TUCOWS INC /PA/
Form 10-Q
November 13, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

o 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)

Pennsylvania (State or Other Jurisdiction of Incorporation or Organization)	**23-2707366** (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 x No o

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 o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

As of November 13, 2008, there were 73,923,542 outstanding shares of common stock, no par value, of the registrant.

Table of Contents

TUCOWS INC.

Form 10-Q Quarterly Report

INDEX

PART I
FINANCIAL INFORMATION

PART II

OTHER INFORMATION

Table of Contents

PART I.

FINANCIAL INFORMATION

Item 1. Financial Statements

Tucows Inc.

Consolidated Balance Sheets

(Dollar amounts in U.S. dollars)

	September 30, 2008 (unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 2,721,033	$ 8,093,476
Accounts receivable, net of allowance for doubtful accounts of $85,000 as of September 30, 2008 and $95,000 as of December 31, 2007	3,656,567	3,422,180
Prepaid expenses and deposits	2,595,737	3,132,129
Prepaid domain name registry and ancillary services fees, current portion	29,008,651	25,473,465
Cash held in escrow (note 3(c))	1,088,793	1,070,632
Deferred tax asset, current portion	500,000	500,000
Total current assets	39,570,781	41,691,882
Prepaid domain name registry and ancillary services fees, long-term portion	11,713,428	10,765,862
Property and equipment	3,551,311	4,963,311
Deferred financing charges	89,800	128,200
Deferred tax asset, long-term portion	2,500,000	2,500,000
Intangible assets (note 4)	20,597,060	22,150,738
Goodwill	17,490,807	17,490,807
Investment	353,737	353,737
Total assets	$ 95,866,924	$ 100,044,537
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,302,239	$ 2,689,346
Accrued liabilities	2,975,686	3,289,087
Customer deposits	3,119,092	3,267,784
Promissory note payable		6,000,000
Loan payable, current portion (note 5)	1,914,242	1,914,242
Deferred revenue, current portion	38,159,670	35,465,584
Accreditation fees payable, current portion	513,989	483,090
Total current liabilities	48,984,918	53,109,133
Deferred revenue, long-term portion	16,221,513	15,147,644

Accreditation fees payable, long-term portion		190,811		181,345
Loan payable, long-term portion (note 5)		4,423,685		6,859,366
Deferred tax liability		5,396,000		5,396,000
Stockholders equity (note 10)				
Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding				
Common stock - no par value, 250,000,000 shares authorized; 73,923,542 shares issued and outstanding as of September 30, 2008 and 73,888,542 shares issued and outstanding as of December 31, 2007		15,368,310		15,350,915
Additional paid-in capital		48,762,868		48,537,313
Deficit		(43,481,181)		(44,537,179)
Total stockholders equity		20,649,997		19,351,049
Total liabilities and stockholders equity	$	95,866,924	$	100,044,537

See accompanying notes to unaudited consolidated financial statements

Subsequent events (note 13).

Table of Contents

Tucows Inc.

Consolidated Statements of Operations

(Dollar amounts in U.S. dollars)

(unaudited)

	Three months ended September 30, 2008	Three months ended September 30, 2007	Nine months ended September 30, 2008	Nine months ended September 30, 2007
Net revenues	$ 20,147,195	$ 17,811,914	$ 59,308,731	$ 56,398,012
Cost of revenues:				
Cost of revenues (*)	13,981,247	12,271,047	40,794,276	35,702,644
Depreciation of property and equipment	795,445	995,954	2,437,542	2,791,050
Amortization of intangible assets	29,199	83,060	134,597	210,132
Total cost of revenues	14,805,891	13,350,061	43,366,415	38,703,826
Gross profit	5,341,304	4,461,853	15,942,316	17,694,186
Expenses:				
Sales and marketing (*)	1,705,512	1,712,676	5,132,380	4,537,198
Technical operations and development (*)	1,527,237	1,723,857	4,666,832	5,288,829
General and administrative (*)	2,240,134	1,257,206	5,361,217	3,566,847
Depreciation of property and equipment	57,386	68,316	177,317	198,107
Loss on disposition of property and equipment	498,529		498,529	
Amortization of intangible assets	360,540	322,781	1,122,655	778,823
Total expenses	6,389,338	5,084,836	16,958,930	14,369,804
Income (loss) from operations	(1,048,034)	(622,983)	(1,016,614)	3,324,382
Other income (expenses):				
Interest income (expense), net	(90,859)	(203,376)	(467,264)	(294,322)
Other income, net	1,098,245	530,583	2,631,010	619,014
Total other income (expenses)	1,007,386	327,207	2,163,746	324,692
Income (loss) before provision for income taxes	(40,648)	(295,776)	1,147,132	3,649,074
Provision for income taxes	30,000	14,816	91,134	38,816
Net income (loss) for the period	$ (70,648)	$ (310,592)	$ 1,055,998	$ 3,610,258
Basic earnings (loss) per common share	$ (0.00)	$ (0.00)	$ 0.01	$ 0.05
Shares used in computing basic earnings (loss) per common share	73,923,542	74,100,911	73,903,998	74,548,903
Diluted earnings (loss) per common share	$ (0.00)	$ (0.00)	$ 0.01	$ 0.05
Shares used in computing diluted earnings (loss) per common share	74,817,244	77,525,973	75,245,047	77,413,998

