Canadian dollar relative to the U.S. dollar.





**OTHER INCOME AND EXPENSES**

	<b>Three months ended</b>		<b>Nine months ended</b>			
	<b>September 30,</b>		<b>September 30,</b>			
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>		
Other income (expenses), net	\$(78,966)	\$(50,228)	\$(271,756)	\$384,001		
Increase over prior period	\$(28,738)		\$(655,757)			
Increase - percentage	57	%	(171)	)%		
Percentage of net revenues	(0	)%	(0	)%	0	%

Other expenses for the three months ended September 30, 2013 remained relatively unchanged when compared to the three months ended September 30, 2012 and primarily consist of interest we incur in connection with our credit facility with the Bank of Montreal (as discussed below).

Other expenses for the nine months ended September 30, 2013 were \$0.3 million when compared to other income of \$0.4 million for the nine months ended September 30, 2012. This change primarily resulted from our selling certain intangible assets with no book value for \$0.5 million during the three months ended March 31, 2012. This income was partially offset by the interest we incur in connection with our credit facility with the Bank of Montreal (as discussed below).

**INCOME TAXES**

The following table presents our provision for income taxes for the periods presented:

	<b>Three months ended</b>		<b>Nine months ended</b>					
	<b>September 30,</b>		<b>September 30,</b>					
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>				
Provision for income taxes	\$999,747	\$577,383	\$1,333,287	\$1,755,284				
Increase (decrease) in provision over prior period	\$422,364		\$(421,997 )					
Increase (decrease) - percentage	73	%	(24	)%				
Percentage of income before income tax	28	%	26	%	29	%	31	%

For the nine months ended September 30, 2013, we recorded a provision for income taxes of \$1.3 million on income before income taxes of \$4.5 million, using an estimated effective tax rate for our 2013 fiscal year adjusted for certain minimum state taxes. Comparatively, for the nine months ended September 30, 2012, we recorded a provision for

income taxes of \$1.8 million on income before taxes of \$5.7 million, using an estimated effective tax rate for our 2012 fiscal year.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the years in which those temporary differences become deductible. We consider projected future taxable income, uncertainties related to the industry in which we operate, and tax planning strategies in making this assessment.

We follow the provisions of FASB ASC Topic 740, Income Taxes to account for income tax exposures. The application of this interpretation requires a two-step process that separates recognition of uncertain tax benefits from measurement thereof.

We had approximately \$0.1 million of total gross unrecognized tax benefit as of September 30, 2013 and \$0.4 million of total gross unrecognized tax benefit as of December 31, 2012, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes. The decrease of \$0.3 million from December 31, 2012 relates to the finalization of prior year German income tax returns and completing our 2012 scientific and research and development claim. We recognize accrued interest and penalties related to income taxes in income tax expense. We did not have significant interest and penalties accrued at September 30, 2013 and December 31, 2012, respectively. We believe that it is reasonably possible that all of the unrecognized tax benefits will decrease in the next twelve months as it is anticipated that the tax authorities will finalize their review of prior taxes owing in Pennsylvania.

## **OTHER COMPREHENSIVE INCOME**

To mitigate the impact of the change in fair value of our foreign exchange contracts on our financial results, in October 2012 we began applying hedge accounting for the majority of the contracts we need to meet our Canadian dollar requirements on a prospective basis. The impact of the fair value adjustment on outstanding hedged contracts for the three months ended September 30, 2013 was a net gain in other comprehensive income of \$0.5 million. The impact of the fair value adjustment on outstanding hedged contracts was a net loss in other comprehensive income of \$48,000 for the nine months ended September 30, 2013.

