TUCOWS INC /PA/
Form 10-Q
November 14, 2007

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

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# FORM 10-Q

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

**For the quarterly period ended September 30, 2007**

**OR**

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

**For the transition period from to**

**Commission file number 1-32600**

# TUCOWS INC.

(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| **Pennsylvania** | **23-2707366** |

| | |
|---|---|
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

**96 Mowat Avenue,**

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

(Address of Principal Executive Offices) (Zip Code)

**(416) 535-0123**

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act:

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x

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

As of November 12, 2007, there were 73,772,502 outstanding shares of common stock, no par value, of the registrant.

**TUCOWS INC.**

**Form 10-Q Quarterly Report**

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**PART I.**

**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Tucows Inc.**

**Consolidated Balance Sheets**

(Dollar amounts in U.S. dollars)

| | | September 30, 2007 (unaudited) | | December 31, 2006 |
|---|---|---|---|---|
| **Assets** | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ | 5,915,732 | $ | 6,256,392 |
| Restricted cash | | 255,000 | | 1,019,423 |
| Accounts receivable, net of allowance for doubtful accounts of $131,500 as of September 30, 2007 and $147,500 as of December 31, 2006 | | 3,971,950 | | 2,969,997 |
| Prepaid expenses and deposits | | 3,474,477 | | 2,394,627 |
| Prepaid domain name registry and other Internet services fees, current portion | | 24,669,326 | | 22,168,558 |
| Cash held in escrow (note 3 (d)) | | 1,058,620 | | |
| Deferred tax asset, current portion | | 1,000,000 | | 1,000,000 |
| Total current assets | | 40,345,105 | | 35,808,997 |
| Prepaid domain name registry and other Internet services fees, long-term portion | | 10,559,073 | | 9,511,341 |
| Property and equipment | | 5,680,675 | | 5,647,532 |
| Deferred financing charges | | 142,600 | | |
| Deferred tax asset, long-term portion | | 2,000,000 | | 2,000,000 |
| Intangible assets (note 4) | | 22,363,906 | | 18,554,436 |
| Goodwill | | 17,762,228 | | 12,094,817 |
| Investment | | 353,737 | | 353,737 |
| Cash held in escrow (note 3(a)) | | | | 694,579 |
| Total assets | $ | 99,207,324 | $ | 84,665,439 |
| **Liabilities and Stockholders Equity** | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ | 1,870,124 | $ | 2,867,814 |
| Accrued liabilities | | 3,038,887 | | 2,567,012 |
| Customer deposits | | 2,978,559 | | 3,144,119 |
| Promissory note payable, current portion | | 6,000,000 | | |
| Loan payable, current portion (note 5) | | 1,914,242 | | |
| Deferred revenue, current portion | | 34,853,150 | | 31,658,081 |
| Accreditation fees payable, current portion | | 479,546 | | 847,325 |
| Total current liabilities | | 51,134,508 | | 41,084,351 |

| | | | | |
|---|---|---|---|---|
| Deferred revenue, long-term portion | | 14,994,772 | | 13,478,525 |
| Accreditation fees payable, long-term portion | | 181,484 | | 163,988 |
| Promissory note payable, long-term portion | | | | 6,000,000 |
| Loan payable, long-term portion (note 5) | | 7,337,927 | | |
| Deferred tax liability | | 5,396,000 | | 5,396,000 |
| | | | | |
| Stockholders equity (note 9) | | | | |
| | | | | |
| Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding | | | | |
| Common stock - no par value, 250,000,000 shares authorized; 73,772,502 shares issued and outstanding as of September 30, 2007 and 75,978,502 shares issued and outstanding as of December 31, 2006 | | 15,250,235 | | 15,395,381 |
| Additional paid-in capital | | 48,514,852 | | 50,359,906 |
| Deficit | | (43,602,454) | | (47,212,712) |
| Total stockholders equity | | 20,162,633 | | 18,542,575 |
| Total liabilities and stockholders equity | $ | 99,207,324 | $ | 84,665,439 |

See accompanying notes to unaudited consolidated financial statements

**Tucows Inc.**

**Consolidated Statements of Operations**

**(Dollar amounts in U.S. dollars)**

**(unaudited)**

| | Three months ended September 30, 2007 | 2006 | Nine months ended September 30, 2007 | 2006 |
|---|---|---|---|---|
| Net revenues | $ 17,811,914 | $ 16,864,320 | $ 56,398,012 | $ 47,830,296 |
| Cost of revenues: | | | | |
| Cost of revenues (*) | 12,271,047 | 10,464,829 | 35,702,644 | 30,458,945 |
| Depreciation of property and equipment | 995,954 | 695,624 | 2,791,050 | 1,889,799 |
| Amortization of intangible assets | 83,060 | 66,550 | 210,132 | 143,628 |
| Total cost of revenues | 13,350,061 | 11,227,003 | 38,703,826 | 32,492,372 |
| Gross profit | 4,461,853 | 5,637,317 | 17,694,186 | 15,337,924 |
| Expenses: | | | | |
| Sales and marketing (*) | 1,712,676 | 1,706,951 | 4,537,198 | 4,738,397 |
| Technical operations and development (*) | 1,723,857 | 1,924,435 | 5,288,829 | 6,335,874 |
| General and administrative (*) | 1,257,206 | 1,698,012 | 3,566,847 | 4,265,529 |
| Depreciation of property and equipment | 68,316 | 43,025 | 198,107 | 125,116 |
| Amortization of intangible assets | 322,781 | 230,291 | 778,823 | 436,175 |
| Total expenses | 5,084,836 | 5,602,714 | 14,369,804 | 15,901,091 |
| Income (loss) from operations | (622,983) | 34,603 | 3,324,382 | (563,167) |
| Other income (expenses): | | | | |
| Interest income (expense), net | (203,376) | (70,297) | (294,322) | 135,256 |
| Other income, net | 530,583 | 1,873,420 | 619,014 | 2,347,026 |
| Total other income | 327,207 | 1,803,123 | 324,692 | 2,482,282 |
| Income before provision for income taxes | (295,776) | 1,837,726 | 3,649,074 | 1,919,115 |
| Provision for income taxes | 14,816 | (96,895) | 38,816 | (84,895) |
| Net income (loss) for the period | $ (310,592) | $ 1,934,621 | $ 3,610,258 | $ 2,004,010 |
| Basic earnings per common share | $ (0.00) | $ 0.03 | $ 0.05 | $ 0.03 |
| Shares used in computing basic earnings per common share | 74,100,911 | 75,706,078 | 74,548,903 | 73,418,358 |
| Diluted earnings per common share | $ (0.00) | $ 0.02 | $ 0.05 | $ 0.03 |
| Shares used in computing diluted earnings per common share | 77,525,973 | 78,214,560 | 77,413,998 | 75,852,576 |

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

| | | | | |
|---|---|---|---|---|
| Cost of revenues | $ 4,100 | $ 2,200 | $ 11,000 | $ 7,700 |
| Sales and marketing | $ 21,400 | $ 23,200 | $ 61,100 | $ 79,200 |
| Technical operations and development | $ 18,900 | $ 14,800 | $ 62,300 | $ 50,800 |
| General and administrative | $ 33,900 | $ 21,300 | $ 118,100 | $ 72,300 |

See accompanying notes to unaudited consolidated financial statements

**Tucows Inc.**

**Consolidated Statements of Cash Flows**

**(Dollar amounts in U.S. dollars)**

**(unaudited)**

| | Three months ended September 30, 2007 | Three months ended September 30, 2006 | Nine months ended September 30, 2007 | Nine months ended September 30, 2006 |
|---|---|---|---|---|
| Cash provided by (used in): | | | | |
| Operating activities: | | | | |
| Net income (loss) for the period | $ (310,592) | $ 1,934,621 | $ 3,610,258 | $ 2,004,010 |
| Items not involving cash: | | | | |
| Depreciation of property and equipment | 1,064,270 | 738,649 | 2,989,157 | 2,014,915 |
| Amortization of intangible assets | 405,841 | 296,841 | 988,955 | 579,803 |
| Unrealized change in the fair value of forward contracts | (61,673) | 145,177 | (1,164,114) | (50,725) |
| Stock-based compensation | 78,300 | 61,500 | 252,500 | 210,000 |
| Change in non-cash operating working capital: | | | | |
| Interest receivable | | 5,027 | | 39,574 |
| Accounts receivable | 87,922 | (2,100,231) | (975,729) | (4,262,944) |
| Prepaid expenses and deposits | 875,841 | 388,487 | (161,669) | 367,608 |
| Prepaid domain name registry and other Internet services fees | (795,949) | (1,058,139) | (3,548,500) | (5,229,809) |
| Deferred financing charges | (142,600) | | (142,600) | |
| Accounts payable | (161,037) | (2,213,494) | (906,624) | 857,048 |
| Accrued liabilities | 218,368 | 135,838 | 651,189 | 1,202,952 |
| Customer deposits | 204,906 | 6,534 | (165,560) | 574,791 |
| Deferred revenue | 834,795 | 1,506,423 | 4,711,315 | 6,702,773 |
| Accreditation fees payable | (34,255) | 19,402 | (350,283) | (89,434) |
| Cash provided by (used in) operating activities | 2,264,137 | (133,365) | 5,788,295 | 4,920,562 |
| Financing activities: | | | | |
| Proceeds received on exercise of stock options | 17,912 | 43,550 | 204,255 | 98,960 |
| Repurchase of shares | | | (2,446,955) | |
| Repayment of promissory note payable | | (2,122,930) | | (2,122,930) |
| Proceeds received on loan payable | 9,571,209 | | 9,571,209 | |
| Repayment of loan payable | (319,040) | | (319,040) | |
| Cash provided by (used in) financing activities | 9,270,081 | (2,079,380) | 7,009,469 | (2,023,970) |
| Investing activities: | | | | |
| Cost of domain names acquired | | | (18,425) | |
| Additions to property and equipment | (200,213) | (787,824) | (3,093,366) | (4,079,249) |
| Decrease in investment in short-term investments | | | | 1,771,569 |
| Decrease (increase) in restricted cash - being margin security against forward exchange contracts | 255,000 | 159,623 | 764,423 | (202,835) |
| Acquisition of Mailbank.com Inc., net of cash acquired | | (655,830) | | (6,486,732) |
| Acquisition of Hosted Messaging Assets from Critical Path Inc., net of cash acquired | | (1,037,303) | (90,050) | (7,456,788) |
| Acquisition of Boardtown Corporation, net of cash acquired | | (22,700) | (4,900) | (22,700) |
| Acquisition of Innerwise Inc., net of cash acquired | (10,332,065) | | (10,332,065) | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Increase (decrease) in cash held in escrow | | (1,058,620) | | 1,563,999 | | (364,041) | | (221,012) |
| Cash used in investing activities | | (11,335,898) | | (780,035) | | (13,138,424) | | (16,697,747) |
| | | | | | | | | |
| Increase (decrease) in cash and cash equivalents | | 198,320 | | (2,992,780) | | (340,660) | | (13,801,155) |
| Cash and cash equivalents, beginning of period | | 5,717,412 | | 6,539,713 | | 6,256,392 | | 17,348,088 |
| Cash and cash equivalents, end of period | $ | 5,915,732 | $ | 3,546,933 | $ | 5,915,732 | $ | 3,546,933 |
| | | | | | | | | |
| Supplemental cash flow information: | | | | | | | | |
| Interest paid | $ | 274,368 | $ | | $ | 484,368 | $ | |
| | | | | | | | | |
| Supplementary disclosure of non-cash investing and financing activity: | | | | | | | | |
| Capital assets acquired during during the period not yet paid for | $ | 293,205 | $ | | $ | 293,205 | $ | |
| Common stock issued on the acquisition of Mailbank.com Inc. | $ | | $ | | $ | | $ | 2,877,070 |
| Promissory notes issued on the acquisition of Mailbank.com Inc. | $ | | $ | | $ | | $ | 8,122,930 |

