

TUCOWS INC /PA/
Form 10-Q
November 13, 2009
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, 2009

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)

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

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 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
(Do not check if a smaller reporting company)

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, 2009, there were 67,080,353 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

| | | |
|-----------------|--|----|
| <u>Item 1.</u> | <u>Consolidated Financial Statements</u> | 3 |
| | <u>Consolidated Balance Sheets as of September 30, 2009 (unaudited) and December 31, 2008</u> | 3 |
| | <u>Consolidated Statements of Operations (unaudited) for the three and nine months ended September 30, 2009 and 2008</u> | 4 |
| | <u>Consolidated Statements of Cash Flows (unaudited) for the three and nine months ended September 30, 2009 and 2008</u> | 5 |
| | <u>Notes to Consolidated Financial Statements (unaudited)</u> | 6 |
| <u>Item 2.</u> | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 18 |
| <u>Item 3.</u> | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 34 |
| <u>Item 4T.</u> | <u>Controls and Procedures</u> | 35 |

PART II
OTHER INFORMATION

| | | |
|--------------------|--------------------------|----|
| <u>Item 1.</u> | <u>Legal Proceedings</u> | 36 |
| <u>Item 1A.</u> | <u>Risk Factors</u> | 36 |
| <u>Item 6.</u> | <u>Exhibits</u> | 37 |
| <u>Signatures.</u> | | 38 |

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

| | September 30, 2009 (unaudited) | December 31, 2008 |
|---|---|------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 8,154,455 | \$ 5,427,467 |
| Accounts receivable, net of allowance for doubtful accounts of \$125,000 as of September 30, 2009 and \$125,000 as of December 31, 2008 | 3,929,882 | 3,200,362 |
| Prepaid expenses and deposits | 2,743,505 | 2,274,043 |
| Derivative instrument assets (note 6) | 1,927,475 | |
| Prepaid domain name registry and ancillary services fees, current portion | 31,513,882 | 29,212,610 |
| Deferred tax asset, current portion | 590,000 | 590,000 |
| Total current assets | 48,859,199 | 40,704,482 |
| Prepaid domain name registry and ancillary services fees, long-term portion | 12,143,175 | 11,855,971 |
| Property and equipment | 2,148,509 | 3,072,958 |
| Deferred financing charges | 49,300 | 78,500 |
| Deferred tax asset, long-term portion | 2,410,000 | 2,410,000 |
| Intangible assets (note 4) | 19,041,083 | 20,206,996 |
| Goodwill | 17,990,807 | 17,990,807 |
| Investment | | 200,000 |
| Total assets | \$ 102,642,073 | \$ 96,519,714 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,373,068 | \$ 1,633,830 |
| Accrued liabilities | 1,888,427 | 2,000,146 |
| Customer deposits | 3,764,320 | 3,319,241 |
| Derivative instrument liabilities (note 6) | | 1,974,919 |
| Loan payable, current portion (note 5) | 3,698,685 | 2,624,242 |
| Deferred revenue, current portion | 40,303,458 | 37,985,821 |
| Accreditation fees payable, current portion | 508,180 | 510,548 |
| Total current liabilities | 51,536,138 | 50,048,747 |
| Deferred revenue, long-term portion | 16,198,501 | 16,201,804 |

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

| | | |
|--|----------------|---------------|
| Accreditation fees payable, long-term portion | 187,285 | 187,374 |
| Loan payable, long-term portion (note 5) | | 3,235,125 |
| Deferred tax liability, long-term portion | 4,899,000 | 5,396,000 |
| 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; 67,865,096 shares issued and outstanding as of September 30, 2009 and 73,073,782 shares issued and outstanding as of December 31, 2008 | | |
| | 14,187,313 | 15,198,358 |
| Additional paid-in capital | 47,601,377 | 48,714,676 |
| Deficit | (31,967,541) | (42,462,370) |
| Total stockholders' equity | 29,821,149 | 21,450,664 |
| Total liabilities and stockholders' equity | \$ 102,642,073 | \$ 96,519,714 |

See accompanying notes to unaudited consolidated financial statements

Subsequent events (note 14).

Table of Contents

Tucows Inc.

Consolidated Statements of Operations

(Dollar amounts in U.S. dollars)

(unaudited)

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

| | Three months ended September 30, 2009 (unaudited) | | 2008 | | Nine months ended September 30, 2009 (unaudited) | | 2008 | |
|--|---|-------------|------|-------------|--|-------------|------|-------------|
| Net revenues | \$ | 20,496,129 | \$ | 20,147,195 | \$ | 60,609,673 | \$ | 59,308,731 |
| Cost of revenues: | | | | | | | | |
| Cost of revenues (*) | | 14,770,868 | | 13,981,247 | | 42,942,314 | | 40,794,276 |
| Depreciation of property and equipment | | 475,445 | | 795,445 | | 1,416,834 | | 2,437,542 |
| Amortization of intangible assets | | 29,199 | | 29,199 | | 87,597 | | 134,597 |
| Total cost of revenues | | 15,275,512 | | 14,805,891 | | 44,446,745 | | 43,366,415 |
| Gross profit | | 5,220,617 | | 5,341,304 | | 16,162,928 | | 15,942,316 |
| Expenses: | | | | | | | | |
| Sales and marketing (*) | | 1,568,727 | | 1,705,512 | | 4,261,070 | | 5,132,380 |
| Technical operations and development (*) | | 1,142,331 | | 1,527,237 | | 3,421,825 | | 4,666,832 |
| General and administrative (*) | | 1,145,951 | | 1,714,563 | | 4,608,173 | | 4,805,853 |
| Depreciation of property and equipment | | 64,704 | | 57,386 | | 230,336 | | 177,317 |
| Loss on disposition of property and equipment | | 40,369 | | 498,529 | | 40,369 | | 498,529 |
| Amortization of intangible assets | | 360,540 | | 360,540 | | 1,081,620 | | 1,122,655 |
| (Gain) / loss in fair value of forward exchange contracts | | (1,878,230) | | 525,571 | | (3,902,394) | | 555,364 |
| Total expenses | | 2,444,392 | | 6,389,338 | | 9,740,999 | | 16,958,930 |
| Income (loss) from operations | | 2,776,225 | | (1,048,034) | | 6,421,929 | | (1,016,614) |
| Other income (expenses): | | | | | | | | |
| Interest income (expense), net | | (52,887) | | (90,859) | | (178,669) | | (467,264) |
| Other income | | 1,880,000 | | 1,098,245 | | 4,493,190 | | 2,631,010 |
| Total other income (expenses) | | 1,827,113 | | 1,007,386 | | 4,314,521 | | 2,163,746 |
| Income (loss) before provision for income taxes | | 4,603,338 | | (40,648) | | 10,736,450 | | 1,147,132 |
| Income tax (recovery) expense (note 7) | | (447,455) | | 30,000 | | 241,621 | | 91,134 |
| Net income (loss) for the period | \$ | 5,050,793 | \$ | (70,648) | \$ | 10,494,829 | \$ | 1,055,998 |
| Basic earnings (loss) per common share (note 8) | | | | | | | | |
| | \$ | 0.07 | \$ | (0.00) | \$ | 0.15 | \$ | 0.01 |
| Shares used in computing basic earnings (loss) per common share (note 8) | | | | | | | | |
| | | 68,008,871 | | 73,923,542 | | 69,841,981 | | 73,903,998 |
| Diluted earnings (loss) per common share (note 8) | | | | | | | | |
| | \$ | 0.07 | \$ | (0.00) | \$ | 0.15 | \$ | 0.01 |
| Shares used in computing diluted earnings (loss) per common share (note 8) | | | | | | | | |
| | | 68,874,517 | | 74,817,244 | | 70,156,521 | | 75,245,047 |

See accompanying notes to consolidated financial statements

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

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

| | | | | | | | | |
|--------------------------------------|----|--------|----|--------|----|---------|----|---------|
| Cost of revenues | \$ | 3,860 | \$ | 5,500 | \$ | 12,227 | \$ | 14,600 |
| Sales and marketing | \$ | 12,807 | \$ | 17,200 | \$ | 42,764 | \$ | 48,500 |
| Technical operations and development | \$ | 12,395 | \$ | 13,100 | \$ | 34,116 | \$ | 41,800 |
| General and administrative | \$ | 70,748 | \$ | 52,500 | \$ | 142,641 | \$ | 128,600 |

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, | | Nine months ended September 30, | |
|--|---|------------------|--|--------------------|
| | 2009 | 2008 | 2009 | 2008 |
| | (unaudited) | | (unaudited) | |
| Cash provided by (used in): | | | | |
| Operating activities: | | | | |
| Net income (loss) for the period | \$ 5,050,793 | \$ (70,648) | \$ 10,494,829 | \$ 1,055,998 |
| Items not involving cash: | | | | |
| Depreciation of property and equipment | 540,149 | 852,831 | 1,647,170 | 2,614,859 |
| Loss on disposition of property and equipment | 40,369 | 498,529 | 40,369 | 498,529 |
| Amortization of deferred financing charges | 9,100 | 12,200 | 29,200 | 38,400 |
| Amortization of intangible assets | 389,739 | 389,739 | 1,169,217 | 1,257,252 |
| Gain on disposal of investment in Afiliis | (1,880,000) | | (3,890,395) | |
| Gain on sale of customer relationships | | (921,384) | | (2,042,449) |
| Reduction of deferred tax liability | (497,000) | | (497,000) | |
| Disposal of domain names | 649 | 4,705 | 2,596 | 4,705 |
| Unrealized (gain)/loss in the fair value of forward exchange contracts | (1,878,230) | 525,571 | (3,902,394) | 555,364 |
| Stock-based compensation | 99,810 | 88,300 | 231,748 | 233,500 |
| Change in non-cash operating working capital: | | | | |
| Accounts receivable | (465,454) | (518,310) | (729,520) | (234,387) |
| Prepaid expenses and deposits | 419,761 | 641,629 | (469,462) | 536,392 |
| Prepaid fees for domain name registry and ancillary services fees | 33,425 | (775,955) | (2,588,476) | (4,482,752) |
| Accounts payable | (977,967) | (480,839) | (597,560) | (231,770) |
| Accrued liabilities | (115,362) | (177,701) | (111,719) | (868,765) |
| Customer deposits | 592,612 | (167,691) | 445,079 | (148,692) |
| Deferred revenue | (398,657) | (9,699) | 2,314,334 | 3,767,955 |
| Accreditation fees payable | (46,762) | 6,245 | (2,457) | 40,365 |
| Income taxes payable | (835,398) | | | |
| Net cash provided by (used in) operating activities | 81,577 | (102,478) | 3,585,559 | 2,594,504 |
| Financing activities: | | | | |
| Proceeds received on exercise of stock options | | | 25,422 | 9,450 |
| Repurchase of common stock | (570,335) | | (2,381,514) | |
| Repayment of loan payable | (478,561) | (478,561) | (2,160,682) | (8,435,681) |
| Net cash used in financing activities | (1,048,896) | (478,561) | (4,516,774) | (8,426,231) |

