

TUCOWS INC /PA/  
Form 10-Q  
August 08, 2016  
**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2016**

**OR**

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

**For the transition period from            to**

**Commission file number 1-32600**

**TUCOWS INC.**

(Exact Name of Registrant as Specified in Its Charter)

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

**96 Mowat Avenue,**

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

(Address of Principal Executive Offices) (Zip Code)

**(416) 535-0123**

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of August 5, there were 10,424,964 outstanding shares of common stock, no par value, of the registrant.

**TUCOWS INC.**

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**Form 10-Q Quarterly Report**

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**TRADEMARKS, TRADE NAMES AND SERVICE MARKS**

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

|  | <b>June 30,<br/>2016</b> | <b>December<br/>31,<br/>2015</b> |
|--|--------------------------|----------------------------------|
| <b>Assets</b>  |                          |                                  |
| Current assets:  |                          |                                  |
| Cash and cash equivalents  | \$5,879,482              | \$7,723,253                      |
| Accounts receivable, net of allowance for doubtful accounts of \$147,793 as of June 30, 2016 and \$122,095 as of December 31, 2015 | 9,982,919                | 7,171,388                        |
| Inventory  | 1,284,692                | 903,775                          |
| Prepaid expenses and deposits  | 6,427,664                | 5,067,790                        |
| Derivative instrument asset, current portion (note 4)  | 73,617                   | -                                |
| Prepaid domain name registry and ancillary services fees, current portion  | 48,350,997               | 44,708,041                       |
| Income taxes recoverable (note 7)  | 1,326,355                | 2,292,915                        |
| Total current assets   | 73,325,726               | 67,867,162                       |
| Prepaid domain name registry and ancillary services fees, long-term portion  | 11,296,936               | 11,040,929                       |
| Property and equipment   | 7,939,984                | 7,126,676                        |
| Deferred tax asset (note 7)  | 6,339,848                | 7,621,092                        |
| Other assets (note 6)  | 133,500                  | -                                |
| Intangible assets (note 5)   | 20,317,568               | 14,469,677                       |
| Goodwill (note 5)  | 21,005,143               | 21,005,143                       |
| Total assets   | \$ 140,358,705           | \$ 129,130,679                   |
| <b>Liabilities and Stockholders' Equity</b>  |                          |                                  |
| Current liabilities:   |                          |                                  |
| Accounts payable   | \$3,312,273              | \$4,166,135                      |
| Accrued liabilities  | 5,008,112                | 5,855,686                        |
| Customer deposits  | 6,171,458                | 5,136,909                        |
| Derivative instrument liability, current portion (note 4)  | 294,170                  | 2,027,086                        |

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|   |                |                |
|---|----------------|----------------|
| Deferred rent, current portion  | 20,854         | 19,463         |
| Loan payable (note 6)   | 9,062,500      | 3,500,000      |
| Deferred revenue, current portion   | 61,337,998     | 56,646,390     |
| Accreditation fees payable, current portion   | 505,175        | 465,300        |
| Income taxes payable (note 7)   | 667,773        | 444,053        |
| Total current liabilities   | 86,380,313     | 78,261,022     |
| Deferred revenue, long-term portion   | 15,362,403     | 14,947,639     |
| Accreditation fees payable, long-term portion   | 115,761        | 118,480        |
| Deferred rent, long-term portion  | 116,137        | 100,864        |
| Other liabilities (note 12)   | 1,202,320      | 1,459,960      |
| Deferred tax liability (note 7)   | 4,843,153      | 4,876,691      |
| Redeemable non-controlling interest (note 8)  | 3,061,244      | 3,036,598      |
| Stockholders' equity (note 13)  |                |                |
| Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding  | -              | -              |
| Common stock - no par value, 250,000,000 shares authorized; 10,422,453 shares issued and outstanding as of June 30, 2016 and 10,685,599 shares issued and outstanding as of December 31, 2015 | 14,295,907     | 14,530,633     |
| Additional paid-in capital  | 2,234,541      | 8,526,395      |
| Retained earnings   | 12,866,227     | 4,381,849      |
| Accumulated other comprehensive income (loss)   | (119,301 )     | (1,109,452 )   |
| Total stockholders' equity  | 29,277,374     | 26,329,425     |
| Total liabilities and stockholders' equity  | \$ 140,358,705 | \$ 129,130,679 |

Commitments and contingencies (note 11)

See accompanying notes to unaudited consolidated financial statements

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

|  | <b>Three months ended<br/>June 30,</b> |              | <b>Six months ended June<br/>30,</b> |              |
|--|--|--------------|--------------------------------------|--------------|
|  | <b>2016</b>                            | <b>2015</b>  | <b>2016</b>                          | <b>2015</b>  |
| Net revenues (note 10)                                   | \$47,466,381                           | \$42,889,220 | \$93,076,794                         | \$83,357,053 |
| Cost of revenues (note 10)                               |  |              |                                      |              |
| Cost of revenues   | 29,849,661                             | 28,250,672   | 58,700,134                           | 55,072,046   |
| Network expenses   | 1,404,826                              | 1,494,838    | 2,637,757                            | 2,716,934    |
| Depreciation of property and equipment                   | 350,920                                | 279,929      | 697,673                              | 479,571      |
| Amortization of intangible assets (note 5)               | 11,532                                 | 11,532       | 23,064                               | 15,456       |
| Total cost of revenues                                   | 31,616,939                             | 30,036,971   | 62,058,628                           | 58,284,007   |
| Gross profit   | 15,849,442                             | 12,852,249   | 31,018,166                           | 25,073,046   |
| Expenses:  |  |              |                                      |              |
| Sales and marketing                                      | 5,435,033                              | 4,847,963    | 10,720,657                           | 8,647,138    |
| Technical operations and development                     | 998,651                                | 1,189,276    | 2,175,011                            | 2,303,471    |
| General and administrative                               | 2,926,608                              | 2,750,466    | 5,331,535                            | 5,218,488    |
| Depreciation of property and equipment                   | 76,922                                 | 62,022       | 150,190                              | 121,284      |
| Amortization of intangible assets (note 5)               | 276,918                                | 56,997       | 333,915                              | 110,212      |
| Impairment of indefinite life intangible assets (note 5) | 3,894                                  | 37,805       | 24,879                               | 50,298       |
| Loss (gain) on currency forward contracts (note 4)       | (8,711 )                               | 25,227       | (119,468 )                           | 329,251      |
| Total expenses   | 9,709,315                              | 8,969,756    | 18,616,719                           | 16,780,142   |
| Income from operations                                   | 6,140,127                              | 3,882,493    | 12,401,447                           | 8,292,904    |
| Other income (expense):                                  |  |              |                                      |              |
| Interest expense, net                                    | (120,528 )                             | (57,402 )    | (166,700 )                           | (82,177 )    |
| Other income, net (note 12)                              | 128,820                                | -            | 257,640                              | -            |
| Total other income (expense)                             | 8,292                                  | (57,402 )    | 90,940                               | (82,177 )    |
| Income before provision for income taxes                 | 6,148,419                              | 3,825,091    | 12,492,387                           | 8,210,727    |
| Provision for income taxes (note 7)                      | 2,077,633                              | 1,540,096    | 3,983,363                            | 3,091,789    |

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|  |             |             |             |              |
|--|-------------|-------------|-------------|--------------|
| Net income before redeemable non-controlling interest  | 4,070,786   | 2,284,995   | 8,509,024   | 5,118,938    |
| Redeemable non-controlling interest (note 8)   | (273,690 )  | (49,985 )   | (444,482 )  | (71,467 )    |
| Net loss attributable to redeemable non-controlling interest   | 273,690     | 49,985      | 444,482     | 71,467       |
| Net income   | 4,070,786   | 2,284,995   | 8,509,024   | 5,118,938    |
| Other comprehensive income (loss), net of tax  |             |             |             |              |
| Unrealized income (loss) on hedging activities (note 4)  | 27,264      | (38,046 )   | 575,227     | (998,912 )   |
| Net amount reclassified to earnings (note 4)   | 79,367      | 371,955     | 414,924     | 788,029      |
| Other comprehensive income (loss) net of tax of \$60,659 and \$184,262 for the three months ended June 30, 2016 and June 30, 2015 and \$544,363 and \$135,616 for the six months ended June 30, 2016 and June 30, 2015 | \$106,631   | \$333,909   | \$990,151   | \$(210,883 ) |
| Comprehensive income for the year  | \$4,177,417 | \$2,618,904 | \$9,499,175 | \$4,908,055  |
| Basic earnings per common share (note 9)   | \$0.39      | \$0.21      | \$0.80      | \$0.46       |
| Shares used in computing basic earnings per common share (note 9)  | 10,541,659  | 11,047,136  | 10,607,843  | 11,094,618   |
| Diluted earnings per common share (note 9)   | \$0.38      | \$0.20      | \$0.79      | \$0.44       |
| Shares used in computing diluted earnings per common share (note 9)  | 10,733,860  | 11,456,670  | 10,797,458  | 11,518,105   |

