

TUCOWS INC /PA/  
Form 10-Q  
November 14, 2012  
**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2012**

**OR**

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

**For the transition period from            to**

**Commission file number 1-32600**

**TUCOWS INC.**

(Exact Name of Registrant as Specified in Its Charter)

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

**96 Mowat Avenue,**

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

(Address of Principal Executive Offices) (Zip Code)

**(416) 535-0123**

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of November 14, 2012, there were 44,261,684 outstanding shares of common stock, no par value, of the registrant.

**TUCOWS INC.**

**Form 10-Q Quarterly Report**

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**TRADEMARKS, TRADE NAMES AND SERVICE MARKS**

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

	<b>September 30, 2012 (unaudited)</b>	<b>December 31, 2011</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$4,969,733	\$6,408,209
Accounts receivable, net of allowance for doubtful accounts of \$72,980 as of September 30, 2012 and \$57,415 as of December 31, 2011	4,826,776	3,880,184
Prepaid expenses and deposits	5,216,617	3,961,905
Derivative instrument asset, current portion (note 7)	468,675	-
Prepaid domain name registry and ancillary services fees, current portion	46,467,392	43,209,033
Income taxes recoverable	434,666	867,093
Total current assets	62,383,859	58,326,424
Derivative instrument asset, long-term portion (note 7)	-	87,023
Prepaid domain name registry and ancillary services fees, long-term portion	12,734,182	12,600,154
Property and equipment	1,413,952	1,437,564
Deferred financing charges	-	2,300
Deferred tax asset, long-term portion (note 8)	6,674,517	6,880,377
Intangible assets (note 5)	16,683,253	17,482,590
Goodwill	18,873,127	18,873,127
Total assets	\$118,762,890	\$115,689,559
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$1,716,725	\$1,051,115
Accrued liabilities	2,219,377	2,081,968
Customer deposits	4,265,716	4,202,899
Derivative instrument liability, current portion (note 7)	13,011	781,027

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Loan payable, current portion (note 6)	4,000,000	850,000
Deferred revenue, current portion	56,780,763	52,683,546
Accreditation fees payable, current portion	536,377	555,869
Deferred tax liability, current portion (note 8)	1,090,959	880,008
Income taxes payable	192,716	158,258
Total current liabilities	70,815,644	63,244,690
Derivative instrument liability, long-term portion (note 7)	-	5,479
Deferred revenue, long-term portion	16,534,807	16,492,155
Accreditation fees payable, long-term portion	148,893	156,061
Deferred rent, long-term portion	47,945	26,487
Deferred tax liability, long-term portion (note 8)	5,262,000	5,345,700
Stockholders' equity (note 13)		
Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding	-	-
Common stock - no par value, 250,000,000 shares authorized; 44,249,184 shares issued and outstanding as of September 30, 2012 and 53,497,584 shares issued and outstanding as of December 31, 2011	10,005,229	11,358,959
Additional paid-in capital	33,887,740	40,994,013
Deficit	(17,939,368 )	(21,933,985 )
Total stockholders' equity	25,953,601	30,418,987
Total liabilities and stockholders' equity	\$ 118,762,890	\$ 115,689,559
Commitments and contingencies (note 12)		
Subsequent events (note 10)		

See accompanying notes to unaudited consolidated financial statements

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
	<b>(unaudited)</b>		<b>(unaudited)</b>	
Net revenues (note 11)	\$29,246,069	\$25,094,056	\$84,935,989	\$70,695,186
Cost of revenues:				
Cost of revenues	21,446,084	17,658,648	60,833,420	49,578,724
Network expenses (*)	1,158,885	1,193,669	3,629,639	3,691,995
Depreciation of property and equipment	157,203	159,191	460,259	608,961
Amortization of intangible assets (note 5)	35,910	23,960	107,730	49,680
Total cost of revenues (note 11)	22,798,082	19,035,468	65,031,048	53,929,360
Gross profit	6,447,987	6,058,588	19,904,941	16,765,826
Expenses:				
Sales and marketing (*)	2,037,338	1,867,085	6,287,702	5,663,759
Technical operations and development (*)	1,010,949	1,220,953	3,229,669	3,651,782
General and administrative (*)	1,486,323	1,611,896	5,018,178	4,619,443
Depreciation of property and equipment	46,981	48,874	139,918	140,556
Amortization of intangible assets (note 5)	219,030	201,180	657,090	785,920
Loss (gain) on currency forward contracts (note 2, note 7)	(615,245 )	1,845,550	(793,516 )	1,374,177
Total expenses	4,185,376	6,795,538	14,539,041	16,235,637
Income (loss) from operations	2,262,611	(736,950 )	5,365,900	530,189
Other income (expense):				
Interest expense, net	(50,228 )	(18,718 )	(145,710 )	(38,915 )
Other income (note 5)	-	-	529,711	374,977
Total other income (expense)	(50,228 )	(18,718 )	384,001	336,062
Income (loss) before provision for income taxes	2,212,383	(755,668 )	5,749,901	866,251
Provision for income taxes (note 8)	577,383	422,592	1,755,284	750,906
Net income (loss) and comprehensive income (loss) for the period	\$1,635,000	\$(1,178,260 )	\$3,994,617	\$115,345

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Basic earnings (loss) per common share (note 9)	\$0.04	\$(0.02	) \$0.09	\$-
Shares used in computing basic earnings (loss) per common share (note 9)	45,094,678	53,452,205	46,362,261	53,444,959
Diluted earnings (loss) per common share (note 9)	\$0.03	\$(0.02	) \$0.08	\$-
Shares used in computing diluted earnings (loss) per common share (note 9)	48,411,429	53,452,205	49,603,870	55,748,777

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

Network expenses

\$5,979 \$5,808 \$18,354 \$17,170

Sales and marketing

24,116 22,695 67,047 67,155

Technical operations and development

15,600 13,020 43,490 40,122

General and administrative

120,676 79,364 163,041 124,170

See accompanying notes to consolidated financial statements



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

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
	<b>(unaudited)</b>			<b>(unaudited)</b>
Cash provided by (used in):				
Operating activities:				
Net income (loss) for the period	\$ 1,635,000	\$ (1,178,260 )	\$ 3,994,617	\$ 115,345
Items not involving cash:				
Depreciation of property and equipment	204,184	208,065	600,177	749,517
Amortization of deferred financing charges	100	3,000	2,300	11,100
Amortization of intangible assets	254,940	225,140	764,820	835,600
Deferred income taxes	228,169	(18,400 )	333,111	(18,400 )
Deferred rent	8,258	5,310	21,458	19,274
Acquisition of domain names	-	-	(3,664 )	-
Disposal of domain names	15,142	8,816	38,181	29,907
Gain on disposition of intangible assets	-	-	(508,800 )	-
(Gain) loss on currency forward contracts	(698,781 )	2,152,243	(1,155,147 )	2,458,104
Stock-based compensation	166,371	120,887	291,932	248,617
Changes in non-cash operating working capital:				
Accounts receivable	90,239	448,692	(946,592 )	(679,872 )
Prepaid expenses and deposits	636,756	299,673	(1,254,712 )	(923,976 )
Prepaid domain name registry and ancillary services fees	905,807	(995,565 )	(3,392,387 )	(4,745,147 )
Income taxes recoverable/payable	226,304	158,467	466,885	318,467
Accounts payable	43,173	(539,199 )	648,250	(335,376 )
Accrued liabilities	(279,427 )	(119,997 )	244,738	261,570
Customer deposits	(2,781 )	168,352	62,817	(89,351 )
Deferred revenue	(1,144,779 )	684,204	4,139,869	4,941,471
Accreditation fees payable	(51,839 )	(16,194 )	(26,660 )	5,598
Net cash provided by operating activities	2,236,836	1,615,234	4,321,193	3,202,448
Financing activities:				
Proceeds received on exercise of stock options	14,186	10,685	363,898	14,145
Repurchase of common stock	(1,630,643 )	-	(9,115,833 )	-

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Proceeds received on loan payable	-	2,530,000	4,000,000	2,530,000
Repayment of loan payable	-	(1,319,040 )	(850,000 )	(2,276,161 )
Net cash provided by (used in) financing activities	(1,616,457 )	1,221,645	(5,601,935 )	267,984
Investing activities:				
Additions to property and equipment	(162,207 )	(138,909 )	(666,534 )	(629,935 )
Acquisition of EPAG Domainservices Inc., net of cash acquired	-	(2,392,461 )	-	(2,392,461 )
Proceeds on disposition of intangible assets	-	-	508,800	-
Net cash used in investing activities	(162,207 )	(2,531,370 )	(157,734 )	(3,022,396 )
Increase (decrease) in cash and cash equivalents	458,172	305,509	(1,438,476 )	448,036
Cash and cash equivalents, beginning of period	4,511,561	4,348,256	6,408,209	4,205,729
Cash and cash equivalents, end of period	\$ 4,969,733	\$ 4,653,765	\$ 4,969,733	\$ 4,653,765
Supplemental cash flow information:				
Interest paid	\$ 50,511	\$ 18,890	\$ 146,342	\$ 39,197
Supplementary disclosure of non-cash investing activity:				
Property and equipment acquired during the period not yet paid for	\$ 167,998	\$ 124,979	\$ 167,998	\$ 124,979

See accompanying notes to unaudited consolidated financial statements

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### 1. ORGANIZATION OF THE COMPANY:

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

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

### 2. BASIS OF PRESENTATION:

The accompanying unaudited interim consolidated balance sheets, and the related consolidated statements of operations and comprehensive income and cash flows reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position of Tucows and its subsidiaries as at September 30, 2012 and the results of operations and cash flows for the interim periods ended September 30, 2012 and 2011. 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, 2011 included in Tucows' 2011 Annual Report on Form 10-K filed with the SEC on March 26, 2012.

There have been no material changes to our significant accounting policies during the three and nine months ended September 30, 2012 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

In the prior period, the Company recorded the realized gain or loss upon settlement of currency forward contracts in General and administrative expenses and recorded the unrealized gain or loss in Loss (gain) on currency forward contracts. The Company has determined that both of these amounts are more appropriately classified in expenses as Loss (gain) on currency forward contracts and as a result a gain of \$0.3 million for the three months ended September 30, 2011 has been reclassified from General and administrative expense to Loss (gain) on currency forward contracts, and a gain of \$1.1 million for the nine months ended September 30, 2011 has been reclassified from General and administrative expense to Loss (gain) on currency forward contracts. As a result of this reclassification, there was no change to previously reported net income, income from operations, net revenues, gross profit, reported cash flows or the amounts recorded in the consolidated balance sheets.