See accompanying notes to unaudited consolidated financial statements

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**1. BUSINESS AND BASIS OF PRESENTATION:**

Tucows Inc., a Pennsylvania corporation (referred to throughout this report as the Company , Tucows , we , us or through similar expressions), together with its consolidated subsidiaries, seeks to make the Internet easier and more effective for Internet users and to reduce complexity for its customers as they acquire, deliver or use Internet services.

Our principle source for distributing Internet services is our global network of over 7,000 hosting companies, Internet Service Providers, or ISPs, and other providers of Internet services, collectively referred to as Service Providers. Service Providers play a critical role in connecting users to the Internet as they interact with individuals and businesses ranging from small business to large corporations. Our wholesale product offerings and our outsourced service management capability allows us to offer Service Providers innovative value-added services that allow these Service Providers to focus their time and resources on customer acquisition and retention while still being able to enhance per customer revenue by offering additional services along with their core services.

In addition to other Internet services, we provision millions of email boxes and manage over 7 million domains. We also have one of the most popular download sites on the Internet, where we connect advertisers to a global audience of Internet users.

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

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

## 2. NEW ACCOUNTING POLICIES:

The accompanying unaudited interim consolidated balance sheet, and the related consolidated statements of operations and cash flows reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position of Tucows and its subsidiaries as at September 30, 2007 and the results of operations and cash flows for the interim periods ended September 30, 2007 and 2006. The results of operations presented in this Quarterly Report on Form 10-Q are not necessarily indicative of the results of operations that may be expected for future periods.

The accompanying interim consolidated financial statements have been prepared by Tucows without audit, in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC ). Certain information and footnote disclosure normally included in the Company s annual audited consolidated financial statements and accompanying notes have been condensed or omitted. These interim financial statements and accompanying notes follow the same accounting policies and methods of application used in the annual financial statements and should be read in conjunction with the Company s audited financial statements and notes thereto for the year ended December 31, 2006 included in Tucows 2006 Annual Report on Form 10-K filed with the SEC on March 29, 2007.

Other than the adoption of FIN 48 described below, there have been no material changes in our significant accounting policies during the nine months ended September 30, 2007 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

*Reclassification*

Certain comparative figures have been reclassified to conform with the current period s presentation.

*Recent Accounting Pronouncements Adopted*

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) Issue No. 06-03, How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (that is, Gross Versus Net Presentation) (EITF 06-03). The EITF reached a consensus that the presentation of taxes on either a gross or net basis is an accounting policy decision that requires disclosure. EITF 06-03 is effective for the

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

first interim or annual reporting period beginning after December 15, 2006. Tucows adopted EITF 06-03 on January 1, 2007. Any amounts we collect, which under common trade practices are referred to as sales taxes, are and have been recorded on a net basis. The Company has no intention of modifying this accounting policy; therefore, the adoption of EITF 06-03 does not have any effect on the Company s financial position or results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for the first interim or annual reporting period beginning after December 15, 2006. The implementation of FIN 48 had no impact on Tucows opening deficit.

Tucows had approximately $180,000 of total gross unrecognized benefits as of the adoption of FIN 48 on January 1, 2007. At September 30, 2007, Tucows unrecognized tax benefits have increased to $230,000, which if recognized would favorably affect the income tax rate in future periods. The increase since adoption is primarily due to the non recognition of current year refundable research and development tax credits and foreign exchange.

Tucows recognizes accrued interest and penalties related to unrecognized tax benefit in tax expense. Tucows does not have any interest and penalties accrued as of January 1, 2007 and September 30, 2007 as the unrecognized tax benefit relates entirely to refundable research and development tax credits. Generally, all tax years are open for examination by the major taxing jurisdictions to which the Company is subject including federal, state and foreign jurisdictions.

*Recent Accounting Pronouncements Not Yet Adopted*

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This statement is effective for all fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged. The Company is currently evaluating the impact of this statement on its financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement expands the use of fair value measurement and applies to entities that elect the fair value option. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact of this statement on its financial statements.

**3. ACQUISITIONS**

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

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

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

**b. Acquisition of Mailbank.com Inc. :**

The results of Mailbank.com Inc. which was acquired on June 19, 2006, have been included in the consolidated statements of operations since its date of acquisition. Unaudited pro forma results of operations for the nine months ended September 30, 2006 are included below. Such pro forma information assumes that the above acquisition had occurred as of January 1, 2006 and is presented in accordance with our accounting policies. This summary is not necessarily indicative of what our results of operations would have been had Mailbank.com Inc. been a combined entity during such period, nor does it purport to represent results of operations for any future periods.

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| | | Nine months ended September 30, 2006 (in thousands) |
|---|---|---|
| Net revenues | $ | 50,193 |
| Net loss for the period | $ | 1,439 |
| Basic loss per common share | $ | 0.02 |

**c.** **Acquisition of Boardtown Corporation:**

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

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

**d.** **Acquisition of Innerwise Inc. (dba ItsYourDomain.com):**

On July 25, 2007, Tucows (Delaware) Inc. ( Tucows DE ), one of the Company s wholly owned subsidiaries, acquired 100% of the outstanding capital stock of Innerwise Inc. (d/b/a ItsYourDomain.com) ( IYD ), a privately held, ICANN-accredited registrar offering domain services through a worldwide wholesale network of over 2,500 affiliates. The total aggregate consideration amounting to $10,950,112 is composed of:

$10,847,650 paid in cash.

$102,462 of estimated transaction costs.

An additional $1.1 million of consideration is being held in escrow, and is payable in whole or in part by Tucows in August 2008, pending the final evaluation of the revenue generating capability of certain domain names acquired by Tucows DE under the purchase agreement, as well as any indemnification claims made by Tucows DE, for which the escrow account also serves as a source or recovery. This additional contingent consideration will be recorded when the amount becomes fixed and determinable and will be reflected as additional goodwill at that time.

$9,571,209 of the cash paid by Tucows at the closing was funded by a bank loan from the Bank of Montreal ( BOM ). The loan bears simple interest at the prime rate plus 0.50% per annum, which rate is subject to reduction based on Tucows ratio of Total Funded Debt of EBITDA, and was not issued at a premium or at a discount. The loan is subject to customary financial covenants, including a restriction on certain capital expenditures. The principal and accrued interest on the loan is payable monthly over the term of the loan, which is five years. Tucows may prepay this loan in full or in part at any time without any premium or penalty.

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

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents | $ | 618,047 | | |
| Accounts receivable | | 26,224 | | |
| Prepaid expenses and deposits | | 251,320 | | |
| Property and equipment | | 20,000 | | |
| Intangible assets | | 4,780,000 | | |
| Goodwill | | 5,572,461 | | |
| Total assets acquired | | | | 11,268,052 |
| | | | | |
| Accrued liabilities | | 317,940 | | |
| Total liabilities | | | | 317,940 |
| | | | | |
| Purchase price | | | $ | 10,950,112 |

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The intangible assets acquired include technology in the amount of $350,000, Brand in the amount of $1,500,000 and customer relationships in the amount of $2,930,000. The residual value from the purchase price has been allocated to goodwill. The technology is being amortized over 3 years, while the remaining amounts are being amortized over 7 years.

The valuation of the intangible assets is management s best estimate, based on a preliminary report from an independent valuator. The purchase price allocation will be finalized to reflect the final report when it is available. Any changes to the value assigned to intangible assets will be reflected by an equal and offsetting adjustment to goodwill.