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

Investing activities:

| | | | | |
|---|-----------|-----------|-----------|-------------|
| Cost of domain names acquired | | | (5,900) | (8,944) |
| Additions to property and equipment | (281,282) | (627,024) | (426,292) | (1,922,764) |
| Sale of customer relationships | | 921,384 | | 2,343,114 |
| Proceeds on disposition of property and equipment | | 66,039 | | 66,039 |
| Proceeds on disposal of investment in Afilias | 1,980,000 | | 4,090,395 | |
| Decrease in cash held in escrow | | (5,396) | | (18,161) |
| Net cash provided by investing activities | 1,698,718 | 355,003 | 3,658,203 | 459,284 |

| | | | | |
|--|---------|-----------|-----------|-------------|
| Increase (decrease) in cash and cash equivalents | 731,399 | (226,036) | 2,726,988 | (5,372,443) |
|--|---------|-----------|-----------|-------------|

| | | | | |
|--|--------------|--------------|--------------|--------------|
| Cash and cash equivalents, beginning of period | 7,423,056 | 2,947,069 | 5,427,467 | 8,093,476 |
| Cash and cash equivalents, end of period | \$ 8,154,455 | \$ 2,721,033 | \$ 8,154,455 | \$ 2,721,033 |

Supplemental cash flow information:

| | | | | |
|---------------|-----------|------------|------------|------------|
| Interest paid | \$ 52,983 | \$ 100,060 | \$ 181,012 | \$ 552,298 |
|---------------|-----------|------------|------------|------------|

Supplementary disclosure of non-cash investing activity:

| | | | | |
|--|------------|------------|------------|------------|
| Property and equipment acquired during the period not yet paid for | \$ 343,777 | \$ 117,733 | \$ 343,777 | \$ 117,733 |
|--|------------|------------|------------|------------|

See accompanying notes to unaudited consolidated financial statements

Table of Contents

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION OF THE COMPANY:

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, is a global distributor of Internet services, including domain name registration, security and identity products through digital certificates and email through its distribution 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 offices in the United Kingdom and the United States.

2. BASIS OF PRESENTATION:

The accompanying unaudited interim consolidated balance sheets, 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, 2009 and the results of operations and cash flows for the interim periods ended September 30, 2009 and 2008. 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, 2008 included in Tucows' 2008 Annual Report on Form 10-K filed with the SEC on March 27, 2009.

There have been no material changes to our significant accounting policies during the nine months ended September 30, 2009 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Subsequent events

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 to the notes to the unaudited interim consolidated financial statements. Subsequent events have been evaluated through November 13, 2009, the date of the issuance of these unaudited interim consolidated financial statements.

3. NEW ACCOUNTING POLICIES:

Recent Accounting Pronouncements Adopted

In April 2009, the Financial Accounting Standards Board (FASB) issued ASC Subtopic 825-10-65, Interim Disclosures about Fair Value of Financial Instruments which requires disclosures about fair value of financial instruments in interim and annual reporting periods. The guidance is effective for interim reporting periods ending after June 15, 2009 and was adopted by the Company. The disclosures required by the guidance are presented in Note 5 Loan payable.

In May 2009, FASB issued ASC Subtopic 855-10, Subsequent Events . This topic establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. ASC Subtopic 855-10 also clarifies the types of subsequent events a Company shall, or shall not, recognize in the financial statements. The statement is effective for financial statement periods ending after June 15, 2009.

Table of Contents

The Company adopted ASC Subtopic 855-10 on June 30, 2009 and the adoption did not result in significant changes in our recognition or disclosure of subsequent events in the financial statements. However, it does require us to disclose the date through which we have evaluated subsequent events and the basis for that date. Our evaluation of subsequent events is disclosed in Note 2 Basis of Presentation.

In June 2009, we adopted FASB ASC Subtopic 820-10-65-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly which addresses measuring fair value for situations in which there has been a significant decrease in trading activity for an asset or liability. The adoption of this guidance in the second quarter of 2009 did not have a material impact on our interim consolidated financial statements.

In June 2009, the FASB issued Statement No. 168 The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162 (the Codification). The Codification has become the single source of authoritative non-government U.S generally accepted accounting principles (GAAP), superseding various existing authoritative accounting pronouncements. The Codification eliminates the GAAP hierarchy contained in Statement No. 162 and establishes one level of authoritative GAAP. All other U.S. GAAP literature is considered non-authoritative. This Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We have adopted the Codification in our third quarter of Fiscal 2009. There was no change to our consolidated financial statements due to the implementation of the Codification other than changes in reference to various authoritative accounting pronouncements in our Notes to consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

In August 2009, the FASB issued Accounting Standards Update 2009-05, Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value (Update 2009-05). Update 2009-05 provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value of such liability using one or more of the techniques prescribed by the update. This guidance is effective for interim and annual periods beginning after August 27, 2009, which will be our fourth quarter of 2009, and applies to all fair-value measurements of liabilities required by GAAP. We are currently assessing the impact of Update 2009-05 on our future consolidated financial statements.

In October 2009, the SEC announced that public companies with a public float below \$75 million must begin to comply with the final stage of Section 404 that requires auditor attestation of the effectiveness of internal control over financial reporting, beginning with annual reports for fiscal years ending on or after June 15, 2010. The previous effective date was for fiscal years ending on or after December 15, 2009. As a result, the Company will now be required to provide the attestation reports commencing with its fiscal year ending December 31, 2010.

In October 2009, the FASB issued Accounting Standards Update 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (Update 2009-13). Update 2009-13 applies to multiple-deliverable revenue arrangements that are currently within the scope of FASB ASC Subtopic 605-25 (previously included in Emerging Issues Task Force Issue no. 00-21, Revenue Arrangements with Multiple Deliverables). Update 2009-13 provides principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and the consideration allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price. The guidance eliminates the use of the residual method, requires entities to allocate revenue using the relative-selling-price method, and significantly expands the disclosure requirements for multiple-deliverable revenue arrangements. Update 2009-13 is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We are currently assessing the impact of Update 2009-13 on our future consolidated financial statements.

4. 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, with the exception of the surname and portfolio domain names that have been determined to have an indefinite life.

Table of Contents

A summary of acquired intangible assets for the three months ended September 30, 2009 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, 2009 | \$ 383,326 | \$ 770,340 | \$ 4,045,940 | \$ 12,134,355 | \$ 2,097,510 | \$ 19,431,471 |
| Sale of domain names | | | | (649) | | (649) |
| Amortization expense | (29,199) | (41,760) | (318,780) | | | (389,739) |
| Net book value, September 30, 2009 | \$ 354,127 | \$ 728,580 | \$ 3,727,160 | \$ 12,133,706 | \$ 2,097,510 | \$ 19,041,083 |

A summary of acquired intangible assets for the nine months ended September 30, 2009 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, 2008 | \$ 441,724 | \$ 853,860 | \$ 4,683,500 | \$ 12,131,502 | \$ 2,096,410 | \$ 20,206,996 |
| Purchase of domain names | | | | 4,800 | 1,100 | 5,900 |
| Sale of domain names | | | | (2,596) | | (2,596) |
| Amortization expense | (87,597) | (125,280) | (956,340) | | | (1,169,217) |
| Net book value, September 30, 2009 | \$ 354,127 | \$ 728,580 | \$ 3,727,160 | \$ 12,133,706 | \$ 2,097,510 | \$ 19,041,083 |

5. LOAN PAYABLE:

The Company entered into a non-revolving, reducing credit facility in the amount of \$9.6 million with a Canadian chartered bank to finance the purchase of Innerwise, Inc. in July 2007. Effective February 23, 2009, the Company agreed to amend the interest rate payable from the bank's US Base rate plus 0.50% per annum to the bank's US Base rate plus 1.50% per annum. The principal and accrued interest on the loan is payable monthly over the term of the loan, which is five years. Tucows may prepay this loan in full or in part without any premium or penalty. The credit 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. Certain covenants under the credit facility may limit the amount of our capital expenditures. The credit 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). As of September 30, 2009, the Company continued to comply with all covenants of the credit facility.

Pursuant to the terms of the facility, the Company is required to make an annual cash sweep payment based on excess cash flow as defined in the credit facility agreement, as well as equal monthly principal repayments of approximately \$160,000. Based on the assessment of the audited results for its 2008 fiscal year, the Company made a cash sweep payment for its 2008 fiscal year amounting to \$0.7 million which was paid on May 1, 2009. The Company currently estimates that the cash sweep payment for its 2009 fiscal year, payable during the three months ending June 30, 2010, will be sufficient to pay off in full the outstanding balance of our non-revolving, reducing credit facility. Accordingly, this

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

amount has now been classified as a current liability at September 30, 2009.

Principal loan repayments are as follows:

| | | | |
|--|-----------|----|-----------|
| Current portion (including an estimate for a cash sweep payment which will be based on our audited 2009 results and will be payable during the three months ending June 30, 2010, which we believe will be sufficient to fully retire the remaining balance of our non-revolving, reducing credit facility): | | | |
| October 2009 | June 2010 | \$ | 3,698,685 |

Table of Contents

The Company uses interest rates that are currently available to the Company for issuance of loans on similar terms and remaining maturities to estimate the fair value of the Company's loan payable. The estimated fair value of the Company's loan payable at September 30, 2009 was \$ 3,688,326, compared to a carrying amount of \$3,698,685 at September 30, 2009.

6. DERIVATIVE INSTRUMENT ASSETS / LIABILITIES:

The Company enters into foreign currency contracts to hedge a portion of the Company's expected Canadian dollar requirements. All derivative financial instruments are recorded at fair value on our consolidated balance sheet. The fair value of our foreign currency contracts at September 30, 2009 was a net unrealized gain of \$1.9 million (as compared to a net unrealized loss of \$2.0 million at December 31, 2008). The unrealized gains / losses are a result of fluctuations in foreign exchange rates between the date the currency forward contracts were entered into and the valuation date at period end. The net unrealized gain of our foreign currency contracts during the three and nine months ended September 30, 2009 is due primarily to the favorable movement in exchange rates between the Canadian and U.S. dollars and the settlement of contracts with significant losses.

At September 30, 2009, the Company had forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars as follows:

| Maturity date | Notional amount of U.S. dollars | Weighted average exchange rate of U.S. dollars | Fair value gain |
|-------------------------|--|---|------------------------|
| October - December 2009 | \$ 3,000,000 | 0.8651 | \$ 245,924 |
| January - March 2010 | 4,278,000 | 0.8297 | 547,750 |
| April - June 2010 | 4,439,000 | 0.8328 | 549,508 |
| July - September 2010 | 3,000,000 | 0.8034 | 494,324 |
| October - December 2010 | 2,500,000 | 0.9032 | 89,969 |
| Total | \$ 17,217,000 | 0.8369 | \$ 1,927,475 |

During the three months ended September 30, 2009, no new foreign currency contracts were entered into by the Company.

The Company is not required to apply hedge accounting and, therefore, for the three months ended September 30, 2009, the Company recorded a gain of \$1.9 million in the fair value of forward contracts in its consolidated statements of operations. For the three months ended September 30, 2008, the Company recorded a loss on forward contracts of \$0.5 million. For the nine months ended September 30, 2009, the Company recorded a gain of \$3.9 million in the fair value of forward contracts in its consolidated statements of operations. For the nine months ended September 30, 2008, the Company recorded a loss on forward contracts of \$0.6 million.