(*) Stock-based compensation has been included in operating expenses as follows:

Cost of revenues	$ 5,500	$ 4,100	$ 14,600	$ 11,000
Sales and marketing	$ 17,200	$ 21,400	$ 48,500	$ 61,100
Technical operations and development	$ 13,100	$ 18,900	$ 41,800	$ 62,300
General and administrative	$ 52,500	$ 33,900	$ 128,600	$ 118,100

See accompanying notes to unaudited consolidated financial statements

Table of Contents

Tucows Inc.

Consolidated Statements of Cash Flows

(Dollar amounts in U.S. dollars)

(unaudited)

	Three months ended September 30, 2008	Three months ended September 30, 2007	Nine months ended September 30, 2008	Nine months ended September 30, 2007
Cash provided by (used in):				
Operating activities:				
Net income for the period	$ (70,648)	$ (310,592)	$ 1,055,998	$ 3,610,258
Items not involving cash:				
Depreciation of property and equipment	852,831	1,064,270	2,614,859	2,989,157
Loss on disposition of property and equipment	498,529		498,529	
Amortization of deferred financing charges	12,200		38,400	
Amortization of intangible assets	389,739	405,841	1,257,252	988,955
Gain on sale of customer relationships	(921,384)		(2,042,449)	
Disposal of domain names	4,705		4,705	
Unrealized change in the fair value of forward contracts	525,571	(61,673)	555,364	(1,164,114)
Stock-based compensation	88,300	78,300	233,500	252,500
Change in non-cash operating working capital:				
Accounts receivable	(518,310)	87,922	(234,387)	(975,729)
Prepaid expenses and deposits	641,629	875,841	536,392	(161,669)
Deferred financing charges		(795,949)		(3,548,500)
Prepaid domain name registry and ancillary services fees	(775,955)	(142,600)	(4,482,752)	(142,600)
Accounts payable	(480,839)	(161,037)	(231,770)	(906,624)
Accrued liabilities	(177,701)	218,368	(868,765)	651,189
Customer deposits	(167,691)	204,906	(148,692)	(165,560)
Deferred revenue	(9,699)	834,795	3,767,955	4,711,315
Accreditation fees payable	6,245	(34,255)	40,365	(350,283)
Net cash provided by (used in)operating activities	(102,478)	2,264,137	2,594,504	5,788,295
Financing activities:				
Proceeds received on exercise of stock options		17,912	9,450	204,255
Repurchase of shares				(2,446,955)
Proceeds received on loan payable		9,571,209		9,571,209
Repayment of promissory note and loan payable	(478,561)	(319,040)	(8,435,681)	(319,070)
Net cash provided by (used in) financing activities	(478,561)	9,270,081	(8,426,231)	7,009,439
Investing activities:				
Cost of domain names acquired			(8,944)	(18,425)
Additions to property and equipment	(627,024)	(200,213)	(1,922,764)	(3,093,366)
Proceeds on disposition of property and equipment	66,039		66,039	
Decrease in restricted cash - being margin security against forward exchange contracts		255,000		764,421
Acquisition of Hosted Messaging Assets, net of cash acquired				(90,050)
Acquisition of Boardtown Corporation, net of cash acquired				(4,900)