The following table presents other comprehensive income for the periods presented:

	<b>Three months ended September 30, 2013</b>		<b>September 30, 2012</b>		<b>Nine months ended September 30, 2013</b>		<b>September 30, 2012</b>	
	Other comprehensive income	\$494,334	\$ -	\$47,608	\$ -	\$47,608	\$ -	
Increase in provision over prior period	\$494,334		\$47,608					
Increase - percentage	N/A	%	N/A	%				
Percentage of net revenues	1	%	-	%	0	%	-	%

## **LIQUIDITY AND CAPITAL RESOURCES**

As of September 30, 2013, our cash and cash equivalents balance increased by \$5.1 million to \$11.5 when compared to December 31, 2012. Our principal sources of liquidity during the nine months ended September 30, 2013 was net cash provided by operating activities of \$7.1 million, the proceeds of \$5.2 million we received from drawing down on our credit facility with the Bank of Montreal (the “Bank”) to fund the Dutch Tender Offer which closed in January 2013 and the proceeds of \$2.5 million we received on the exercise of stock options.

We have credit agreements (collectively the “Amended Credit Facility”) with the Bank that were amended on November 19, 2012, and which provide us with access to two revolving demand loan facilities (the “2012 Demand Loan Facilities”) that provide for a \$14 million, five year revolving credit facility, a \$3.5 million treasury risk management facility and a \$1.0 million operating demand loan. The Amended Credit Facility contains customary events of default and affirmative and negative covenants and restrictions, including certain financial maintenance covenants such as a maximum total funded debt to EBITDA ratio and a minimum fixed charge ratio. As of September 30, 2013, we were in compliance with all our covenants.

As of September 30, 2013, the outstanding principal balance outstanding under our Amended Credit Facility was \$6.9 million with \$8.1 million still available for borrowing under the facility. In addition, under our treasury risk management facility we can place approximately \$39.0 million in foreign exchange forward contracts and/or currency options to trade U.S. dollars in exchange for Canadian dollars. As of September 30, 2013, we held contracts in the amount of \$32.8 million to trade U.S. dollars in exchange for Canadian dollars.

### ***Cash Flow from Operating Activities***

Net cash inflows from operating activities during the nine months ended September 30, 2013 was \$7.1 million, an increase of 63% or \$2.7 million when compared to the nine months ended September 30, 2012. Net income for the nine months ended September 30, 2013 was \$3.3 million, which included non-cash charges and recoveries of \$1.0 million such as a recovery for deferred tax and the provision for unrealized losses on currency forward contracts, depreciation, amortization and stock-based compensation. In addition, changes in our working capital generated \$2.8 million. Positive contributions of \$4.5 million from movements in deferred revenue, income taxes, prepaid expenses and deposits, accounts payable and accrued liabilities and inventory were partially offset by our utilizing \$1.7 million to fund a reduction in customer deposits, accounts receivable, and deferred registration costs. These changes in our working capital were primarily driven by the timing of payments in the normal business cycle.

### ***Cash Flow from Financing Activities***

Net cash used in financing activities during the nine months ended September 30, 2013 totaled \$0.8 million. Net cash of \$6.5 million was used to fund the repurchase of 4.1 million of our shares through a modified “Dutch auction tender offer” that was successfully concluded on January 4, 2013 and to repurchase 0.1 million shares under our current Normal Course Issuer Bid during the three months ended March 31, 2013. In addition, \$2.0 million was used to fund principal repayments under our Amended Credit Facility. These uses of funds in financing activities were partially offset by our drawing \$5.2 million under our Amended Credit Facility in January 2013 to fund a portion of the modified Dutch auction tender offer and by the proceeds of \$2.5 million we received on the exercise of options by directors and employees of the Company.

### *Cash Flow from Investing Activities*

Investing activities during the nine months ended September 30, 2013 used net cash of \$1.1 million to acquire additional property and equipment.

Based on our operations, we believe that our cash flow from operations will be adequate to meet our anticipated requirements for working capital, capital expenditures and our loan repayments for at least the next 12 months.

We may choose to raise additional funds or seek other financing arrangements to facilitate more rapid expansion, develop new or enhance existing products or services, respond to competitive pressures or acquire or invest in complementary businesses, technologies, services or products.