7. INCOME TAXES

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

For the nine months ended September 30, 2009, the Company recorded an income tax expense of \$242,000, which included current tax expense of \$913,000 on income before taxes of \$10.7 million using an estimated effective tax rate for its 2009 fiscal year that accounts for the utilization of remaining net operating loss carry forwards and alternative minimum tax credits available to the Company. Included in the income tax expense is a recovery of \$174,000 for investment tax credits earned during the period, as well as a reduction of \$497,000 in the Company's recorded deferred tax liability. The reduction in the deferred tax liability relates to the rate at which the Company expects the temporary differences resulting from its unlimited life intangibles to reverse. This change in estimate arose as a result of the Company no longer being subject to state tax in the United States given the change in the jurisdictions in which the Company now operates.

Comparatively, for the nine months ended September 30, 2008, the Company recorded a current tax expense of \$91,000 on income before taxes of \$1.1 million primarily related to our estimate for federal alternative minimum tax obligations for our 2008 fiscal year and Pennsylvania state franchise tax related to prior years.

As of December 31, 2008, the Company recorded a valuation allowance of \$10.8 million and a net deferred tax asset of \$3.0 million. The net deferred tax asset has been allocated on a pro rata basis between current and non-current deferred tax

Table of Contents

assets, resulting in current deferred tax assets of \$0.6 million and non-current deferred tax assets of \$2.4 million as at December 31, 2008. No significant changes have occurred during the nine month period ended September 30, 2009.

The Company analyzes the carrying value of its deferred tax asset on a regular basis. In determining future taxable income, assumptions are made to forecast federal, state and international operating income, the reversal of temporary timing differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income and are consistent with other forecasts used to manage the business. During the nine months ended September 30, 2009, there was no reversal of the valuation allowance. The valuation allowance will be maintained until sufficient evidence exists to support a reversal of, or decrease in, the valuation allowance.

The Company follows the provisions of Accounting Standards Codification (FASB ASC): Topic 740, *Income Taxes*, in accounting for income tax exposures. The application of this interpretation requires a two-step accounting process that separates recognition of uncertain tax benefits from measurement thereof.

The Company had approximately \$301,000 of gross unrecognized tax benefit as of December 31, 2008 and \$209,000 of gross unrecognized tax benefit as of September 30, 2009, which if recognized, would favorably affect its income tax rate in future periods. The unrecognized tax benefit relates to non-recognition of refundable research and development tax credits in Canada earned during its 2008 fiscal year and certain state tax exposures from prior periods. During the nine months ended September 30, 2009, the Company's unrecognized tax benefits decreased by \$205,000 as a result of the settlement of the Company's 2006 and 2007 Canadian research and development tax credit claims. The Company increased its unrecognized tax benefits by \$113,000 related to its 2008 research and development tax credit claim. The Company expects its 2009 research and development tax credit claim to be insignificant.

The Company recognizes accrued interest and penalties to unrecognized tax benefit as a tax expense. The Company has not accrued any interest or penalties as of December 31, 2008 and September 30, 2009. The Company believes it is reasonably possible that \$209,000 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 2008 research and development claim for the credits, and that the state tax matters will also be settled, within that period.

8. BASIC AND DILUTED EARNINGS (LOSS) 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.

Table of Contents

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

| | Three months ended September 30, 2009 | Three months ended September 30, 2008 | Nine months ended September 30, 2009 | Nine months ended September 30, 2008 |
|--|--|--|---|---|
| Numerator for basic and diluted earnings per common share: | | | | |
| Income for the period | \$ 5,050,793 | \$ (70,648) | \$ 10,494,829 | \$ 1,055,998 |
| Denominator for basic and diluted earnings per common share: | | | | |
| Basic weighted average number of common shares outstanding | 68,008,871 | 73,923,542 | 69,841,981 | 73,903,998 |
| Effect of outstanding stock options | 865,646 | 893,702 | 314,540 | 1,341,049 |
| Diluted weighted average number of shares outstanding | 68,874,517 | 74,817,244 | 70,156,521 | 75,245,047 |
| Basic earnings per common share | \$ 0.07 | \$ 0.00 | \$ 0.15 | \$ 0.01 |
| Diluted earnings per common share | \$ 0.07 | \$ 0.00 | \$ 0.15 | \$ 0.01 |

Options to purchase 3,468,420 common shares that were outstanding as of the three months ended September 30, 2009 were not included in the computation of diluted income per common share because all such options had an exercise price greater than the average market price of the common shares (during the three months ended September 30, 2008, options to purchase 3,217,828 shares of common stock were outstanding).

Options to purchase 4,015,587 common shares that were outstanding as of the nine months ended September 30, 2009 were not included in the computation of diluted income per common share because all such options had an exercise price greater than the average market price of the common shares (during the nine months ended September 30, 2008, options to purchase 2,341,230 shares of common stock were outstanding).

On March 23, 2009, 4,185,769 common shares were repurchased and cancelled under the terms of a modified Dutch auction tender offer, and on July 14, 2009, an additional 1,103,824 common shares were repurchased and cancelled under the terms of a second modified Dutch tender offer. This reduction in the number of shares outstanding has been included in the computation of earnings per share and diluted earnings per share for the three and nine months ended September 30, 2009 (see note 11).

On October 2, 2009, subsequent to the quarter end, the Company repurchased and cancelled an additional 784,643 common shares under the terms of a third modified Dutch auction tender offer (see note 14).

9. SUPPLEMENTAL INFORMATION:

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

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------|----------------------------------|---------------|---------------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| OpenSRS : | | | | |
| Domain Services | \$ 15,097,640 | \$ 13,688,084 | \$ 44,037,596 | \$ 39,828,983 |
| Email Services | 842,262 | 1,516,726 | 2,838,052 | 4,642,977 |
| Other Services | 1,109,341 | 1,104,374 | 3,295,789 | 3,339,758 |
| Total OpenSRS Services | 17,049,243 | 16,309,184 | 50,171,437 | 47,811,718 |
| YummyNames | | | | |
| YummyNames | 1,781,725 | 1,264,903 | 5,102,315 | 4,042,830 |
| Hover | 1,203,742 | 2,071,200 | 3,763,155 | 5,757,890 |
| Butterscotch | 461,419 | 501,908 | 1,572,766 | 1,696,293 |
| | \$ 20,496,129 | \$ 20,147,195 | \$ 60,609,673 | \$ 59,308,731 |

No customer accounted for more than 10% of revenue for the three or nine months ended September 30, 2009 or the three or nine months ended September 30, 2008. 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.

Table of Contents

As of September 30, 2009, no customer accounted for more than 10% of accounts receivable. As of September 30, 2008, two customers accounted for approximately 24% of accounts receivable.

(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, | |
|--|----------------------------------|---------------|---------------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| OpenSRS : | | | | |
| Domain Services | \$ 12,325,620 | \$ 11,015,952 | \$ 35,624,222 | \$ 31,456,663 |
| Email Services | 103,071 | 161,848 | 436,216 | 244,848 |
| Other Services | 411,949 | 403,431 | 1,212,087 | 1,226,508 |
| Total OpenSRS Services | 12,840,640 | 11,581,231 | 37,272,525 | 32,928,019 |
| YummyNames | 218,371 | 182,614 | 654,456 | 542,065 |
| Hover | 493,181 | 558,190 | 1,481,761 | 1,701,786 |
| Butterscotch | 25,491 | 4,600 | 33,341 | 15,225 |
| Network, other costs | 1,193,185 | 1,654,612 | 3,500,231 | 5,607,181 |
| Network, depreciation and amortization costs | 504,644 | 824,644 | 1,504,431 | 2,572,139 |
| | \$ 15,275,512 | \$ 14,805,891 | \$ 44,446,745 | \$ 43,366,415 |

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

| | September 30, 2009 | December 31, 2008 |
|----------------|--------------------|-------------------|
| Canada | \$ 1,603,231 | \$ 2,292,358 |
| United States | 539,026 | 752,274 |
| United Kingdom | 6,252 | 28,326 |
| | \$ 2,148,509 | \$ 3,072,958 |

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, 2009 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

11. STOCKHOLDERS' EQUITY:

The following unaudited table summarizes stockholders' equity transactions for the period ended September 30, 2009:

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

| | Number | Common stock Amount | Additional paid in capital | Deficit | Total stockholders equity |
|--|-------------|------------------------|----------------------------------|-----------------|---------------------------------|
| Balances, December 31, 2008 | 73,073,782 | \$ 15,198,358 | \$ 48,714,676 | \$ (42,462,370) | \$ 21,450,664 |
| Exercise of stock options | 68,707 | 46,858 | (21,436) | | 25,422 |
| Repurchase and retirement of shares | (4,185,769) | (837,138) | (974,041) | | (1,811,179) |
| Stock-based compensation | | | 131,938 | | 131,938 |
| Issuance of restricted stock | 12,600 | | | | |
| Cancellation of restricted stock | (100) | | | | |
| Net income for the period | | | | 5,444,036 | 5,444,036 |
| Balances, June 30, 2009 | 68,969,220 | 14,408,078 | 47,851,137 | (37,018,334) | 25,240,881 |
| Stock-based compensation | | | 99,810 | | 99,810 |
| Cancellation of restricted stock | (300) | | | | |
| Repurchase and retirement of shares | (1,103,824) | (220,765) | (349,570) | | (570,335) |
| Net income for the period | | | | 5,050,793 | 5,050,793 |
| Balances, September 30, 2009 | 67,865,096 | \$ 14,187,313 | \$ 47,601,377 | \$ (31,967,541) | \$ 29,821,149 |

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

Table of Contents

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

| | Number | Common stock Amount | Additional paid in capital | Deficit | Total stockholders equity |
|------------------------------|------------|------------------------|----------------------------------|-----------------|---------------------------------|
| 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 |

On March 23, 2009, the Company announced that it successfully concluded a modified Dutch auction tender offer that was previously announced on February 12, 2009. Under the terms of the offer, the Company repurchased an aggregate of 4,185,769 shares of its common stock at a purchase price of \$0.41 per share, for a total of \$1,716,132, excluding transaction costs of \$95,046. The purchase price was funded from available cash. Of the 4,185,769 shares purchased, 4,000,000 were shares the Company offered to purchase in the offer and 185,769 were shares purchased pursuant to the Company's right to purchase up to an additional 2% of the shares outstanding immediately prior to the commencement of the tender offer. Due to over-subscription, the final proration factor for shares tendered at or below \$0.41 per share was approximately 99.42%. For this purpose, shares tendered at \$0.41 per share included shares tendered by those persons who indicated, in their letter of transmittal, that they were willing to accept the price determined in the offer. All shares purchased in the tender offer received the same price. As a result of the completion of the tender offer, as of March 23, 2009, the Company had 68,888,092 shares issued and outstanding, as all shares repurchased were immediately retired.