Acquisition of Innerwise Inc., net of cash acquired				(10,332,065)				(10,332,065)
Sale of customer relationships		921,384				2,343,114		
Decrease (increase) in cash held in escrow		(5,396)		(1,058,620)		(18,161)		(364,041)
Net cash provided by (used in) investing activities		355,003		(11,335,898)		459,284		(13,138,426)
Increase (decrease) in cash and cash equivalents		(226,036)		198,320		(5,372,443)		(340,692)
Cash and cash equivalents, beginning of period		2,947,069		5,717,412		8,093,476		6,256,392
Cash and cash equivalents, end of period	$	2,721,033	$	5,915,732	$	2,721,033	$	5,915,700
Supplemental cash flow information:								
Interest paid	$	100,061	$	274,368	$	552,298	$	484,368
Supplementary disclosure of non-cash investing and financing activities:								
Capital assets acquired during the period not yet paid for	$	117,733	$	293,205	$	117,733	$	293,205

See accompanying notes to unaudited consolidated financial statements

Table of Contents

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. BUSINESS AND BASIS OF PRESENTATION:

Tucows Inc., a Pennsylvania corporation (referred to throughout this report as the Company , Tucows , we , us or through similar expressions), together with our consolidated subsidiaries, provides domain names, email and other services through our extensive reseller network and directly to consumers and small businesses through our retail and content groups.

Our worldwide reseller network has grown to include more than 9,000 web-hosting companies, Internet Service Providers, or ISPs, and other resellers in more than 100 countries. 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 to our services, so that resellers can quickly and easily integrate our services into their individual business processes, and offering brand-able end-user interfaces that emphasize simplicity and visual appeal. In the event resellers experience issues or problems with our services, we also provide second tier support to our resellers by email and phone. In addition, our Network Operating Center provides proactive support to our resellers by monitoring all services and network infrastructure to eliminate issues before they pose a problem for our resellers.

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

Our Company is organized into four service and product related groups, which are discussed below in more detail.

Our *Reseller Services* group manages over eight million domain names, millions of mailboxes and tens of thousands of Secure Socket Layer, or SSL, certificates through a network of over 9,000 web hosts, ISPs, and other resellers around the world.

Our *Retail Services* group offers these services to consumers and small businesses through our three consumer brands: Domain Direct (domaindirect.com), NetIdentity (netidentity.com), and IYD (ItsYourDomain.com).

Our *Domain Portfolio* group oversees our domain name portfolio, most of which generate advertising revenue and many of which we offer for resale via our reseller network and other channels. Included in our Domain Portfolio are domains that are the basis of our Personal Names Service that allows over two-thirds of Americans to purchase a domain or email address based on their name.

Additionally, our *Content* group generates advertising revenue through tucows.com, one of the oldest and most popular software download sites on the Internet.

We were among the first group of 34 registrars to be accredited by the Internet Corporation for Assigned Names and Numbers (ICANN) in 1999. ICANN maintains a list of accredited registrars at www.icann.org /registrars/accredited-list.html.

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 offices are located in Toronto, Ontario and we have offices in the United Kingdom and the United States.

2. NEW ACCOUNTING POLICIES:

The accompanying unaudited interim consolidated balance sheet, and the related consolidated statements of operations 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, 2008 and the results of operations and cash flows for the interim periods ended September 30, 2008 and 2007. 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 interim consolidated financial statements have been prepared by Tucows without audit, 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 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 financial statements and notes thereto for the year ended December 31, 2007 included in Tucows 2007 Annual Report on Form 10-K filed with the SEC on March 28, 2008.