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

| | Three months ended September 30, | | | | Nine months ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| | (unaudited in thousands - except earnings per share) | | | | | | | |
| Net revenue | $ | 18,211 | $ | 18,480 | $ | 60,575 | $ | 52,428 |
| Net income (loss) for the period | | (409) | | 1,527 | | 3,015 | | 487 |
| | | | | | | | | |
| Basic earnings (loss) per common share | $ | (0.01) | $ | (0.02) | $ | 0.04 | $ | 0.01 |

## 4. INTANGIBLE ASSETS:

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

A summary of acquired intangible assets for the three and nine months ended September 30, 2007, is as follows:

| Amortization period | Technology 2 - 7 years | Brand 7 years | Customer relationships 4 - 7 years | Non-compete agreements 3 years | Surname domain names indefinite life | Direct navigation domain names indefinite life | Total |
|---|---|---|---|---|---|---|---|
| Net book value, June 30, 2007 | $ 431,280 | $ 92,920 | $ 3,247,122 | $ | $ 12,129,403 | $ 2,089,022 | $ 17,989,747 |
| Purchase of domain names | | | | | | | |
| Disposition of domain names | | | | | | | |
| | 350,000 | 1,500,000 | 2,930,000 | | | | 4,780,000 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Acquisition of Innerwise Inc. (1) | | | | | | | |
| Amortization expense | (83,060) | (41,540) | (281,241) | | | | (405,841) |
| Net book value, September 30, 2007 | $ 698,220 | $ 1,551,380 | $ 5,895,881 | $ | $ 12,129,403 | $ 2,089,022 | $ 22,363,906 |

| **Amortization period** | **Technology 2 - 7 years** | **Brand 7 years** | **Customer relationships 4 - 7 years** | **Non-compete agreements 3 years** | **Surname domain names indefinite life** | **Direct navigation domain names indefinite life** | **Total** |
|---|---|---|---|---|---|---|---|
| Net book value, December 31, 2006 | $ 558,352 | $ 105,040 | $ 3,669,924 | $ 21,120 | $ 12,100,000 | $ 2,100,000 | $ 18,554,436 |
| Purchase of domain names | | | | | 30,048 | | 30,048 |
| Disposition of domain names | | | | | (645) | (10,978) | (11,623) |
| Acquisition of Innerwise Inc. (1) | 350,000 | 1,500,000 | 2,930,000 | | | | 4,780,000 |
| Amortization expense | (210,132) | (53,660) | (704,043) | (21,120) | | | (988,955) |
| Net book value, September 30, 2007 | $ 698,220 | $ 1,551,380 | $ 5,895,881 | $ | $ 12,129,403 | $ 2,089,022 | $ 22,363,906 |

(1) Preliminary allocation.

**5. LOAN PAYABLE:**

The Company entered into a non-revolving, reducing credit facility in the amount of $9,571,209 million with BMO to finance the purchase of Innerwise Inc. in July 2007. The loan bears simple interest at the rate of prime rate plus 0.50% per annum, and was not issued at a premium or at a discount. The principal and accrued interest on the loan is payable monthly

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

over the term of the loan, which is 5 years. Tucows may prepay this loan in full or in part without any premium or penalty. The BMO facility provides that we maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and coverage ratios during the term of the loan. Certain covenants under the facility may limit the amount of our capital expenditures. The facility is collateralized by a first lien on, and pledge of, the majority of the combined Company s present and future property and assets (subject to certain exclusions).

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

| | | | |
|---|---|---|---|
| October 2007 | September 2008 | $ | 1,914,242 |
| October 2008 | September 2009 | $ | 1,914,242 |
| October 2009 | September 2010 | $ | 1,914,242 |
| October 2010 | September 2011 | $ | 1,914,242 |
| October 2011 | July 2012 | $ | 1,595,201 |

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

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

The diluted earnings per common share have been calculated using the weighted average number of common shares outstanding and potentially dilutive common shares outstanding during the periods. Options to purchase 3,692,809 shares of common stock were outstanding during the three months ended September 30, 2007 (during the three months ended September 30, 2006, options to purchase 3,355,148 shares of common stock were outstanding) but were not included in the computation of diluted income per common share as the impact of the options was anti-dilutive because the options exercise price was greater than the average market price of the common shares. Options to purchase 651,416 shares of common stock were outstanding during the nine months ended September 30, 2007 (during the nine months ended September 30, 2006, options to purchase 700,734 shares of common stock were outstanding) but were not included in the computation of diluted income per common share as the impact of the options was anti-dilutive because the options exercise price was greater than the average market price of the common shares.

**7. SUPPLEMENTAL INFORMATION:**

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

| | Three months ended September 30, 2007 | 2006 | Nine months ended September 30, 2007 | 2006 |
|---|---|---|---|---|
| Domain names and other Internet servicews: | | | | |
| Domain names, excluding Domain Direct | $ 12,300,559 | $ 11,271,808 | $ 36,475,249 | $ 32,498,060 |
| Other Internet services, including Domain Direct | 4,421,820 | 4,304,777 | 13,050,510 | 12,125,805 |
| Sale of domain names | 21,340 | | 3,171,820 | |
| Total domain names and other Internet services | 16,743,719 | 15,576,585 | 52,697,579 | 44,623,865 |
| Advertising and other revenue | 1,068,195 | 1,287,735 | 3,700,433 | 3,206,431 |
| | $ 17,811,914 | $ 16,864,320 | $ 56,398,012 | $ 47,830,296 |

No customer accounted for more than 10% of revenue during the three or the nine months ended September 30, 2007.

At September 30, 2007, one customer accounted for 12% of accounts receivable. Significant management judgment

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

is required at the time of recording of revenue to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

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

| | Three months ended September 30, 2007 | Three months ended September 30, 2006 | Nine months ended September 30, 2007 | Nine months ended September 30, 2006 |
|---|---|---|---|---|
| Domain names and other Internet servicews: | | | | |
| Domain names, excluding Domain Direct | $ 9,158,156 | $ 8,069,626 | $ 27,086,194 | $ 23,253,335 |
| Other Internet services, including Domain Direct | 1,028,206 | 1,128,795 | 3,080,895 | 3,072,513 |
| Sale of domain names | | | 11,623 | |
| Total domain names and other Internet services | 10,186,362 | 9,198,421 | 30,178,712 | 26,325,848 |
| Advertising and other revenue | 144,654 | | 308,639 | |
| Network, other costs | 1,940,031 | 1,266,408 | 5,215,293 | 4,133,097 |
| Network, depreciation and amortization costs | 1,079,014 | 762,174 | 3,001,182 | 2,033,427 |
| | $ 13,350,061 | $ 11,227,003 | $ 38,703,826 | $ 32,492,372 |

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

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Canada | $ 2,043,195 | $ 2,521,328 |
| United States | 3,560,621 | 3,045,236 |
| United Kingdom | 76,859 | 80,968 |
| | $ 5,680,675 | $ 5,647,532 |

**8. COMMITMENTS AND CONTINGENCIES:**

As of September 30, 2007, we had outstanding foreign currency forward contracts with a notional value of $5.1 million, whereby $850,000 is converted into Canadian dollars on a semi-monthly basis from October 2007 to December 2007 at foreign exchange rates varying from U.S.$1:Cdn$1.1250 to U.S.$1:Cdn$1.1269. During the three months ended September 30, 2007, Tucows recorded a gain in fair value in respect of its foreign exchange forward contracts in the amount of $62,000, and during the nine months ended September 30, 2007 the Company recorded a gain in fair value in respect of its foreign exchange forward contracts, in the amount of $1.2 million. These amounts have been recorded in the general and administrative expense.

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. STOCKHOLDERS EQUITY:**

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

| | Common stock Number | | Common stock Amount | | Additional paid in capital | | Deficit | | Total stockholders equity |
|---|---|---|---|---|---|---|---|---|---|
| Balances, December 31, 2006 | 75,978,502 | $ | 15,395,381 | $ | 50,359,906 | $ | (47,212,712) | $ | 18,542,575 |
| Exercise of stock options | 373,880 | | 345,218 | | (158,875) | | | | 186,343 |
| Repurchase of shares | (2,616,600) | | (523,320) | | (1,923,635) | | | | (2,446,955) |
| Stock-based compensation (note 10) | | | | | 174,200 | | | | 174,200 |
| Net income for the period | | | | | | | 3,920,850 | | 3,920,850 |
| Balances, June 30, 2007 | 73,735,782 | | 15,217,279 | | 48,451,596 | | (43,291,862) | | 20,377,013 |
| | | | | | | | | | |
| Exercise of stock options | 36,720 | | 32,956 | | | | | | 32,956 |
| Stock-based compensation (note 10) | | | | | 63,256 | | | | 63,256 |
| Net income for the period | | | | | | | (310,592) | | (310,592) |
| Balances, September 30, 2007 | 73,772,502 | $ | 15,250,235 | $ | 48,514,852 | $ | (43,602,454) | $ | 20,162,633 |

The following unaudited table summarizes stockholders equity transactions for the period ended September 30, 2006:

| | Common stock Number | | Common stock Amount | | Additional paid in capital | | Deficit | | Total stockholders equity |
|---|---|---|---|---|---|---|---|---|---|
| Balances, December 31, 2005 | 71,945,303 | $ | 12,403,422 | $ | 50,061,866 | $ | (49,373,146) | $ | 13,092,142 |
| Exercise of stock options | 122,011 | | 55,409 | | | | | | 55,409 |
| Acquisition of Boardtown Corporation | 3,569 | | 3,281 | | | | | | 3,281 |
| Acquisition of Mailbank.com Inc. | 3,596,337 | | 2,803,070 | | | | | | 2,803,070 |
| Stock-based compensation | | | | | 148,500 | | | | 148,500 |
| Net loss for the period | | | | | | | 69,389 | | 69,389 |
| Balances, June 30, 2006 | 75,667,220 | | 15,265,182 | | 50,210,366 | | (49,303,757) | | 16,171,791 |
| Exercise of stock options | 65,000 | | 43,550 | | | | | | 43,550 |
| Acquisition of Mailbank.com Inc. | | | (21,000) | | | | | | (21,000) |
| Stock-based compensation | | | | | 61,500 | | | | 61,500 |
| Net loss for the period | | | | | | | 1,934,621 | | 1,934,621 |
| Balances, September 30, 2006 | 75,732,220 | $ | 15,287,732 | $ | 50,271,866 | $ | (47,369,136) | $ | 18,190,462 |

**10. SHARE-BASED PAYMENTS**

Valuation method:

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

The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

are appropriate in calculating the fair value of the Company s stock option grants. Estimates of fair value are not intended, however, to predict actual future events or the value ultimately realized by employees who receive equity awards.