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.

### 3. ACQUISITIONS:

#### a. Acquisition of EPAG Domainservices GMBH:

On August 1, 2011, Tucows (Germany) Inc. ( Tucows Germany ), one of the Company's wholly owned subsidiaries, acquired 100% of the outstanding capital stock of EPAG Domainservices GMBH ( EPAG ), from QSC AG. EPAG, based in Bonn, Germany, is an ICANN-accredited registrar with over 400,000 domains under management and is notable for offering over 200 Top Level Domains (TLDs). Consideration for the acquisition of EPAG was approximately US\$2.4 million ( 1.7 million to purchase the shares and the settlement of a working capital adjustment of 0.25 million) through an all-cash transaction which was financed by utilizing the Company's non-revolving, reducing demand loan facility in the amount of US\$2.5 million. In August 2011, the Company repaid \$1.0 million of this loan. The acquisition consideration is net of cash acquired of US\$0.1 million and a loan receivable from EPAG assumed in the amount of US\$0.1 million. In connection with the acquisition, the Company incurred approximately US\$0.1 million of acquisition costs during the three months ended September 30, 2011 and recorded the expenses in the general and administrative expenses caption in the consolidated statement of operations. These costs include legal and other professional services.



The Company has accounted for the acquisition of EPAG using the acquisition method as required by ASC 805, *Business Combinations*. As such, fair values have been assigned to the assets and liabilities acquired and the excess of the total purchase price over the fair value of the net assets acquired is recorded as goodwill. The Company has completed the final valuation of the fair value assessment of certain intangible assets during the quarter ended September 30, 2011. The goodwill represents business benefits the Company anticipates realizing from optimizing resources and access to additional domain name TLD's. The goodwill is not expected to be deductible for tax purposes.

#### Purchase price allocation

The following table summarizes the Company's purchase price allocation based on the fair value of the assets acquired and liabilities assumed on August 1, 2011:

Accounts receivable	\$587,595	
Cash acquired	118,477	
Prepaid expenses and deposits	468,523	
Prepaid domain name registry fees	1,116,798	
Property and equipment	29,198	
Intangible assets	1,723,800	
Goodwill	882,320	
Total assets acquired		4,926,711
Accounts payable	92,950	
Accrued liabilities	140,658	
Customer deposits	32,603	
Deferred revenue	1,425,182	
Income taxes payable	172,380	
Deferred tax liability	552,000	
Total liabilities acquired		2,415,773
Purchase price		\$2,510,938

The intangible assets acquired include technology in the amount of \$0.3 million, brand in the amount of \$0.2 million and customer relationships in the amount of \$1.2 million. The residual value from the purchase price has been allocated to goodwill. The technology is being amortized over two years, while the customer relationships and brand are being amortized over seven years.

The amount of EPAG's revenues in Tucows' Consolidated Statements of Operations and Comprehensive Income for the three and nine months ended September 30, 2011 are set forth below:

<b>Revenues for the three</b>		<b>Revenues for the nine</b>	
<b>months ended September 30, 2011</b>		<b>months ended September 30, 2010</b>	

Actual \$584,192 \$ 584,192 \$

The amount of EPAG's net income (loss) included in Tucows' Consolidated Statements of Operations and Comprehensive Income for the three and nine months ended September 30, 2011 are set forth below:

<b>Net income for the three</b>		<b>Net income for the nine</b>	
<b>months ended September 30, 2011</b>		<b>months ended September 30, 2010</b>	

Actual \$16,564 \$ 16,564 \$

The unaudited pro forma revenues and net income of the combined entity had the acquisition been consummated as of January 1, 2011 are set forth below:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Supplemental Unaudited Pro Forma Information				
Total revenue	\$29,246,069	\$25,457,160	\$84,935,989	\$72,929,498
Net income	\$1,635,000	\$(1,213,578)	\$3,994,617	\$(51,195)

The unaudited pro forma financial information in the table above is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of the period presented or the result that may be realized in the future.

#### **4. NEW ACCOUNTING POLICIES:**

##### *Recent Accounting Pronouncements Adopted*

##### *Comprehensive Income*

The Company adopted Accounting Standards Update No. 2011-05, *Comprehensive Income* (Topic 220) Presentation of Comprehensive Income ( ASU 2011-05 ), effective January 1, 2012 and applied retrospectively, which requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity.

##### *Fair Value Measurement and Disclosures*

The Company adopted Accounting Standards Update No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards* (Topic 820) Fair Value Measurement ( ASU 2011-04 ), effective January 1, 2012 and applied retrospectively, which provides a consistent definition of fair value and ensures that the fair value measurement and disclosure requirements are similar



between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for level 3 fair value measurements (as defined in note 14 below). The adoption of ASU 2011-08 did not materially impact the fair value measurements of our assets and/or liabilities.

### *Testing Goodwill for Impairment*

The Company adopted Accounting Standards Update No. 2011-08, Intangibles – Goodwill and Other (Topic 350) Testing Goodwill for Impairment ( ASU 2011-08 ), effective January 1, 2012, which allows entities to use a qualitative approach to test goodwill for impairment. ASU 2011-08 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. The adoption of ASU 2011-08 did not materially impact the carrying value of our recorded goodwill. The Company will perform its next annual goodwill impairment testing on December 31, 2012.

### *Recent Accounting Pronouncement Not Yet Adopted*

In July 2012, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2012-02, Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ( ASU 2012-02 ) to allow entities to use a qualitative approach to test indefinite-lived intangible assets for impairment. ASU 2012-02 allows an entity to first perform a qualitative assessment to determine whether it is more likely than not that the indefinite-lived intangible asset is impaired. If an entity concludes that this is the case, it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount. ASU 2012-02 is effective for annual and interim indefinite-lived intangible asset impairment tests performed for fiscal years beginning after September 15, 2012 and early adoption is permitted. We do not expect the adoption of ASU 2012-02 to materially impact the carrying value of our recorded indefinite-lived intangible assets.

**5. INTANGIBLE ASSETS:**

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

A summary of acquired intangible assets for the three months ended September 30, 2012 is as follows:

	<b>Technology</b>	<b>Brand</b>	<b>Customer relationships</b>	<b>Surname domain names indefinite life</b>	<b>Direct navigation domain names indefinite life</b>	<b>Total</b>
	<b>2 7 years</b>	<b>7 years</b>	<b>4 7 years</b>			
Net book value, June 30, 2012	\$ 155,610	\$485,110	\$ 2,161,420	\$12,115,858	\$2,035,337	\$16,953,335
Sales of domain names				(2,596 )	(12,546 )	(15,142 )
Amortization expense	(35,910 )	(43,410 )	(175,620 )			(254,940 )
Net book value, September 30, 2012	\$ 119,700	\$441,700	\$ 1,985,800	\$12,113,262	\$2,022,791	\$16,683,253

A summary of acquired intangible assets for the nine months ended September 30, 2012 is as follows:

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

	<b>life</b>					
Net book value, December 31, 2011	\$ 227,430	\$ 571,930	\$ 2,512,660	\$ 12,120,077	\$ 2,050,493	\$ 17,482,590
Acquisition of domain names					3,664	3,664
Sales of domain names				(6,815 )	(31,366 )	(38,181 )
Amortization expense	(107,730 )	(130,230)	(526,860 )			(764,820 )
Net book value, September 30, 2012	\$ 119,700	\$ 441,700	\$ 1,985,800	\$ 12,113,262	\$ 2,022,791	\$ 16,683,253

As of September 30, 2012, the accumulated amortization for the definite life intangibles was \$3.9 million.

During the nine months ended September 30, 2012, the Company sold certain intangible assets with no book value for \$0.5 million

## 6. LOAN PAYABLE:

The Company has credit agreements (collectively the Amended Credit Facility ) with the Bank of Montreal (the Bank or BMO ) that were amended on July 27, 2011, and which provide it with access to two revolving demand loan facilities, a treasury risk management facility and an operating demand loan.

### *Two Revolving Demand Loan Facilities*

The Amended Credit Facility provides for \$8.0 million in funds available through a demand loan revolving facility (the DLR Loan ) and a demand loan revolving, reducing facility (the DLRR Loan , and together with the DLR Loan, the Revolving Demand Loan Facilities ). Advances under the Revolving Demand Loan Facilities may be used to finance the repurchases of the Company's common stock and for certain permitted acquisitions. The Amended Credit Facility provides that aggregate advances under the Revolving Demand Loan Facilities may not exceed \$8.0 million and that no more than \$2.0 million of such advances may be used to finance repurchases of the Company's common stock (the Share Repurchase Limit ). On December 13, 2011, the Company entered into a letter of acknowledgment with the Bank that provided for the waiver of the Share Repurchase Limit and permitted it to use any funds available under the Revolving Demand Loan Facilities to finance share repurchases through March 31, 2012. As of March 31, 2012, the Share Repurchase Limit was reinstated and the Company may now draw additional funds on the Revolving Demand Loan Facilities to fund share repurchases only to the extent that the outstanding balance of the Revolving Demand Loan Facilities does not exceed \$2.0 million.



The DLR Loan accrues interest at the BMO U.S. Base Rate plus 1.25%. The Company may elect to pay interest on the DLRR Loan either at the BMO U.S. Base Rate plus 1.25% or LIBOR plus 2.50%. In addition, the Revolving Demand Loan Facilities are subject to an undrawn aggregate standby fee of 0.20% following the first draw, which such fee is payable quarterly in arrears. Outstanding amounts under the Revolving Demand Loan Facilities are payable on demand at any time, at the sole discretion of the Bank, with or without cause, and the Bank may terminate these loan facilities at any time.

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

On July 28, 2011, the Company drew down \$2.5 million on the DLR Loan to fund the acquisition of EPAG as more fully described under Note 3, Acquisitions. On August 11, 2011, the Company prepaid \$1.0 million of this loan. On December 31, 2011, in accordance with the terms of the Revolving Demand Loan Facilities, the remaining balance under the DLR Loan was fully repaid by an equivalent advance made under the DLRR Loan. At June 30, 2012, the DLRR Loan was fully repaid.