There have been no material changes in our significant accounting policies during the nine months ended September 30, 2008 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Recent Accounting Pronouncements Adopted

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 157, Fair Value Measurements (SFAS 157), which addresses how companies should measure fair value when they are required to use a fair value measurement for recognition or disclosure purposes under generally accepted accounting principles. The Company adopted the provisions of SFAS 157 on January 1, 2008. In February 2008, FASB issued a staff position, FAS 157-2, which defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in an entity s financial statements on a recurring basis. The adoption of SFAS 157 did not have a significant impact on the Company s consolidated financial statements (see note 12)

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115 (SFAS 159), which permits companies to measure many financial instruments and certain other items at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions. The Company adopted SFAS 159 effective January 1, 2008. The Company did not elect the fair value option for any items upon adoption of SFAS 159 and, therefore, the adoption of the statement did not have a significant impact on the Company s consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

In December 2007, the FASB issued Statement No. 141 (revised 2007), Business Combinations (SFAS 141(R)), which applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses. SFAS 141(R) establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the assets, liabilities, non-controlling interest and goodwill related to a business combination. SFAS 141(R) also establishes what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009 and will impact the Company with respect to future business combinations entered into on or after January 1, 2009.

In December 2007, the FASB issued Statement No. 160, Non-controlling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160), which establishes accounting and reporting standards for entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. A non-controlling interest is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent. SFAS 160 is effective for the Company s fiscal year beginning January 1, 2009 and will impact the Company with respect to certain future business combinations entered into on or after January 1, 2009.

SFAS 161 - Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133, changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. The requirements of this Statement are effective for financial statements issued for fiscal years and interim periods beginning January 1, 2009, and will impact the Company with respect to disclosures about its use of derivative instruments.

In May 2008, the FASB issued Statement No. 162 (SFAS 162), The Hierarchy of Generally Accepted Accounting Principles. SFAS 162 identifies the sources of generally accepted accounting principles and provides a framework, or hierarchy, for selecting the principles to be used in preparing U.S. GAAP financial statements for non-governmental entities. SFAS 162 makes the GAAP hierarchy explicitly and directly applicable to preparers of financial statements, a step that recognizes preparers responsibilities for selecting the accounting principles for their financial statements. SFAS 162 is effective 60 days following the Securities and Exchange Commission s approval of the Public Company Accounting Oversight Board (United States) related amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not expect the adoption of SFAS 162 to have an impact on its consolidated financial position, financial performance or cash flows.

Table of Contents

3. ACQUISITIONS

a. Acquisition of the Hosted Messaging assets from Critical Path Inc. :

To expand our presence in the email market, on January 3, 2006, Tucows.com Co., one of the Company s wholly owned subsidiaries, completed the purchase of all of the Hosted Messaging assets from Critical Path, Inc. (Critical Path).

In January 2007, an amount of $90,050 was released from escrow and paid to Critical Path. This amount was reflected as additional goodwill. Critical Path s portion of the $50,019 interest earned on the escrow account through the release date amounted to $36,433 and was paid to them in January 2007.

b. Acquisition of Boardtown Corporation:

On April 27, 2004, the Company finalized the acquisition of 100% of the outstanding capital stock of Boardtown Corporation (Boardtown).

In March 2007, the former shareholders of Boardtown agreed to an early release of the remaining $554,510 contingent consideration, inclusive of accrued interest, from the Boardtown escrow account to Tucows and the escrow account has been closed. During the three months ended June 30, 2007, goodwill was increased by an amount of $4,900, as certain customers renewed their support contracts in accordance with the escrow agreement established upon the closing of the Boardtown acquisition. Due to the early release of the escrow account as described above, this amount was paid to the former shareholders of Boardtown Corporation directly by Tucows.

c. Acquisition of Innerwise Inc. (dba ItsYourDomain.com):

On July 25, 2007, Tucows (Delaware) Inc. (Tucows DE), one of the Company s wholly owned subsidiaries, acquired 100% of the outstanding capital stock of Innerwise Inc. (d/b/a ItsYourDomain.com) (IYD), a privately held, ICANN-accredited registrar offering domain services on a retail basis and through a worldwide wholesale network of affiliates. The total aggregate consideration of $10,950,112 is comprised of:

- $10,847,650 in cash; and
- $102,462 of estimated transaction costs.

An additional $1.1 million of consideration is being held in escrow and is payable in whole or in part by Tucows after August 2008, pending the final evaluation of the revenue generating capability of certain domain names acquired by Tucows DE under the purchase agreement, as well as the resolution of any indemnification claims made by Tucows DE, for which the escrow account also serves as a source of recovery. To date, the parties have not been able to agree on a final evaluation of the revenue generating capability of the domain names and the monies remain in escrow. Once resolved, if any additional contingent consideration being held in escrow is payable, it will be recorded as additional goodwill at the time of its release.