No cash is used by the Company to settle equity instruments granted under share-based compensation arrangements.

Summary of Outstanding Stock Options:

(a) 1996 Stock Options Plan

As of September 30, 2007, options to purchase an aggregate of 5,201,023 shares of common stock are outstanding under the Company s 1996 Stock Option Plan. No further shares of common stock may be issued under this option plan. Stock options that have been issued under the 1996 Stock Option Plan generally vest over four years and expire ten years from the date of the grant. The exercise price of options granted is equivalent to the fair market value of the stock on the day prior to the date of grant.

A summary of unaudited option activity under the Company s 1996 Stock Option Plan for the three months ended September 30, 2007 is as follows:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value ($ 000s) |
|---|---|---|---|---|
| Outstanding at June 30, 2007 | 5,273,729 | $ 0.49 | | |
| Granted | | | | |
| Exercised | (36,720) | 0.49 | | |
| Forfeited | (35,986) | 0.78 | | |
| Expired | | | | |
| Outstanding at September 30, 2007 | 5,201,023 | $ 0.49 | 5.54 | $ 2,527 |
| Exercisable at September 30, 2007 | 4,972,642 | $ 0.48 | 5.47 | $ 2,460 |

A summary of unaudited option activity under the Company s 1996 Stock Option Plan for the nine months ended September 30, 2007 is as follows:

| Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual | Aggregate Intrinsic Value ($ 000s) |
|---|---|---|---|

| | | | | Term (years) | | |
|---|---|---|---|---|---|---|
| Outstanding at December 31, 2006 | 5,910,192 | $ | 0.52 | | | |
| Granted | | | | | | |
| Exercised | (410,600) | | 0.50 | | | |
| Forfeited | (298,569) | | 1.12 | | | |
| Expired | | | | | | |
| Outstanding at September 30, 2007 | 5,201,023 | $ | 0.49 | 5.54 | $ | 2,527 |
| Exercisable at September 30, 2007 | 4,972,642 | $ | 0.48 | 5.47 | $ | 2,460 |

Total unrecognized compensation cost relating to unvested stock options at September 30, 2007, prior to the consideration of expected forfeitures, is approximately $146,000 and is expected to be recognized over a weighted average period of 1.9 years.

There were no options granted during the nine months ended September 30, 2007.

For the nine months ended September 30, 2006, the weighted-average fair value of options granted, as of the grant date, during the period was $0.83, using the following assumptions: expected volatility of 121%; risk-free interest rate of 4.5%, expected dividend yield of 0%; and expected life of six years. 233,000 options were granted during the three and nine months ended September 30, 2006.

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(b) 2006 Equity Compensation Plan

As of September 30, 2007, options to purchase an aggregate of 1,282,500 shares of common stock are outstanding under the Company s 2006 Equity Compensation Plan. Stock options that have been issued under the 2006 Equity Compensation Plan vest over four years and expire seven years from the date of the grant. The exercise price of options granted is equivalent to the fair market value of the stock on the day of grant.

A summary of unaudited option activity under the Company s 2006 Equity Compensation Plan for the three months ended September 30, 2007 is as follows:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value ($ 000s) |
|---|---|---|---|---|
| Outstanding at June 30, 2007 | 1,398,500 | $ 0.85 | | |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | (116,000) | 0.85 | | |
| Expired | | | | |
| Outstanding at September 30, 2007 | 1,282,500 | $ 0.86 | 6.28 | $ 136 |
| Exercisable at September 30, 2007 | 120,000 | $ 0.90 | 4.42 | $ 10 |

A summary of unaudited option activity under the Company s 2006 Equity Compensation Plan for the nine months ended September 30, 2007 is as follows:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value ($ 000s) |
|---|---|---|---|---|
| Outstanding at December 31, 2006 | 60,000 | $ 0.83 | | |
| Granted | 1,472,500 | 0.86 | | |
| Exercised | | | | |
| Forfeited | (250,000) | 0.85 | | |
| Expired | | | | |
| Outstanding at September 30, 2007 | 1,282,500 | $ 0.86 | 6.28 | $ 136 |
| Exercisable at September 30, 2007 | 120,000 | $ 0.90 | 4.42 | $ 10 |

Total unrecognized compensation cost relating to unvested stock options at September 30, 2007, prior to the consideration of expected forfeitures, is approximately $577,000 and is expected to be recognized over a weighted average period of 4.2 years

No options were granted during the three months ended September 30, 2007.

For the nine months ended September 30, 2007, the weighted-average fair value of options granted, as of the grant date, during the period was $0.57, using the following assumptions: expected volatility of 83%; risk-free interest rate of 4.5%, expected dividend yield of 0%; and expected life of 4.75 years. A total of 1,472,500 options were granted during the nine months ended September 30, 2007.

No options were granted during the nine months ended September 30, 2006.

(c) Share-based compensation expense.

Share-based compensation expense included in the Statement of Operations for the three months ended September 30, 2007 was $78,300 while share-based compensation expense included in the Statement of Operations for the three months ended September 30, 2006 was $61,500.

Share-based compensation expense included in the Statement of Operations for the nine months ended September 30, 2007

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

was $252,500 share-based compensation expense included in the Statement of Operations for the nine months ended September 30, 2006 was $210,000

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

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

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Some of the statements under Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-Q constitute forward-looking statements.

These statements involve known and unknown risks, uncertainties and other factors that may cause our or our industry s actual results, levels of activity, performance or achievements to be materially different from the information expressed or implied by these forward-looking statements. While we believe that we have a reasonable basis for each forward-looking statement contained in this Form 10-Q, we caution you that these statements are based on a combination of facts and factors currently known by us and projections of the future, about which we cannot be certain or even relatively certain. 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; and

Pending or new litigation.

In addition, you should refer to the Risk Factors section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 for a discussion of other factors that may cause our actual results to differ materially from those implied by our forward-looking statements. As a result of these factors, we cannot assure you that the forward-looking statements in this Form 10-Q will prove to be accurate. Furthermore, if our forward-looking statements prove to be inaccurate, the inaccuracy may be material. In light of the significant uncertainties in these forward-looking statements, you should not regard these statements as a representation or warranty by us or any other person that we will achieve our objectives and plans in any specified time frame, if at all.

You should read this Form 10-Q completely. In some cases, you can identify forward-looking statements by the following words: may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, potential, continue or the negative of these terms or other c terminology. All forward-looking statements included in this Form 10-Q are based on information available to us as of the date of this Form 10-Q, and we assume no obligation to update these cautionary statements or any forward-looking statements. 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**

We provide Internet services and downloadable software through a global distribution network of more than 7,000 customers, or Service Providers, in more than 100 countries. We are an accredited registrar ICANN, and we generate revenue primarily through the provision of domain registration and other Internet services to Service Providers who offer such services to their own customers in a process known as wholesale distribution.

Our distribution network of Service Providers is comprised primarily of web hosting companies, Internet Service Providers, or ISPs, and providers of other services over the Internet. These Service Providers typically provide their customers, the end-users of the Internet, with a critical component to enable their use of the Internet. End-users typically consist of individuals and businesses ranging from small businesses to large corporations.

**Net Revenues**

We generate net revenues primarily through the provision of domain registration and other Internet services. Additional revenue is generated from the sale of domain names and advertising and other services.

**Domain registration and other Internet services**

We generate revenues from the provision of Internet services on both a wholesale and retail basis. To date, the majority of net revenues has been derived from the sale of services provided as an accredited domain registrar. As of September 30, 2007, we offered registration services for the generic top-level domains, or gTLDs, ..com, .net, .org, .info, .name .biz and .mobi and for the country code top-level domains, or ccTLDs .at, .be, .ca, .cc, .ch, .cn, .de, .dk, .es, .eu, ..fr, .it, .nl, .tv, .uk, .us and .vc.

We receive revenues for each domain registration or other Internet service processed through our retail site or through our system by Service Providers.

With respect to the sale of domain registrations, we earn registration fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to Service Providers and registrars on a monthly basis. Domain registrations are generally purchased for terms of one to ten years. Payments for the full term of all services, or billed revenue, 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.

Other Internet services currently consist of the sale of expiring domain names, digital certificates, billing, provisioning and customer care software solutions, hosted email and anti-spam services, blogware and website building tools which are used by our Service Providers to create bundles of Internet services for their end-users. In addition, we also offer premium domain name sales, which allow our customers to present existing domain names owned by third parties as names available for purchase. We earn a referral fee for each name sold, which we share with the customer that facilitated the transaction.

We earn fees when a service is activated. Other Internet services are generally purchased for terms of one month to three years. Payments for domain registrations and other Internet services are for the full term of all services 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.