If additional financing is required, we may not be able to raise it on acceptable terms, or at all, and additional financing may be dilutive to existing investors. We may also evaluate potential acquisitions of other businesses, products and technologies. To complete potential acquisitions, we may issue additional securities or need additional equity or debt financing and any additional financing may be dilutive to existing investors. There are currently no material understandings, commitments or agreements regarding the acquisition of other businesses.

**Subsequent events**

None.

33

---

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

We develop products in Canada and sell these services in North America and Europe. Our sales are primarily made in U.S. dollars, while a major portion of expenses are incurred in Canadian dollars. Our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our interest income is sensitive to changes in the general level of Canadian and U.S. interest rates, particularly since the majority of our investments are in short-term instruments. Based on the nature of our short-term investments, we have concluded that there is no material interest rate risk exposure as of September 30, 2013. We are also subject to market risk exposure related to changes in interest rates under our Amended Credit Facility. We do not expect that any changes in interest rates will be material; however, fluctuations in interest rates are beyond our control. We will continue to monitor and assess the risks associated with interest expense exposure and may take additional actions in the future to mitigate these risks.

Although our functional currency is the U.S. dollar, a substantial portion of our fixed expenses are incurred in Canadian dollars. Our policy with respect to foreign currency exposure is to manage financial exposure to certain foreign exchange fluctuations with the objective of neutralizing some of the impact of foreign currency exchange movements. Exchange rates are, however, subject to significant and rapid fluctuations, and therefore we cannot predict the prospective impact of exchange rate fluctuations on our business, results of operations and financial condition. Accordingly, we have entered into foreign exchange contracts to mitigate the exchange rate risk on portions of our Canadian dollar exposure.

At September 30, 2013, the Company had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

Maturity date	Notional amount of U.S. dollars	Weighted average exchange rate of U.S. dollars	Fair value
October – December, 2013	6,260,000	1.0134	(109,935)
January – March, 2014	6,410,000	1.0149	(117,599)
April – June, 2014	6,610,000	1.0471	68,742
April – September, 2014	6,710,000	1.0634	175,539
October – December, 2014	6,810,000	1.0648	138,796
Total	\$32,800,000	1.0414	\$155,543

As of September 30, 2013 the Company has \$32.8 million of outstanding foreign exchange forward contracts which will convert to CDN \$34.2 million. Of these contracts, \$25.5 million met the requirements for hedge accounting (as at September 30, 2012 – nil).

During July 2013, the Company entered into foreign exchange forward contracts which have a notional value of \$20.4 million, whereby \$20.4 million is converted into Canadian dollars during 2013 and 2014 at an average foreign exchange rate of US\$1.00: Cdn\$1.0630. Of these contracts, \$16.4 million of the total notional value hedge a portion of its expected Canadian dollar requirements for the 2013 and 2014 fiscal years.

We have performed a sensitivity analysis model for foreign exchange exposure over the three months ended September 30, 2013. The analysis used a modeling technique that compares the U.S. dollar equivalent of all expenses incurred in Canadian dollars, at the actual exchange rate, to a hypothetical 10% adverse movement in the foreign currency exchange rates against the U.S. dollar, with all other variables held constant. Foreign currency exchange rates used were based on the market rates in effect during the three months ended September 30, 2013. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a decrease in net income for the three months ended September 30, 2013 of approximately \$0.5 million. There can be no assurances that the above projected exchange rate decrease will materialize. Fluctuations of exchange rates are beyond our control. We will continue to monitor and assess the risk associated with these exposures and may take additional actions in the future to hedge or mitigate these risks.

## **Credit Risk**

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents, marketable securities, foreign exchange contracts and accounts receivable. Our cash, cash equivalents and short-term investments are in high-quality securities placed with major banks and financial institutions whom we have evaluated as highly creditworthy and commercial paper. With respect to accounts receivable, we perform ongoing evaluations of our customers, generally granting uncollateralized credit terms to our customers, and maintaining an allowance for doubtful accounts based on historical experience and our expectation of future losses.