On July 14, 2009 the Company announced that it successfully concluded a second modified Dutch auction tender offer that was previously announced May 26, 2009. Under the terms of the offer, the Company repurchased an aggregate of 1,103,824 shares of its common stock at a purchase price of \$0.45 per share, for a total of \$496,721, excluding transaction costs of \$73,614. The purchase price was funded from available cash. Of the 1,103,824 shares purchased, 1,000,000 were shares the Company offered to purchase in the offer and 103,824 were shares purchased pursuant to the Company's right to purchase up to an additional 2% of the shares outstanding immediately prior to the commencement of the tender offer. Due to over-subscription, the final proration factor for shares tendered at or below \$0.45 per share was approximately 99.82%. For this purpose, shares tendered at \$0.45 per share included shares tendered by those persons who indicated, in their letter of transmittal, that they were willing to accept the price determined in the offer. All shares purchased in the tender offer received the same price. As a result of the completion of the tender offer, as of July 14, 2009, the Company had 67,865,396 shares issued and outstanding, as all shares repurchased were immediately retired.

On October 2, 2009, subsequent to the quarter end, the Company repurchased and cancelled an additional 784,643 common shares under the terms of a third modified Dutch auction tender offer (see note 14).

On May 6, 2008, the Company's Board of Directors authorized the repurchase of up to \$10 million of the Company's common stock at the Company's discretion. The Company had repurchased 849,760 shares under this repurchase program, which expired on May 11, 2009.

Table of Contents

12. SHARE-BASED PAYMENTS

(a) Stock options:

The Company's 1996 Stock Option Plan (the "1996 Plan") was established for the benefit of the employees, officers, directors and certain consultants of the Company. The maximum number of common shares which may be set aside for issuance under the 1996 Plan was 11,150,000 shares, provided that the Board of Directors of the Company has the right, from time to time, to increase such number subject to the approval of the stockholders of the Company when required by law or regulatory authority. Generally, options issued under the 1996 Plan vest over a four-year period. The 1996 Plan expired on February 25, 2006 and no options were issued from the 1996 Plan after that date.

On November 22, 2006, the stockholders of the Company approved the implementation of the Company's 2006 Equity Compensation Plan (the "2006 Plan"), which serves as a successor to the 1996 Plan. The 2006 Plan has been established for the benefit of the employees, officers, directors and certain consultants of the Company. The 5,000,000 common shares that have been set aside for issuance under the 2006 Plan are to provide eligible persons with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in Tucows Inc. Generally, options issued under the 2006 Plan vest over a four-year period and have a term not exceeding seven years.

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, 2009, 200,000 stock options were granted as compared to 180,000 stock options granted during the three months ended September 30, 2008.

During the nine months ended September 30, 2009, 225,000 stock options were granted as compared to 1,251,000 stock options granted during the nine months ended September 30, 2008.

The fair value of stock options granted during the three and nine months ended September 30, 2009 and during the three and nine months ended September 30, 2008 was estimated using the following assumptions:

| | | | |
|-------------------------|-------------------------|------------------------------|------------------------------|
| Three months | Three months | Nine months ended | Nine months ended |
|-------------------------|-------------------------|------------------------------|------------------------------|

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

| | ended September 30, 2009 | ended September 30, 2008 | September 30, 2009 | September 30, 2008 |
|---|--------------------------------|--------------------------------|-----------------------|-----------------------|
| Volatility | 82.0% | 60.6% | 81.6% | 65.4% |
| Risk-free interest rate | 1.2% | 2.7% | 1.2% | 2.9% |
| Expected life (in years) | 2.50 | 4.75 | 2.50 | 4.75 |
| Dividend yield | % | % | % | % |
| The weighted average grant date fair value for options issued, with the exercise price equal to market value on the date of grant | \$ 0.28 | \$ 0.19 | \$ 0.26 | \$ 0.31 |

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

Table of Contents

Details of stock option transactions for the three months ended September 30, 2009 and 2008 are as follows:

| | Three months ended September 30, 2009 | | Three months ended September 30, 2008 | |
|------------------------------------|--|--|--|--|
| | Number of shares | Weighted average exercise price per share | Number of shares | Weighted average exercise price per share |
| Outstanding, beginning of period | 7,029,258 | \$ 0.56 | 4,974,111 | \$ 0.48 |
| Granted | 200,000 | 0.56 | | |
| Exercised | | | | |
| Forfeited | (35,656) | 0.72 | (2,313) | 0.92 |
| Expired | | | | |
| Outstanding, end of period | 7,193,602 | \$ 0.56 | 4,971,798 | \$ 0.48 |
| Options exercisable, end of period | 6,060,574 | \$ 0.53 | 4,949,204 | \$ 0.48 |

Details of stock option transactions for the nine months ended September 30, 2009 and 2008 are as follows:

| | Nine months ended September 30, 2009 | | Nine months ended September 30, 2008 | |
|------------------------------------|---|--|---|--|
| | Number of shares | Weighted average exercise price per share | Number of shares | Weighted average exercise price per share |
| Outstanding, beginning of period | 7,282,777 | \$ 0.56 | 5,048,517 | \$ 0.48 |
| Granted | 225,000 | 0.54 | | |
| Exercised | (68,707) | 0.37 | (35,000) | 0.27 |
| Forfeited | (203,968) | 0.58 | (36,719) | 0.675 |
| Expired | (41,500) | 0.80 | (5,000) | 0.27 |
| Outstanding, end of period | 7,193,602 | \$ 0.56 | 4,971,798 | \$ 0.48 |
| Options exercisable, end of period | 6,060,574 | \$ 0.53 | 4,949,204 | \$ 0.48 |

The stock options expire on various dates through 2016.

As of September 30, 2009, the exercise prices, weighted average remaining contractual life of outstanding options and intrinsic values were as follows:

| Exercise price | Options outstanding | | | | Options exercisable | | | |
|----------------|-----------------------|--|---|---------------------------------|-----------------------|--|---------------------------------|--|
| | Number outstanding | 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 | |
| \$0.31-\$0.49 | 3,725,182 | \$ 0.38 | 3.8 | \$ 848,956 | 3,725,144 | \$ 0.38 | \$ 848,947 | |
| \$0.52-\$0.69 | 1,807,829 | \$ 0.59 | 5.2 | 37,592 | 1,150,789 | \$ 0.58 | 31,771 | |
| \$0.80-\$0.99 | 1,630,417 | \$ 0.87 | 3.2 | | 1,154,469 | \$ 0.88 | | |

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

| | | | | | | | | | | | |
|---------------|-----------|----|------|-----|----|---------|-----------|------|------|----|---------|
| \$2.21-\$4.84 | 30,174 | \$ | 2.82 | 0.4 | | 30,172 | \$ | 2.82 | | | |
| | 7,193,602 | \$ | 0.56 | | \$ | 886,548 | 6,060,574 | \$ | 0.53 | \$ | 880,718 |

Total unrecognized compensation cost relating to unvested stock options at September 30, 2009, prior to the consideration of expected forfeitures, was approximately \$383,000 and is expected to be recognized over a weighted average period of 2.1 years.

The Company recorded stock-based compensation of \$99,810 and \$88,300 for the three months ended September 30, 2009 and 2008, respectively. The Company recorded stock-based compensation of \$231,748 and \$233,500 for the nine months ended September 30, 2009 and 2008, respectively.

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

Table of Contents

(b) Restricted stock awards:

During the three months ended June 30, 2009, under the terms of the 2006 Plan, the Company issued 12,600 restricted stock awards to eligible employees of the Company.

Restricted stock awards generally vest annually over a four year period. Holders of restricted stock awards may not sell, assign, transfer, pledge or otherwise dispose of an unvested stock award. Unvested shares are held in escrow by the Company until the Participant's interest in such shares vests.

Holders of restricted stock awards shall have full shareholder rights with respect to any shares of Company stock issued to the participant under a stock award, whether or not the participant's interest in those shares is vested. Accordingly, the participant shall have the right to vote such shares and to receive any regular cash dividends paid on such shares.

The fair value of restricted stock awards granted during the nine months ended September 30, 2009 was estimated using the closing share price of the Company's common stock on the NYSE Amex on the date preceding the date that the restricted stock awards were issued.

Details of restricted stock awards transactions for the nine months ended September 30, 2009 and 2008 are as follows:

| | Nine months ended September 30, 2009 | | Nine months ended September 30, 2008 | |
|--|---|--|---|--|
| | Number of shares | Weighted average fair value per share | Number of shares | Weighted average fair value per share |
| Outstanding, beginning of period | | \$ | | |
| Granted | 12,600 | 0.32 | | |
| Forfeited | 400 | 0.32 | | |
| Outstanding, end of period | 12,200 | \$ 0.32 | | |
| Restricted stock awards exercisable, end of period | | | | |

Total unrecognized compensation cost relating to unvested restricted stock awards at September 30, 2009, prior to the consideration of expected forfeitures, was approximately \$3,000 and is expected to be recognized over a weighted average period of 3.5 years.

The Company recorded stock-based compensation of \$221 for the three months ended September 30, 2009 and \$451 for the nine months ended September 30, 2009.

13. FAIR VALUE MEASUREMENT

FASB 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 assets measured at fair value on a recurring basis:

| | September 30, 2009 | | | |
|--------------|--------------------------------------|----------------|----------------|-------------------|
| | Fair Value Measurements Using | | | Assets at |
| | Level 1 | Level 2 | Level 3 | Fair Value |
| Forward Plus | | | | |
| Contracts | \$ | \$ 1,927,475 | \$ | \$ 1,927,475 |
| Total Assets | \$ | \$ 1,927,475 | \$ | \$ 1,927,475 |

Table of Contents

14. SUBSEQUENT EVENTS

During October 2009, the Company entered into foreign exchange forward contracts to hedge a portion of its 2010 fiscal year expected Canadian dollar requirements. These contracts have a notional value of \$5.8 million, whereby \$5.8 million is converted into Canadian dollars during 2010 at an average foreign exchange rate of US\$1.00: Cdn\$1.0617.

During October 2009, the Company entered into foreign exchange forward contracts to hedge a portion of its 2011 fiscal year expected Canadian dollar requirements. These contracts have a notional value of \$5.2 million, whereby \$5.2 million is converted into Canadian dollars during 2011 at an average foreign exchange rate of US\$1.00: Cdn\$1.0669.

On October 2, 2009, the Company announced that it successfully concluded a third modified Dutch auction tender offer that was previously announced on August 20, 2009. Under the terms of the offer, the Company repurchased an aggregate of 784,643 shares of its common stock at a purchase price of \$0.60 per share, for a total of \$470,786, excluding transaction costs of \$48,440. The purchase price was funded from available cash. All shares purchased in the tender offer received the same price. As a result of the completion of the tender offer, as of October 2, 2009, the Company had 67,080,453 shares issued and outstanding, as all shares repurchased were immediately retired.

15. RECLASSIFICATION

Certain of the prior periods comparative figures have been reclassified to conform with the presentation adopted in the current period.

Table of Contents

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 and intend, and other similar 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 estimated annual cash sweep payment due under the Company's credit facility; the number of new, renewed and transferred-in domain names, the competition we expect to encounter as our business develops and competes in a broad range of Internet services, our valuations of certain deferred tax assets, our expectation to collect our outstanding receivables, net of our allowance for doubtful accounts; the potential impact of current and pending claims on our business; our expectation regarding fluctuations in certain expense and cost categories; 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 applications and services we offer, we will be able to generate higher revenues; and our belief that the actions we have taken have positioned the Company for long-term growth. 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;

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

- 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, 2008.

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 Form 10-Q by the foregoing cautionary statements.

Table of Contents

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 9,000 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.