On a retail basis, we offer Internet services directly to end-users through our Domain Direct division. These services include domain registration and other Internet services such as email, personalized email through our portfolio of surname-based domain names, blogware, hosting and website creation. Depending on the service offered, Domain Direct receives standard fees for its services that are published on its website. In addition, Domain Direct offers referral commissions based on a percentage of net registration revenues to participants in its affiliate program and, through the recent acquisition of IYD has contractual relationships with over 2,500 third-party resellers to sell our domain name registration and other services under their own brands. We pay our resellers an amount based on the difference between the pricing of their sale of the given service and the wholesale rate upon which we agree.

**Domain name sales**

We also generate revenue from the sale of domain names held in our portfolio of generic and surname domains. These names are included as intangible assets on our balance sheet.

In evaluating these 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 this evaluation the name is deemed non essential to our business, and management believes that the proceeds from this sale is strategically more beneficial to the Company. The cost of these names is included as intangible assets with indefinite lives on our consolidated balance sheet.

**Advertising and other revenue**

We also generate advertising and other revenue through our online libraries of shareware, freeware and online services presented at our website, www.tucows.com, as well as from traffic and search sessions originating on our portfolio of domain names.

Our software libraries advertising revenue is generated from third-party advertisers and from software developers who rely on us as a primary source of distribution. Software developers use our Author Resource Center, or ARC, to submit their products for inclusion in our software libraries and to purchase promotional placement of their software in the library categories, as well as purchase other promotional services on a cost-per-click through or flat rate basis. Software developers are able to promote their software through advertising services including keyword search placements, banners, promotional placements, expedited reviews and premium data services. Revenue is also generated from companies who contract with us to provide them with co-branded content. Advertising and other revenue is recognized ratably over the period in which it is presented.

We also offer pay-per-click advertising on the pages of certain domains within our domain name portfolio. When a user types one of these domain names into the command line of the browser (direct navigation), they are presented with dynamically generated links which are pay-per-click advertising. Every time a user clicks on one of the links listed on a web page, it generates revenue for us through our partnership with third-parties who provide syndicated pay-per-click results. These amounts are recognized on a monthly basis once the advertising has been served.

**Critical Accounting Policies**

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

Other than the adoption of EITF 06-03 and FIN 48 during the three months ended March 31, 2007, there have been no significant changes in our critical accounting policies during the three and nine months ended September 30, 2007 as compared to the critical accounting policies disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007 AS COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006**

**NET REVENUES**

The following table presents our revenues, by revenue source, for the periods presented (unaudited):

| | **Three months ended September 30,** | | **Nine months ended September 30,** | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Domain name and other Internet services: | | | | |
| Domain names, excluding Domain Direct | $12,300,559 | $11,271,809 | $36,475,249 | $32,498,060 |
| Other Internet services, including Domain Direct | 4,421,820 | 4,304,777 | 13,050,510 | 12,125,805 |
| Sale of domain names | 21,340 | | 3,171,820 | |
| Total domain name and other Internet services | 16,743,719 | 15,576,586 | 52,697,579 | 44,623,865 |
| Advertising and other revenue | 1,068,195 | 1,287,734 | 3,700,433 | 3,206,431 |
| | $17,811,914 | $16,864,320 | $56,398,012 | $47,830,296 |
| Increase over prior period | $947,594 | | $8,567,716 | |
| Increase - percentage | 6% | | 18% | |

The following table presents our revenues, by revenue source, as a percentage of total revenues for the periods presented (unaudited):

| | **Three months ended September 30,** | | **Nine months ended September 30,** | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Domain name and other Internet services: | | | | |
| Domain names, excluding Domain Direct | 69.1% | 66.9% | 64.7% | 67.9% |
| Other Internet services, including Domain Direct | 24.8% | 25.5% | 23.1% | 25.4% |
| Sale of domain names | 0.1% | 0.0% | 5.6% | 0.0% |
| Total domain name and other Internet services | 94.0% | 92.4% | 93.4% | 93.3% |
| Advertising and other revenue | 6.0% | 7.6% | 6.6% | 6.7% |
| | 100.0% | 100.0% | 100.0% | 100.0% |

Total net revenues for the three months ended September 30, 2007 increased to $17.8 million from $16.9 million for the three months ended September 30, 2006.

Total net revenues for the nine months ended September 30, 2007 increased to $56.4 million from $47.8 million for the nine months ended September 30, 2006.

No customer accounted for more than 10% of revenue during the three or the nine months ended September 30, 2007.

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At September 30, 2007, one customer accounted for 12% of accounts receivable. Significant management judgment is required at the time of recording of revenue to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

*Domain name and other Internet services*

Net revenues from domain name and other Internet services for the three months ended September 30, 2007 increased by $1.1 million, or 7.5%, to $16.7 million from $15.6 million for the three months ended September 30, 2006. This increase was primarily as a result of increased volumes from new and existing customers and the additional revenue of $0.1 million we earned during the three months ended September 30, 2007 from the acquisition of Innerwise Inc. ( IYD ) in July 2007.

Net revenues from domain name and other Internet services for the nine months ended September 30, 2007 increased by $8.1 million, or 18.1%, to $52.7 million from $44.6 million for the nine months ended September 30, 2006. This increase resulted primarily from a $3.0 million sale of approximately 2,500 domain names from our portfolio of domain names during the fiscal quarter ended June 30, 2007, as well as increased volumes from new and existing customers, the incremental revenue we earned during the nine months ended September 30, 2007 from our acquisition of IYD in July 2007 and the incremental revenue from the acquisition of the name-based domain assets from Mailbank.com, Inc. in June 2006.

During the three months ended September 30, 2007, the number of domain names that we processed increased by 206,000 to 1.4 million new, renewed and transferred-in domain name registrations, compared to the three months ended September 30, 2006. This increase resulted primarily from our continuing to compete aggressively to attract new clients and retain existing customers and to a lesser extent by the incremental registrations we generated as a result of our acquisition of IYD in July 2007. The market for domain name and other internet services remains intensely competitive and rapidly evolving. Effective August 2007, as part of our ongoing initiatives to improve our competitive position and to provide wholesale domain resellers a transparent cost breakdown, we invested in a new cost-plus domain pricing structure and a reduction in our domain name pricing. These steps have contributed to our average selling price declining and are likely to adversely impact our revenue and profitability in the short term. They also may or may not result in increased volumes, which would adversely impact our revenues and profitability in the longer term.

During the nine months ended September 30, 2007, the number of domain names that we processed increased by 498,000 to 4.2 million new, renewed and transferred-in domain name registrations, compared to the nine months ended September 30, 2006, largely for the same reasons discussed in the preceding paragraph..

The renewal rate for domain name registrations, excluding Innerwise Inc., remained relatively constant at 72% for the three months ended September 30, 2007, compared to the three months ended September 30, 2006.

While we anticipate that the number of new, renewed and transferred-in domain name registrations will incrementally increase, the volatility in the market could affect the growth of domain names under our management. At September 30, 2007, the total number of domain names under our management increased by 1.5 million to 7.1 million, compared to the total number of domain names under our management as at September 30, 2006 partly as a result of the approximately 700,000 names we acquired in our acquisition of IYD in July 2007 . As of September 30, 2007, we provided provisioning services on a monthly basis to nine registrars who use our technical systems to process domain registrations with their own accreditation. The decrease in the number of registrars processing names resulted from the insolvency of one of our registrars who had 800,000 names under management with us that have now transferred to another registrar. As of September 30, 2007, we managed an incremental 1.1 million domain names for these nine registrars, compared to 1.8 million for ten registrars at September 30, 2006, on their behalf. Deferred revenue from domain name registrations and other Internet services at September 30, 2007 increased to $49.8 million from $44.7 million at September 30, 2006.

*Advertising and other revenue*

Advertising and other revenue for the three months ended September 30, 2007 decreased by $220,000, or 17.0%, to $1.1 million from $1.3 million for the three months ended September 30, 2006. This decrease was primarily the result of a decline in our Google Adsense revenue and reflects the further contraction in the yields from our syndicated Google feeds, which impacts both our software library and direct navigation revenue.

Advertising and other revenue for the nine months ended September 30, 2007 increased by $494,000, or 15.4%, to

$3.7 million from $3.2 million for the nine months ended September 30, 2006. This increase was primarily as a result of our delivery of third party advertisements on parked pages amounting to $1.5 million for the nine months ended September 30, 2007 compared to $695,000 for the nine months ended September 30, 2006. This increase was partially offset by a decline in our Google Adsense revenue of $235,000, and a decline in our online advertising revenue of $80,000. The decrease in our Google Adsense revenue primarily reflects the further contraction in the yields from our syndicated Google feeds, which impacts both our software library and direct navigation revenue.

During the three months ended September 30, 2007, revenue from advertising and other revenue comprised 6.0% of total revenue, compared to 7.6% for the three months ended September 30, 2006. This decrease resulted primarily from the impact of the lower Google Adsense revenue described above.

During the nine months ended September 30, 2007, revenue from advertising and other revenue remained fairly constant at 6.6% of total revenue, compared to 6.7% for the nine months ended September 30, 2006.

**COST OF REVENUES**

Cost of revenues includes the costs associated with providing domain registration, other Internet services, the costs of domain name sales, advertising and other revenue and network costs.

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 recorded as prepaid domain registry fees.

Costs of revenues for other Internet services, includes the cost incurred for the renewal of surname domain names and any impairment charges that may arise from our assessment of the domain name intangible assets as well as fees paid to third-party service providers. Fees paid to third-party service providers and renewal fees are recognized ratably over the periods in which the services are provided.

Cost of revenues for the sale of domain names includes the value ascribed to it under intangible assets and is expensed as cost of revenues at the time of the sale.