#### **Item 4. Controls and Procedures**

##### **(a) Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. We believe that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

##### **(b) Change in Internal Control over Financial Reporting**

No change in our internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II.**

**OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are involved in various investigations, claims and lawsuits arising in the normal conduct of our business, none of which, individually or in the aggregate, in our opinion, will materially harm our business. We cannot assure that we will prevail in any litigation. Regardless of the outcome, any litigation may require us to incur significant litigation expense and may result in significant diversion of our attention.

**Item 1A. Risk Factors**

In addition to the other information set forth in this Quarterly Report, you should also carefully consider the risk factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2012, all of which could materially affect our business, financial condition or operating results and should be considered before making an investment decision regarding our securities. The risks described in our Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition or operating results.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 6. Exhibits**

(a) Exhibits.

**Exhibit No. Description**

3.1	Fourth Amended and Restated Articles of Incorporation of Tucows Inc. (Incorporated by reference to Exhibit 3.1 filed with Tucows' Current Report on Form 8-K, as filed with the SEC on November 29, 2007).
3.2	Second Amended and Restated Bylaws of Tucows Inc. (Incorporated by reference to Exhibit 3.2 filed with Tucows' Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the SEC on March 29, 2007).
3.3	Amendment No. 1 to Second Amended and Restated Bylaws of Tucows Inc. (Incorporated by reference to Exhibit 3.3 filed with Tucows' Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012, as filed with the SEC on August 14, 2012).
31.1	Chief Executive Officer's Rule 13a-14(a)/15d-14(a) Certification *
31.2	Chief Financial Officer's Rule 13a-14(a)/15d-14(a) Certification *
32.1	Chief Executive Officer's Section 1350 Certification †
32.2	Chief Financial Officer's Section 1350 Certification †
101.INS**	XBRL Instance
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation
101.DEF**	XBRL Taxonomy Extension Definition
101.LAB**	XBRL Taxonomy Extension Labels
101.PRE**	XBRL Taxonomy Extension Presentation

*Information is 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, as amended, is deemed not filed for purposes of section 18*

*\*\* of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these XBRL sections.*

\* Filed herewith.

† Furnished herewith.

## 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.

Date: November 13, 2013 TUCOWS INC.

By: /s/ Elliot Noss  
Elliot Noss  
President and Chief Executive Officer

By: /s/ Michael Cooperman  
Michael Cooperman Chief Financial Officer  
(Principal Financial and Accounting Officer)

**EXHIBIT INDEX**

**Exhibit No. Description**

- 3.1 Fourth Amended and Restated Articles of Incorporation of Tucows Inc. (Incorporated by reference to Exhibit 3.1 filed with Tucows' Current Report on Form 8-K, as filed with the SEC on November 29, 2007).
- 3.2 Second Amended and Restated Bylaws of Tucows Inc. (Incorporated by reference to Exhibit 3.2 filed with Tucows' Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the SEC on March 29, 2007).
- 3.3 Amendment No. 1 to Second Amended and Restated Bylaws of Tucows Inc. (Incorporated by reference to Exhibit 3.3 filed with Tucows' Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2012, as filed with the SEC on August 14, 2012).
- 31.1 Chief Executive Officer's Rule 13a-14(a)/15d-14(a) Certification \*
- 31.2 Chief Financial Officer's Rule 13a-14(a)/15d-14(a) Certification \*
- 32.1 Chief Executive Officer's Section 1350 Certification †
- 32.2 Chief Financial Officer's Section 1350 Certification †
- 101.INS\*\* XBRL Instance
- 101.SCH\*\* XBRL Taxonomy Extension Schema
- 101.CAL\*\* XBRL Taxonomy Extension Calculation
- 101.DEF\*\* XBRL Taxonomy Extension Definition
- 101.LAB\*\* XBRL Taxonomy Extension Labels
- 101.PRE\*\* XBRL Taxonomy Extension Presentation

*Information is 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, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.*

\*\* XBRL

\* Filed herewith.

† Furnished herewith.