To assist us in forecasting growth and to help us monitor the effectiveness of our operational strategies we categorize our revenue into the following services:

OpenSRS, our wholesale service, manages over nine million domain names, millions of mailboxes and tens of thousands of digital certificates through a network of over 9,000 web hosts, Internet service providers, or ISPs, and other resellers around the world, including Platypus, our billing service, which provides ISPs with an industry-specific solution for billing, service provisioning and customer account management.

Hover, our retail service, offers services similar to those of OpenSRS to consumers and small businesses.

YummyNames, our domain portfolio service, manages tens of thousands of domain names, most of which generate advertising revenue and many of which we offer for resale via our reseller network and other channels. Included in the YummyNames domain portfolio are over 30,000 domains that allow over two-thirds of Americans to purchase a domain or email address based on their name.

Butterscotch, our content service, operates two advertising-supported websites, butterscotch.com and tucows.com, that provide content to help consumers overcome the complexity of modern technology and the Internet, in the form of over 1,500 videos and over 46,000 software listings and articles. Additionally, Butterscotch provides custom video production services for technology manufacturers and Internet services providers.

We periodically acquire companies or technology when we determine that the related products or technology are strategic or complementary to our current or future service offerings, as opportunities arise. For example:

- On July 25, 2007, we acquired Innerwise, Inc., or IYD, a privately held, Internet Corporation for Assigned Names and Numbers, or ICANN, accredited registrar offering domain services through a worldwide wholesale affiliate network.
- On June 19, 2006, we acquired Mailbank.com, Inc. (doing business as NetIdentity). We use the assets from this acquisition to offer personalized Internet services directly to end-users through Hover and to resellers through OpenSRS Personal Names Service, as well as to generate income from the parked page of each domain address.
- To expand our presence in the email market, on January 3, 2006, we acquired all of the Hosted Messaging assets of Critical Path, Inc.

Our business model is characterized by non-refundable, up-front payments, which lead to recurring revenue and positive operating cash flow. We are an ICANN-accredited registrar and manage over eight million domains.

Table of Contents

Net Revenues

OpenSRS

We derive revenue from our reseller network by providing them with reseller services that comprise (a) domain services, (b) email services and (c) other services currently consisting of secure sockets layer, or SSL, certificates, blogware and website building tools that are used by our resellers to create bundles of Internet services for their end-users along with billing solutions for ISPs.

OpenSRS Domain Service

Historically, the domain services provided by OpenSRS Domain Service has been 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 customer will engage us, enabling us to follow on with other services and allowing us to add to our domain portfolio by purchasing names registered through us upon their expiration. We also provide resellers with the ability to sell personal names. This service allows resellers the opportunity to sell email addresses based on our domain portfolio of surname domain names.

On August 7, 2007, in advance of the announced October 2007 registry fee increases, we modified our pricing structure for domain names to provide greater 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. 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 name services.

As of September 30, 2009, we offer registration services for the gTLDs .com, .net, .org, .info, .name, .biz, .tel, .mobi and .asia and for the country code top-level domains, or ccTLDs, at, .be, .ca, .cc, .ch, .cn, .de, .dk, .es, .eu, .fr, .it, .li, .me, .mx, .nl, .tv, .uk, and .us.

With respect to the sale of domain registrations, 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. Except for certain large customers with whom we have negotiated alternative arrangements, payments for the full term of service, or billed revenue, is received at the time of activation of service. All fees received in connection with domain name registration are non-refundable, and where appropriate, are recorded as deferred revenue and 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.

OpenSRS Email Service

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

We derive revenue from our hosted email service through our global distribution network. Our 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 email service also includes spam and virus filtering on all accounts. End-users can access the email service via a full-featured multi-language AJAX-enabled web interface, a WAP mobile interface, or through traditional desktop email clients, such as Microsoft Outlook or Apple Mail, using IMAP or POP/SMTP and 2GB of email storage.

We earn fees for email services when they are activated. Email services are generally purchased monthly and at month-end, are either deducted on a pre-authorized basis from reseller's deposit account, or are invoiced.

Other OpenSRS Services

Other services currently consist of SSL certificates; blogware and website building tools that are used by our resellers to create bundles of Internet services for their end-users, as well as the provision of billing, provisioning and customer care software solutions to Internet Service Providers through our Platypus billing software.

We earn fees from such services when a service is activated. These services are generally purchased for terms of one month to three years. Platypus software is generally purchased for terms of one month to one year. Payments for services are for the full term of all services at the time of activation of service, are non-refundable and, where appropriate, are recorded as

Table of Contents

deferred revenue and recognized as earned ratably over the service term. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

YummyNames

We derive revenue from our portfolio of domain names by displaying advertising on the domains and by making them available for sale or lease. In addition we display advertising on Parked Pages within OpenSRS. Parked Pages are domain names registered with us that do not yet contain an active website. When a user types one of these domain names into a web browser, they are presented with dynamically generated links which 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.

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.

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.

In addition, we also offer the same services to our customers, allowing them to make available names registered by them for monetization on a similar basis. For customer names, we earn a referral fee for premium names or names sold or leased, and participate on a revenue share basis for names offered through our pay-per-click advertising program.

We recognize revenue from these services, net of any fees payable to resellers or customers, immediately upon completion of the service, or in the case of advertising revenue, on a monthly basis once the advertising has been served.

Hover

We generate revenues from the provisioning and management of Internet services, on a retail basis, to consumers and small businesses through our *Hover.com* website. These services include domain registration and other Internet services such as email and personalized email through our portfolio of surname-based domain names, as well as an easy-to-use interface that allows users to connect domain names to websites and email addresses through a unique DNS forwarding system. Depending on the service offered, we typically receive fees for our services.

Our customers generally purchase services for terms of one to ten years, with a majority of services purchased for a one-year term. Certain services are also offered on a monthly basis. Payments for the full term of all services, or billed revenue, are received at the time of service activation and, where appropriate, are recorded as deferred revenue and 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 quarterly and annual periods.

Butterscotch

We also generate advertising and other revenue through two ad-support content sites, *butterscotch.com* and *tucows.com*.

Butterscotch.com derives revenue from banner and text advertising on the site, as well as video advertising and product placement within the videos that make up the bulk of the site. In addition, revenue is earned through custom video production for technology manufacturers and Internet services customers.

Tucows.com advertising revenue is generated from third-party advertisers and 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 placement of their software. Software developers may also purchase other promotional services on a cost-per-click or flat rate basis. Software developers are able to promote their software through advertising services including keyword search placements, banners, promotional placements, expedited reviews and premium data services. Revenue is also generated from companies that contract with us to provide them with co-branded content. Advertising and other revenue is recognized ratably over the period in which it is presented.

Table of Contents

Advertising and other revenue is recognized ratably over the period in which it is presented. To the extent that we do not meet the minimum number of impressions that we guarantee to customers post-presentation, we defer recognition of the corresponding revenues until the guaranteed impressions are achieved. Custom video production revenue is recognized on acceptance of the completed video by the customer.

Critical Accounting Policies

In preparing our consolidated financial statements, we make assumptions, judgments and estimates that can have a significant impact on amounts reported in our consolidated financial statements. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making estimates about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ materially from these estimates under different assumptions or conditions.

During the nine months ended September 30, 2009, there have been no significant changes in our critical accounting policies as compared to the critical accounting policies disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Table of Contents**RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2009 AS COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008**

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------------------|----------------------------------|---------------|---------------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| OpenSRS : | | | | |
| Domain Services | \$ 15,097,640 | \$ 13,688,084 | \$ 44,037,596 | \$ 39,828,983 |
| Email Services | 842,262 | 1,516,726 | 2,838,052 | 4,642,977 |
| Other Services | 1,109,341 | 1,104,374 | 3,295,789 | 3,339,758 |
| Total OpenSRS Services | 17,049,243 | 16,309,184 | 50,171,437 | 47,811,718 |
| YummyNames | 1,781,725 | 1,264,903 | 5,102,315 | 4,042,830 |
| Hover | 1,203,742 | 2,071,200 | 3,763,155 | 5,757,890 |
| Butterscotch | 461,419 | 501,908 | 1,572,766 | 1,696,293 |
| | \$ 20,496,129 | \$ 20,147,195 | \$ 60,609,673 | \$ 59,308,731 |
| Increase over comparative period | \$ 348,934 | | \$ 1,300,942 | |
| Increase - percentage | | 2% | | 2% |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------|----------------------------------|------|---------------------------------|------|
| | 2009 | 2008 | 2009 | 2008 |
| OpenSRS : | | | | |
| Domain Services | 74% | 69% | 73% | 66% |
| Email Services | 4% | 8% | 5% | 8% |
| Other Services | 5% | 5% | 5% | 6% |
| Total OpenSRS Services | 83% | 82% | 83% | 80% |
| YummyNames | 9% | 6% | 8% | 7% |
| Hover | 6% | 10% | 6% | 10% |
| Butterscotch | 2% | 2% | 3% | 3% |
| | 100% | 100% | 100% | 100% |

Deferred revenue from domain name registrations and other services at September 30, 2009 increased to \$56.5 million from \$54.4 million at September 30, 2008.

No customer accounted for more than 10% of revenue during the three and nine months ended September 30, 2009 and, at September 30, 2009, no customer accounted for more than 10% of accounts receivable. 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.

OpenSRS

Net revenues from OpenSRS revenue for the three months ended September 30, 2009 as compared to the three months ended September 30, 2008, increased by \$0.7 million to \$17.0 million.

The main contributor to this increase was domain services which increased by \$1.4 million to \$15.1 million, primarily as a result of the impact of the 7% registry price increase that was levied by some of our domain name suppliers in October 2008. This increase was partially offset by a decrease in email services revenue of \$0.7 million during the period.

During the nine months ended September 30, 2009, OpenSRS revenue increased by \$2.4 million to \$50.2 million when compared to the nine months ended September 30, 2008.

The main contributor to this increase was domain services revenue, which increased by \$4.2 million to \$44.0 million, primarily as a result of the impact of the 7% registry price increase that was levied by some of our domain name suppliers in October 2008 and from our continuing to aggressively compete to attract new clients and retain existing customers. This increase was partially offset by a decrease in email services revenue of \$1.8 million during the period.

As previously disclosed, the decrease in email service revenue is primarily attributable to two factors:

- our decision to eliminate certain enterprise customers acquired as part of the Hosted Messaging Business of Critical Path, Inc. in January 2006 that were not part of our strategic focus and who were receiving pricing that was not competitive in the marketplaces; and

Table of Contents

- certain of our email customers, who are media portal companies and for whom email is only a small component of their overall service offerings, who have chosen to include their email services as part of larger supply contracts for competitive and cost-control reasons.

Our original expectation was that the companies described above would have completed their migrations by March 2009. One of these customers has modified its migration plans and is now expected to migrate away from our hosted email platform during the three months ending December 31, 2009. As our marketing efforts to date have not yet been successful in offsetting these customer losses, these customer losses have had a material impact on our results of operations for email services for the fiscal year ending December 31, 2009.

During the three months ended September 30, 2009, the total new, renewed and transferred-in domain name registrations that we processed remained essentially flat at 1.6 million compared to the three months ended September 30, 2008. This result is primarily related to certain of our customers who own large name portfolios restructuring their portfolios during the quarter. As such, we believe this result is temporary and does not reflect a longer term trend.