Cost of revenues for advertising and other revenues, includes the renewal cost of domain names in our portfolio of generic domain names, which are amortized ratably over the term of provision of the renewal, as well as any impairment charges that may arise from our assessment of the domain name intangible assets. As the total names in our portfolio continue to grow this will become a more significant component of our cost of revenues. Network costs include personnel and related expenses, depreciation and amortization, communication costs, equipment maintenance, stock based compensation and employee and related costs directly associated with the management and maintenance of our network. Communication costs include bandwidth, co-location and provisioning costs we incur to support the supply of all our services.

The following table presents our cost of revenues, by revenue source, for the periods presented (unaudited):

| | Three months ended September 30, 2007 | 2006 | Nine months ended September 30, 2007 | 2006 |
|---|---|---|---|---|
| Domain name and other Internet services: | | | | |
| Domain names, excluding Domain Direct | $ 9,158,156 | $ 8,069,626 | $ 27,086,194 | $ 23,253,335 |
| Other Internet services, including Domain Direct | 1,028,206 | 1,128,795 | 3,080,895 | 3,072,513 |
| Sale of domain names | | | 11,623 | |
| Total domain name and other Internet services | 10,186,362 | 9,198,421 | 30,178,712 | 26,325,848 |
| Advertising and other revenue | 144,654 | | 308,639 | |
| Network, other costs | 1,940,031 | 1,266,408 | 5,215,293 | 4,133,097 |
| Network, depreciation and amortization costs | 1,079,014 | 762,174 | 3,001,182 | 2,033,427 |
| | $ 13,350,061 | $ 11,227,003 | $ 38,703,826 | $ 32,492,372 |
| Increase over prior period | $ 2,123,058 | | $ 6,211,454 | |
| Increase - percentage | 19% | | 19% | |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Domain name and other Internet services: | | | | |
| Domain names, excluding Domain Direct | 68.6% | 71.8% | 69.9% | 71.5% |
| Other Internet services, including Domain Direct | 7.7% | 10.1% | 8.0% | 9.5% |
| Sale of domain names | 0.0% | 0.0% | 0.0% | 0.0% |
| Total domain name and other Internet services | 76.3% | 81.9% | 77.9% | 81.0% |
| Advertising and other revenue | 1.1% | 0.0% | 0.8% | 0.0% |
| Network, other costs | 14.5% | 11.3% | 13.5% | 12.7% |
| Network, depreciation and amortization costs | 8.1% | 6.8% | 7.8% | 6.3% |
| | 100.0% | 100.0% | 100.0% | 100.0% |

Cost of revenues for the three months ended September 30, 2007 increased to $13.4 million from $11.2 million for the three months ended September 30, 2006, primarily as a result of higher costs attributable to higher volumes of domain registrations and other Internet services of $1.1 million and included $144,000 relating to the renewal cost of domain names in our portfolio of generic domain names, which are amortized ratably over the term of provision of the renewal. Network costs increased by $1.0 million to $3.0 million from $2.0 million primarily a result of the additional labor, bandwidth and co-location and other costs required to manage the data centers of $674,000, depreciation of additional information technology assets acquired or purchased of $300,000 and additional amortization of $16,000 resulting from acquisitions. Cost of revenues for the nine months ended September 30, 2007 increased to $38.7 million from $32.5 million for the nine months ended September 30, 2006, primarily as a result of higher costs attributable to higher volumes of domain registrations and other Internet services of $3.9 million and included $300,000 relating to the renewal cost of domain names in our portfolio of generic domain names, which are amortized ratably over the term of provision of the renewal. Network costs increased by $2.0 million to $8.2 million from $6.2 million primarily a result of the additional labor, bandwidth and co-location and other costs required to manage multiple systems at our data centers of $1.1 million, depreciation of additional information technology assets acquired or purchased of $901,000 and additional amortization of $67,000 resulting from acquisitions.

These increases were offset in part by a reversal in March 2007 of a contingency of $220,000 that was recorded for a planned network operation initiative that the Company was not ultimately obligated to settle, as those initiatives were terminated and the liability to settle the contingency was eliminated. In addition, transitional costs incurred during the nine months ended September 30, 2006 in the amount of $513,000 as a result of the acquisition of the Hosted Messaging assets of Critical Path Inc. were not incurred during the nine months ended September 30, 2007.

Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered. Registry fees are recorded as prepaid domain registry fees and are recognized ratably over the term of provision of the service. Other Internet service costs and ICANN accreditation transaction fees are generally paid either monthly or quarterly. Services provided over periods longer than one month are recognized ratably over the term of provision of the service.

Prepaid domain registration and other Internet services fees at September 30, 2007 increased by $4.1 million, to approximately $35.2 million from $31.1 million at September 30, 2006.

We anticipate that cost of revenues will continue to increase in absolute dollars primarily as a result of continued growth in domain registration and other Internet services and as our network activity increases.

**SALES AND MARKETING**

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Sales and marketing | $ 1,712,676 | $ 1,706,951 | $ 4,537,198 | $ 4,738,397 |
| Increase (decrease) over prior period | $ 5,725 | | $ (201,199) | |
| Increase (decrease) - percentage | 0% | | (4)% | |
| Percentage of net revenues | 10% | 10% | 8% | 10% |

Sales and marketing expenses during the three months ended September 30, 2007 remained at $1.7 million compared to the three months ended September 30, 2006.

Sales and marketing expenses during the nine months ended September 30, 2007 decreased to $4.5 million compared to $4.7 million during the nine months ended September 30, 2006.

This increase during the three months ended September 30, 2007 was primarily the result of additional people costs, being additional outside contractors offset in part by reduced commissions earned, which were offset by lower travel costs.

This decrease during the nine months ended September 30, 2007 was primarily the result of the reversal of a contingency of $231,000 that was recorded for certain marketing initiatives that the Company was not ultimately obligated to settle, as those initiatives were terminated and the liability to settle the contingency was eliminated. In addition, transitional costs incurred during the nine months ended September 30, 2006 in the amount of $37,000, as a result of the acquisition of the Hosted Messaging assets of Critical Path Inc., were not incurred during the nine months ended September 30, 2007. Travel and other selling expenses also decreased by approximately $133,000 when compared to the same period last year. These decreases were partly offset by additional people and other costs of $200,000, predominantly in customer service and marketing as we continue to invest in customer service improvements.

We believe that sales and marketing expenses will continue to increase, in absolute dollars, as we adjust our marketing programs and sales strategies to meet future opportunities in the marketplace.

**TECHNICAL OPERATIONS AND DEVELOPMENT**

Technical operations and development expenses consist primarily of personnel costs and related expenses required to support the development of new or enhanced service offerings and the maintenance and upgrading of existing infrastructure. This includes expenses incurred in the research, design and development of technology that we use to register domain names and other Internet services and to distribute our digital content services. Editorial costs relating to the rating and review of the software content libraries are included in the costs of product development. In accordance with the American Institute of Certified Public Accountants Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, costs incurred during the application development stage are capitalized and primarily include personnel costs for employees directly related to the development project. All other costs are expensed as incurred.

| | Three months ended September 30, | | | | Nine months ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| Technical operations and development | $ | 1,723,857 | $ | 1,924,435 | $ | 5,288,829 | $ | 6,335,874 |
| Decrease over prior period | $ | (200,578) | | | $ | (1,047,045) | | |
| Decrease - percentage | | (10)% | | | | (17)% | | |
| Percentage of net revenues | | 10% | | 11% | | 9% | | 13% |

Technical operations and development expenses for the three months ended September 30, 2007 decreased by $201,000 to $1.7 million compared to $1.9 million during the three months ended September 30, 2006.

Technical operations and development expenses for the nine months ended September 30, 2007 decreased by $1.0 million to $5.3 million compared to $6.3 million during the three months ended September 30, 2006.

This decrease during the three months ended September 30, 2007 primarily resulted from people-related costs, including contract and outside service costs, decreasing by $288,000, principally as a result of the steps we took to streamline our operations in Flint, Michigan. Other costs, including travel and conferences, decreased by $29,000 for the three months ended September 30, 2007, compared to the three months ended September 30, 2006. There were no capitalized personnel costs for employees directly related to the application development stage of development projects during the three months ended September 30, 2007 compared to $58,000 for the three months ended September 30, 2006.

This decrease during the nine months ended September 30, 2007 was primarily the result of the fact that we did not incur transitional costs relating to the acquisition of the Hosted Messaging assets of Critical Path during the nine months ended September 30, 2007 compared to $679,000 during the nine months ended September 30, 2006. In addition, as a result of steps we took to streamline our operations in Flint, Michigan, people-related costs, including contract and outside service costs, decreased by approximately $466,000. Other costs, predominantly travel, decreased by $27,000 for the nine months ended September 30, 2007, compared to the nine months ended September 30, 2006. Capitalized personnel costs for employees directly related to the application development stage of development projects decreased by $104,000 to $32,000, while other costs including dues and subscriptions increased by $21,000 during the nine months ended September 30, 2007, compared to the nine months ended September 30, 2006.

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

**GENERAL AND ADMINISTRATIVE**

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| General and administrative | $ 1,257,206 | $ 1,698,012 | $ 3,566,847 | $ 4,265,529 |
| Decrease over prior period | $ (440,806) | | $ (698,682) | |
| Decrease - percentage | (26)% | | (16)% | |
| Percentage of net revenues | 7% | 10% | 6% | 9% |

General and administrative expenses for the three months ended September 30, 2007 decreased by $441,000 to $1.3 million compared to $1.7 million during the three months ended September 30, 2006.

General and administrative expenses for the nine months ended September 30, 2007 decreased by $699,000 to $3.6 million compared to $4.3 million during the nine months ended September 30, 2006.

The decrease during the three months ended September 30, 2007 primarily resulted from our recording a foreign exchange gain of $370,000 for the three months ended September 30, 2007 compared to a loss of $28,000 for the three months ended September 30, 2006. In addition, people related costs, including contract and outside services, decreased by approximately $121,000 for the three months ended September 30, 2007, while professional fees, predominantly legal fees and other costs such as conferences, insurance and office supplies, decreased by approximately $77,000, compared to the three months ended September 30, 2006.