See accompanying notes to unaudited consolidated financial statements



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

|   | <b>Three months ended June 30,</b> |              | <b>Six months ended June 30,</b> |              |
|---|------------------------------------|--------------|----------------------------------|--------------|
|   | <b>2016</b>                        | <b>2015</b>  | <b>2016</b>                      | <b>2015</b>  |
| Cash provided by:   |                                    |              |                                  |              |
| Operating activities:   |                                    |              |                                  |              |
| Net income for the period   | \$4,070,786                        | \$2,284,995  | \$8,509,024                      | \$5,118,938  |
| Items not involving cash:   |                                    |              |                                  |              |
| Depreciation of property and equipment                                  | 427,842                            | 341,951      | 847,863                          | 600,855      |
| Amortization of intangible assets                                       | 288,450                            | 68,529       | 356,979                          | 125,668      |
| Impairment of indefinite life intangible asset                          | 3,894                              | 37,805       | 24,879                           | 50,298       |
| Deferred income taxes (recovery)  | 430,184                            | (801,919 )   | 703,343                          | (966,169 )   |
| Amortization of deferred rent   | 4,749                              | 13,039       | 16,664                           | 10,547       |
| Disposal of domain names  | 12,601                             | 11,357       | 20,821                           | 17,685       |
| Other income  | (128,820 )                         | -            | (257,640 )                       | -            |
| Loss (gain) on change in the fair value of forward contracts            | (28,977 )                          | (97,451 )    | (272,019 )                       | 61,342       |
| Stock-based compensation  | 190,187                            | 124,605      | 390,415                          | 249,653      |
| Change in non-cash operating working capital:                           |                                    |              |                                  |              |
| Accounts receivable   | (1,921,021 )                       | (1,088,453 ) | (2,811,531 )                     | (1,257,038 ) |
| Inventory   | (141,830 )                         | (45,294 )    | (380,917 )                       | (158,444 )   |
| Prepaid expenses and deposits   | (1,106,950 )                       | (592,614 )   | (1,359,874 )                     | (1,892,392 ) |
| Prepaid domain name registry and ancillary services fees                | (3,101,043 )                       | (755,932 )   | (3,898,963 )                     | (2,218,776 ) |
| Income taxes recoverable  | (36,174 )                          | 121,248      | 1,190,280                        | 783,016      |
| Accounts payable  | (1,233,092 )                       | (109,990 )   | (683,296 )                       | 7,576        |
| Accrued liabilities   | (396,328 )                         | 1,169,753    | (847,574 )                       | 1,110,533    |
| Customer deposits   | 1,214,472                          | 589,361      | 1,034,549                        | 452,918      |
| Deferred revenue  | 3,597,790                          | 983,586      | 5,106,372                        | 3,045,096    |
| Accreditation fees payable  | 26,537                             | (18,981 )    | 37,156                           | 32,046       |
| Net cash provided by operating activities                               | 2,173,257                          | 2,235,595    | 7,726,531                        | 5,173,352    |
| Financing activities:   |                                    |              |                                  |              |
| Proceeds received on exercise of stock options                          | 37,209                             | 299,472      | 56,767                           | 547,455      |
| Payment of tax obligations resulting from net exercise of stock options | (203,019 )                         | -            | (239,704 )                       | -            |
| Excess tax benefits from share-based compensation expense               | 384,839                            | 676,060      | 446,199                          | 1,088,702    |
| Repurchase of common stock  | (4,999,978 )                       | (489,536 )   | (7,180,257 )                     | (8,201,681 ) |
| Proceeds received on loan payable                                       | -                                  | -            | 6,000,000                        | 3,500,000    |
| Repayment of loan payable   | (218,750 )                         | -            | (437,500 )                       | -            |

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|  |              |              |             |              |
|--|--------------|--------------|-------------|--------------|
| Payment of credit facility renegotiation costs   | (133,500 )   | -            | (133,500 )  | -            |
| Net cash provided by (used in) financing activities  | (5,133,199 ) | 485,996      | (1,487,995) | (3,065,524 ) |
| Investing activities:  |              |              |             |              |
| Additions to property and equipment  | (975,401 )   | (1,149,020 ) | (1,831,737) | (1,340,782 ) |
| Gross proceeds from the waiver of rights to .online registry                                   | -            | -            | -           | 6,619,832    |
| Remaining payment for the acquisition of Ting Virginia, LLC., net of cash of \$21,423 (note 8) | -            | 50,000       | -           | (357,493 )   |
| Acquisition of intangible assets (note 5)  | (196,024 )   | -            | (6,250,570) | -            |
| Net cash provided by (used in) investing activities  | (1,171,425 ) | (1,099,020 ) | (8,082,307) | 4,921,557    |
| Increase in cash and cash equivalents  | (4,131,367 ) | 1,622,571    | (1,843,771) | 7,029,385    |
| Cash and cash equivalents, beginning of period   | 10,010,849   | 13,678,191   | 7,723,253   | 8,271,377    |
| Cash and cash equivalents, end of period   | \$5,879,482  | \$15,300,762 | \$5,879,482 | \$15,300,762 |
| Supplemental cash flow information:  |              |              |             |              |
| Interest paid  | \$120,566    | \$57,409     | \$166,947   | \$96,302     |
| Income taxes paid, net   | \$1,274,739  | \$1,380,448  | \$1,591,959 | \$1,944,470  |
| Supplementary disclosure of non-cash investing and financing activities:                       |              |              |             |              |
| Property and equipment acquired during the period not yet paid for                             | \$46,632     | \$70,577     | \$46,632    | \$70,577     |

See accompanying notes to unaudited consolidated financial statements

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### 1. Organization of the Company:

Tucows Inc., a Pennsylvania corporation (referred to throughout this report as the “Company”, “Tucows”, “we”, “us” or through similar expressions), together with our consolidated subsidiaries, is a provider of retail mobile phone service and fixed Internet access as well as a global distributor of Internet Services, such as domain name registration, digital certificates and email. The Company’s Internet Services are distributed through its global Internet-based distribution network of Internet service providers, web hosting companies and other companies that provide services to end-users.

We were incorporated under the laws of the Commonwealth of Pennsylvania in November 1992 under the name Infonautics, Inc. In August 2001, we completed our acquisition of Tucows Inc., a Delaware corporation, and we changed our name from Infonautics, Inc. to Tucows Inc. Our principal executive office is located in Toronto, Ontario and we have other offices in the Netherlands, Germany and the United States. Our common stock is listed on NASDAQ under the symbol “TCX” and on the Toronto Stock Exchange under the symbol “TC”.

### 2. Basis of presentation:

The accompanying unaudited interim consolidated balance sheets, and the related consolidated statements of operations and comprehensive income and cash flows reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position of Tucows and its subsidiaries as at June 30, 2016 and the results of operations and cash flows for the interim periods ended June 30, 2016 and 2015. The results of operations presented in this Quarterly Report on Form 10-Q are not necessarily indicative of the results of operations that may be expected for future periods.

The accompanying unaudited interim consolidated financial statements have been prepared by Tucows in accordance with the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosure normally included in the Company's annual audited consolidated financial statements and accompanying notes have been condensed or omitted. These interim consolidated financial statements and accompanying notes follow the same accounting policies and methods of application used in the annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended December 31, 2015 included in Tucows' 2015 Annual Report on Form 10-K filed with the SEC on March 9, 2016.

Prior to the third quarter of 2015, the Company recorded the effective portion of the gain or loss upon settlement of hedged currency forward contracts in “Loss on currency forward contracts” and reclassified the same amount from “General and administrative expense” to the income statement line item for the hedged item. The Company has determined that the reclassification of the effective portion of gain or loss upon settlement amounts are more appropriately reclassified from “Loss on currency forward contracts” to the income statement line item for the hedged item. As a result, a loss of \$0.6 million for the three months ended June 30, 2015 has been reclassified to “General and administrative expense” from “Loss on currency forward contracts”, and a loss of \$1.2 million for the six months ended June 30, 2015 has been reclassified to “General and administrative expense” from “Loss on currency forward contracts”. As a result of this reclassification, there was no change to previously reported net income, comprehensive income, income from operations, net revenues, gross profit, reported cash flows or the amounts recorded in the consolidated balance sheets.

There have been no material changes to our significant accounting policies and estimates during the six months ended June 30, 2016 as compared to the significant accounting policies and estimates described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, except for the adoption of Accounting Standard Update No. 2015-17, *Income Taxes (Topic 740)*.

The Company's most significant accounting policies are revenue recognition, property and equipment and derivative financial instruments and are included below:

*(a) Revenue recognition*

The Company's revenues are derived from domain name registration fees on both a wholesale and retail basis, the sale of domain names, the provisioning of other Internet services and advertising and other revenue. Amounts received in advance of meeting the revenue recognition criteria described below are recorded as deferred revenue.

The Company earns registration fees in connection with each new, renewed and transferred-in registration and from providing provisioning of other Internet services to resellers and registrars on a monthly basis. Service has been provided in connection with registration fees once the Company has confirmed that the requested domain name has been appropriately recorded in the registry under contractual performance standards.

Domain names are generally purchased for terms of one to ten years. Registration fees charged for domain name registration and provisioning services are recognized on a straight-line basis over the life of the contracted term. Other Internet services that are provisioned for annual periods or longer, are recognized on a straight-line basis over the life of the contracted term. Other Internet services that are provisioned on a monthly basis are recognized as services are provided.