During the nine months ended September 30, 2009, the total new, renewed and transferred-in domain name registrations that we processed increased by 0.2 million to 5.0 million as compared to the nine months ended September 30, 2008. This increase resulted primarily from our continuing to aggressively compete to attract new clients and retain existing customers.

While we anticipate that the number of new, renewed and transferred-in domain name registrations will continue to incrementally increase, the volatility in the market could affect the growth of domain names that we manage. As of September 30, 2009, the total domain names under our management increased by 0.4 million to 8.0 million, as compared to the total domain names under our management as of September 30, 2008. In addition, we provide provisioning services on a monthly basis to accredited registrars who use our technical systems to process domain registrations with their own accreditation. As of September 30, 2009, we managed 1.2 million domain names on behalf of other accredited registrars, consistent with the 1.2 million managed for accredited registrars as of September 30, 2008.

YummyNames

Net revenues from our YummyNames domain portfolio service for the three months ended September 30, 2009 as compared to the three months ended September 30, 2008 increased by \$0.5 million, or 41%, to \$1.8 million.

During the three months ended September 30, 2009, we earned \$1.3 million in revenue by making domain names in our portfolio available for sale or lease compared to \$0.5 million during the three months ended September 30, 2008. In addition we earned \$0.4 million from our pay-per-click advertising or parked pages program during the three months ended September 30, 2009 compared to \$0.7 million for the three months ended September 30, 2008.

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

This increase primarily reflects the timing of larger portfolio sales of domain names as well as the improved performance we are currently experiencing with our auction initiatives. These increases have been partially offset by the decrease in the delivery of third-party advertisements on Parked Pages of \$0.3 million as a result of the impact of our domain name sales on our advertising revenue and the general economic conditions resulting in a generally slower advertising environment.

During the nine months ended September 30, 2009, we earned \$3.5 million by making domain names in our portfolio available for sale or lease compared to \$1.8 million during the three months ended September 30, 2008. In addition we earned \$1.6 million from our pay-per-click advertising or parked pages program during the three months ended September 30, 2009 compared to \$2.2 million for the three months ended September 30, 2008.

This increase primarily reflects the timing of larger portfolio sales of domain names as well as the improved performance we are currently experiencing with our auction initiatives. These increases have been partially offset by the decrease in the delivery of third-party advertisements on Parked Pages of \$0.6 million as a result of the impact of our domain name sales on our advertising revenue and the general economic conditions resulting in a generally slower advertising environment.

The market for monetization of domain names is rapidly evolving and there is no guarantee that we will be able to grow revenue at the rate achieved during the three or nine months ended September 30, 2009, nor that we will be able to continue to acquire the same caliber of names for our portfolio from future expiring domains or that names we acquire in

Table of Contents

future will provide the same revenue impact as we have experienced from past acquisitions. In addition, the revenue we derive from domain portfolio services is driven by general macroeconomic factors that affect internet advertising. Our advertising expenditures are typically sensitive to economic conditions and tend to decline in recessionary periods and other periods of economic uncertainty. A slowing economy may thus be accompanied by a decrease in advertising spending which could adversely impact our ability to grow or maintain our domain portfolio services revenue.

Hover

Net revenues from Hover for the three months ended September 30, 2009 as compared to the three months ended September 30, 2008 decreased by \$0.9 million, or 42%, to \$1.2 million.

Net revenues from Hover for the nine months ended September 30, 2009 as compared to the nine months ended September 30, 2008 decreased by \$2.0 million, or 35%, to \$3.8 million.

This decrease primarily resulted from the impact of the sale of our retail hosting assets during the 2008 fiscal year on current period revenues. To a lesser extent, our decisions to reclassify certain retail customers acquired in the IYD acquisition that did not meet our definition of retail customers to OpenSRS and de-emphasize new customer acquisitions while we transitioned our retail customers from our Domain Direct, NetIdentity and IYD services to Hover also contributed to this decrease.

Butterscotch

Net revenues from Butterscotch for the three months ended September 30, 2009 as compared to the three months ended September 30, 2008 remained relatively flat at \$0.5 million.

Net revenues from Butterscotch for the nine months ended September 30, 2009 as compared to the nine months ended September 30, 2008 decreased by \$0.1 million, or 7%, to \$1.6 million. This decrease is primarily a result of the contraction in the yields from our syndicated Google feeds, and decreased revenue from our Author Resource Center of \$0.3 million, offset by an increase in advertising and video revenue of \$0.2 million.

COST OF REVENUES

OpenSRS

- 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.

- OpenSRS Email Service

Cost of revenues for email services are payable to third-party providers for licensing and royalty costs related to the provision of certain components of our email services. Fees payable for these components are included in the cost of revenues in the month they are incurred.

- Other OpenSRS Services

Costs of revenues for other reseller services include fees paid to third-party service providers, primarily for SSL certificates and for printing services in connection with Platypus. Fees payable for SSL certificates are amortized on a basis consistent with the provision of service, generally one year, while monthly printing fees are included in cost of revenues in the month they are incurred.

YummyNames

Costs of revenues for our domain portfolio service 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

Table of Contents

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.

Hover

Costs of revenues for our provision and management of Internet services on a retail basis 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 and includes the amortization of registry fees payable to renew the domains in our surname portfolio. 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.

Butterscotch

Costs of revenues for our ad-supported content sites 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, for the periods presented

| | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------|----------------------------------|---------------|---------------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| OpenSRS : | | | | |
| Domain Services | \$ 12,325,620 | \$ 11,015,952 | \$ 35,624,222 | \$ 31,456,663 |
| Email Services | 103,071 | 161,848 | 436,216 | 244,848 |
| Other Services | 411,949 | 403,431 | 1,212,087 | 1,226,508 |
| Total OpenSRS Services | 12,840,640 | 11,581,231 | 37,272,525 | 32,928,019 |
| YummyNames | 218,371 | 182,614 | 654,456 | 542,065 |
| Hover | 493,181 | 558,190 | 1,481,761 | 1,701,786 |
| Butterscotch | 25,491 | 4,600 | 33,341 | 15,225 |
| Network, other costs | 1,193,185 | 1,654,612 | 3,500,231 | 5,607,181 |

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

| | | | | |
|--|---------------|---------------|---------------|---------------|
| Network, depreciation and amortization costs | 504,644 | 824,644 | 1,504,431 | 2,572,139 |
| | \$ 15,275,512 | \$ 14,805,891 | \$ 44,446,745 | \$ 43,366,415 |
| Increase over comparative period | \$ 469,621 | | \$ 1,080,330 | |
| Increase - percentage | 3% | | 2% | |

The following table presents our cost of revenues, as a percentage of total cost of revenues for the periods presented:

| | | | | |
|--|------|------|------|------|
| OpenSRS : | | | | |
| Domain Services | 81% | 74% | 81% | 72% |
| Email Services | 1% | 1% | 1% | 1% |
| Other Services | 3% | 3% | 3% | 3% |
| Total OpenSRS Services | 85% | 78% | 85% | 76% |
| YummyNames | 1% | 1% | 1% | 1% |
| Hover | 3% | 4% | 3% | 4% |
| Butterscotch | 0% | 0% | 0% | 0% |
| Network, other costs | 8% | 11% | 8% | 13% |
| Network, depreciation and amortization costs | 3% | 6% | 3% | 6% |
| | 100% | 100% | 100% | 100% |

Prepaid domain registration and other Internet services fees as of September 30, 2009 increased by \$3.0 million, or 7%, to \$43.7 million from \$40.7 million at September 30, 2008.

OpenSRS

Costs for OpenSRS for the three months ended September 30, 2009 increased by \$1.3 million, or 11%, when compared to the three months ended September 30, 2008, while costs for OpenSRS for the nine months ended September 30, 2009 increased by \$4.4 million, or 13%, when compared to the nine months ended September 30, 2008. Higher domain registration volumes and increases in registration fees paid to the registries that were implemented in October

Table of Contents

2007 and October 2008 accounted for \$1.3 million of this increase for the three months ended September 30, 2009 when compared to the three months ended September 30, 2008 and \$4.2 million of this increase for the nine months ended September 30, 2009 when compared to the nine months ended September 30, 2008. In addition, \$0.2 million of the increase resulted from licensing and royalty costs payable to third-party service providers for email services.

YummyNames

Costs for YummyNames for the three months ended September 30, 2009 as compared to the three months ended September 30, 2008 remained relatively flat at \$0.2 million.

Costs for YummyNames for the nine months ended September 30, 2009 as compared to the nine months ended September 30, 2008 increased by \$0.1 million, to \$0.7 million, as the total names in our portfolio continued to increase.

Hover

Costs for Hover for the three and nine months ended September 30, 2009 as compared to the three and nine months ended September 30, 2008 decreased by \$0.1 million and \$0.2 million, respectively, to \$0.5 million and \$1.5 million, respectively, and primarily reflect the lower revenue experienced during the periods as well as the impact that the sale of our retail hosting assets during the 2008 fiscal year has had on our retail gross margins.

Network costs

Network costs before depreciation and amortization for the three and nine months ended September 30, 2009 decreased by \$0.5 million, or 28%, to \$1.2 million, and \$2.1 million, or 38%, to \$3.5 million, respectively primarily as a result of lower bandwidth, support contract and workforce costs. The decrease is primarily attributable to the lower co-location costs stemming from the closure and relocation of our US-based co-location facilities during September 2008 and the restructuring we implemented in November 2008. Network depreciation and amortization costs for the three and nine months ended September 30, 2009 decreased by \$0.3 million, or 39%, to \$0.5 million, and \$1.1 million, or 42%, to \$1.5 million, respectively primarily as a result of certain of our older computer hardware being fully depreciated and not requiring replacement.

In addition, as a significant portion of our expenses are incurred in Canadian dollars, the weakening of the Canadian dollar relative to the U.S. dollar has positively impacted network costs, during the three and nine months ended September 30, 2009 when compared to the three and nine months ended September 30, 2008,. 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.

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

Amortization of intangible assets consists of amounts arising in connection with the acquisition of technology from each of the Boardtown Corporation in April 2004, the hosted messaging business of Critical Path, Inc. in January 2006, Mailbank.com Inc. in June 2006 and IYD in July 2007.

The technology purchased in connection with the acquisition of Boardtown Corporation is amortized on a straight-line basis over seven years, and for IYD over three years, while the technology acquired in connection with each of the acquisitions of the hosted messaging assets of Critical Path, Inc. and the in-house software of Mailbank.com Inc. was amortized on a straight-line basis over two years.

We expect network costs to decrease for the fiscal year ending December 31, 2009 as compared to the fiscal year ending December 31, 2008 as we realize the benefits from completing the consolidation of some of the multiple systems we support, thereby reducing our overall space and resource utilization at our data centers.

Table of Contents**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.

| | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------------------|----------------------------------|--------------|---------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Sales and marketing | \$ 1,568,727 | \$ 1,705,512 | \$ 4,261,070 | \$ 5,132,380 |
| Decrease over comparative period | \$ (136,785) | | \$ (871,310) | |
| Decrease - percentage | (8)% | | (17)% | |
| Percentage of net revenues | 8% | 8% | 7% | 9% |

Sales and marketing expenses for the three months ended September 30, 2009 decreased by \$0.1 million, or 8%, to \$1.6 million for the three months ended September 30, 2008. This decrease was primarily due to lower workforce costs that resulted from the restructuring we undertook in November 2008, which was slightly offset by and higher marketing expenses incurred during the period.