During the period ended March 31, 2012, the Company successfully concluded a modified Dutch auction tender offer , which was funded from available cash and an advance under the DLR Loan in the amount of \$4.0 million. Under the terms of the offer, the Company repurchased an aggregate of 7,570,236 shares of its common stock at a purchase price of \$0.77 per share, for a total of \$5,829,082, excluding transaction costs of approximately \$64,000. At June 30, 2012, the outstanding balance under the DLR Loan was \$4.0 million.

#### *Treasury Risk Management Facility*

The Amended Credit Facility also provides for a \$3.5 million settlement risk line to assist us with hedging Canadian dollar exposure through foreign exchange forward contracts and/or currency options. Under the terms of the Amended Credit Facility, the Company may enter into such agreements at market rates with terms not to exceed 18 months. As of September 30, 2012, the Company held contracts in the amount of \$15.1 million to trade U.S. dollars in exchange for Canadian dollars (Note 7).

#### Operating Demand Loan

The Amended Credit Facility also provides the Company with a \$1.0 million operating demand loan facility to assist it in meeting its operational needs (the Operating Demand Loan ). The Operating Demand Loan accrues interest at a rate of BMO U.S. Base Rate plus 1.25%. Interest is payable monthly in arrears with any borrowing under the Operating Demand Loan fluctuating widely with periodic clean-up, at a minimum on an annual basis. The Company has also agreed to pay the Bank a monthly monitoring fee of US\$500 with respect to this loan. The Operating Demand Loan is payable on demand at any time, at the sole discretion of the Bank, with or without cause, and the Bank may terminate the Operating Demand Loan at any time. As of September 30, 2012, the Company had no amounts outstanding under the Operating Demand Loan.

*General Terms*

The Amended Credit Facility contains customary representations and warranties, affirmative and negative covenants, and events of default. The Amended Credit Facility also requires the Company to make annual cash sweep payments based on its audited financial statements provided. These cash sweep payments are applied solely to amounts outstanding under the DLRR Loan in inverse order of maturity. The Amended Credit Facility also requires that the Company comply with certain non-financial covenants and restrictions. In addition, the Company has agreed to comply with the following financial covenants at all times: (i) Maximum Senior Funded Debt to earnings before Interest, taxes, depreciation and amortization ( EBITDA ) of 2.00:1; (ii) Maximum Total Funded Debt to EBITDA of 2.50:1; and (iii) Minimum Fixed Charge Coverage of 1.25:1. Further, the Maximum Annual Capital Expenditures cannot exceed \$3.6 million per year, which limit will be reviewed on an annual basis. As of, and for the period ended, September 30, 2012, the Company was in compliance with these covenants.

Scheduled principal loan repayments are as follows:

Remainder of 2012	\$-
2013	750,000
2014	1,000,000
2015	1,000,000
2016	1,000,000
2017	250,000

**7. DERIVATIVE INSTRUMENT ASSETS AND 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, 2012 was a net unrealized gain of \$0.5 million as compared to a net unrealized loss of \$1.6 million at September 30, 2011. The net unrealized gain is 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.

At September 30, 2012, the Company had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

Maturity date	Notional amount of U.S. dollars	Weighted average exchange rate of U.S. dollars	Fair value
October December, 2012	5,100,000	0.9855	5,108
January March, 2013	6,000,000	1.0277	249,008
April May, 2013	4,000,000	1.0385	201,548
Total	\$15,100,000	1.0163	\$455,664

The Company does not apply hedge accounting and, therefore, for the three and nine months ended September 30, 2012, the Company recorded a gain of \$0.6 million and a gain of \$0.8 million, respectively, on currency forward contracts in its consolidated statements of operations and comprehensive income. For the three and nine months ended September 30, 2011, the Company recorded a loss on currency forward exchange contracts of \$1.8 million and \$1.4 million, respectively.

**8. INCOME TAXES**

For the nine months ended September 30, 2012, the Company recorded a provision for income taxes of \$1.8 million on income before income taxes of \$5.7 million, using an estimated effective tax rate for our 2012 fiscal year. Included in the tax expense is a recovery of \$0.1 million related to research and development tax credits received during the period. Comparatively, for the nine months ended September 30, 2011, the Company recorded a provision for income taxes of \$0.8 million on income before taxes of \$0.9 million, using an estimated effective tax rate for its 2011 fiscal year adjusted for certain foreign exchange losses for which we did not anticipate obtaining a current tax benefit in that fiscal year.

The effective tax rate for the nine months ended September 30, 2012 differs from the effective rate for the comparative period ended September 30, 2011 as a result of the change in temporary differences during the period in respect of deferred tax assets that were recognized in the fourth quarter of 2011.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the years in which those temporary differences become deductible. Management considers projected future taxable income, uncertainties related to the industry in which it operates, and tax planning strategies in making this assessment. During the fourth quarter of 2011 the Company released the remaining valuation allowance of \$3.6 million.

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

We had approximately \$0.1 million of total gross unrecognized tax benefits as of September 30, 2012 and \$0.2 million of total gross unrecognized tax benefits as of December 31, 2011, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes and other insignificant U.S. state taxes. The Company recognizes accrued interest and penalties related to income taxes in income tax expense. The Company did not have significant interest and penalties accrued as of September 30, 2012 and December 31, 2011, respectively. The Company believes that it is reasonably possible that all of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the U.S. tax authorities will finalize their review of prior taxes owing in Pennsylvania within the period and certain other prior year state tax returns will be filed.



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

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

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

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Numerator for basic and diluted earnings per common share:				
Net income (loss) for the period	\$1,635,000	\$(1,178,260)	\$3,994,617	\$115,345
Denominator for basic and diluted earnings per common share:				
Basic weighted average number of common shares outstanding	45,094,678	53,452,205	46,362,261	53,444,959
Effect of outstanding stock options	3,316,751	-	3,241,609	2,303,818
Diluted weighted average number of shares outstanding	48,411,429	53,452,205	49,603,870	55,748,777
Basic earnings (loss) per common share	\$0.04	\$(0.02)	\$0.09	\$-
Diluted earnings (loss) per common share	\$0.03	\$(0.02)	\$0.08	\$-

For the three months ended September 30, 2012, outstanding options to purchase 758,374 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

For the nine months ended September 30, 2012, outstanding options to purchase 758,374 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

During the three and nine months ended September 30, 2012, 1,255,900 common shares and 2,371,204 common shares, respectively, were repurchased and cancelled under the terms of our stock repurchase program announced in November 2011.

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

The computation of earnings per share and diluted earnings per share for the three and nine months ended September 30, 2012 includes reductions in the number of shares outstanding due to these repurchases. No common shares were repurchased during the three and nine months ended September 30, 2011.

#### **10. SUBSEQUENT EVENTS:**

During October 2012, the Company entered into foreign exchange forward contracts to hedge a portion of its expected Canadian dollar requirements for the 2013 and 2014 fiscal years. These contracts have a notional value of \$19.3 million, whereby \$19.3 million is converted into Canadian dollars during 2013 and 2014 at an average foreign exchange rate of US\$1.00: Cdn\$1.0073.

On November 13, 2012, the Company announced its plan to launch a modified Dutch auction tender offer (the Tender Offer ) to repurchase up to 6,500,000 shares of its common stock, at a price per share not less than \$1.35 and not greater than \$1.50. The tender offer is expected to commence the week of November 19, 2012 and will remain open for at least 20 business days.

**11. SUPPLEMENTAL INFORMATION:**

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

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Wholesale:				
Domain Services	\$22,267,806	\$19,698,404	\$65,043,412	\$55,458,510
Value-Added Services	2,603,513	2,608,651	7,881,213	7,082,583
Wholesale	24,871,319	22,307,055	72,924,625	62,541,093
Retail	2,964,943	1,357,878	7,112,823	3,831,299
Portfolio	1,409,807	1,429,123	4,898,541	4,322,794
	\$29,246,069	\$25,094,056	\$84,935,989	\$70,695,186

No customer accounted for more than 10% of the Company's revenue for the three and nine months ended September 30, 2012 or the three and nine months ended September 30, 2011. Significant management judgment is required at the time revenue is recorded to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis, we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

As of September 30, 2012, one customer accounted for 13% of accounts receivable. As of September 30, 2011, one customer accounted for 13% of accounts receivable.

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

	<b>Three months ended September 30</b>		<b>Nine months ended September 30</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Wholesale:				
Domain Services	\$18,644,315	\$16,469,843	\$54,275,405	\$46,144,055
Value-Added Services	532,296	515,152	1,576,228	1,534,701
Wholesale	19,176,611	16,984,995	55,851,633	47,678,756

Retail	2,064,448	494,879	4,350,722	1,332,743
Portfolio	205,025	178,774	631,065	567,225
Network, other costs	1,158,885	1,193,669	3,629,639	3,691,995
Network, depreciation and amortization costs	193,113	183,151	567,989	658,641
	\$22,798,082	\$19,035,468	\$65,031,048	\$53,929,360

## 12. 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, 2012 cannot be predicted with certainty, management does not believe that the resolution of these claims, individually or in the aggregate, will have a material adverse effect on the Company's financial position.

## 13. STOCKHOLDERS' EQUITY:

The following unaudited table summarizes stockholders' equity transactions for the three month period ended September 30, 2012:

	Common Stock		Additional	Total
	Shares	Amount	Paid in Capital	
Balances, June 30, 2012	45,484,997	\$10,233,628	\$35,109,427	\$(19,574,368) \$25,768,687
Exercise of stock options	20,187	22,781	(8,595 )	14,186
Repurchase and cancellation of shares Normal Course Issuer Bid	(1,255,900 )	(251,180 )	(1,379,463 )	(1,630,643 )
Cancellation of Restricted Stock Awards	(100 )			
Stock-based compensation			166,371	166,371
Net income for the period				1,635,000 1,635,000
Balances, September 30, 2012	44,249,184	\$10,005,229	\$33,887,740	\$(17,939,368) \$25,953,601

The following unaudited table summarizes stockholders' equity transactions for the nine month period ended September 30, 2012:

	Common Stock		Additional	Total	
	Shares	Amount	Paid in Capital	Deficit	Stockholders' equity
Balances, December 31, 2011	53,497,584	\$ 11,358,959	\$ 40,994,013	\$(21,933,985)	\$ 30,418,987
Exercise of stock options	693,340	634,558	(270,660 )		363,898
Repurchase and cancellation of shares Dutch Auction	(7,570,236 )	(1,514,047 )	(4,379,400 )		(5,893,447 )
Repurchase and cancellation of shares Normal Course Issuer Bid	(2,371,204 )	(474,241 )	(2,748,145 )		(3,222,386 )
Cancellation of Restricted Stock Awards	(300 )				
Stock-based compensation			291,932		291,932
Net income for the period				3,994,617	3,994,617
Balances, September 30, 2012	44,249,184	\$ 10,005,229	\$ 33,887,740	\$(17,939,368)	\$ 25,953,601

On January 23, 2012, the Company announced that it successfully concluded a modified Dutch auction tender offer that was previously announced on December 15, 2011. Under the terms of the offer, the Company repurchased an aggregate of 7,570,236 shares of its common stock at a purchase price of \$0.77 per share, for a total of \$5,829,082, excluding transaction costs of approximately \$64,000. The purchase price and all transaction costs were funded from available cash and an additional advance under its Amended Credit Facility from the Bank in the amount of \$4.0 million. All shares purchased in the tender offer received the same price and all shares repurchased were immediately cancelled. As a result of the completion of the tender offer, as of January 23, 2012, the Company had 46,047,053 shares issued and outstanding.