For arrangements with multiple deliverables, the Company allocates revenue to each deliverable if the delivered item(s) has value to the customer on a standalone basis and, if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. The fair value of the selling price for a deliverable is determined using a hierarchy of (1) Company specific objective and reliable evidence, then (2) third-party evidence, then (3) best estimate of selling price. The Company allocates any arrangement fee to each of the elements based on their relative selling prices.

Revenue generated from the sale of domain names, earned from transferring the rights to domain names under the Company's control, are recognized once the rights have been transferred and payment has been received in full.

The Company derives revenues from the provisioning of mobile phone and fixed Internet access services primarily through its Ting website. These revenues are recognized once services have been provided. Revenues for wireless services are billed based on the actual amount of monthly services utilized by each customer during their billing cycle on a postpaid basis. The Company's billing cycle for each customer is computed based on the customer's activation date. As a result, the Company estimates the amount of revenues earned but not billed from the end of each billing cycle to the end of each reporting period. In addition, revenues associated with the sale of wireless devices and accessories to subscribers is recognized when title and risk of loss is transferred to the subscriber and shipment has occurred. Incentive marketing credits given to customers are recorded as a reduction of revenue.

The Company also generates advertising and other revenue through its online libraries of shareware, freeware and online services presented on its website. Advertising revenue includes revenue derived from cost per action advertising links we display on third party websites who provide syndicated pay-per-click advertising on OpenSRS Domain Expiry Stream domains and the Company's Portfolio Domains. In addition, the Company uses third party partners to derive pay-per-click advertising on the Tucows.com website. Advertising revenue is recognized on a monthly basis based on the number of cost-per-action services that were provided in the month.

Impression based advertising revenue and other revenues are recognized ratably over the period in which it is presented. To the extent that minimum guaranteed impressions are not met, the Company defers recognition of the corresponding revenues until the guaranteed impressions are achieved.

In those cases, where payment is not received at the time of sale, additional conditions for recognition of revenue are that the collection of the related accounts receivable is reasonably assured and the Company has no further performance obligations. The Company records costs that reflect expected refunds, rebates and credit card charge-backs as a reduction of revenues at the time of the sale based on historical experiences and current expectations.

The Company establishes provisions for possible uncollectible accounts receivable and other contingent liabilities which may arise in the normal course of business. Historically, credit losses have been within the Company's expectations and the provisions the Company has established have been appropriate. However, the Company has, on occasion, experienced issues which have led to accounts receivable not being fully collected. Should these issues occur more frequently, additional provisions may be required.

*(b) Property and equipment*

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is provided on a straight-line basis so as to depreciate the cost of depreciable assets over their estimated useful lives at the following rates:

| <b>Asset</b>                                 | <b>Rate</b>                      |      |
|--|----------------------------------|------|
| Computer equipment                           | 30%                              |      |
| Computer software                            | 33 <sup>1</sup> / <sub>3</sub> % | 100% |
| Furniture and equipment                      | 20%                              |      |
| Vehicles and tools                           | 20%                              |      |
| Fiber network (years)                        | 15                               |      |
| Customer equipment and installations (years) | 3                                |      |
| Leasehold improvements                       | Over term<br>of lease            |      |

The Company reviews the carrying values of its property and equipment for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the estimated undiscounted future cash flows expected to result from the use of the group of assets and their eventual disposition is less than their carrying amount, they are considered to be impaired. The amount of the impairment loss recognized is measured as the amount by which the carrying value of the asset exceeds the fair value of the asset, with fair value being determined based upon discounted cash flows or appraised values, depending on the nature of the assets.

Additions to the fiber network are recorded at cost, including all material, labor, vehicle and installation and construction costs and certain indirect costs associated with the construction of cable transmission and distribution facilities. While the Company's capitalization is based on specific activities, once capitalized, costs are tracked by fixed asset category at the fiber network level and not on a specific asset basis. For assets that are retired, the estimated historical cost and related accumulated depreciation is removed.

*(c) Derivative Financial Instruments*

During the three and six months ended June 30, 2016 and the year ended December 31, 2015 ("Fiscal 2015"), the Company used derivative financial instruments to manage foreign currency exchange risk. The Company accounts for these instruments in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 815, "Derivatives and Hedging" ("Topic 815"), which requires that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at its fair value as of the reporting date. Topic 815 also requires that changes in the derivative financial instruments' fair values be recognized in earnings, unless specific hedge accounting and documentation criteria are met (i.e. the instruments are accounted for as hedges).

The Company recorded the effective portions of the gain or loss on derivative financial instruments that were designated as cash flow hedges in accumulated other comprehensive income in the accompanying Consolidated Balance Sheets. Any ineffective or excluded portion of a designated cash flow hedge, if applicable, is recognized in net income.

For certain contracts, the Company has not complied with the documentation standards required for its forward foreign exchange contracts to be accounted for as hedges and has, therefore, accounted for such forward foreign exchange contracts at their fair values with the changes in fair value recorded in net income.

The fair value of the forward exchange contracts is determined using an estimated credit adjusted mark-to-market valuation which takes into consideration the Company's and the counterparty's credit risk. The valuation technique used to measure the fair values of the derivative instruments is a discounted cash flow technique, with all significant inputs derived from or corroborated by observable market data, as no quoted market prices exist for the derivative instruments. The discounted cash flow techniques use observable market inputs, such as foreign currency spot and forward rates.

### **3. Recent accounting pronouncements:**

#### *Recent Accounting Pronouncements Adopted*

On January 1, 2016, the Company adopted Accounting Standards Updates ("ASU") No. 2015-16, *Business Combinations (Topic 805)*, No. 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* and Nos. 2015-03 and 2015-15, *Interest - Imputation of Interest (Subtopic 835-30)*. The adoption of these Accounting Standards Updates did not have a significant impact on the consolidated financial statements.



On January 1, 2016, the Company elected to early adopt Accounting Standard Update No. 2015-17, *Income Taxes (Topic 740)*, which simplifies the presentation of deferred income taxes, such that deferred tax liabilities and assets be classified as non-current on a balance sheet. The impact of the change on the consolidated balance sheet at December 31, 2015 is the reclassification of \$3,243,718 from the deferred tax asset, current portion to deferred tax asset long-term portion.

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

In June 2016, the FASB issued FASB ASU 2016-13, *Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments* (“ASU 2016-13”), which changes the impairment model for most financial assets. The new model uses a forward-looking expected loss method, which will generally result in earlier recognition of allowances for losses. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019 and early adoption is permitted for annual and interim periods beginning after December 15, 2018. The Company will apply ASU 2016-13 on January 1, 2020. The Company is currently in the process of evaluating the impact that the adoption of ASU 2016-13 will have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718)* (“ASU 2016-09”). The areas for modification under ASU No. 2016-9 involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This guidance is effective for annual and interim reporting periods of public entities beginning after December 15, 2016 (January 1, 2017 for the Company). Early adoption of the standard is permitted as of the beginning of an interim or annual reporting period. Dependent upon the specific amendment, the implementation of the amendments in ASU 2016-09 are to be made on a prospective, retrospective or modified retrospective basis after the date of adoption. The Company is currently in the process of evaluating the impact that the adoption of ASU 2016-09 will have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-05, *Derivatives and Hedging (Topic 815)* (“ASU 2016-05”). The amendments in ASU 2016-05 clarifies the effect of derivative contract novations on existing hedge accounting relationships whereby a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. This guidance is effective for annual and interim reporting periods of public entities beginning after December 15, 2016 (January 1, 2017 for the Company). Early adoption of the standard is permitted as of the beginning of an interim or annual reporting period. The implementation of the amendments in ASU 2016-05 are to be made on a prospective or modified retrospective basis after the date of adoption. The Company is currently in the process of evaluating the impact that the adoption of ASU 2016-05 will have on its consolidated financial statements.

In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-02, *Leases (Topic 842)*. The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. ASU 2016-02 requires the recognition on the balance sheet of a lease liability to make lease payments by lessees and a right-of-use asset representing its right to use the underlying asset for the lease term. The new guidance will also require significant additional disclosure about the amount, timing and uncertainty of cash flows from leases. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018 (January 1, 2019 for the Company). The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company will adopt this guidance in the first quarter of fiscal 2019 and is in the process of evaluating the impact of the adoption of ASU 2016-02 will have on its consolidated financial statements.

In January 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-01, *Financial Instruments – Overall (Subtopic 825-10)* which relates to the recognition and measurement of financial assets and financial liabilities. ASU 2016-01 requires that all equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) be measured at fair value with changes in fair value recognized in net income. The new guidance requires the performance of a qualitative assessment for equity investments without readily determinable fair values. The update also requires an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The guidance is effective for annual and interim reporting periods beginning after December 15, 2017 (January 1, 2018 for the Company). Earlier adoption is not permitted. The Company is in the process of evaluating the impact that the adoption of ASU 2016-1 will have on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which is a comprehensive revenue recognition standard that will supersede nearly all existing revenue recognition guidance under U.S. GAAP. The new standard provides a single principles-based, five-step model to be applied to all contracts with customers, which steps are to (1) identify the contract(s) with the customer, (2) identify the performance obligations in the contracts, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contracts and (5) recognize revenue when each performance obligation is satisfied. More specifically, revenue will be recognized when promised goods or services are transferred to the customer in an amount that reflects the consideration expected in exchange for those goods or services. ASU 2014-09 was set to be effective for interim and annual periods beginning after December 15, 2016. On July 9, 2015, the FASB voted to defer the effective date by one year, such that the new standard will be effective for the Company for the interim and annual reporting periods beginning after December 15, 2017 (January 1, 2018 for the Company). In March 2016, FASB issued ASU No. 2016-08 clarifying the implementation guidance on principal versus agent considerations. In April 2016, FASB issued ASU No. 2016-10 providing further guidance on identifying performance obligations and licensing. In May 2016, FASB issued ASU No. 2016-12 providing guidance related revenue recognition and consideration received. Early adoption of these standards is permitted but not before the original effective date. Companies can transition to the standards either retrospectively or as a cumulative-effect adjustment as of the date of adoption. The Company does not intend to adopt the standards early and is currently in the process of evaluating the impact that the adoption of ASU 2014-09, ASU 2016-08, ASU 2016-10 and ASU 2016-12 will have on its consolidated financial statements and the selected method of transition to the new standard.