$9,571,209 of the cash paid by Tucows at the closing was funded by a bank loan from the Bank of Montreal (BMO) (see note 5).

The allocation of the fair value of the net assets acquired based on the consideration paid, is as follows:

Cash and cash equivalents			$	618,047
Accounts receivable				26,224
Prepaid expenses and deposits				252,128
Property and equipment				20,000
Intangible assets including:				
Technology	$	350,000		
Brand		1,000,000		
Customer relationships		3,700,000		5,050,000
Goodwill				5,301,040
Total assets acquired				11,267,439
Accrued liabilities		317,327		
Total liabilities				317,327
Purchase price			$	10,950,112

Table of Contents

The residual value from the purchase price has been allocated to goodwill. The technology is being amortized over three years, while the remaining intangible assets are being amortized over seven years.

The purchase price allocation is based on the working capital estimate computed as of July 25, 2007. The final adjustment to working capital as at July 25, 2007 is still being determined with the sellers. Any adjustment will be allocated against goodwill.

The valuation of the intangible assets is management s best estimate based, in part, on a report from an independent valuator.

The following supplemental pro-forma information is presented to illustrate the effects of the acquisition on the historical operating results for the three and nine months ended September 30, 2007, as if the acquisition had occurred at the beginning of the period presented.

	Three months ended September 30, 2007 Unaudited in thousands except earnings per share	Nine months ended September 30, 2007 Unaudited in thousands except earnings per share
Net revenue	$ 18,211	$ 60,575
Net income (loss) for the period	(409)	3,015
Basic earnings (loss) per common share	$ (0.01)	$ 0.05

4. INTANGIBLE ASSETS:

Intangible assets consist of acquired technology, brand, customer relationships, non-competition agreements, surname domain names and direct navigation domain names. These balances, with the exception of the surname and direct navigation domain names that have been determined to have an indefinite life, are being amortized on a straight-line basis over the term of the intangible assets, as reflected in the table below.

A summary of acquired intangible assets for the three months ended September 30, 2008 is as follows:

Amortization period	Technology 2 - 7 years	Brand 7 years	Customer relationships 4 - 7 years	Surname domain names indefinite life	Direct navigation domain names indefinite life	Total
Net book value, June 30, 2008	$ 500,122	$ 937,380	$ 5,321,060	$ 12,131,827	$ 2,101,115	$ 20,991,504
Sale of domain names					(4,705)	(4,705)
Amortization expense	(29,199)	(41,760)	(318,780)			(389,739)
	$ 470,923	$ 895,620	$ 5,002,280	$ 12,131,827	$ 2,096,410	$ 20,597,060

Net book value,
September 30, 2008

Table of Contents

A summary of acquired intangible assets for the nine months ended September 30, 2008 is as follows:

Amortization period	Technology 2 - 7 years	Brand 7 years	Customer relationships 4 - 7 years	Surname domain names indefinite life	Direct navigation domain names indefinite life	Total
Net book value, December 31, 2007	$ 605,520	$ 1,020,900	$ 6,300,320	$ 12,129,303	$ 2,094,695	$ 22,150,738
Purchase of domain names				2,524	1,715	4,239
Sale of customer relationships (1)			(300,665)			(300,665)
Amortization expense	(134,597)	(125,280)	(997,375)			(1,257,252)
Net book value, September 30, 2008	$ 470,923	$ 895,620	$ 5,002,280	$ 12,131,827	$ 2,096,410	$ 20,597,060

(1) Pertains to the sale of certain shared hosting assets that were sold to Hostopia.com Inc., in terms of a purchase and sale agreement signed with Tucows.com Co, a wholly-owned subsidiary of the Company, on May 7, 2008.

5. LOAN PAYABLE:

The Company entered into a non-revolving, reducing credit facility in the amount of $9,571,209 with The Bank of Montreal (BMO) to finance the purchase of IYD in July 2007. The loan bears simple interest at the BMO US base rate plus 0.50% per annum (currently 6.0 %), and was not issued at a premium or at a discount. The principal and accrued interest on the loan is payable monthly over the term of the loan, which is 5 years. Tucows may prepay this loan in full or in part without any premium or penalty. The BMO facility provides that we maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and coverage ratios during the term of the loan.