These decreases were partially offset by incremental costs of $155,000 being incurred in expenses such as credit card processing fees, investor relation costs, telephone, travel and other miscellaneous expenses, during the three months ended September 30, 2007, when compared to the three months ended September 30, 2006.

During the nine months ended September 30, 2007, general and administrative expenses decreased by $699,000, primarily as a result of our recording a foreign exchange gain of $1.4 million for the nine months ended September 30, 2007 compared to $664,000 for the nine months ended September 30, 2006. In addition, we did not incur any transitional costs during the nine months ended September 30, 2007 relating to the acquisition of the Hosted Messaging assets of Critical Path compared to $51,000 during the nine months ended September 30, 2006. People-related costs, including contract and outside service costs, also decreased by approximately $108,000 compared to the nine months ended September 30, 2006 primarily as a result of our incurring lower consulting fees in reviewing our long term compensation alternatives and training costs during the nine months ended September 30, 2007. Other costs such as professional fees, bad debts, business taxes, supplies and other general and administrative related expenses also decreased by approximately $102,000 for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006.

These decreases were partially offset by an amount of $127,000 relating to an increase in credit card processing fees and bank charges, as well as an increase in the amount of $153,000 relating to increases in investor and public relations, telephone, facility and other miscellaneous expenses, when compared to the nine months ended September 30, 2006.

We expect general and administrative expenses to continue to increase, in absolute dollars, as our business continues to grow and the impact of a higher Canadian dollar is recognized.

**DEPRECIATION OF PROPERTY AND EQUIPMENT**

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Depreciation of property and equipment | $ 68,316 | $ 43,025 | $ 198,107 | $ 125,116 |
| Increase over prior period | $ 25,291 | | $ 72,991 | |
| Increase - percentage | 59% | | 58% | |

The increase in depreciation for the three months ended September 30, 2007 compared to the three months ended September 30, 2006 was primarily due to the acquisition of additional computer equipment purchased to update our older equipment.

**AMORTIZATION OF INTANGIBLE ASSETS**

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Amortization of intangible assets | $ 322,781 | $ 230,291 | $ 778,823 | $ 436,175 |
| Increase over prior period | $ 92,490 | | $ 342,648 | |
| Increase - percentage | 40% | | 79% | |

Amortization of intangible assets consists of amounts arising in connection with the acquisition of Boardtown in April 2004, from the acquisition of the Hosted Messaging assets of Critical Path in January 2006, the acquisition of Mailbank.com Inc. in September 2006 and the acquisition on Innerwise Inc. in July 2007.

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

Technology acquired in connection with the acquisition of the Hosted Messaging assets of Critical Path is amortized on a straight-line basis over two years, while the customer relationships are amortized on a straight-line basis over five years.

In connection with the acquisition of Mailbank.com Inc., customer and customer relationships purchased are amortized on a straight-line basis over five years, while in-house software purchased is amortized on a straight-line basis over two years.

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

**OTHER INCOME AND EXPENSES**

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Other income (expenses), net | $ 327,207 | $ 1,803,123 | $ 324,692 | $ 2,482,282 |

Other income includes interest income of $71,000 for the three months ended September 30, 2007, compared to $61,000 for the three months ended September 30, 2006. Interest income has decreased as we have lower investment balances available, primarily as a result of the acquisitions we have made. As a result of the promissory notes issued in association with the acquisition of Mailbank.com Inc. in June 2006 and the bank loan used to fund the acquisition of IYD in July 2007, we also incurred an interest expense of $274,000 during the three months ended September 30, 2007, compared to

$131,000 during the three months ended September 30, 2006.

During the nine months ended September 30, 2007, interest income decreased to $190,000, compared to $285,000 for the nine months ended September 30, 2006 primarily as a result of our having lower investment balances as a result of the acquisitions we have made. We also incurred interest on the promissory notes issued in association with the acquisition of Mailbank.com Inc. in June 2006 and the bank loan used to fund the acquisition of IYD in July 2007, of $484,000 during the nine months ended September 30, 2007, compared to $150,000 during the nine months ended September 30, 2006.

In addition, Afilias Inc., a company in which we hold an investment, has declared two dividends payable to its shareholders of record, one as of March 31, 2007for $88,000 and one as of September 30, 2007 for $531,000. The March 31, 2007 dividend was paid in April 2007. The September 30, 2007 dividend was partially paid in November 2007 in the amount of $437,000 with the balance payable before the end of November 2007.

In 2002, we assigned to an unrelated third party (our Partner), various patents which were acquired by us in the merger with Infonautics, Inc. in 2001. In connection with the assignment of these patents, we retained the right to a revenue share relating to any cash flow received by our Partner relating to the commercialization of these patents. On August 15, 2006, we were informed by our Partner that it had assigned certain of these patents to another unrelated third party. As a result of this assignment, during the three months ended September 30, 2006, we recognized $1.9 million in other revenue. This amount was fully paid to us on October 20, 2006.

In connection with the patents discussed above, during the nine months ended September 30, 2006, we received $2.3 million from the assignment of the patents. We do not expect to receive any additional revenue share from this arrangement in the future.

**INCOME TAXES**

In preparing our financial statements, we make estimates of our current tax obligations and temporary differences resulting from differences in carrying values of reporting items for financial statement and tax purposes. We recognize deferred taxes by the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred taxes are recognized for differences between the financial statement and tax basis of assets and liabilities at enacted statutory tax rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is recognized as income or expense in the period that includes the enactment date. Valuation allowances based on management s judgment are established when appropriate to reduce the carrying value of deferred tax assets to the amounts expected to be realized.

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Provision for income taxes | $ 14,816 | $ (96,895) | $ 38,816 | $ (84,895) |

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for the first interim or annual reporting period beginning after December 15, 2006. The implementation of FIN 48 had no impact on Tucows opening deficit.

As a result of the adoption of FIN 48 on January 1, 2007, we had approximately $180,000 of total gross unrecognized benefits. At September 30, 2007 Tucows unrecognized tax benefits have increased to $230,000, which if recognized would favorably affect the income tax rate in future periods. The increase since adoption is primarily due to the non recognition of current year refundable research and development tax credits and foreign exchange.

We recognize accrued interest and penalties related to unrecognized tax benefit in tax expense. We did not have any interest and penalties accrued as of January 1, 2007 and September 30, 2007 as the unrecognized tax benefit relates entirely to refundable tax credits. We believes it is reasonably possible that $200,000 of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the Canadian tax authorities will review the Company s 2006 research and development claim for the credits within that period.

We operate in various tax jurisdictions, and accordingly, our income is subject to varying rates of tax. Losses incurred in one jurisdiction cannot be used to offset income taxes payable in another. No provision for income taxes other than for alternative minimum tax has been recorded for the three months ended September 30, 2007 because we had net operating losses to offset against our operating income in our major operating jurisdictions. Our ability to use income tax loss carryforwards and future income tax deductions is dependant upon our operations in the tax jurisdictions in which such losses or deductions arise.

**LIQUIDITY AND CAPITAL RESOURCES**

At September 30, 2007, our principal source of liquidity was cash and cash equivalents, of $5.9 million compared to $6.3 million at December 31, 2006.

Net cash provided by operating activities for the nine months ended September 30, 2007 was $5.8 million, compared to $4.9 million for the nine months ended September 30, 2006. Operating activities, after adjustment for non-cash and other items including the net change in deferred revenue and prepaid domain name registry and other Internet services fees, depreciation, amortization, unrealized change in the fair value of forward contracts and stock-based compensation of $4.2 million, for the nine months ended September 30, 2007 generated $7.8 million. Other non-cash operating working capital decreased by $2.0 million, which decrease primarily reflects our improved management of operating working capital.

Net cash provided by financing activities was $7.0 million for the nine months ended September 30, 2007. We used the primary source of these funds, the net amount of the non-revolving, reducing credit facility of $9.6 million with BMO to finance the purchase of IYD in July 2007. The BMO facility provides that we maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and coverage ratios effective beginning with the third quarter of 2007. Certain covenants under the facility also limit the amount of our capital expenditures. The facility is collateralized by a first priority perfected lien on, and pledge of, the majority of the combined company s present and future property and assets (subject to certain exclusions). In addition, we received proceeds of $204,000 on the exercise of stock options by employees of the Company and repurchased 2.6 million of our shares at a cost of $2.4 million during the nine months ended September 30, 2007 under the terms of the normal course issuer bid we announced in January 2007.

Net cash used in investing activities was $13.1 million for the nine months ended September 30, 2007. This was primarily as a result of our purchase of IYD in July 2007 for $10.8 million, net of cash acquired. The former shareholders of IYD also have the opportunity to realize a further $1,050,000, which was placed in an escrow account at the closing and which may be distributed in whole or in part to the former shareholders of IYD pending the final evaluation of the revenue generating capability of certain domain names acquired by Tucows DE under the purchase agreement, as well as any indemnification claims made by Tucows DE, for which the escrow account also serves as a source or recovery.. To fund this potential incremental acquisition price, we transferred an additional $1.1 million into an escrow account. This was partially offset by $568,000 (including $13,000 of interest earned) that was returned to Tucows on the closure of the escrow accounts originally established in connection with the acquisitions of Boardtown and the Hosted Messaging assets of Critical Path and $127,000 (including $37,000 of interest earned) that was held in escrow and returned to Critical Path as a result of their satisfaction of certain post-closing conditions relating to customer retention.

We invested an additional $3.1 million in property and equipment related to our hosted email environment during the nine months ended September 30, 2007 in order to combat the significant increase we have experienced in inbound spam.