On March 16, 2012, the Company announced that it was reinstating its previously announced stock buyback program, which initially commenced on November 15, 2011 and which was temporarily suspended when the Company undertook its Dutch auction tender offer. Under this buyback program, the Company may repurchase up to 3,840,000 shares of the Company's common stock over the 12-month period that commenced on November 15, 2011. The Company repurchased 1,255,900 shares and 2,371,204 shares respectively under this program during the three and nine month periods ended September 30, 2012.

#### 14. SHARE-BASED PAYMENTS

(a) Stock options

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

During the three months ended September 30, 2012, stock options to purchase 220,000 common shares were granted. During the three months ended September 30, 2011, stock options to purchase 706,000 common shares were granted.

During the nine months ended September 30, 2012, stock options to purchase 769,000 common shares were granted. During the nine months ended September 30, 2011, stock options to purchase 706,000 common shares were granted.

The stock options granted during the three and nine months ended September 30, 2012 expire on various dates through 2019.

Details of stock option transactions for the three months ended September 30, 2012 and September 30, 2011 are as follows:

	<b>Three months ended</b>		<b>Three months ended</b>	
	<b>September 30, 2012</b>		<b>September 30, 2011</b>	
	<b>Weighted</b>		<b>Weighted</b>	
	<b>Number of</b>	<b>Average</b>	<b>Number of</b>	<b>Average</b>
	<b>Shares</b>	<b>exercise price</b>	<b>Shares</b>	<b>exercise price</b>
		<b>per share</b>		<b>per share</b>
Outstanding, beginning of period	8,524,499	\$ 0.62	8,237,124	\$ 0.55
Granted	220,000	1.38	706,000	0.74
Exercised	(20,187 )	0.70	(22,583 )	0.47
Forfeited	(56,689 )	0.83	(24,875 )	0.75
Expired	(3,000 )	0.44		
Outstanding, end of period	8,664,623	\$ 0.64	8,895,666	\$ 0.54
Options exercisable, end of period	7,160,766	\$ 0.57	7,155,916	\$ 0.54

Details of stock option transactions for the nine months ended September 30, 2012 and September 30, 2011 are as follows:

	<b>Nine months ended</b>		<b>Nine months ended</b>	
	<b>September 30, 2012</b>		<b>September 30, 2011</b>	
	<b>Weighted</b>		<b>Weighted</b>	
	<b>Number of</b>	<b>Average</b>	<b>Number of</b>	<b>Average</b>
	<b>Shares</b>	<b>exercise price</b>	<b>Shares</b>	<b>exercise price</b>
		<b>per share</b>		<b>per share</b>
Outstanding, beginning of period	8,746,041	\$ 0.57	8,272,249	\$ 0.56
Granted	769,000	1.36	706,000	0.74
Exercised	(693,340 )	0.52	(29,833 )	0.47
Forfeited	(154,064 )	0.80	(52,750 )	0.72
Expired	(3,014 )	0.44		
Outstanding, end of period	8,664,623	\$ 0.64	8,895,666	\$ 0.54
Options exercisable, end of period	7,160,766	\$ 0.57	7,155,916	\$ 0.54

As of September 30, 2012, the exercise prices, weighted average remaining contractual life and intrinsic values of outstanding options were as follows:

Exercise price	Options outstanding			Options exercisable			
	Outstanding Number	Weighted average exercise price per share	Weighted Average remaining contractual life (years)	Aggregate intrinsic value	Number exercisable	Weighted average exercise price per share	Aggregate intrinsic value
\$ 0.31 - \$0.48	3,133,074	\$ 0.38	0.9	\$2,834,818	3,133,074	\$ 0.38	\$2,834,818
\$ 0.56 - \$0.75	3,836,549	\$ 0.66	3.6	2,392,655	2,868,692	\$ 0.64	1,841,014
\$ 0.80 - \$1.38	1,695,000	\$ 1.08	3.6	409,700	1,159,000	\$ 0.95	399,350
	8,664,623	\$ 0.64	2.6	\$5,637,173	7,160,766	\$ 0.57	\$5,075,182

Total unrecognized compensation cost relating to unvested stock options at September 30, 2012, prior to the consideration of expected forfeitures, was approximately \$693,000 and is expected to be recognized over a weighted average period of 2.6 years.

The Company recorded stock-based compensation of \$166,032 and \$120,685 for the three months ended September 30, 2012 and 2011, respectively.

The Company recorded stock-based compensation of \$291,239 and \$248,058 for the nine months ended September 30, 2012 and 2011, respectively.

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



(b) Restricted stock awards

During the three and nine months ended September 30, 2012, no restricted stock awards were granted to any employees of the Company.

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

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

Total unrecognized compensation cost relating to unvested restricted stock awards at September 30, 2012, prior to the consideration of expected forfeitures, was approximately \$300 and is expected to be recognized over a weighted average period of 0.5 years.

The Company recorded stock-based compensation associated with restricted stock awards of \$339 and \$202 for the three months ended September 30, 2012 and 2011, respectively.

The Company recorded stock-based compensation associated with restricted stock awards of \$693 and \$559 for the nine months ended September 30, 2012 and 2011, respectively.

## 15. FAIR VALUE MEASUREMENT

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

that is significant to the fair value measurement.

The following table provides a summary of the fair values of the Company's derivative instrument assets and liabilities measured at fair value on a recurring basis at September 30, 2012:

	September 30, 2012			
	Fair Value Measurements		Using	Assets at
	Level 1	Level 2	Level 3	Fair Value
Derivative instrument asset	\$	\$468,675	\$	\$468,675
Total Assets	\$	\$468,675	\$	\$468,675
Derivative instrument liability	\$	\$13,011	\$	\$13,011
Total Liabilities	\$	\$13,011	\$	\$13,011

The following table provides a summary of the fair values of the Company's derivative instrument assets measured at fair value on a recurring basis as at December 31, 2011:

	December 31, 2011			
	Fair Value Measurements		Using	Assets at
	Level 1	Level 2	Level 3	Fair Value
Derivative instrument asset	\$	\$87,023	\$	\$87,023
Total Assets	\$	\$87,023	\$	\$87,023
Derivative instrument liability	\$	\$786,506	\$	\$786,506
Total Liabilities	\$	\$786,506	\$	\$786,506

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accreditation fees payable, customer deposits, loan payable and accrued liabilities approximate their fair values due to the relatively short periods to maturity of the instruments. The fair value of these financial assets and liabilities is determined using Level 3 inputs.

## 16. RECLASSIFICATION

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

## 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, 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 number of new, renewed and transferred-in domain names we register as our business develops and competes; the effect of a potential global top level domain ( gTLD ) expansion by the Internet Corporation for Assigned Names and Numbers ( ICANN ) on the number of domains we register and the impact it may have on related revenues; our belief that the market for domain name registration will trend upward gradually and may be affected by market volatility; our belief that, by increasing the number of services we offer, we will be able to generate higher revenues; the revenue that our parked page vendor relationships may generate in the future, the effectiveness of our intellectual property protection, including our ability to license proprietary rights to network partners and to register additional trademarks and service marks; the potential impact of current and pending claims on our business; our valuations of certain deferred tax assets, our expectation to collect our outstanding receivables, net of our allowance for doubtful accounts; our expectation regarding fluctuations in certain expense and cost categories; our expectations regarding future revenue from our patent assignments; our expectations regarding our unrecognized tax benefit and the timing or completion of certain audits of our US tax returns; our expectations regarding cash from operations to fund our business; our expectation regarding increased competition due to the introduction of new gTLDs by ICANN; the impact of cancellations of or amendments to market development fund programs under which we receive funds; and our belief that a slowing economy may lead to a decrease in advertising spending. These statements are based on management's current expectations and are subject to a number of uncertainties and risks that could cause actual results to differ materially from those described in the forward-looking statements. Many factors affect our ability to achieve our objectives and to successfully develop and commercialize our services including:

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

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

The ability of vendors to continue to supply our needs;

Actions by our competitors;

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

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

Our ability to effectively manage our business;

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

Pending or new litigation; and

Factors set forth under the caption "Item 1A Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

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.

## **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 services.

Our primary distribution channel is a global network of more than 13,000 resellers in more than 100 countries who typically provide their customers, the end-users of the Internet, with a critical component for establishing and maintaining an online presence. Our primary focus is serving the needs of this network of resellers by providing superior services, easy-to-use interfaces, reseller-oriented technology, and agile 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, we provide proactive support to our resellers by monitoring all services and network infrastructure to address deficiencies before our resellers or their customers are impacted.

We believe that the underlying platform for our services is 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 this platform for both resellers and end-users.

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

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

Retail, primarily our Hover and Ting websites, derives revenues from the sale of domain name registration, email services and mobile phone service to individuals and small businesses. Retail also includes our Personal Names Service based on over 42,000 surname domains that allows roughly two-thirds of Americans to purchase an email address based on their last name.

Portfolio generates advertising revenue from our domain name portfolio and from our two large advertising-supported websites, butterscotch.com and tucows.com. We also generate revenue by offering names in our domain portfolio for resale via our reseller network and other channels.

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

For the three months ended September 30, 2012 and 2011, we reported revenue of \$29.2 million and \$25.1 million, respectively. For the three months ended September 30, 2012 and 2011, the OpenSRS Domain Service accounted for 76% and 79% of our total revenue, respectively.