Included in these covenants is a requirement for the Company to make an annual cash sweep payment based on excess cash flow as defined in the credit facility agreement. Once it has been determined that a cash sweep payment is payable, based on the Company s audited results, such payment is classified as a current liability on the Company s consolidated balance sheet. For the first year, the cash flow sweep is limited to a maximum of $1.0 million. Based on the assessment of the audited results for the fiscal year ended December 31, 2007, the Company made a cash sweep payment of $1.0 million in May 2008. As the cash sweep for the year ending December 31, 2008 has not yet been determined, no amount has been reclassified as a current liability for this period, other than the monthly principal loan repayments that are due within the next twelve months.

Certain covenants under the facility may limit the amount of our capital expenditures. The facility is collateralized by a first lien on, and pledge of, the majority of the combined company s present and future property and assets (subject to certain exclusions).

Principal loan repayments over the next four years are as follows:

October 2008	September 2009	$	1,914,242
October 2009	September 2010	$	1,914,242
October 2010	September 2011	$	1,914,242
October 2011	January 2012	$	595,201

Table of Contents

6. INCOME TAXES

Tucows had approximately $225,000 of total gross unrecognized tax benefit as of December 31, 2007 and $234,000 of total gross unrecognized tax benefit as of September 30, 2008, which if recognized would favorably affect the income tax rate in future periods. The unrecognized tax benefit relates to non-recognition of refundable research and development tax credits for 2006 and 2007. The unrecognized tax benefit for 2008 for the research and development claim is not expected to be significant. We recognize accrued interest and penalties to unrecognized tax benefit in tax expense. We did not have any interest and penalties accrued as of December 31, 2007 and September 30, 2008 as the unrecognized tax benefit relates entirely to refundable tax credits. We believe it is reasonably possible that $234,000 of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the Canadian tax authorities will conclude its review of the Company s 2006 and 2007 research and development claim for the credits within the period.

The valuation allowance amounting to $11.3 million recognized for deferred tax assets has been allocated on a pro rata basis between current and non-current deferred tax assets, resulting in current deferred tax assets in the amount of $0.5 million and non-current deferred tax assets of $2.5 million as at September 30, 2008. The comparatives as at December 31, 2007 have been reclassified to conform to this presentation.

7. BASIC AND DILUTED EARNINGS (LOSS) PER COMMON SHARE:

The Company s basic earnings (loss) per common share have been calculated by dividing net income by the weighted average number of common shares outstanding.

The diluted earnings per common share for the three and nine months ended September 30, 2007 have been calculated using the weighted average number of common shares outstanding and potentially dilutive common shares outstanding during the periods. Options to purchase 3,217,828 shares of common stock were outstanding during the three months ended September 30, 2008 (during the three months ended September 30, 2007, options to purchase 3,692,809 shares of common stock were outstanding). Options to purchase 2,341,230 shares of common stock were outstanding during the nine months ended September 30, 2008 (during the nine months ended September 30, 2007, options to purchase 651,416 shares of common stock were outstanding).

8. SUPPLEMENTAL INFORMATION:

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Traditional Domain Registration Services	$ 13,687,815	$ 12,331,765	$ 39,828,374	$ 36,506,455
Domain Portfolio Services	1,265,172	538,488	4,043,439	4,781,139
Email Services	1,516,726	1,771,266	4,642,977	5,786,033

Retail Services		2,071,200		1,461,729		5,757,890		3,876,808
Other Services		1,606,282		1,708,666		5,036,051		5,447,577
	$	20,147,195	$	17,811,914	$	59,308,731	$	56,398,012

No customer accounted for more than 10% of revenue during the three or nine months ended September 30, 2008 or the three or nine months ended September 30, 2007. Significant management judgment is required at the time of recording of revenue 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.

At September 30, 2008, two customers each accounted for more than 10% of accounts receivable, for a combined 24%. At September 30, 2007, one customer accounted for more than 10% of accounts receivable.