In addition, as certain of our forward contracts mature, margin security against these contracts is released from restricted cash. During the nine months ended September 30, 2007, $764,000 was released from restricted cash.

Based on our operations, we believe that our cash flow from operations will be adequate to meet our anticipated requirements for working capital and capital expenditures 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 about any acquisition of other businesses.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our services are developed in and are sold primarily from North America. Our sales are primarily made in United States 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 excess funds are held in money market accounts. Based on the nature of our investments, we have concluded that there is no material interest rate risk exposure at September 30, 2007.

Although we have a functional currency of U.S. dollars, 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. We will continue to regularly assess if we should enter into additional forward exchange contracts to offset the risk associated with the effects of Canadian dollar to U.S. dollar transaction exposures. We do not use forward contracts for trading purposes.

Foreign exchange forward contracts have not been treated as cash flow hedges for accounting purposes as we have not complied with the documentation requirements. Accordingly, we have accounted for the fair value of the derivative instruments within the consolidated balance sheets as a derivative financial asset or liability and the corresponding change in fair value is recorded in the consolidated statement of operations. We have no other freestanding or embedded derivative instruments.

The impact of the foreign exchange forward contracts for the three months ended September 30, 2007 was a net gain of approximately $62,000, which is reflected on the consolidated statements of operations in general and administrative expenses.

The impact of the foreign exchange forward contracts for the nine months ended September 30, 2007 was a net gain of approximately $1.2 million, which is reflected on the consolidated statements of operations in general and administrative expenses.

As of September 30, 2007, we had outstanding foreign currency forward contracts with a notional value of $5.1 million, whereby $850,000 is converted into Canadian dollars on a semi-monthly basis from July 2007 to December 2007 at foreign exchange rates varying from U.S.$1:Cdn$1.1250 to U.S.$1:Cdn$1.1279.

We have performed a sensitivity analysis model for foreign exchange exposure over the three months ended September 30, 2007. 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, 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, 2007. 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, 2007 of $508,000. 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 at some point in the future take actions to hedge or mitigate these risks. There is no assurance that any strategy will be successful in avoiding losses due to exchange fluctuations, or that the failure to manage currency risks effectively would not have a material effect on our results of operations.

**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, in our opinion, will harm our business. We cannot assure that we will prevail in any litigation. Regardless of the outcome, any litigation may require us to incur significant litigation expense and may result in significant diversion of our attention.

**Item 1A. Risk factors**

In addition to the other information set forth in this Quarterly Report, you should also carefully consider the risk factors discussed below and in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006, 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 and in this Item 1A 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.

***As part of our business strategy, we have entered into and may enter into or seek to enter into business combinations and acquisitions that may be difficult to integrate, disrupt our business, dilute stockholder value or divert management attention.***

On July 25, 2007, we completed our acquisition of IYD and in June 2006 and January 2006 we completed our acquisitions of Mailbank.com Inc. and of all of the Hosted Messaging assets from Critical Path, respectively. We may seek to enter into additional business combinations or acquisitions in the future. Acquisitions are typically accompanied by a number of risks, including the difficulty of integrating the operations and personnel of the acquired companies, the potential disruption of our ongoing business, the potential distraction of management, dealing with unfamiliar laws, customs and practices in foreign jurisdictions, the effectiveness of the acquired company s internal controls and procedures and expenses related to the acquisition and the potential unknown liabilities associated with the acquired businesses. Any inability to integrate completed acquisitions in an efficient and timely manner could have an adverse impact on our results of operations. If we are not successful in completing acquisitions that we may pursue in the future, we may incur substantial expenses and devote significant management time and resources without a productive result. As well, in paying for an acquisition, we may deplete our cash resources, dilute our shareholder base by issuing additional shares, or incur debt as was the case with both the IYD and Mailbank.com Inc. acquisitions.

Furthermore, there is the risk that our valuation assumptions and our models for an acquired product or business may be erroneous or inappropriate due to foreseen or unforeseen circumstances and thereby cause us to overvalue an acquisition target. There is also the risk that the contemplated benefits of an acquisition may not materialize as planned or may not materialize within the time period or to the extent anticipated. Likewise, we make strategic decisions relating to all aspects of our operations including with respect to the direction of product development, acquisitions and other strategic investments, transactions and initiatives. These decisions often involve the review and consideration of competing alternatives and advice from various advisors, culminating in the exercise of judgment. There is the risk that our decision to proceed, or not to proceed, in a particular direction or with a particular strategic investment, transaction or initiative may not ultimately be the optimal decision for the company. Such decisions may hamper our competitiveness in the marketplace and have an adverse impact on our operational and financial performance.

***If we are unable to sell our services at acceptable prices relative to our costs, our business and financial results are likely to suffer.***

The intensely competitive markets in which we compete has resulted in the prices we have been charging for some of our services to decline in recent years. We expect that this decline may continue in the future as a result of, among other things, existing and new competition in the markets we serve. In response, in August 2007 we announced a reduction in the list price we charge for wholesale domain name registrations and a new pricing structure. Consequently, our historical revenue rates may not be indicative of future revenues based on comparable traffic volumes. In addition, our operating expenses have increased on an absolute basis in each of 2004, 2005 and 2006. If we are unable to sell our services at acceptable prices relative to our costs, or if the steps we have taken in reducing prices and adopting a new pricing structure does not result in increased volumes, or if we are unsuccessful with our strategy of selling additional services to our existing customers, our revenues and gross margins will decrease, and our business and financial results will suffer.

***Disruptions of our reseller and affiliate sales channels could affect our future operating results.***

Our relationships with our wholesale reseller and affiliate channel partners are important elements of our marketing and sales efforts. Our financial results could be adversely affected if our relationships with channel partners were to deteriorate or if they terminated their relationships with us, if any of our competitors enter into strategic relationships with or acquire a significant channel partner or if the financial condition of our channel partners were to weaken. There can be no assurance that we will be successful in maintaining, expanding or developing our relationships with channel partners. If we are not successful, we may lose sales opportunities, customers and market share.

***Any failure to meet our debt obligations would damage our business.***

We have long-term debt. As of September 30, 2007, our total long-term debt was approximately $7.3 million. If we are unable to remain profitable or if we use more cash than we generate in the future, our level of indebtedness could adversely affect our future operations by increasing our vulnerability to adverse changes in general economic and industry conditions and by limiting or prohibiting our ability to obtain additional financing for future capital expenditures, acquisitions and general corporate and other purposes. In addition, if we are unable to make interest or principal payments when due, or if we are unable to maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and coverage ratios effective beginning with the third quarter of 2007, we would be in default under the terms of our long-term debt obligations, which would result in all principal and interest becoming due and payable which, in turn, would seriously harm our business.

***New accounting pronouncements or guidance may require us to change the way in which we account for our operational or business activities.***

The Financial Accounting Standards Board ( **FASB** ), the SEC, the Public Company Accounting Oversight Board ( **PCAOB** ) and other bodies that have jurisdiction over the form and content of our accounts are constantly discussing and interpreting proposals and existing pronouncements designed to ensure that companies best display relevant and transparent information relating to their respective businesses. The pronouncements and interpretations of pronouncements by FASB, the SEC, the PCAOB and other bodies may have the effect of requiring us to account for revenues and/or expenses in a different manner. For example, beginning with the first quarter of the fiscal year ended December 31, 2006, we began expensing the fair value of stock options. As a result, we now report increased expenses in our income statement and a reduction of our net income and earnings per share. The impact on Tucows current financial statements of applying a fair value method of accounting for stock options is disclosed in Note 10 of the Notes to the Consolidated Financial Statements included in Item 1 of this Form 10-Q.

***Revenue from the sale of domain names and performance- based online advertising are relatively new services and have an unproven business model, which may make it difficult for you to evaluate our business and prospects.***

We have begun to derive substantial revenue from the sale of domain names and performance-based online advertising, both of which services are undergoing rapid and dramatic change. Our business model for these services is new and evolving and it may not be successful. Our prospects for these and other new services are difficult to evaluate and must be considered in light of the risks and uncertainties often encountered in emerging markets. Some of these risks and uncertainties, among other things, relate to our ability to continue to grow our revenue and meet anticipated growth targets, maintain and develop relationships with online advertising providers or third party suppliers of domain names, continue to be able to successfully acquire domain names that can be resold profitably and our having the ability to respond effectively to competition and industry consolidation.

If we are unable to do any of these successfully, our business, results of operations and prospects could suffer.

**Item 6. Exhibits**

(a) Exhibits.

| Exhibit No. | **Description** |
|---|---|
| 2.1 | Stock Purchase Agreement, dated as of July 25, 2007, by and among Tucows (Delaware) Inc. and each of James McKenzie, Theodore Cucci, Steven Forte and Jennifer Larsen, who collectively owned 100% of the issued and outstanding stock of Innerwise, Inc., an Illinois corporation. (Incorporated by reference to Exhibit 2.1 filed with Tucows current report on Form 8-K, as filed with the SEC on July 31, 2007). |
| 31.1 | Chief Executive Officer s Rule 13a-14(a)/15d-14(a) Certification * |
| 31.2 | Chief Financial Officer s Rule 13a-14(a)/15d-14(a) Certification * |
| 32.1 | Chief Executive Officer s Section 1350 Certification |
| 32.2 | Chief Financial Officer s Section 1350 Certification |

* Filed herewith.

Furnished herewith.

**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, 2007 | TUCOWS INC. | |
| | By: | /s/ Elliot Noss<br>Elliot Noss<br>President and Chief Executive Officer |
| | By: | /s/ Michael Cooperman<br>Michael Cooperman Chief Financial Officer<br>(Principal Financial and Accounting Officer) |

**EXHIBIT INDEX**

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