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

##### *Foreign currency forward contracts*

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

The Company has designated certain of these transactions as cash flow hedges of forecasted transactions under ASC Topic 815. For certain contracts, as the critical terms of the hedging instrument, and of the entire hedged forecasted transaction, are the same, in accordance with ASC Topic 815, the Company has been able to conclude that changes in fair value and cash flows attributable to the risk of being hedged are expected to completely offset at inception and on an ongoing basis. Accordingly, unrealized gains or losses on the effective portion of these contracts have been included within other comprehensive income. The fair value of the contracts, as of June 30, 2016, is recorded as derivative instrument assets and derivative instrument liabilities.

As of June 30, 2016, the notional amount of forward contracts that the Company held to sell U.S. dollars in exchange for Canadian dollars was \$11.0 million, of which \$9.3 million met the requirements of ASC Topic 815 and were designated as hedges (June 30, 2015 - \$24.0 million of which \$20.4 million were designated as hedges).

As of June 30, 2016, we had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

| <b>Maturity date</b>    | <b>Notional<br/>amount<br/>of U.S. dollars</b> | <b>Weighted<br/>average<br/>exchange rate<br/>of<br/>U.S. dollars</b> | <b>Fair value</b> |
|-------------------------|--|---|-------------------|
| July - September 2016   | 6,002,500                                      | 1.2554  | (190,264 )        |
| October - December 2016 | 4,952,500                                      | 1.2885  | (30,289 )         |
|                         | \$ 10,955,000                                  | 1.2703  | \$ (220,553 )     |

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

The effect of these derivative instruments on our consolidated financial statements as of, and for the six months ended June 30, 2016, were as follows (amounts presented do not include any income tax effects).

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

| Derivatives   | Balance Sheet Location | As of         | As of             |
|---|------------------------|---------------|-------------------|
|   |                        | June 30, 2016 | December 31, 2015 |
|   |                        | Fair Value    | Fair Value        |
|   |                        | Asset         | Asset             |
|   |                        | (Liability)   | (Liability)       |
| Foreign currency forward contracts designated as cash flow hedges     | Derivative instruments | \$ (187,169 ) | \$ (1,721,683 )   |
| Foreign currency forward contracts not designated as cash flow hedges | Derivative instruments | \$ (33,384 )  | \$ (305,403 )     |
| Total foreign currency forward contracts                              | Derivative instruments | \$ (220,553 ) | \$ (2,027,086 )   |

*Movement in Accumulated Other Comprehensive Income ("AOCI") balance for the three months ended June 30, 2016:*

| Gains and losses on cash flow hedges | Tax impact | Total AOCI |
|--------------------------------------|------------|------------|
|--------------------------------------|------------|------------|

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|  |              |            |              |
|--|--------------|------------|--------------|
| Opening AOCI balance – March 31, 2016                                      | \$ (354,459) | \$ 128,527 | \$ (225,932) |
| Other comprehensive income (loss) before reclassifications                 | 42,774       | (15,510)   | 27,264       |
| Amount reclassified from accumulated other comprehensive income            | 124,516      | (45,149)   | 79,367       |
| Other comprehensive income (loss) for the three months ended June 30, 2016 | 167,290      | (60,659)   | 106,631      |
| Ending AOCI balance – June 30, 2016  | \$ (187,169) | \$ 67,868  | \$ (119,301) |

*Movement in Accumulated Other Comprehensive Income ("AOCI") balance for the six months ended June 30, 2016:*

|  | Gains and      |            |                |
|--|----------------|------------|----------------|
|  | losses on      | Tax        | Total AOCI     |
|  | cash           | impact     |                |
|  | flow hedges    |            |                |
| Opening AOCI balance – December 31, 2015                                 | \$ (1,721,683) | \$ 612,231 | \$ (1,109,452) |
| Other comprehensive income (loss) before reclassifications               | 883,551        | (308,324)  | 575,227        |
| Amount reclassified from accumulated other comprehensive income          | 650,963        | (236,039)  | 414,924        |
| Other comprehensive income (loss) for the six months ended June 30, 2016 | 1,534,514      | (544,363)  | 990,151        |
| Ending AOCI balance – June 30, 2016                                      | \$ (187,169 )  | \$ 67,868  | \$ (119,301 )  |

Effects of derivative instruments on income and other comprehensive income (OCI) for the three months ended June 30, 2016 and June 30, 2015 are as follows:

|   |  |   |  | <b>Location of<br/>Gain or (Loss)<br/>Recognized<br/>in<br/>Income on<br/>Derivative<br/>(ineffective<br/>Portion and<br/>Amount<br/>Excluded<br/>from<br/>Effectiveness<br/>Testing)</b> | <b>Amount of<br/>Gain or<br/>(Loss)<br/>Recognized<br/>in Income on<br/>Derivative<br/>(ineffective<br/>Portion and<br/>Amount<br/>Excluded<br/>from<br/>Effectiveness<br/>Testing)</b> |
|---|--|---|--|---|---|
| <b>Derivatives in Cash Flow<br/>Hedging Relationship</b>                    | <b>Amount of<br/>Gain or<br/>(Loss)<br/>Recognized<br/>in OCI, net of<br/>tax, on<br/>Derivative<br/>(Effective<br/>Portion)</b> | <b>Location of<br/>Gain or<br/>(Loss)<br/>Reclassified<br/>from<br/>Accumulated<br/>OCI into<br/>Income<br/>(Effective<br/>Portion)</b> | <b>Amount of<br/>Gain or<br/>(Loss)<br/>Reclassified<br/>from<br/>Accumulated<br/>OCI into<br/>Income,<br/>(Effective<br/>Portion)</b> |   |   |
| Foreign currency forward contracts for the three months ended June 30, 2016 | \$ 106,631   | Operating expenses<br>Cost of revenues  | \$ (88,441)<br>(36,075)  | ) Operating expenses<br>) Cost of revenues  | \$ —<br>—   |
| Foreign currency forward contracts for the three months ended June 30, 2015 | \$ 333,909   | Operating expenses<br>Cost of revenues  | \$ (418,444)<br>(158,768)  | ) Operating expenses<br>) Cost of revenues  | \$ (8,741 )<br>—  |

Effects of derivative instruments on income and other comprehensive income (OCI) for the six months ended June 30, 2016 and June 30, 2015 are as follows:

|   | Amount of     | Location of                            | Amount of                   | Location of                            | Amount of         |
|---|---------------|--|-----------------------------|--|-------------------|
|   | Gain or       | Gain or                                | Gain or                     | Gain or                                | Gain or           |
|   | (Loss)        | (Loss)                                 | (Loss)                      | (Loss)                                 | (Loss)            |
|   | Recognized    | Reclassified                           | Reclassified                | Recognized                             | Recognized        |
|   | in OCI, net   | from                                   | from                        | in                                     | in Income         |
|   | of            | Accumulated                            | Accumulated                 | Derivative                             | on                |
|   | tax, on       | OCI into                               | OCI into                    | Portion and                            | Derivative        |
|   | Derivative    | Income                                 | Income,                     | Amount                                 | (ineffective      |
|   | (Effective    | (Effective                             | (Effective                  | Excluded                               | Portion and       |
|   | Portion)      | Portion)                               | Portion)                    | from                                   | Amount            |
|   |               |  |                             | Effectiveness                          | Excluded          |
|   |               |  |                             | Testing)                               | from              |
|   |               |  |                             |  | Effectiveness     |
|   |               |  |                             |  | Testing)          |
| Foreign currency forward contracts for the six months ended June 30, 2016 | \$ 990,151    | Operating expenses<br>Cost of revenues | \$ (460,830 )<br>(142,891 ) | Operating expenses<br>Cost of revenues | \$ (47,242 )<br>— |
| Foreign currency forward contracts for the six months ended June 30, 2015 | \$ (210,883 ) | Operating expenses<br>Cost of revenues | \$ (886,461 )<br>(336,428 ) | Operating expenses<br>Cost of revenues | \$ (31,323 )<br>— |



In addition to the above, for those foreign currency forward contracts not designated as hedges, the Company has recorded a loss of \$21,008 upon settlement and a gain of \$28,977 for the change in fair value of outstanding contracts for the three months ended June 30, 2016, in the consolidated statement of operations and comprehensive income. The Company has recorded a loss of \$0.1 million upon settlement and a gain of \$0.1 million for the change in fair value of outstanding contracts for the three months ended June 30, 2015, in the consolidated statement of operations and comprehensive income.