For the nine months ended September 30, 2012 and 2011, we reported revenue of \$84.9 million and \$70.7 million, respectively. For the nine months ended September 30, 2012 and 2011, the OpenSRS Domain Service accounted for 77% and 79% of our total revenue, respectively.

## **KEY BUSINESS METRICS**

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

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30, 2012(1) 2011(1)</b>		<b>September 30, 2012(1) 2011 (1)</b>	
	<b>(in 000's)</b>		<b>(in 000's)</b>	
Total new, renewed and transferred-in domain name registrations	2,252	2,154	7,137	6,355

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

Domain names under management:

	<b>As at September 30, 2012(1) 2011(1)</b>	
	<b>(in 000's)</b>	
Domain names under management:		
Registered using the Tucows Registrar Accreditation	10,773	10,348
Registered using our Resellers' Registrar Accreditations	3,392	1,368
Total domain names under management	14,165	11,716

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

## **OPPORTUNITIES, CHALLENGES AND RISKS**

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

Our direct costs to register domain names on behalf of our customers are almost exclusively controlled by registries such as Verisign and by ICANN. Verisign provides all the registry services operations for the .com, .net, .cc, .tv and



.name domain names. ICANN is a private sector, not-for-profit corporation formed to oversee a number of Internet related tasks, including domain registrations for which it collects fees. The market for wholesale registrar services is both price sensitive and competitive, particularly for large volume customers, such as large web hosting companies and owners of large portfolios of domain names. We have a relatively limited ability to increase the pricing of domain name registrations without negatively impacting our ability to maintain or grow our customer base.

In 2007, we entered into contractual agreements with Verisign for the supply of domain names. These agreements were automatically renewed in February 2012 until February 2017. Under the agreements, effective January 15, 2012, Verisign increased their domain name fees to \$7.85 for .com and \$5.86 for .net. Mandated registry price increases such as these will adversely increase our service costs as a percentage of our total revenue.

In 2009, our contractual agreement with ICANN was amended to extend the terms of the agreement through June 30, 2014. Under the agreement, ICANN charges a \$0.18 fee for each year that a domain name is registered in the TLDs that fall within its purview. In addition, ICANN has approved a framework for the significant expansion of the number of gTLDs in 2012. The New gTLD Program's goals include enhancing competition and consumer choice, and enabling the benefits of innovation via the introduction of a wide range of new gTLDs. We believe that such expansion, once completed, will result in an increase in the number of domains we register and related revenues in 2013. In addition, we believe that the new gTLD Program could also provide us with new revenue opportunities in 2013, which include operating the back-end infrastructure for new TLD registries and/or owning one or more TLDs in our own right.

Under the terms of the New gTLD program, in April 2012 we paid the required \$1.1 million application fee in support of our application for six domain strings under ICANN's new gTLD Program. A declining percentage of these evaluation fees are refundable if any application is withdrawn prior to our executing a registry agreement with ICANN. In May 2012 we withdrew two of our applications and under the terms of the New gTLD application process have received a full refund of \$0.4 million against these applications. While there can be no assurance that we will be awarded any gTLDs, we have determined that the applications embody probable economic benefit and they have been capitalized and are included in prepaid expenses and deposits at September 30, 2012. As part of the New gTLD Program, we may elect to receive partial cash refunds for certain gTLD applications, and to the extent we elect to sell or dispose of certain gTLD applications throughout the process, may also incur gains or losses on amounts invested. Gains on the sale of our interest in gTLDs will be recognized when realized, while losses will be recognized when deemed probable. Upon the delegation of operator rights for each gTLD by ICANN, which we expect to commence in 2013, gTLD application fees will be reclassified as finite lived intangible assets and amortized on a straight-line basis over their estimated useful life.

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

Sales of domain names from our domain portfolio have a negative impact on our advertising revenue as these names are no longer available for advertising purposes. In addition, the timing of larger domain names portfolio sales is unpredictable and may lead to significant quarterly and annual fluctuations in our Portfolio revenue.

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

## **Net Revenues**

### **Wholesale - OpenSRS Domain Service**

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

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

With respect to the sale of domain registrations, our pricing structure for domain names provides visibility into the various fees that make up the cost of a domain name by breaking out the cost of the registry and ICANN fees

separately from our management fee. Effective January 2012, registry fees for the .com and .net registrations were increased by the registry to \$7.85 and \$5.86, respectively. The management fee provides our resellers with access to our provisioning and management tools to enable them to register and administer domain names and access to additional services like WHOIS privacy and DNS services, enhanced domain name suggestion tools and access to our premium domain names. We earn fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to resellers and registrars on a monthly basis. Domain registrations are generally purchased for terms of one to ten years, with a majority having a one-year term.

#### Wholesale OpenSRS Value-Added Services

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

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

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

#### Retail Hover

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

#### Retail - Ting

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

#### Portfolio

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

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

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

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

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

### **Critical Accounting Policies**

The following is a discussion of our critical accounting policies and methods. Critical accounting policies are defined as those that are both important to the portrayal of our financial condition and results of operations and are reflective of significant judgments and estimates made by management that may result in materially different results under different assumptions and conditions. Note 2 to the consolidated financial statements for the year ended December 31, 2011 includes further information on the significant accounting policies and methods used in the preparation of our consolidated financial statements.

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

## Revenue recognition policy

We earn revenues from the following services:

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

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

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

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

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

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

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

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

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

Goodwill and indefinite life intangibles are not amortized, but are tested for impairment annually or more frequently if circumstances indicate potential impairment, through a comparison of fair value to carrying amount. Goodwill is tested for impairment annually at the same time every year, and when an event occurs or circumstances change such that it is reasonably possible that impairment may exist. We review goodwill and indefinite life intangibles at least annually for possible impairment in the fourth quarter of each year as more fully described under the caption "Critical Accounting Policies" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

With regards to property, equipment and definite life intangible assets, we continually evaluate whether events or circumstances have occurred that indicate the remaining estimated useful lives of our definite-life intangible assets may warrant revision or that the remaining balance of such assets may not be recoverable. We use an estimate of the related undiscounted cash flows over the remaining life of the asset in measuring whether the asset is recoverable. There was no impairment recorded on definite-life intangible assets and property and equipment during the three and nine months ended September 30, 2012 or during the three and nine months ended September 30, 2011.

Determining the number of reporting units and the fair value of a reporting unit requires us to make judgments and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables as more fully described under the caption *Critical Accounting Policies* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. The long-term financial forecast represents the best estimate that we have at this time and we believe that its underlying assumptions are reasonable. However, actual performance in the near-term and longer-term could be materially different from these forecasts, which could impact future estimates of fair value of our reporting units and may result in a charge to earnings in future periods due to the potential for a write-down of goodwill in connection with such tests.

Any changes to our key assumptions about our businesses and our prospects, or changes in market conditions, could cause the fair value of our reporting unit to fall below its carrying value, resulting in a potential impairment charge. In addition, changes in our organizational structure or how our management allocates resources and assesses performance, could result in a change in our operating segments or reporting units, requiring a reallocation and updated impairment analysis of goodwill. A goodwill or intangible asset impairment charge could have a material effect on our consolidated financial statements because of the significance of goodwill and intangible assets to our consolidated balance sheet. As of September 30, 2012, we had \$18.9 million in goodwill and \$16.7 million in intangible assets.

### **Accounting for income taxes**

For the nine months ended September 30, 2012, we recorded a provision for income taxes of \$1.8 million on income before income taxes of \$5.7 million, using an estimated effective tax rate for our 2012 fiscal year. Included in the tax expense is a recovery of \$0.1 million related to research and development tax credits received during the period.

Comparatively, for the nine months ended September 30, 2011, we recorded a provision for income taxes of \$0.8 million on income before taxes of \$0.9 million, using an estimated effective tax rate for its 2011 fiscal year adjusted for certain foreign exchange losses for which we did not anticipate obtaining a current tax benefit in that fiscal year.



The effective tax rate for the nine months ended September 30, 2012 differs from the effective rate for the comparative period ended September 30, 2011 as a result of the change in temporary differences during the period in respect of deferred tax assets that were recognized in the fourth quarter of 2011.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the years in which those temporary differences become deductible. Management considers projected future taxable income, uncertainties related to the industry in which it operates, and tax planning strategies in making this assessment. During the fourth quarter of 2011 we released the remaining valuation allowance of \$3.6 million.

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

We had approximately \$0.1 million of total gross unrecognized tax benefit as of September 30, 2012 and \$0.2 million of total gross unrecognized tax benefit as of December 31, 2011, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes and other insignificant U.S. state taxes. We recognize accrued interest and penalties related to income taxes in income tax expense. We did not have significant interest and penalties accrued as of September 30, 2012 and December 31, 2011, respectively. The Company believes that it is reasonably possible that all of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the U.S. tax authorities will finalize their review of prior taxes owing in Pennsylvania within the period and certain other prior year state tax returns will be filed.

## **RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012 AS COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2011**

### **NET REVENUES**

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

	<b>Three months ended September 30, 2012</b>		<b>Nine months ended September 30, 2011</b>	
Wholesale:				
Domain Services	\$22,267,806	\$19,698,404	\$65,043,412	\$55,458,510
Value-Added Services	2,603,513	2,608,651	7,881,213	7,082,583
Wholesale	24,871,319	22,307,055	72,924,625	62,541,093
Retail	2,964,943	1,357,878	7,112,823	3,831,299
Portfolio	1,409,807	1,429,123	4,898,541	4,322,794
	\$29,246,069	\$25,094,056	\$84,935,989	\$70,695,186
Increase over comparative period	\$4,152,013		\$14,240,803	
Increase - percentage	17	%	20	%

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

	<b>Three months ended September</b>	<b>Nine months ended September</b>
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	<b>30,</b>		<b>30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Wholesale:				
Domain Services	76 %	79 %	77 %	79 %
Value-Added Services	9 %	10 %	9 %	10 %
Wholesale	85 %	89 %	86 %	89 %
Retail	10 %	5 %	8 %	5 %
Portfolio	5 %	6 %	6 %	6 %
	100 %	100 %	100 %	100 %

Deferred revenue from domain name registrations and other services declined to \$73.3 million at September 30, 2012 from \$74.5 million at June 30, 2012. The primary reason for this decline was the transfer of a significant number of names by two of our customers from our registrar accreditation to their own registrar accreditation on our platform. This required us to recognize all remaining deferred revenue associated with the transferred domain names during the quarter.