Sales and marketing expenses for the nine months ended September 30, 2009 decreased by \$0.8 million, or 17%, to \$4.3 million for the nine months ended September 30, 2008. This decrease was primarily due to lower workforce costs that resulted from the restructuring we undertook in November 2008. This decrease was partially offset by an increase in marketing and travel related costs of \$0.1 million for the nine months ended September 30 2009, as compared to the nine months ended September 30, 2008.

In addition, as a significant portion of our expenses are incurred in Canadian dollars, the weakening of the Canadian dollar relative to the U.S. dollar has positively impacted sales and marketing expenses during the three and nine months ended September 30, 2009 when compared to the three and nine months ended September 30, 2008. 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.

We expect sales and marketing expenses will increase slightly, in absolute dollars, as we adjust our marketing programs and sales and customer support strategies to meet future opportunities in the marketplace.

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. In accordance with FASB ASC: Topic 350-40, Goodwill and Other Internal-Use Software, costs incurred during the application development stage are capitalized and primarily include personnel costs for employees directly related to the development

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

project. All other costs are expensed as incurred.

| | Three months ended September 30, | | Nine months ended September 30, | |
|--------------------------------------|----------------------------------|--------------|---------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Technical operations and development | \$ 1,142,331 | \$ 1,527,237 | \$ 3,421,825 | \$ 4,666,832 |
| Decrease over comparative period | \$ (384,906) | | \$ (1,245,007) | |
| Decrease - percentage | (25)% | | (27)% | |
| Percentage of net revenues | 6% | 8% | 6% | 8% |

Technical operations and development expenses for the three months ended September 30, 2009 decreased by \$0.4 million, or 25%, to \$1.1 million as compared to the three months ended September 30, 2008.

Technical operations and development expenses for the nine months ended September 30, 2009 decreased by \$1.3 million, or 27%, to \$3.4 million as compared to the nine months ended September 30, 2008.

This decrease for the three and nine months ended September 30, 2009 resulted primarily from a decrease in workforce-related costs, including contract and outside service costs, that resulted from the restructuring we undertook in November 2008.

In addition, as a significant portion of our expenses are incurred in Canadian dollars, the weakening of the Canadian dollar relative to the U.S. dollar has positively impacted technical operations and development expenses during the three and

Table of Contents

nine months ended September 30, 2009 when compared to the three and nine months ended September 30, 2008. 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.

We expect technical operations and development expenses to increase slightly, in absolute dollars, as our business continues to grow and as we further develop our applications and services.

GENERAL AND ADMINISTRATIVE

General and administrative expenses consist primarily of compensation and related costs for managerial and administrative personnel, fees for professional services, public listing expenses, rent and other general corporate expenses.

| | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------------------|----------------------------------|--------------|---------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| General and administrative | \$ 1,145,951 | \$ 1,714,563 | \$ 4,608,173 | \$ 4,805,853 |
| Decrease over comparative period | \$ (568,612) | | \$ (197,680) | |
| Decrease - percentage | (33)% | | (4)% | |
| Percentage of net revenues | 6% | 9% | 8% | 8% |

General and administrative expenses for the three months ended September 30, 2009 decreased by \$0.6 million, or 33%, to \$1.1 million as compared to the three months ended September 30, 2008.

General and administrative expenses for the nine months ended September 30, 2009 decreased by \$0.2 million, or 4%, to \$4.6 million as compared to the nine months ended September 30, 2008.

As a significant portion of our expenses are incurred in Canadian dollars, the weakening of the Canadian dollar relative to the U.S. dollar has positively impacted general and administrative expenses during the three and nine months ended September 30, 2009 when compared to the three and nine months ended September 30, 2008. 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.

General and administrative expenses decreased during the three months ended September 30, 2009 compared to the three months ended September 30, 2008 primarily as a result a reduction of professional fees of \$0.2 million, a decrease in net bank charges of \$0.2 million as a result of our initiative introduced in January 2009 to recover payment processing fees and as a result of our recording a foreign exchange gain of \$49,000 during the three months ended September 30, 2009 as compared to a foreign exchange loss of \$0.2 million during the three months ended September 30, 2008. The \$0.2 million increase in foreign exchange was primarily due to the impact of translating our Canadian dollars to our functional currency of U.S. dollars, and the weakening of the Canadian dollar relative to the U.S. dollar compared to the three months ended September 30, 2008. These decreases were offset by an increase in workforce related costs of \$0.1 during the three months ended September 30, 2009, as compared to the three months ended September 30, 2008.

General and administrative expenses decreased during the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008 primarily as a result a reduction in professional fees of \$0.4 million, a decrease in net bank charges of \$0.7 million as a result of our initiative introduced in January 2009 to recover payment processing fees and a decrease in facility costs, telephone, investor and public relations costs of \$0.3 million. These decreases were offset by our recognizing a foreign exchange loss of \$1.0 million during the nine months ended September 30, 2009 as compared to a foreign exchange loss of \$13,000 during the nine months ended September 30, 2008. This \$1.0 million increase was primarily due to the impact of translating our Canadian dollar net assets on hand at September 30, 2009, to our functional currency of U.S. dollars. This impact has resulted from the significant weakening of the Canadian dollar relative to the U.S. dollar compared to the nine months ended September 30, 2008. In addition, general and administrative expenses increased by \$0.2 million as a result of additional public listing and workforce related costs incurred during the period.

DEPRECIATION OF PROPERTY AND EQUIPMENT

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|----------------------------------|-----------|---------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Depreciation of property and equipment | \$ 64,704 | \$ 57,386 | \$ 230,336 | \$ 177,317 |
| Increase over comparative period | \$ 7,318 | | \$ 53,019 | |
| Increase - percentage | 13% | | 30% | |

Table of Contents**LOSS ON DISPOSITION OF PROPERTY AND EQUIPMENT**

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|----------------------------------|------------|---------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Loss on disposition of property and equipment | \$ 40,369 | \$ 498,529 | \$ 40,369 | \$ 498,529 |
| Decrease over comparative period | \$ (458,160) | | \$ (458,160) | |

As part of our ongoing initiatives to improve the efficiency of our production environment, we retired some older computer hardware at our co-location facilities during the three months ended September 30, 2009, which resulted in a loss on the disposition of such equipment of \$40,000.

During the three months ended September 30, 2008, as part of our consolidation of the multiple systems that we were supporting, we disposed of some of our older computer hardware at co-location facilities that we no longer intend to deploy, and incurred a loss on the disposition of such equipment of \$0.5 million.

AMORTIZATION OF INTANGIBLE ASSETS

| | Three months ended September 30, | | Nine months ended September 30, | |
|-----------------------------------|----------------------------------|------------|---------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Amortization of intangible assets | \$ 360,540 | \$ 360,540 | \$ 1,081,620 | \$ 1,122,655 |
| Decrease over comparative period | \$ | | \$ (41,035) | |
| Decrease - percentage | | % | (4)% | |

Amortization of intangible assets consists of amounts arising in connection with the acquisition of Boardtown in April 2004, the acquisition of the hosted messaging assets of Critical Path Inc. in January 2006, the acquisition of Mailbank.com Inc. in June 2006 and the acquisition of IYD in July 2007.

In connection with the acquisition of Boardtown Corporation, the brand and customer relationships purchased are amortized on a straight-line basis over seven years, while the non-competition agreements entered into with the former owners of Boardtown Corporation are amortized on a straight-line basis over three years.

Customer relationships acquired in connection with the acquisition of the hosted messaging assets of Critical Path Inc. are amortized on a straight-line basis over five years.

In connection with the acquisition of Mailbank.com Inc., customer relationships purchased are amortized on a straight-line basis over five years.

In connection with the acquisition of IYD, the brand and customer relationships purchased are amortized on a straight-line basis over seven years.

(GAIN) LOSS IN FAIR VALUE OF FORWARD EXCHANGE 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.

As we are not required to comply with the documentation requirements for hedge accounting, we account for the fair value of the derivative instruments within the consolidated balance sheet as a derivative financial asset or liability and the corresponding change in fair value is recorded in the consolidated statement of operations.

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| (Gain)/loss on change in fair value of forward contracts | \$ (1,878,230) | \$ 525,571 | \$ (3,902,394) | \$ 555,364 |
| Decrease over comparative period | \$ (2,403,801) | | \$ (4,457,758) | |

We have entered into forward exchange contracts to meet a portion of our future Canadian dollar requirements through December 2010. The impact of the fair value adjustment on unrealized foreign exchange on these contracts for the three months ended September 30, 2009 was a net gain of \$1.9 million, as compared to a net loss of \$0.5 million for the three months ended September 30, 2008. This net gain in fair value of forward contracts results from a combination of the impact

Table of Contents

from the change in foreign exchange rates over time, as well as from the impact of the settlement of forward exchange contracts as they mature. The impact of the fair value adjustment on unrealized foreign exchange on these contracts for the nine months ended September 30, 2009 was a net gain of \$4.0 million, as compared to a net loss of \$0.6 million for the nine months ended September 30, 2008.

At September 30, 2009, we reflect a derivative instrument asset of \$1.9 million on our balance sheet as a result of the foreign exchange contracts we have entered into. Until their respective maturity dates, these contracts will fluctuate in value in line with movements in the Canadian vs. U.S. dollar pair. As all of the remaining contracts pertaining to the 2009 fiscal year will have matured during the course of the 2009 fiscal year, a derivative instrument asset pertaining to 2009 fiscal year contracts of \$0.2 million will reverse during the 2009 fiscal year and will result in our recognizing an additional non-cash loss of this amount by December 31, 2009. This loss will, however, be impacted by any additional contracts, with maturity dates after September 30, 2009, that we may enter into and fluctuations in the value of our existing contracts that mature during the 2009 fiscal year and the 2010 fiscal year.

OTHER INCOME AND EXPENSES

| | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------------|----------------------------------|--------------|---------------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Other income (expenses), net | \$ 1,827,113 | \$ 1,007,386 | \$ 4,314,521 | \$ 2,163,746 |

Other income, net, increased by \$0.8 million, or 81%, to \$1.8 million as compared to the three months ended September 30, 2008 and by \$2.1 million, or 99%, to \$4.3 million as compared to the nine months ended September 30, 2008.

The net increase during the three and nine months ended September 30, 2009 when compared to the three and nine months ended September 30, 2008 was primarily the result of the following:

- In April 2009, we received \$2.1 million from Afilius Inc. or Afilius, to complete the second closing under the terms of a stock redemption agreement signed in November 2008 whereby one of our subsidiaries agreed to sell its investment in Afilius back to Afilius in three stages for \$7.5 million. This sale resulted in a gain of \$2.0 million for the corresponding quarter.
- In September 2009, we received \$2.0 million from Afilius to complete the third and final closing under the terms of a stock redemption agreement signed in November 2008 whereby one of our subsidiaries agreed to sell its investment in Afilius back to Afilius in three stages for \$7.5 million. This sale resulted in a gain of \$1.9 million for the corresponding quarter.
- In June 2009, we received an additional payment of \$0.6 million in connection with Infonautics patents that we assigned in 2002 to a third party. In connection with the assignment of these patents, we retained the right to share in certain revenue relating to any cash flow received by the third party with respect to the commercialization of these patents. This revenue is comparable to the \$0.2 million we recognized in June 2008 in connection with these patents. As the third party's costs of commercializing the patents are expected to increase in the future, we do not expect any future revenue received to be material.