The Company has recorded a loss of \$0.1 million upon settlement and a gain of \$0.3 million for the change in fair value of outstanding contracts for the six months ended June 30, 2016, in the consolidated statement of operations and comprehensive income. The Company has recorded a loss of \$0.2 million upon settlement and a loss of \$0.1 million for the change in fair value of outstanding contracts for the six months ended June 30, 2015, in the consolidated statement of operations and comprehensive income.

## 5. Goodwill and Other Intangible Assets:

### Goodwill

Goodwill represents the excess of the purchase price over the fair value of tangible or identifiable intangible assets acquired and liabilities assumed in our acquisitions.

Goodwill consists of the following:

|  | <b>June 30,</b> | <b>December</b> |
|--|-----------------|-----------------|
|  | <b>2016</b>     | <b>31,</b>      |
|  |                 | <b>2015</b>     |
| Boardtown Corporation                    | \$2,044,847     | \$2,044,847     |
| Hosted Messaging Assets of Critical Path | 4,072,297       | 4,072,297       |
| Innerwise Inc.                           | 5,801,040       | 5,801,040       |
| Mailbank.com Inc.                        | 6,072,623       | 6,072,623       |
| EPAG Domainservices GmbH                 | 882,320         | 882,320         |
| Ting Fiber Inc.                          | 1,426,893       | 1,426,893       |
| Ting Virginia Inc.                       | 705,123         | 705,123         |

|       |              |              |
|-------|--------------|--------------|
| Total | \$21,005,143 | \$21,005,143 |
|-------|--------------|--------------|

The Company's goodwill relates 90% to its Domain Services operating segment and 10% to its Network Access Services operating segment.

Goodwill is not amortized, but is subject to an annual impairment evaluation.

**Other Intangible Assets:**

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

A summary of acquired intangible assets for the three months ended June 30, 2016 is as follows:

| Amortization period                                 | Surname                      | Direct                                  | Brand    | Customer relationships | Network rights | Total        |
|---|------------------------------|---|----------|------------------------|----------------|--------------|
|   | domain names indefinite life | navigation domain names indefinite life |          |                        |                |              |
| Balances, March 31, 2016                            | \$11,319,560                 | \$1,887,908                             | \$71,960 | \$450,567              | \$641,948      | \$14,371,943 |
| Acquisition of customer relationships               | -                            | -                                       | -        | 6,250,570              | -              | 6,250,570    |
| Additions to/(disposals from) domain portfolio, net | (1,623 )                     | (10,978 )                               | -        | -                      | -              | (12,601 )    |
| Impairment of indefinite life intangible assets     | (3,894 )                     | -                                       | -        | -                      | -              | (3,894 )     |
| Amortization expense                                | -                            | -                                       | (7,710 ) | (269,208 )             | (11,532 )      | (288,450 )   |
| Balance June 30, 2016                               | \$11,314,043                 | \$1,876,930                             | \$64,250 | \$6,431,929            | \$630,416      | \$20,317,568 |

A summary of acquired intangible assets for the six months ended June 30, 2016 is as follows:

| Amortization period                                 | Surname                      | Direct                                  | Brand    | Customer relationships | Network rights | Total        |
|---|------------------------------|---|----------|------------------------|----------------|--------------|
|   | domain names indefinite life | navigation domain names indefinite life |          |                        |                |              |
| Balances, December 31, 2015                         | \$11,339,355                 | \$1,897,318                             | \$79,670 | \$499,854              | \$653,480      | \$14,469,677 |
| Acquisition of customer relationships               | -                            | -                                       | -        | 6,250,570              | -              | 6,250,570    |
| Additions to/(disposals from) domain portfolio, net | (3,570 )                     | (17,251 )                               | -        | -                      | -              | (20,821 )    |

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|   |              |             |          |              |           |              |
|---|--------------|-------------|----------|--------------|-----------|--------------|
| Impairment of indefinite life intangible assets | (21,742 )    | (3,137 )    | -        | -            | -         | (24,879 )    |
| Amortization expense                            | -            | -           | (15,420) | (318,495 )   | (23,064 ) | (356,979 )   |
| Balance June 30, 2016                           | \$11,314,043 | \$1,876,930 | \$64,250 | \$ 6,431,929 | \$630,416 | \$20,317,568 |

The following table shows the estimated amortization expense for each of the next 5 years, assuming no further additions to acquired intangible assets are made:

|                   | <b>Year<br/>ending<br/><br/>December<br/>31,</b> |
|-------------------|--|
| Remainder of 2016 | \$583,758  |
| 2017              | 1,167,516  |
| 2018              | 1,063,076  |
| 2019              | 939,528  |
| 2020              | 939,528  |
| Thereafter        | 2,433,189  |
| Total             | \$7,126,595                                      |

As of June 30, 2016, the accumulated amortization for the definite life intangible assets was \$6.3 million.

With regard to indefinite life intangible assets, as part of our normal renewal process we assessed that certain domain names that were acquired in the June 2006 acquisition of Mailbank.com Inc. and that were up for renewal should not be renewed. Accordingly, for the three months ended June 30, 2016, domain names, with a book value of \$3,894 (three months ended June 30, 2015 - \$37,805) were not renewed and were recorded as an impairment of indefinite life intangible assets. For the six months ended June 30, 2016, domain names, with a book value of \$24,879 (six months ended June 30, 2015 - \$50,298), were not renewed and were recorded as an impairment of indefinite life intangible assets.

On April 1, 2016, the Company acquired the international reseller channel from Melbourne IT Limited for consideration of \$6.0 million, excluding legal and registry related transaction costs of \$0.2 million. The acquired assets were funded through a \$6.0 million advance under the 2012 Demand Loan Facilities on March 31, 2016. These assets have been assigned to Other Intangible Assets, Customer Relationships and will be amortized over 7 years.

## **6. Loan payable:**

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

*Two Revolving Demand Loan Facilities.*

The 2012 Demand Loan Facilities are governed by the terms of the Offer Letter, dated as of November 19, 2012, by and between the Company and the Bank and filed with the SEC on November 21, 2012.

Under the terms of the Amended Credit Facility, our prior demand loan facilities have been amended to provide an aggregate of \$14 million in funds available through the 2012 Demand Loan Facilities, which consist of a demand loan revolving facility (the “2012 DLR Loan”) and a demand loan revolving reducing facility (the “2012 DLRR Loan”). The 2012 DLR Loan accrues interest at the Bank’s U.S. Base Rate plus 1.25%. The Company may elect to pay interest on the 2012 DLRR Loan either at the Bank’s U.S. Base Rate plus 1.25% or LIBOR plus 2.50%. Aggregate advances under the 2012 Demand Loan Facilities may not exceed \$14 million and no more than \$2 million of such advances may be used to finance repurchases of the Company’s common stock. The 2012 Demand Loan Facilities are subject to an undrawn aggregate standby fee of 0.20% following the first draw, which such fee is payable quarterly in arrears.

Repayment of advances under the 2012 DLR Loan consist of interest only payments made monthly in arrears and prepayment is permitted without penalty. The outstanding balance under the 2012 DLR Loan as of December 31st of each year is to be fully repaid within 30 days of December 31st through an equivalent advance made under the 2012 DLRR Loan. Advances under the 2012 DLRR Loan will be made annually and solely for such purpose. Each advance under the 2012 DLRR Loan is to be repaid in equal monthly principal payments plus interest, over a period of four years from the date of such advance. During the three months ended June 30, 2016, \$6.0 million was drawn down on the 2012 DLR Loan to support the April 1, 2016 acquisition of the international reseller channel of Melbourne IT Limited. At June 30, 2016, the outstanding balance under the 2012 DLR Loan was \$6.0 million (December 31, 2015 - \$3.5 million).

At June 30, 2016, the outstanding balance under the 2012 DLRR Loan was \$3.1 million (December 31, 2015 – nil). Credit facility renegotiation costs of \$0.1 million have been reflected in other assets.

#### *Treasury Risk Management Facility*

The Amended Credit Facility also provides for a \$3.5 million settlement risk line to assist the Company with hedging Canadian dollar exposure through foreign exchange forward contracts and/or currency options. Under the terms of the Amended Credit Facility, the Company may enter into such agreements at market rates with terms not to exceed 18 months. As of June 30, 2016, the Company held contracts in the amount of \$11.0 million to trade U.S. dollars in exchange for Canadian dollars.

#### *Operating Demand Loan*

The Amended Credit Facility also provides the Company with a \$1.0 million operating demand loan facility to assist in meeting its operational needs (the “Operating Demand Loan”). The Operating Demand Loan accrues interest at the Bank’s U.S. Base Rate plus 1.25%. Interest is payable monthly in arrears with any borrowing under the Operating Demand Loan fluctuating widely with periodic clean-up, at a minimum on an annual basis. The Company has also agreed to pay to the Bank a monthly monitoring fee of US\$500 with respect to this loan. The Operating Demand Loan is payable on demand at any time, at the sole discretion of the Bank, with or without cause, and the Bank may terminate the Operating Demand Loan at any time. As of June 30, 2016, the Company had no amounts outstanding under its Operating Demand Loan.