Deferred revenue from domain name registrations and other services at September 30, 2012 increased to \$73.3 million from \$68.9 million at September 30, 2011. Included in this increase is an amount of \$0.9 million pertaining to EPAG, which was acquired on August 1, 2011.

No customer accounted for more than 10% of revenue during the three and nine months ended September 30, 2012 and September 30, 2011. At September 30, 2012, one customer accounted for 13% of accounts receivable, and as of September 30, 2011, one customer accounted for 13% of accounts receivable. Significant management judgment is required at the time revenue is recorded to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

### ***Wholesale***

For the three months ended September 30, 2012, Wholesale revenue increased by \$2.6 million, or 11%, to \$24.9 million when compared to the three months ended September 30, 2011, primarily as a result of OpenSRS Domain Service revenue increasing by \$2.6 million or 13% to \$22.3 million. For the nine months ended September 30, 2012, Wholesale revenue increased by \$10.4 million, or 17%, to \$72.9 million when compared to the nine months ended September 30, 2011, primarily as a result of OpenSRS Domain Service revenue increasing by \$9.6 million or 17% to \$65.0 million. These increases resulted primarily from our success in attracting customers with increased transaction volumes, the impact of the transfer of a significant number of names by two of our customers from our registrar accreditation to their own registrar accreditation on our platform, the contribution from the EPAG acquisition that we completed during the third quarter of last year and the impact of our passing on the 7% registration fee increase implemented in January 2012 for registration fees paid to certain registries.

Value-Added Services remained relatively flat at \$2.6 million for the three months ended September 30, 2012 and 2011 respectively. Value-Added Services increased by \$0.8 million or 11% to \$7.9 million when compared to the nine months ended September 30, 2011. These increases resulted primarily from the sale of domain names and advertising from the OpenSRS Domain Expiry Stream and increased digital certificate sales.

During the three months ended September 30, 2012, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed increased by 0.1 million transactions to 2.3 million when compared to the three months ended September 30, 2011. During the nine months ended September 30, 2012, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed increased by 0.7 million transactions to 7.1 million when compared to the nine months ended September 30, 2011. While we anticipate that the number of new, renewed and transferred-in domain name registrations will continue to incrementally increase in the long term, the volatility in the market could affect the growth of domain names that we manage.

In addition, the anticipated introduction of new gTLDs by ICANN (the "New gTLD Program") approved in June 2011 could substantially change the domain name industry in unexpected ways. We cannot assess the impact, if any, the introduction of these new TLDs will have on our revenues and results of operations. See Item 1A Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

As of September 30, 2012, the total domain names under our management increased by 0.4 million to 10.8 million, when compared to September 30, 2011. This increase includes the 0.4 million domains that were added through the acquisition of EPAG. 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, 2012, we managed 3.4 million domain names on behalf of other accredited registrars, an increase of 2.0 million compared to the 1.4 million we managed as of September 30, 2011. The increase is attributable to one of our accredited registrars transferring 1.8 million domain names they were directly managing under their own accreditation onto our platform.

### ***Retail***

Net revenues from Retail for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 increased by \$1.6 million to \$3.0 million. This increase reflects the impact of \$0.9 million in Ting's mobile device sales made during the quarter as well as the success that our retail marketing initiatives and improved websites are having on our ability to attract new customers and retain existing ones.

Net revenues from Retail for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 increased by \$3.3 million to \$7.1 million. This increase reflects the impact of \$1.7 million in Ting's mobile device sales made during the nine months ended September 30, 2012 as well as the success that our retail marketing initiatives and improved websites are having on our ability to attract new customers and retain existing ones.

As of September 30, 2012, Ting had over 5,000 subscribers and 8,000 mobile devices under our management. During the three months ended September 30, 2012, Ting added 3,000 subscribers and 4,500 devices.

### ***Portfolio***

For the three months ended September 30, 2012, Portfolio revenue remained relatively flat at \$1.4 million when compared to the three months ended June 30, 2011. For the nine months ended September 30, 2012, Portfolio revenue increased by \$0.6 million, or 13%, to \$4.9 million when compared to the nine months ended September 30, 2011.

These increases primarily reflect the impact from the sale of domain names from our domain name portfolio. The increase in portfolio sales primarily reflects the timing of portfolio domain name sales and may not be repeatable in future quarters. The market for monetization of domain names is rapidly evolving and there is no guarantee 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 future will provide the same revenue impact as we have experienced from past acquisitions. In addition, the revenue we derive from our Portfolio is driven by general macroeconomic factors that affect Internet advertising. Our advertising revenues are typically sensitive to economic conditions and tend to decline in recessionary periods and other periods of economic uncertainty.

## **COST OF REVENUES**

### ***Wholesale***

#### *OpenSRS Domain Service*

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

#### *Value-Added Services*

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

***Retail***

Costs of revenues for our provision and management of Internet services 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.

***Portfolio***

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

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

***Network costs***

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

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

<b>Three months ended</b>		<b>Nine months ended</b>	
<b>September 30,</b>		<b>September 30,</b>	
<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>

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Wholesale:				
Domain Services	\$18,644,315	\$16,469,843	\$54,275,405	\$46,144,055
Value-Added Services	532,296	515,152	1,576,228	1,534,701
Wholesale	19,176,611	16,984,995	55,851,633	47,678,756
Retail				
Portfolio	2,064,448	494,879	4,350,722	1,332,743
Network, other costs	205,025	178,774	631,065	567,225
Network, depreciation and amortization costs	1,158,885	1,193,669	3,629,639	3,691,995
	193,113	183,151	567,989	658,641
	\$22,798,082	\$19,035,468	\$65,031,048	\$53,929,360
Increase over comparative period	\$3,762,614		\$11,101,688	
Increase - percentage	20	%	21	%

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

	<b>Three months ended September 30, 2012</b>		<b>Nine months ended September 30, 2011</b>	
Wholesale:				
Domain Services	63 %	65 %	64 %	65 %
Value-Added Services	2 %	2 %	2 %	2 %
Wholesale	65 %	67 %	66 %	67 %
Retail				
Portfolio	7 %	2 %	5 %	2 %
Network, other costs	1 %	1 %	1 %	1 %
Network, depreciation and amortization costs	4 %	5 %	4 %	5 %
	1 %	1 %	1 %	1 %
	78 %	76 %	77 %	76 %

Total cost of revenues for the three months ended September 30, 2012 increased by \$3.8 million, or 20%, to \$22.8 million from \$19.0 million for the three months ended September 30, 2011.

Total cost of revenues for the nine months ended September 30, 2012 increased by \$11.1 million, or 21%, to \$65.0 million from \$53.9 million for the nine months ended September 30, 2011.



We expect cost of sales to increase as a result of transactional volumes and the competitive and general business environment during fiscal year 2012.

Prepaid domain registration and other Internet services fees as of September 30, 2012 increased by \$3.5 million, or 6%, to \$59.2 million from \$55.7 million at September 30, 2011. Included in this increase is an amount of \$1.5 million pertaining to EPAG, the Company we acquired on August 1, 2011.

### ***Wholesale***

Costs for Wholesale for the three months ended September 30, 2012 increased by \$2.2 million, or 13%, to \$19.2 million, when compared to the three months ended September 30, 2011.

Costs for Wholesale for the nine months ended September 30, 2012 increased by \$8.2 million, or 17%, to \$55.9 million, when compared to the nine months ended September 30, 2011.

This increase was primarily the result of increased domain registration volumes and increases in registration fees paid to the registries that were implemented in January 2012 experienced during the three and nine months ended September 30, 2012 when compared to the three and nine months ended September 30, 2011.

### ***Retail***

Costs for Retail for the three months ended September 30, 2012 increased by \$1.6 million, to \$2.1 million, when compared to the three months ended September 30, 2011. This increase resulted primarily from an additional cost of \$1.1 million incurred in Ting mobile device sales made during the quarter, as well as the increased cost resulting from the additional volume in Hover services and in provisioning Ting services.

Costs for Retail for the nine months ended September 30, 2012 increased by \$3.0 million, to \$4.4 million, when compared to the nine months ended September 30, 2011. This increase resulted primarily from an incremental cost of \$2.1 million incurred in Ting mobile device sales as well as the increased cost resulting from the additional volume in Hover services and in provisioning Ting services.

### ***Portfolio***

Costs for Portfolio remained relatively flat at \$0.2 million and \$0.6 million, respectively for the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011.

### *Network Costs*

Network costs before depreciation and amortization remained relatively flat at \$1.2 million for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011.

Network costs before depreciation and amortization decreased by \$1.0 million, to \$3.6 million when compared to the nine months ended September 30, 2011. This decrease resulted primarily from a decrease in bandwidth costs during the period.

Network depreciation and amortization costs for the three and nine months ended September 30, 2012 remained relatively flat at \$0.2 million and \$0.6 million.

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

## **SALES AND MARKETING**

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

	<b>Three months ended</b>		<b>Nine months ended</b>		
	<b>September 30,</b>		<b>September 30,</b>		
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>	
Sales and marketing	\$2,037,338	\$1,867,085	\$6,287,702	\$5,663,759	
Increase over comparative period	\$170,253		\$623,943		
Increase - percentage	9	%	11	%	
Percentage of net revenues	7	% 7	% 7	% 8	%

Sales and marketing expenses for the three months ended September 30, 2012 increased by \$0.2 million, or 9%, to \$2.0 million, when compared to the three months ended September 30, 2011. Sales and marketing expenses for the

nine months ended September 30, 2012 increased by \$0.6 million, or 11%, to \$6.3 million, when compared to the nine months ended September 30, 2011. This increase primarily related to workforce costs and marketing expenses incurred with our new Ting's mobile device service offering. The increase in workforce costs was impacted by our reversing an overachievement bonus accrual that was established primarily in the first quarter. We accrued conservatively and it now does not appear likely that we will incur any meaningful costs in this regard.