Interest expense, net, decreased during the three and nine months ended September 30, 2009 when compared to the three and nine months ended September 30, 2008 by \$38,000 and \$0.3 million, respectively, primarily as a result of the monthly capital repayments of \$0.2 million and the annual cash sweep payment of \$0.7 million we made in April 2009 pursuant to the terms of our Bank of Montreal credit facility.

As a result of the sale of certain shared hosting assets to Hostopia.com Inc., pursuant to the terms of a purchase and sale agreement signed with Tucows.com Co., a wholly-owned subsidiary of the Company, on May 7, 2008, we recorded a profit on the sale of these customer relationships of \$1.1 million. In another transaction in September 2008, we sold the remaining shared hosting assets and recorded a profit on the sale of these customer relationships of \$0.9 million.

In June 2008 and September 2008, we received dividends in the amount of \$0.2 million and \$0.2 million, respectively, from Afilias, a company in which we held an investment. Afilias has not paid any dividends during the three and nine months ended September 30, 2009, and, effective September 2009, we sold our investment back to Afilias and no longer hold any interest in the Company.

Table of Contents**INCOME TAXES**

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| (Recovery of) provision for income taxes | \$ (447,455) | \$ 30,000 | \$ 241,621 | \$ 91,134 |

For the three months ended September 30, 2009, we recorded an income tax recovery of \$447,000 on income before taxes of \$4.6 million. Included in income tax recovery is current income tax of \$50,000 using an estimated effective tax rate for our 2009 fiscal year that accounts for the utilization of remaining net operating loss carry forwards and alternative minimum tax credits available to us. This tax expense was offset by a reduction of \$497,000 in our recorded deferred tax liability. The reduction in the deferred tax liability relates to a change in the rate at which we expect the temporary differences resulting from our unlimited life intangibles to reverse. This change in estimate arose as a result of our no longer being subject to state taxes in the United States given the change in the jurisdictions in which we now operate. Comparatively, for the three months ended September 30, 2008, we recorded an income tax expense of \$30,000 on income before taxes primarily related to our estimate of federal alternative minimum tax obligations for our 2008 fiscal year and Pennsylvania state franchise tax related to prior years.

For the nine months ended September 30, 2009, we recorded an income tax expense of \$242,000, which included current tax expense of \$913,000 on income before income taxes of \$10.7 million using an estimated effective tax rate for its 2009 fiscal year that accounts for the utilization of remaining net operating loss carry forwards and alternative minimum tax credits available to us. Included in the income tax expense is a recovery of \$174,000 for investment tax credits earned during the three months ended June 30, 2009, as well as a reduction of \$497,000 in our recorded deferred tax liability. The reduction in the deferred tax liability relates to the rate at which we expect the temporary differences resulting from our unlimited life intangibles to reverse. This change in estimate arose as a result of our no longer being subject to state tax in the United States given the change in the jurisdictions in which we now operate in.

Comparatively, for the nine months ended September 30, 2008, we recorded an income tax expense of \$91,000 on income before taxes of \$1.1 million primarily related to our estimate of federal alternative minimum tax obligations for our 2008 fiscal year and Pennsylvania state franchise tax related to prior years.

As of December 31, 2008, we recorded a valuation allowance of \$10.8 million and a net deferred tax asset of \$3.0 million. The net deferred tax asset has been allocated on a pro rata basis between current and non-current deferred tax assets, resulting in current deferred tax assets of \$0.6 million and non-current deferred tax assets of \$2.4 million as at December 31, 2008. No significant changes have occurred during the nine month period ended September 30, 2009.

We analyze the carrying value of our deferred tax asset on a regular basis. In determining future taxable income, assumptions are made to forecast federal, state and international operating income, the reversal of temporary timing differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with other forecasts used to manage the business. During the nine months ended September 30, 2009, there was no reversal of the valuation allowance. The valuation allowance will be maintained until sufficient evidence exists to support a reversal of, or decrease in, the valuation allowance.

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 \$301,000 of gross unrecognized tax benefit as of December 31, 2008 and \$209,000 as of September 30, 2009, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates to non-recognition of refundable research and development tax credits in Canada earned during our 2008 fiscal year and certain state tax exposures from prior periods. During the nine months ended September 30, 2009, our unrecognized tax benefits decreased by \$205,000 as a result of the settlement of our 2006 and 2007 Canadian research and development tax credit claims. We increased our unrecognized tax benefits by \$113,000 related to our 2008 research and development tax credit claim. We expect our 2009 research and development tax credit claim to be insignificant.

We recognize accrued interest and penalties to unrecognized tax benefit as a tax expense. We have not accrued any interest or penalties as of December 31, 2008 or September 30, 2009, as these amounts are not considered material. We believe it is reasonably possible that \$209,000 of the unrecognized tax benefit will decrease in the next twelve months as it is

Table of Contents

anticipated that the Canadian tax authorities will conclude its review of our 2008 research and development claim for the credits, and that the state tax matters will also be settled, within that period.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2009, our principal sources of liquidity were cash flows generated from operations and cash and cash equivalents of \$8.2 million, as compared to \$5.4 million at December 31, 2008. Fluctuations in foreign exchange rates had a material impact on the balances of our assets and liabilities year-over-year as reported in our condensed consolidated balance sheets, which impacted amounts shown in our condensed consolidated statement of cash flows.

Net cash provided by operating activities for the nine months ended September 30, 2009 totaled \$3.6 million, compared to \$2.6 million for the nine months ended September 30, 2008. This increased contribution of \$1.0 million was primarily the result the restructuring we undertook in November 2008 and the impact of the lower Canadian dollar. Operating activities for the nine months ended September 30, 2009 generated \$5.1 million, after adjustment for non-cash and other items, including the net change in deferred revenue and prepaid domain name registry and other Internet services fees, depreciation, amortization, unrealized change in the fair value of forward contracts, the gain on disposal of our investment in Afilius and stock-based compensation, aggregating \$4.9 million. This was partially offset by an increase in other non-cash operating working capital of \$1.5 million, which was primarily the result of a reduction in accounts payable and accruals, as well an increase in accounts receivable, prepaid expenses and customer deposits.

Net cash used in financing activities during the nine months ended September 30, 2009 totaled \$4.5 million. We used \$1.8 million to repurchase 4.2 million shares pursuant to the terms of a Dutch auction tender offer during March 2009 and \$0.6 million to repurchase 1.1 million shares pursuant to the terms of a second Dutch auction tender offer during July 2009. Pursuant to the terms of our non-revolving, reducing credit facility, we also made equal monthly principal repayments of \$1.4 million. In addition, under this credit facility, based on our 2008 fiscal year operating results, we also made a cash sweep payment for the 2009 fiscal year of \$0.7 million on May 1, 2009. We currently estimate that the cash sweep payment which will be based on our audited 2009 results and will be payable during the three months ending June 30, 2010 will be sufficient to pay off in full the outstanding balance of our non-revolving, reducing credit facility.

Investing activities generated net cash of \$3.7 million for the nine months ended September 30, 2009. This generation of cash is attributable to the \$4.1 million we received on the second and third closings under the terms of the sale of our investment in Afilius in May and September 2009. This increase in cash was offset by \$0.4 million that we have invested during the nine months ended September 30, 2009 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, loan repayments and our third Dutch auction tender offer 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.

Table of Contents**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, 2009. We are also subject to market risk exposure related to changes in interest rates on our non-revolving, reducing credit facility with The Bank of Montreal. Any changes in interest rates are not expected to be material. 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, 2009, the Company had forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars as follows:

| Maturity date | Notional amount of U.S. dollars | Weighted average exchange rate of U.S. dollars | Fair value gain |
|-------------------------|--|---|------------------------|
| October - December 2009 | \$ 3,000,000 | 0.8651 | \$ 245,924 |
| January - March 2010 | 4,278,000 | 0.8297 | 547,750 |
| April - June 2010 | 4,439,000 | 0.8328 | 549,508 |
| July - September 2010 | 3,000,000 | 0.8034 | 494,324 |
| October - December 2010 | 2,500,000 | 0.9032 | 89,969 |
| Total | \$ 17,217,000 | 0.8369 | \$ 1,927,475 |

During the three months ended September 30, 2009, no new foreign currency contracts were entered into by the Company.

During October 2009, the Company entered into foreign exchange forward contracts to hedge a portion of its 2010 fiscal year expected Canadian dollar requirements. These contracts have a notional value of \$5.8 million, whereby \$5.8 million is converted into Canadian dollars during 2010 at an average foreign exchange rate of US\$1.00: Cdn\$1.0617.

During October 2009, the Company entered into foreign exchange forward contracts to hedge a portion of its 2011 fiscal year expected Canadian dollar requirements. These contracts have a notional value of \$5.2 million, whereby \$5.2 million is converted into Canadian dollars during 2011 at an average foreign exchange rate of US\$1.00: Cdn\$1.0669.

As we are not required to comply with the documentation requirements for hedge accounting, we account for the fair value of the derivative instruments within the consolidated balance sheet as a derivative financial asset or liability and the corresponding change in fair value is recorded in our consolidated statement of operations. We have no other freestanding or embedded derivative instruments.

We have performed a sensitivity analysis model for foreign exchange exposure over the three months ended September 30, 2009. 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, 2009. 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

Table of Contents

three months ended September 30, 2009 of approximately \$0.4 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 SEC'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.

Table of Contents

**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, in our opinion, will 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, 2008, 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 2. Unregistered Sale of Equity Securities and Use of Proceeds

On July 14, 2009, the Company announced that it successfully concluded a second modified Dutch auction tender offer that was previously announced on May 26, 2009. Under the terms of the offer, the Company repurchased an aggregate of 1,103,824 shares of its common stock at a purchase price of \$0.45 per share, for a total of \$496,720.80, excluding transaction costs of \$56,936. The purchase price was funded from available cash. Of the 1,103,824 shares purchased, 1,000,000 were shares the Company offered to purchase in the offer and 103,824 were shares purchased pursuant to the Company's right to purchase up to an additional 2% of the shares outstanding immediately prior to the commencement of the tender offer. Due to over-subscription, the final proration factor for shares tendered at or below \$0.45 per share was approximately 99.8%. For this purpose, shares tendered at \$0.45 per share included shares tendered by those persons who indicated, in their letter of transmittal, that they were willing to accept the price determined in the offer. All shares purchased in the tender offer received the same price. As a result of the completion of the tender offer, as of July 14, 2009, the Company had 67,852,896 shares issued and outstanding, as all shares repurchased were immediately retired.

Table of Contents

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) |
| 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 |

* Filed herewith.

Furnished herewith.

Table of Contents

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, 2009

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)

Table of Contents

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) |
| 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 |

* Filed herewith.

Furnished herewith.