Table of Contents

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Traditional Domain Registration Services	$ 11,015,952	$ 9,158,683	$ 31,456,663	$ 27,000,115
Domain Portfolio Services	182,614	160,823	542,065	419,061
Email Services	161,848	153,304	244,848	567,318
Retail Services	558,190	441,406	1,701,786	1,263,850
Other Services	408,031	416,801	1,241,733	1,237,007
Network, other costs	1,654,612	1,940,030	5,607,181	5,215,293
Network, depreciation and amortization costs	824,644	1,079,014	2,572,139	3,001,182
	$ 14,805,891	$ 13,350,061	$ 43,366,415	$ 38,703,826

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

	September 30, 2008	December 31, 2007
Canada	$ 2,098,910	$ 2,706,810
United States	1,415,348	2,194,624
United Kingdom	37,053	61,877
	$ 3,551,311	$ 4,963,311

9. COMMITMENTS AND CONTINGENCIES:

On February 20, 2008, Tucows entered into a series of forward plus contracts with a notional value of $18.9 million, whereby $900,000 is converted into Canadian dollars on a semi-monthly basis through December 31, 2008. These forward plus contracts are designed to hedge our expected Canadian dollar requirements over the period. On each expiry date, provided that the limit rate (US$1.00 : Cdn$1.05) has not been reached, we will sell US$ 900,000 and buy Canadian dollars at the then current exchange rate or at the base rate of US$1.00 : Cdn$1.014 whichever is more beneficial to Tucows. As the limit rate was reached during August 2008, all remaining forward plus contracts will be fixed at the base rate of US$1.00 : Cdn$1.014 for delivery on the respective value dates.

On September 29, 2008, Tucows entered into a series of window contracts with a notional value of $9 million, whereby $500,000 is converted into Canadian dollars on a semi-monthly basis through September 2009. These window contracts are designed to hedge our expected Canadian dollar requirements over the period. On each expiry date, provided that the limit rate (US$1.00 : Cdn$1.09) has not been reached during the one month window before the expiration date of each contract, we will sell US$ 500,000 and buy Canadian dollars at the then current exchange rate or at the base rate of US$1.00 : Cdn$1.02, whichever is more beneficial to Tucows. Should the limit rate be reached during the one month window before the expiration date of each contract, then that contract will be fixed at the base rate of US$1.00 : Cdn$1.02 for delivery on its value dates.

As of September 30, 2008, we had outstanding forward plus contracts with a notional value of $14.4 million and during the three months ended September 30, 2008 we recorded a loss in fair value in respect of these contracts in the amount of $0.5 million, while during the nine months ended September 30, 2008 we recorded a loss in fair value in respect of these contracts in the amount of $0.6 million. The balance of these forward contracts included under current liabilities amounted to $0.6 million as of September 30, 2008. During the three months ended September 30, 2007, we recorded a gain in the change in fair value in respect of outstanding contracts of $62,000, while during the nine months ended September 30, 2007, we recorded a gain in the change in fair value in respect of outstanding contracts of $1.2 million. These amounts have been recorded in general and administrative expenses. The balance of these forward contracts included under current assets amounted to $0.7 million as of September 30, 2007.

Table of Contents

10. STOCKHOLDERS EQUITY:

The following unaudited table summarizes stockholders equity transactions for the period ended September 30, 2008:

	Common stock				Additional paid in capital		Deficit		Total stockholders equity
	Number		Amount						
Balances, December 31, 2007	73,888,542	$	15,350,915	$	48,537,313	$	(44,537,179)	$	19,351,049
Stock-based compensation					145,200				145,200
Exercise of stock options	35,000		17,395		(7,945)				9,450
Net income for the period							1,126,646		1,126,646
Balances, June 30, 2008	73,923,542		15,368,310		48,674,568		(43,410,533)		20,632,345
Stock-based compensation					88,300				88,300
Net loss for the period							(70,648)		(70,648)
Balances, September 30, 2008	73,923,542	$	15,368,310	$	48,762,868	$	(43,481,181)	$	20,649,997

The following unaudited table summarizes stockholders equity transactions for the period ended September 30, 2007:

	Common stock				Additional paid in capital		Deficit		Total stockholders equity
	Number		Amount						
Balances, December 31, 2006	75,978,502	$	15,395,381	$	50,359,906	$	(47,212,712)	$	18,542,575
Exercise of stock options	373,880		345,218		(158,875)				186,343
Repurchase of shares	(2,616,600)		(523,320)		(1,923,635)				(2,446,955)
Stock-based compensation					174,200				174,200
Net income for the period							3,920,850		3,920,850
Balances, June 30, 2007	73,735,782		15,217,279		48,451,596		(43,291,862)		20,377,013
Exercise of stock options	36,720		32,956		(15,044)				17,912
Stock-based compensation					78,300				78,300
Net loss for the period							(310,592)		(310,592)
Balances, September 30, 2007	73,772,502	$	15,250,235	$	48,514,852	$	(43,602,454)	$	20,162,633

On May 6, 2008, Tucows Inc. s board of directors authorized the repurchase of up to $10 million of the Company s common stock at the Company s discretion. To date, the Company has not repurchased any shares under this repurchase program.

11. SHARE-BASED PAYMENTS

Valuation method:

We estimate the fair value of stock options using the Black-Scholes option pricing model, consistent with the provisions of SFAS 123R and SEC Staff Accounting Bulletin No. 107. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, while the options we issue are subject to both vesting and restrictions on transfer. In addition, option-pricing models require input of subjective assumptions including the estimated life of the option and the expected volatility of the underlying stock over the estimated life of the option. We use historical volatility as a basis for projecting the expected volatility of the underlying stock and estimate the expected life of our stock options based upon historical data.

We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair value of our stock option grants. Estimates of fair value are not intended, however, to predict actual future events or the value ultimately realized by employees who receive equity awards.

We do not use any cash to settle equity instruments granted under share-based compensation arrangements.

Summary of Outstanding Stock Options:

(a) 1996 Stock Options Plan

Table of Contents

As of September 30, 2008, options to purchase an aggregate of 4,971,798 shares of common stock are outstanding under our 1996 Stock Option Plan (1996 Plan). No further shares of common stock may be issued under this option plan. Stock options that have been issued under the 1996 Plan generally vest over four years and expire ten years from the date of the grant. The exercise price of options granted is equivalent to the fair market value of the stock on the day prior to the date of grant.

A summary of unaudited option activity under our 1996 Plan for the three months ended September 30, 2008 is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($ 000s)
Outstanding at June 30, 2008	4,974,111	$ 0.48		
Granted				
Exercised				
Forfeited	(2,313)	0.92		
Expired				
Outstanding at September 30, 2008	4,971,798	$ 0.48	4.56	$ 70
Exercisable at September 30, 2008	4,949,204	$ 0.48	4.55	$ 70

A summary of unaudited option activity under our 1996 Plan for the nine months ended September 30, 2008 is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($ 000s)
Outstanding at December 31, 2007	5,048,517	$ 0.48		
Granted				
Exercised	(35,000)	0.27		
Forfeited	(36,719)	0.67		
Expired	(5,000)	0.27		
Outstanding at September 30, 2008	4,971,798	$ 0.48	4.56	$ 70
Exercisable at September 30, 2008	4,949,204	$ 0.48	4.55	$ 70

As all options granted under the 1996 Plan have an exercise price greater than the September 30, 2008 closing price, no unrecognized compensation cost relating to unvested stock options at September 30, 2008 has been shown.

(b) 2006 Equity Compensation Plan

As of September 30, 2008, options to purchase an aggregate of 2,347,250 shares of common stock are outstanding under our 2006 Equity Compensation Plan (2006 Plan). Stock options that have been issued to employees under the 2006 Plan generally vest over four years and expire seven years from the date of the grant. The exercise price of options granted is equivalent to the fair market value of the stock on the day of grant.

A summary of unaudited option activity under our 2006 Plan for the three months ended September 30, 2008 is as follows:

Table of Contents

	Options		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)		Aggregate Intrinsic Value ($ 000s)
Outstanding at June 30, 2008	2,195,750	$	0.74			
Granted	180,000		0.48			
Exercised						
Forfeited	(28,500)		0.70			
Expired						
Outstanding at September 30, 2008	2,347,250	$	0.71	5.73	$	
Exercisable at September 30, 2008	651,250	$	0.72	4.82	$	

A summary of unaudited option activity under our 2006 Plan for the nine months ended September 30, 2008 is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)