**TECHNICAL OPERATIONS AND DEVELOPMENT**

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

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Technical operations and development	\$1,010,949	\$1,220,953	\$3,229,669	\$3,651,782
Decrease over comparative period	\$(210,004 )		\$(422,113 )	
Decrease - percentage	(17 )	%	(12 )	%
Percentage of net revenues	3	%	5	%

Technical operations and development expenses for the three months ended September 30, 2012 decreased by \$0.2 million or 17% to \$1.0 million when compared to the three months ended September 30, 2011. Technical operations and development expenses for the nine months ended September 30, 2012 decreased by \$0.4 million or 12% to \$3.2 million when compared to the nine months ended September 30, 2011. These decreases primarily resulted from a decrease in workforce costs. Workforce costs were impacted by our reversing an overachievement bonus accrual that was established primarily in the first quarter. We accrued conservatively and it now does not appear likely that we will incur any meaningful costs in this regard

**GENERAL AND ADMINISTRATIVE**

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
General and administrative	\$1,486,323	\$1,611,896	\$5,018,178	\$4,619,443
(Decrease) increase over comparative period	\$(125,573 )		\$398,735	
(Decrease) increase - percentage	(8 )	%	9	%
Percentage of net revenues	5	%	6	%

General and administrative expenses for the three months ended September 30, 2012 decreased by \$0.1 million, or 8%, to \$1.5 million as compared to the three months ended September 30, 2011. This decrease was primarily the

result of lower workforce related costs. Workforce costs were impacted by our reversing an overachievement bonus accrual that was established primarily in the first quarter. We accrued conservatively and it now does not appear likely that we will incur any meaningful costs in this regard. This decrease was partially offset by additional costs incurred in processing a higher volume of credit cards.

General and administrative expenses for the nine months ended September 30, 2012 increased by \$0.4 million, or 9%, to \$5.0 million as compared to the nine months ended September 30, 2011. This increase was primarily the result of incremental workforce related costs as well as additional costs incurred in processing a higher volume of credit cards.

## DEPRECIATION OF PROPERTY AND EQUIPMENT

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

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Depreciation of property and equipment	\$46,981	\$48,874	\$139,918	\$140,556
Decrease over comparative period	\$(1,893)		\$(638)	
Decrease - percentage	(4)	)%	(0)	)%
Percentage of net revenues	-	%	-	%

Depreciation costs remained relatively flat at \$0.05 million and \$0.1 million, respectively, for the three and nine months ended September 30, 2012 as compared to the three and nine months ended September 30, 2011.

## AMORTIZATION OF INTANGIBLE ASSETS

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Amortization of intangible assets	\$219,030	\$201,180	\$657,090	\$785,920
Increase (decrease) over comparative period	\$17,850		\$(128,830)	
Increase (decrease) - percentage	9	%	(16)	)%
Percentage of net revenues	1	%	1	%

Amortization of intangible assets consists of amounts arising in connection with the acquisition of Mailbank.com Inc. in June 2006, the acquisition of IYD in July 2007 and the acquisition of EPAG in July 2011.

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

Customer relationships acquired in connection with the acquisition of Mailbank.com Inc. are each amortized on a straight-line basis over five years.

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

### LOSS (GAIN) ON CURRENCY FORWARD CONTRACTS

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

As we do not 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.

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>		
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>	
Loss (gain) on currency forward contracts	\$(615,245 )	\$1,845,550	\$(793,516 )	\$1,374,177	
Decrease over comparative period	\$ (2,460,795)		\$ (2,167,693)		
Decrease - percentage	133	%	158	%	
Percentage of net revenues	(2	)% 7	% (1	)% 2	%

We have entered into forward exchange contracts to meet a portion of our future Canadian dollar requirements through May 2013.

The impact of the fair value adjustment on unrealized foreign exchange on these contracts for the three months ended September 30, 2012 was a net gain of \$0.7 million compared to a net loss of \$2.2 million for the three months ended



September 30, 2011. The impact of the fair value adjustment on unrealized foreign exchange on these contracts for the nine months ended September 30, 2012 was a net gain of \$1.2 million compared to a net loss of \$2.5 million for the nine months ended September 30, 2011. This impact of the fair value adjustment on unrealized foreign exchange on these contracts was partially offset by the realized loss upon settlement of currency forward contracts of \$0.1 million for the three months ended September 30, 2012 and \$0.4 million for the nine months ended September 30, 2012, while further enhanced by a gain upon settlement of currency forward contracts of \$0.3 million for the three months ended September 30, 2011 and \$1.1 million for the nine months ended September 30, 2011.

Until their respective maturity dates, these contracts will fluctuate in value in line with movements in the Canadian dollar relative to the U.S. dollar.

## OTHER INCOME AND EXPENSES

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Other income (expenses), net	\$ (50,228)	\$ (18,718)	\$ 384,001	\$ 336,062
(Decrease) increase over comparative period	\$ (31,510)		\$ 47,939	
(Decrease) increase - percentage	168	%	14	%
Percentage of net revenues	-	%	-	%

Other expenses for the three months ended September 30, 2012 increased by \$31,000, to \$50,000 when compared to other income of \$19,000 for the three months ended September 30, 2011. This decrease was predominantly as a result of the interest payable pursuant to the terms of our Amended Credit Facility.

Other income for the nine months ended September 30, 2012 increased by \$48,000 to \$0.4 million, as compared with the nine months ended September 30, 2011. This primarily resulted from our selling certain intangible assets with no book value for \$0.5 million during the three months ended March 31, 2012. This increase was partially offset by the \$0.3 million we received during the three months ended March 31, 2011 from the third party who is commercializing the Infonautics patents we assigned to them in 2002, undertaking a routine audit of one of their licensees. In addition, other income for the nine months ended September 30, 2012 decreased when compared to the nine months ended September 30, 2011 as a result of the interest payable pursuant to the terms of our Amended Credit Facility.

**INCOME TAXES**

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Provision for income taxes	\$577,383	\$422,592	\$1,755,284	\$750,906
Increase over comparative period	\$154,791		\$1,004,378	
Increase - percentage	37	%	134	%
Percentage of income before provision for income taxes	26	%	- 56	%
			31	%
			87	%

For the nine months ended September 30, 2012, we recorded a provision for income taxes of \$1.8 million on income before income taxes of \$5.7 million, using an estimated effective tax rate for our 2012 fiscal year. Included in the tax expense is a recovery of \$0.1 million related to research and development tax credits received during the period. Comparatively, for the nine months ended September 30, 2011, we recorded a provision for income taxes of \$0.8 million on income before taxes of \$0.9 million, using an estimated effective tax rate for our 2011 fiscal year adjusted for certain foreign exchange losses for which we did not anticipate obtaining a current tax benefit in that period.

The effective tax rate for the nine months ended September 30, 2012 differs from the effective rate for the comparative period ended September 30, 2011 as a result of the change in temporary differences during the period in respect of deferred tax assets that were recognized in the fourth quarter of 2011.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the years in which those temporary differences become deductible. We consider projected future taxable income, uncertainties related to the industry in which we operate, and tax planning strategies in making this assessment. During the fourth quarter of 2011 we released the remaining valuation allowance of \$3.6 million.

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

We had approximately \$0.1 million of total gross unrecognized tax benefit as of September 30, 2012 and \$0.2 million of total gross unrecognized tax benefit as of December 31, 2011, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes and other insignificant US state taxes. We recognize accrued interest and penalties related to income taxes in income tax expense. We did not have significant interest and penalties accrued as of September 30, 2012 and December 31, 2011, respectively. We believe that it is reasonably possible that all of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the U.S. tax authorities will finalize their review of prior taxes owing in Pennsylvania within the period and certain other prior year state tax returns will be filed.

## LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2012, our cash and cash equivalents balance decreased by an amount of \$1.4 million to \$5.0 million when compared to December 31, 2011. Our principal sources of liquidity during the nine months ended September 30, 2012 was net cash provided by operating activities of \$4.3 million, the proceeds of \$0.5 million we received on the sale of certain intangible assets with no book value and our Amended Credit Facility with the Bank of Montreal (the Bank or BMO).

We have credit agreements (collectively the Amended Credit Facility) with the Bank that were amended on July 27, 2011, and which provide us with access to two revolving demand loan facilities, a treasury risk management facility and an operating demand loan.

### *Two Revolving Demand Loan Facilities.*

The Amended Credit Facility provides for \$8.0 million in funds available through a demand loan revolving facility (the DLR Loan) and a demand loan revolving, reducing facility (the DLRR Loan), and together with the DLR Loan, the Revolving Demand Loan Facilities). Advances under the Revolving Demand Loan Facilities may be used to finance the repurchases of the Company's common stock and for certain permitted acquisitions. The Amended Credit Facility provides that aggregate advances under the Revolving Demand Loan Facilities may not exceed \$8.0 million and that no more than \$2.0 million of such advances may be used to finance repurchases of our common stock (the Share Repurchase Limit). On December 13, 2011, we entered into a letter of acknowledgment with the Bank that provided for the waiver of the Share Repurchase Limit and permitted us to use any funds available under the Revolving Demand Loan Facilities to finance share repurchases through March 31, 2012. As of March 31, 2012, the Share Repurchase Limit was reinstated and we may now draw additional funds on the Revolving Demand Loan Facilities to fund share repurchases only to the extent that the outstanding balance of the Revolving Demand Loan Facilities does not exceed \$2.0 million.

The DLR Loan accrues interest at the BMO U.S. Base Rate plus 1.25%. We may elect to pay interest on the DLRR Loan either at the BMO U.S. Base Rate plus 1.25% or LIBOR plus 2.50%. In addition, the Revolving Demand Loan Facilities are subject to an undrawn aggregate standby fee of 0.20% following the first draw, which such fee is payable quarterly in arrears. Outstanding amounts under the Revolving Demand Loan Facilities are payable on demand at any time, at the sole discretion of the Bank, with or without cause, and the Bank may terminate these loan facilities at any time.

Repayment of advances under the DLR Loan consists of interest only payments made monthly in arrears and prepayment is permitted without penalty. The outstanding balance under the DLR Loan as of December 31st of each

year is to be fully repaid within 31 days of December 31st through an equivalent advance made under the DLRR Loan. Advances under the DLRR Loan will be made annually and solely for such purpose. Each advance under the DLRR Loan is to be repaid in equal monthly principal payments plus interest, over a period of four years from the date of such advance.

On July 28, 2011, we drew down \$2.5 million on the DLR Loan to fund the acquisition of EPAG as more fully described under Note 3, Business acquisitions. On December 31, 2011, in accordance with the terms of the Revolving Demand Loan Facilities, the remaining balance under the DLR Loan was fully repaid by an equivalent advance made under the DLRR Loan. At June 30, 2012, the DLRR Loan was fully repaid.