#### *General Terms*

The Company’s Amended Credit Facility contains customary representations and warranties, affirmative and negative covenants, and events of default. The Company’s obligations under the Amended Credit Facility are guaranteed and secured by a security interest in substantially all of its assets. The Amended Credit Facility also requires that the Company comply with certain customary non-financial covenants and restrictions. In addition, the Company has agreed to comply with the following financial covenants at all times, which are to be calculated on a rolling four quarter basis: (i) Maximum Total Funded Debt to EBITDA of 2.00:1; and (ii) Minimum Fixed Charge Coverage of 1.20:1. Further, its Maximum Annual Capital Expenditures cannot exceed \$5 million per year, which limit will be reviewed on an annual basis. As at and for the period ended June 30, 2016, the Company was in compliance with these covenants.

## 7. Income taxes

For the three months ended June 30, 2016, the Company recorded a provision for income taxes of \$2.1 million on income before income taxes of \$6.1 million, using an estimated effective tax rate for the fiscal year ending December 31, 2016 (“Fiscal 2016”) adjusted for certain minimum state taxes. Comparatively, for the three months ended June 30, 2015, the Company recorded a provision for income taxes of \$1.5 million on income before taxes of \$3.8 million, using an estimated effective tax rate for the 2015 fiscal year.

For the six months ended June 30, 2016, the Company recorded a provision for income taxes of \$4.0 million on income before income taxes of \$12.5 million, using an estimated effective tax rate for Fiscal 2016 adjusted for certain minimum state taxes. Comparatively, for the six months ended June 30, 2015, the Company recorded a provision for income taxes of \$3.0 million on income before taxes of \$8.2 million, using an estimated effective tax rate for its fiscal year ending December 31, 2015.

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

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



The Company had approximately \$0.1 million of total gross unrecognized tax benefit as of June 30, 2016 and as of December 31, 2015, which if recognized would favorably affect its income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes. The Company recognizes accrued interest and penalties related to income taxes in income tax expense. The Company did not have significant interest and penalties accrued at June 30, 2016 and December 31, 2015, respectively.

## **8. Acquisitions:**

On February 27, 2015, Ting Fiber, Inc., one of our wholly owned subsidiaries, acquired a 70% ownership interest in the newly formed Ting Virginia, LLC and its subsidiaries, Blue Ridge Websoft, LLC (doing business as Blue Ridge Internet Works), Fiber Roads, LLC and Navigator Network Services, LLC (the “BRI Group”) for consideration of approximately \$3.5 million. The Company advanced in escrow \$3,125,000 during the year ended December 31, 2014, and paid the remaining purchase price of \$357,493 during the year ended December 31, 2015. Ting Virginia, LLC was an independent Internet service provider in Charlottesville, Virginia, doing business primarily as Blue Ridge Internet Works. The BRI Group provides high speed internet access, Internet hosting and network consulting services to over 3,000 customers in central Virginia. The purchase price was primarily satisfied through an advance under our 2012 DLR Loan facility.

Ting Fiber Inc. and the selling shareholders (the “Minority Shareholders”) also agreed to certain put and call options with regard to the remaining 30% interest in Ting Virginia, LLC retained by the Minority Shareholders. On the second anniversary of the closing date, Ting Fiber, Inc. may exercise a call option to purchase an additional 20% ownership interest in Ting Virginia, LLC. Contingent upon the exercise of the call option by Ting Fiber, Inc., the Minority Shareholders may exercise a put option within 7 days following the exercise of the call option by Ting Fiber, Inc., to sell their remaining 10% ownership interest in Ting Virginia, LLC. The consideration to be exchanged for the shares acquired or sold under the options shall be \$100,000 per percentage point of the additional equity interest acquired.

In addition, on the fourth anniversary of the closing date, the Minority Shareholders may exercise a put option under which Ting Fiber, Inc. shall be obligated to purchase the Minority Shareholders’ remaining interest for \$120,000 per percentage point of the additional equity interest acquired.

The Company has determined that the put options described above are embedded within the non-controlling interest shares that are subject to the put options. The redemption feature requires classification of the Minority Shareholders’ Interest in the Consolidated Balance Sheets outside of equity under the caption “Redeemable non-controlling interest”. The present value of the liability at the acquisition date was \$3,000,000 and is being accreted to the estimated liability amount using a discount rate of 5% over a period of four years from the acquisition date. During the three and six months ended June 30, 2016, this amount was increased by \$12,348 and \$24,646, respectively, (\$12,150 for the three and six months ended June 30, 2015) to \$3,061,244, to reflect the present value of this Redeemable non-controlling interest as at June 30, 2016.



The purchase consideration is comprised as follows:

|   |             |
|---|-------------|
| Cash  | \$3,135,140 |
| Less refund from working capital adjustment | (50,000 )   |
| Repayment of debt                           | 418,775     |
| Redeemable non-controlling interest         | 3,000,000   |
|   | \$6,503,915 |

The following table represents the finalized purchase price allocation based on the fair values of the assets

|   |                    |
|---|--------------------|
| Current assets (including cash of \$21,423) | \$338,577          |
| Current liabilities                         | (529,702 )         |
| Property and equipment, including:          |                    |
| Fiber network                               | 3,456,024          |
| Computer equipment                          | 200,000            |
| Furniture and equipment                     | 5,000              |
| Vehicles                                    | 92,000             |
| Leasehold improvements                      | 50,000             |
| Intangible assets, including:               |                    |
| Network rights                              | 692,000            |
| Customer equipment and installations        | 68,000             |
| Goodwill                                    | 2,132,016          |
| <b>Net assets acquired</b>                  | <b>\$6,503,915</b> |

### 9. Basic and diluted earnings per common share:

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

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

|  | <b>Three months ended<br/>June 30,</b> |             | <b>Six months ended June<br/>30,</b> |             |
|--|--|-------------|--------------------------------------|-------------|
|  | <b>2016</b>                            | <b>2015</b> | <b>2016</b>                          | <b>2015</b> |
| Numerator for basic and diluted earnings per common share:   |  |             |                                      |             |
| Net income for the period                                    | \$4,070,786                            | \$2,284,995 | \$8,509,024                          | \$5,118,938 |
| Denominator for basic and diluted earnings per common share: |  |             |                                      |             |
| Basic weighted average number of common shares outstanding   | 10,541,659                             | 11,047,136  | 10,607,843                           | 11,094,618  |
| Effect of outstanding stock options                          | 192,201                                | 409,534     | 189,615                              | 423,487     |
| Diluted weighted average number of shares outstanding        | 10,733,860                             | 11,456,670  | 10,797,458                           | 11,518,105  |
| Basic earnings per common share                              | \$0.39                                 | \$0.21      | \$0.80                               | \$0.46      |
| Diluted earnings per common share                            | \$0.38                                 | \$0.20      | \$0.79                               | \$0.44      |

For the three months ended June 30, 2016, outstanding options to purchase 76,800 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

For the six months ended June 30, 2016, outstanding options to purchase 126,800 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

During the three and six months ended June 30, 2016, 209,698 and 308,416 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in February 2016.

During the three and six months ended June 30, 2015, 25,413 and 239,502 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in February 2015.

During the six months ended June 30, 2015, 193,907 common shares were repurchased and cancelled under the terms of a modified Dutch auction tender offer announced in December 2014 and concluded in January 2015.

The computation of earnings per share and diluted earnings per share for the three and six months ended June 30, 2016 and 2015 include reductions in the number of shares outstanding due to these repurchases.

#### **10. Segment reporting:**

(a) We are organized and managed based on three operating segments which are differentiated primarily by their services, the markets they serve and the regulatory environments in which they operate and are described as follows:

1. Network Access - Mobile Services - This segment derives revenue from the sale of mobile phones and telephony services to individuals and small businesses through the Ting website. Revenues are generated in the United States.
2. Network Access - Other Services - This segment derives revenue from the provisioning of high speed Internet access, Internet hosting and consulting services. Revenues are generated in the United States.
3. Domain Services – This segment includes wholesale and retail domain name registration services, value added services and portfolio services. The Company primarily earns revenues from the registration fees charged to resellers in connection with new, renewed and transferred domain name registrations; the sale of retail Internet domain name registration and email services to individuals and small businesses; and by making its portfolio of domain names available for sale or lease. Domain Services revenues are attributed to the country in which the contract originates, primarily Canada.

The Chief Executive Officer is the chief operating decision maker and regularly reviews the operations and performance by segment. The chief operating decision maker reviews gross profit as a key measure of performance for each segment and to make decisions about the allocation of resources. Sales and marketing expenses, technical operations and development expenses, general and administrative expenses, depreciation of property and equipment, amortization of intangibles assets, impairment of indefinite life intangible assets, loss (gain) on currency forward contracts, other income (expense), and provision for income taxes, are organized along functional lines and are not included in the measurement of segment profitability. Total assets and total liabilities are centrally managed and are not reviewed at the segment level by the chief operating decision maker.

Information by reportable segments, which is regularly reported to the chief operating decision maker is as follows:

|   | Network Access (1) |                | Domain Name Services | Consolidated Totals |
|---|--------------------|----------------|----------------------|---------------------|
|   | Mobile Services    | Other Services |                      |                     |
| <b>Three months ended June 30, 2016</b>         |                    |                |                      |                     |
| Net Revenues                                    | \$ 18,026,420      | 972,123        | 28,467,838           | \$ 47,466,381       |
| Cost of revenues                                |                    |                |                      |                     |
| Cost of revenues                                | 9,380,533          | 528,957        | 19,940,171           | 29,849,661          |
| Network expenses                                | 35,999             | 183,799        | 1,185,028            | 1,404,826           |
| Depreciation of property and equipment          | -                  | 211,382        | 139,538              | 350,920             |
| Amortization of intangible assets               | -                  | 11,532         | -                    | 11,532              |
| Total cost of revenues                          | 9,416,532          | 935,670        | 21,264,737           | 31,616,939          |
| Gross Profit                                    | 8,609,888          | 36,453         | 7,203,101            | 15,849,442          |
| Expenses:                                       |                    |                |                      |                     |
| Sales and marketing                             |                    |                |                      | 5,435,033           |
| Technical operations and development            |                    |                |                      | 998,651             |
| General and administrative                      |                    |                |                      | 2,926,608           |
| Depreciation of property and equipment          |                    |                |                      | 76,922              |
| Amortization of intangible assets               |                    |                |                      | 276,918             |
| Impairment of indefinite life intangible assets |                    |                |                      | 3,894               |
| Loss on currency forward contracts              |                    |                |                      | (8,711 )            |
| Income from operations                          |                    |                |                      | 6,140,127           |
| Other income (expense), net                     |                    |                |                      | 8,292               |
| Income before provision for income taxes        |                    |                |                      | \$ 6,148,419        |

(1) Network access includes Mobile Services and Other Services. Other Services includes the provisioning of high speed Internet access, Internet hosting and network consulting services.

|   | Network Access (1) |  | Domain Name Services | Consolidated Totals |
|---|--------------------|--|----------------------|---------------------|
|   |                    |  |                      |                     |
| <b>Three months ended June 30, 2015</b> |                    |  |                      |                     |

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|   | <b>Mobile<br/>Services</b> | <b>Other<br/>Services</b> |            |               |
|---|----------------------------|---------------------------|------------|---------------|
| Net Revenues                                    | \$ 14,351,903              | 1,066,066                 | 27,471,251 | \$ 42,889,220 |
| Cost of revenues                                |                            |                           |            |               |
| Cost of revenues                                | 7,996,331                  | 502,306                   | 19,752,035 | 28,250,672    |
| Network expenses                                | 26,265                     | 199,077                   | 1,269,496  | 1,494,838     |
| Depreciation of property and equipment          | -                          | 104,921                   | 175,008    | 279,929       |
| Amortization of intangible assets               | -                          | 11,532                    | -          | 11,532        |
| Total cost of revenues                          | 8,022,596                  | 817,836                   | 21,196,539 | 30,036,971    |
| Gross Profit                                    | 6,329,307                  | 248,230                   | 6,274,712  | 12,852,249    |
| Expenses:                                       |                            |                           |            |               |
| Sales and marketing                             |                            |                           |            | 4,847,963     |
| Technical operations and development            |                            |                           |            | 1,189,276     |
| General and administrative                      |                            |                           |            | 2,750,466     |
| Depreciation of property and equipment          |                            |                           |            | 62,022        |
| Amortization of intangible assets               |                            |                           |            | 56,997        |
| Impairment of indefinite life intangible assets |                            |                           |            | 37,805        |
| Loss on currency forward contracts              |                            |                           |            | 25,227        |
| Income from operations                          |                            |                           |            | 3,882,493     |
| Other income (expense), net                     |                            |                           |            | (57,402 )     |
| Income before provision for income taxes        |                            |                           |            | \$ 3,825,091  |

(1) Network access includes Mobile Services and Other Services. Other Services includes the provisioning of high speed Internet access, Internet hosting and network consulting services.



|   | <b>Network Access (1)</b> |                       | <b>Domain Name Services</b> | <b>Consolidated Totals</b> |
|---|---------------------------|-----------------------|-----------------------------|----------------------------|
| <b>Six months ended June 30, 2016</b>           |                           |                       |                             |                            |
|   | <b>Mobile Services</b>    | <b>Other Services</b> |                             |                            |
| Net Revenues                                    | \$34,970,490              | 1,867,185             | 56,239,119                  | \$ 93,076,794              |
| Cost of revenues                                |                           |                       |                             |                            |
| Cost of revenues                                | 17,938,968                | 959,554               | 39,801,612                  | 58,700,134                 |
| Network expenses                                | 73,150                    | 361,172               | 2,203,435                   | 2,637,757                  |
| Depreciation of property and equipment          | -                         | 397,062               | 300,611                     | 697,673                    |
| Amortization of intangible assets               | -                         | 23,064                | -                           | 23,064                     |
| Total cost of revenues                          | 18,012,118                | 1,740,852             | 42,305,658                  | 62,058,628                 |
| Gross Profit                                    | 16,958,372                | 126,333               | 13,933,461                  | 31,018,166                 |
| Expenses:                                       |                           |                       |                             |                            |
| Sales and marketing                             |                           |                       |                             | 10,720,657                 |
| Technical operations and development            |                           |                       |                             | 2,175,011                  |
| General and administrative                      |                           |                       |                             | 5,331,535                  |
| Depreciation of property and equipment          |                           |                       |                             | 150,190                    |
| Amortization of intangible assets               |                           |                       |                             | 333,915                    |
| Impairment of indefinite life intangible assets |                           |                       |                             | 24,879                     |
| Loss on currency forward contracts              |                           |                       |                             | (119,468 )                 |
| Income from operations                          |                           |                       |                             | 12,401,447                 |
| Other income (expense), net                     |                           |                       |                             | 90,940                     |
| Income before provision for income taxes        |                           |                       |                             | \$ 12,492,387              |

(1) Network access includes Mobile Services and Other Services. Other Services includes the provisioning of high speed Internet access, Internet hosting and network consulting services.

|                                       | <b>Network Access (1)</b> |                       | <b>Domain Name Services</b> | <b>Consolidated Totals</b> |
|---------------------------------------|---------------------------|-----------------------|-----------------------------|----------------------------|
| <b>Six months ended June 30, 2015</b> |                           |                       |                             |                            |
|                                       | <b>Mobile Services</b>    | <b>Other Services</b> |                             |                            |
| Net Revenues                          | \$26,911,135              | 1,433,848             | 55,012,070                  | \$ 83,357,053              |

|  |            |           |            |            |
|--|------------|-----------|------------|------------|
| Cost of revenues                       |            |           |            |            |
| Cost of revenues                       | 15,126,180 | 717,614   | 39,228,252 | 55,072,046 |
| Network expenses                       | 38,168     | 260,590   | 2,418,176  | 2,716,934  |
| Depreciation of property and equipment | -          | 133,811   | 345,760    | 479,571    |
| Amortization of intangible assets      | -          | 15,456    | -          | 15,456     |
| Total cost of revenues                 | 15,164,348 | 1,127,471 | 41,992,188 | 58,284,007 |
| Gross Profit                           | 11,746,787 | 306,377   | 13,019,882 | 25,073,046 |

Expenses:

|   |  |  |  |              |
|---|--|--|--|--------------|
| Sales and marketing                             |  |  |  | 8,647,138    |
| Technical operations and development            |  |  |  | 2,303,471    |
| General and administrative                      |  |  |  | 5,218,488    |
| Depreciation of property and equipment          |  |  |  | 121,284      |
| Amortization of intangible assets               |  |  |  | 110,212      |
| Impairment of indefinite life intangible assets |  |  |  | 50,298       |
| Loss on currency forward contracts              |  |  |  | 329,251      |
| Income from operations                          |  |  |  | 8,292,904    |
| Other income (expense), net                     |  |  |  | (82,177 )    |
| Income before provision for income taxes        |  |  |  | \$ 8,210,727 |

(1) Network access includes Mobile Services and Other Services. Other Services includes the provisioning of high speed Internet access, Internet hosting and network consulting services.

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

|                                 | <b>Three months ended<br/>June 30,</b> |               | <b>Six months ended June<br/>30,</b> |               |
|---------------------------------|--|---------------|--------------------------------------|---------------|
|                                 | <b>2016</b>                            | <b>2015</b>   | <b>2016</b>                          | <b>2015</b>   |
| <u>Network Access Services:</u> |  |               |                                      |               |
| Mobile Services                 | \$ 18,026,420                          | \$ 14,351,903 | \$ 34,970,490                        | \$ 26,911,135 |
| Other Services                  | 972,123                                | 1,066,066     | 1,867,185                            | 1,433,848     |
| Total Network Access Services   | 18,998,543                             | 15,417,969    | 36,837,675                           | 28,344,983    |
| <u>Domain Services:</u>         |  |               |                                      |               |
| Wholesale                       |  |               |                                      |               |
| Domain Services                 | 21,698,720                             | 21,286,863    | 42,969,585                           | 42,461,994    |
| Value Added Services            | 2,309,621                              | 2,355,837     | 4,612,054                            | 4,597,835     |
| Total Wholesale                 | 24,008,341                             | 23,642,700    | 47,581,639                           | 47,059,829    |
| Retail                          |  |               |                                      |               |
| Portfolio                       | 3,556,140                              | 3,009,465     | 6,970,772                            | 5,885,193     |
| Total Domain Services           | 903,357                                | 819,086       | 1,686,708                            | 2,067,048     |
|                                 | 28,467,838                             | 27,471,251    | 56,239,119                           | 55,012,070    |
|                                 | \$47,466,381                           | \$42,889,220  | \$93,076,794                         | \$83,357,053  |

During the three and six months ended June 30, 2016 and 2015, no customer accounted for more than 10% of total revenue. As at June 30, 2016, no customer accounted for more than 10% of accounts receivable and two customers accounted for 21% accounts receivable as at June 30, 2015.