During the period ended March 31, 2012, we successfully concluded a modified Dutch auction tender offer, which was funded from available cash and an advance under the DLR Loan in the amount of \$4.0 million. Under the terms of the offer, we repurchased an aggregate of 7,570,236 shares of our common stock at a purchase price of \$0.77 per share, for a total of \$5,829,082, excluding transaction costs of approximately \$64,000. At September 30, 2012, the outstanding balance under the DLR Loan was \$4.0 million.

#### *Treasury Risk Management Facility*

The Amended Credit Facility also provides for a \$3.5 million settlement risk line to assist us with hedging Canadian dollar exposure through foreign exchange forward contracts and/or currency options. Under the terms of the Amended Credit Facility, we may enter into such agreements at market rates with terms not to exceed 18 months. As of September 30, 2012, we held contracts in the amount of \$15.1 million to trade U.S. dollars in exchange for Canadian dollars.

#### Operating Demand Loan

The Amended Credit Facility also provides us with a \$1.0 million operating demand loan facility to assist us in meeting our operational needs (the Operating Demand Loan). The Operating Demand Loan accrues interest at a rate of BMO U.S. Base Rate plus 1.25%. Interest is payable monthly in arrears with any borrowing under the Operating Demand Loan fluctuating widely with periodic clean-up, at a minimum on an annual basis. We have also agreed to pay to the Bank a monthly monitoring fee of US\$500 with respect to this loan. The Operating Demand Loan is payable on demand at any time, at the sole discretion of the Bank, with or without cause, and the Bank may terminate the Operating Demand Loan at any time. As of September 30, 2012, we had no amounts outstanding under the Operating Demand Loan.



*General Terms*

Our Amended Credit Facility contains customary representations and warranties, affirmative and negative covenants, and events of default. Our Amended Credit Facility also requires us to make annual cash sweep payments based on our audited financial statements provided. These cash sweep payments will be applied solely to amounts outstanding under the DLRR Loan in inverse order of maturity. The Amended Credit Facility also requires that we comply with certain customary non-financial covenants and restrictions. In addition, we have agreed to comply with the following financial covenants at all times: (i) Maximum Senior Funded Debt to EBITDA of 2.00:1; (ii) Maximum Total Funded Debt to EBITDA of 2.50:1; and (iii) Minimum Fixed Charge Coverage of 1.25:1. Further, our Maximum Annual Capital Expenditures cannot exceed \$3.6 million per year, which limit will be reviewed on an annual basis. As of, and for the period ended, September 30, 2012, we were in compliance with these covenants.

*Cash Flow from (used in) Operating, Financing and Investing Activities*

Net cash provided by operating activities for the nine months ended September 30, 2012 totaled \$4.3 million, compared to \$3.2 million for the nine months ended September 30, 2011. Net cash provided by operating activities, before changes in non-cash operating working capital, remained relatively flat at \$4.4 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 primarily the result of the impact our currency forward contracts have on our results and the gain on the sale of certain intangible assets with no book value for \$0.5 million during the three months ended March 31, 2012.

Net cash used in non-cash operating working capital during the nine months ended September 31, 2012 decreased by \$1.1 million to \$0.1 million when compared to the \$1.2 million used during the nine months ended September 30, 2011 primarily from improved management of our other current working capital requirements. These increases in working capital were partially offset by our making the required evaluation fee payments in support of our application for four domain strings under ICANN's new gTLD Program of \$0.7 million which is included in prepaid expenses and deposits at September 30, 2012.

Net cash used in financing activities during the nine months ended September 30, 2012 totaled \$5.6 million as compared to net cash proceeds of \$0.3 million during the nine months ended September 30, 2011. Net cash of \$9.1 million was used to fund the repurchase of 7.6 million of our shares through a modified Dutch auction tender offer that was successfully concluded on January 23, 2012 and to repurchase 2.4 million shares under our current Normal Course Issuer Bid during the nine months ended September 30, 2012. A portion of the amount to fund the modified Dutch auction tender offer was from a \$4.0 million draw down on our DLR Loan facility. In addition, during the nine months ended September 30, 2012, \$0.9 million was used to fund principal repayments under our loan agreements. These uses were partially offset by the proceeds of \$0.4 million we received on the exercise of options by directors and employees of the Company.

Investing activities during the nine months ended September 30, 2012 used \$0.2 million. This use was the result of our acquisition of \$0.7 million of additional property and equipment during the nine months ended September 30, 2012, which was partially offset by the selling of certain intangible assets with no book value for \$0.5 million during the three months ended March 31, 2012.

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

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

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



### **Subsequent events**

During October 2012, the Company entered into foreign exchange forward contracts to hedge a portion of its expected Canadian dollar requirements during the 2013 and 2014 fiscal years. These contracts have a notional value of \$19.3 million, whereby \$19.3 million is converted into Canadian dollars during 2013 and 2014 at an average foreign exchange rate of US\$1.00: Cdn\$1.0073.

On November 13, 2012, the Company announced its plan to launch a modified Dutch auction tender offer (the Tender Offer ) to repurchase up to 6,500,000 shares of its common stock, at a price per share not less than \$1.35 and not greater than \$1.50. The tender offer is expected to commence the week of November 19, 2012 and will remain open for at least 20 business days.

### 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, 2012. We are also subject to market risk exposure related to changes in interest rates under our Amended Credit Facility. We do not expect that any changes in interest rates will be material; however, fluctuations in interest rates are beyond our control. We will continue to monitor and assess the risks associated with interest expense exposure and may take additional actions in the future to mitigate these risks.

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

At September 30, 2012, the Company had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

Maturity date	Notional amount of U.S. dollars	Weighted	
		average exchange rate of U.S. dollars	Fair value
October December, 2012	5,100,000	0.9855	5,108
January March, 2013	6,000,000	1.0277	249,008
April May, 2013	4,000,000	1.0385	201,548
Total	\$15,100,000	1.0163	\$455,664

As of September 30, 2012 the Company has \$15.1 million of outstanding foreign exchange forward contracts which will convert to CDN \$15.3 million.

The Company does not apply hedge accounting and, therefore, for the nine months ended September 30, 2012, the Company recorded a gain of \$0.8 million in the fair value of forward contracts in its consolidated statements of operations. For the nine months ended September 30, 2011, the Company recorded a loss on forward contracts of \$1.4 million.

We have performed a sensitivity analysis model for foreign exchange exposure over the three months ended September 30, 2012. 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, 2012. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a decrease in net income for the three months ended September 30, 2012 of approximately \$0.5 million. There can be no assurances that the above projected exchange rate decrease will materialize. Fluctuations of exchange rates are beyond our control. We will continue to monitor and assess the risk associated with these exposures and may take additional actions in the future to hedge or mitigate these risks.

### **Credit Risk**

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

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

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the 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.

## **PART II.**

### **OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

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

#### **Item 1A. Risk Factors**

In addition to the other information set forth in this Quarterly Report, you should also carefully consider the risk factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2011, 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 Sales of Equity Securities and Use of Proceeds**

In the three months ended September 30, 2012, we used \$1.6 million to repurchase 1.3 million shares of the Company's common stock pursuant to its previously announced stock buyback program, which initially commenced on November 15, 2011 and which was temporarily suspended when the Company undertook its Dutch auction tender offer.

In the three months ended June 30, 2012, we used \$1.6 million to repurchase 1.1 million shares of the Company's common stock pursuant to its previously announced stock buyback program, which initially commenced on November 15, 2011 and which was temporarily suspended when the Company undertook its Dutch auction tender offer.

In the three months ended March 31, 2012 we used \$5.9 million to repurchase 7.6 million shares of the Company's common stock pursuant to a Dutch auction tender offer .

All shares repurchased were cancelled. The following table shows the monthly activity related to our stock repurchases for the nine months ended September 30, 2012.

<b>Period</b>	<b>Total number of shares purchased (1) (2)</b>	<b>Average price paid per share</b>	<b>Total number of shares purchased as part of publicly announced plans or programs</b>	<b>Maximum number of shares that may yet be purchased under the plans or programs</b>
January 1, 2012 through January 31, 2012	7,570,236	\$ 0.77	7,570,236	
February 1, 2012 through February 29, 2012				
March 1, 2012 through March 31, 2012				
April 1, 2012 through April 30, 2012				
May 1, 2012 through May 31, 2012	1,115,304	1.43	1,115,304	
June 1, 2012 through June 30, 2012				
July 1, 2012 through July 31, 2012				
August 1, 2012 through August 31, 2012	584,200	1.24	584,200	
September 1, 2012 through September 30, 2012	671,700	1.35	671,700	
<b>Total</b>	<b>9,941,440</b>	<b>\$ 0.91</b>	<b>9,941,440</b>	<b>1,445,031</b>

(1) On January 23, 2012, the Company announced that it successfully concluded a modified Dutch auction tender offer that was previously announced on December 15, 2011. Under the terms of the offer, the Company repurchased an aggregate of 7,570,236 shares of its common stock at a purchase price of \$0.77 per share, for a total of \$5,829,082, excluding transaction costs of approximately \$64,000. The purchase price and all transaction costs were funded from available cash and an additional advance under its Amended Credit Facility from the Bank in the amount of \$4.0 million. All shares purchased in the tender offer received the same price and all shares repurchased were immediately cancelled.

(2) On March 16, 2012, the Company announced that it was reinstating its previously announced stock buyback program, which initially commenced on November 15, 2011 and which was temporarily suspended when the Company undertook its Dutch auction tender offer. Under this buyback program, the Company may repurchase up to 3,840,000 shares of the Company's common stock over the 12-month period that commenced on November 15, 2011. The Company repurchased 1,255,900 shares under this program during the three month period ended September 30, 2012, and 2,371,204 shares under this program during the nine month period ended September 30, 2012.



**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information.**

On July 18, 2012, the Board of Directors of the Company (the Board ) approved an amendment to the Company's Bylaws to provide for a leadership structure for the Board in which two individuals serve as Co-Chairman of the Board, each with full authority to act as a Chairman of the Board. The full text of the amendment is attached as Exhibit 3.3 to this Quarterly Report on Form 10-Q.



**Item 6. Exhibits**

(a) Exhibits.

**Exhibit No. Description**

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

*Information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.*

\*\* XBRL

\* Filed herewith.

Furnished herewith.

**SIGNATURES**

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

Date: November 14, 2012 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)

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