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

|                                 | <b>Three months ended<br/>June 30,</b> |             | <b>Six months ended June<br/>30,</b> |              |
|---------------------------------|--|-------------|--------------------------------------|--------------|
|                                 | <b>2016</b>                            | <b>2015</b> | <b>2016</b>                          | <b>2015</b>  |
| <u>Network Access Services:</u> |  |             |                                      |              |
| Mobile Services                 | \$9,380,533                            | \$7,996,331 | \$17,938,968                         | \$15,126,180 |
| Other Services                  | 528,957                                | 502,306     | 959,554                              | 717,614      |
| Total Network Access Services   | 9,909,490                              | 8,498,637   | 18,898,522                           | 15,843,794   |

Domain Services:

## Wholesale

|                      |            |            |            |            |
|----------------------|------------|------------|------------|------------|
| Domain Services      | 17,645,470 | 17,744,966 | 35,288,241 | 35,291,293 |
| Value Added Services | 451,604    | 501,518    | 930,986    | 1,037,650  |
| Total Wholesale      | 18,097,074 | 18,246,484 | 36,219,227 | 36,328,943 |

|                       |            |            |            |            |
|-----------------------|------------|------------|------------|------------|
| Retail                | 1,639,755  | 1,322,620  | 3,218,081  | 2,543,120  |
| Portfolio             | 203,342    | 182,931    | 364,304    | 356,189    |
| Total Domain Services | 19,940,171 | 19,752,035 | 39,801,612 | 39,228,252 |

Network Expenses:

|  |              |              |              |              |
|--|--------------|--------------|--------------|--------------|
| Network, other costs                         | 1,404,826    | 1,494,838    | 2,637,757    | 2,716,934    |
| Network, depreciation and amortization costs | 362,452      | 291,461      | 720,737      | 495,027      |
|  | 1,767,278    | 1,786,299    | 3,358,494    | 3,211,961    |
|  | \$31,616,939 | \$30,036,971 | \$62,058,628 | \$58,284,007 |

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

|               | <b>June 30,<br/>2016</b> | <b>December<br/>31, 2015</b> |
|---------------|--------------------------|------------------------------|
| Canada        | \$1,017,649              | \$1,225,236                  |
| United States | 6,809,041                | 5,847,666                    |
| Germany       | 113,294                  | 53,774                       |
|               | \$7,939,984              | \$7,126,676                  |

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

|               | <b>June 30,<br/>2016</b> | <b>December<br/>31, 2015</b> |
|---------------|--------------------------|------------------------------|
| Canada        | \$6,030,650              | \$-                          |
| United States | 668,195                  | 702,594                      |
| Germany       | 427,750                  | 530,410                      |
|               | <b>\$7,126,595</b>       | <b>\$1,233,004</b>           |

(f) The following is a summary of the Company's deferred tax asset by geographic region:

|        | <b>June 30,<br/>2016</b> | <b>December<br/>31, 2015</b> |
|--------|--------------------------|------------------------------|
| Canada | \$6,339,848              | \$7,621,092                  |
|        | <b>\$6,339,848</b>       | <b>\$7,621,092</b>           |

(g) Valuation and qualifying accounts:

|  | <b>Balance<br/>at<br/>beginning<br/>of<br/>period</b> | <b>Charged to<br/>(recovered)<br/>costs and<br/>expenses</b> | <b>Write-offs<br/>during<br/>period</b> | <b>Balance<br/>at<br/>end of<br/>period</b> |
|--|---|--|---|---|
| <b>Allowance for doubtful accounts</b> |   |  |   |   |
| Six months ended June 30, 2016         | \$ 122,095  | \$ 25,698  | \$ -                                    | \$ 147,793                                  |
| Year ended December 31, 2015           | \$ 125,766  | \$ (3,671 )  | \$ -                                    | \$ 122,095                                  |

## 11. Commitments and contingencies:

The Company is involved in various legal claims and lawsuits in connection with its ordinary business operations. The Company intends to vigorously defend these claims. While the final outcome with respect to any actions or claims

outstanding or pending as of June 30, 2016 cannot be predicted with certainty, management does not believe that the resolution of these claims, individually or in the aggregate, will have a material adverse effect on the Company's financial position.

**12. Other income, net:**

In February 2015, we waived our rights under the proposed joint venture to operate the .online registry and instead entered into a Joint Marketing agreement with our venture partners under which our original capital contributions have been returned and a set of go-forward marketing arrangements have been created instead. Under the terms of the agreement, the Company has undertaken to provide certain marketing support for .online registry and has agreed to certain volume commitments during the term of the agreement. The Joint Marketing Agreement is for a term of three years and commenced in November 2015. The Company generated a gain of \$1.5 million for waiving its rights and entering the Joint Marketing Agreement. The gain is being recognized over the term of three years. An amount of \$0.1 million of this gain was recognized during the three months ended June 30, 2016 and \$0.3 million of the gain for the six months ended June 30, 2016 (the amount was \$0 for the three and six months ended June 30, 2015).

**13. Stockholders' Equity:**

The following unaudited table summarizes stockholders' equity transactions for the three month period ended June 30, 2016:

|  | <b>Common stock</b> |               | <b>Additional</b> | <b>Retained</b>  | <b>Accumulated</b>   | <b>Total</b>         |
|--|---------------------|---------------|-------------------|------------------|----------------------|----------------------|
|  | <b>Number</b>       | <b>Amount</b> | <b>paid in</b>    | <b>earnings</b>  | <b>other</b>         |                      |
|  |                     |               | <b>capital</b>    | <b>(deficit)</b> | <b>comprehensive</b> | <b>stockholders'</b> |
|  |                     |               |                   |                  | <b>income (loss)</b> | <b>equity</b>        |
| Balances, March 31, 2016   | 10,594,733          | \$14,445,114  | \$6,676,096       | \$8,807,789      | \$ (225,932 )        | \$29,703,067         |
| Exercise of stock options  | 51,963              | 137,176       | (97,438 )         | -                | -                    | 39,738               |
| Shares deducted from exercise of stock options for payment of withholding taxes and exercise consideration | (14,545 )           | -             | (205,548 )        | -                | -                    | (205,548 )           |
| Repurchase and retirement of shares (note 13)  | (209,698 )          | (286,383 )    | (4,713,595)       | -                | -                    | (4,999,978 )         |
| Income tax effect related to stock options exercised   | -                   | -             | 384,839           | -                | -                    | 384,839              |
| Stock-based compensation (note 14)   | -                   | -             | 190,187           | -                | -                    | 190,187              |
| Net income   | -                   | -             | -                 | 4,070,786        | -                    | 4,070,786            |
| Accretion of redeemable non-controlling interest in Ting Virginia, LLC.                                    | -                   | -             | -                 | (12,348 )        | -                    | (12,348 )            |
| Other comprehensive income (loss)  | -                   | -             | -                 | -                | 106,631              | 106,631              |
| Balances, June 30, 2016  | 10,422,453          | \$14,295,907  | \$2,234,541       | \$12,866,227     | \$ (119,301 )        | \$29,277,374         |

The following unaudited table summarizes stockholders' equity transactions for the six month period ended June 30, 2016:

|  | <b>Common stock</b> |  | <b>Additional</b> | <b>Retained</b> | <b>Accumulated</b> | <b>Total</b>         |
|--|---------------------|--|-------------------|-----------------|--------------------|----------------------|
|  |                     |  | <b>paid in</b>    | <b>earnings</b> | <b>other</b>       |                      |
|  |                     |  |                   |                 |                    | <b>stockholders'</b> |

|  | Number     | Amount        | capital      | (deficit)     | comprehensive<br>income (loss) | equity        |
|--|------------|---------------|--------------|---------------|--------------------------------|---------------|
| Balances, December 31, 2015  | 10,685,599 | \$ 14,530,633 | \$ 8,526,395 | \$ 4,381,849  | \$ (1,109,452 )                | \$ 26,329,425 |
| Exercise of stock options  | 63,537     | 185,913       | (126,617 )   | -             | -                              | 59,296        |
| Shares deducted from exercise of stock options for payment of withholding taxes and exercise consideration | (18,267 )  | -             | (242,233 )   | -             | -                              | (242,233 )    |
| Repurchase and retirement of shares (note 13)  | (308,416 ) | (420,639 )    | (6,759,618)  | -             | -                              | (7,180,257 )  |
| Income tax effect related to stock options exercised   | -          | -             | 446,199      | -             | -                              | 446,199       |
| Stock-based compensation (note 14)   | -          | -             | 390,415      | -             | -                              | 390,415       |
| Net income   | -          | -             | -            | 8,509,024     | -                              | 8,509,024     |
| Accretion of redeemable non-controlling interest in Ting Virginia, LLC.                                    | -          | -             | -            | (24,646 )     | -                              | (24,646 )     |
| Other comprehensive income (loss)  | -          | -             | -            | -             | 990,151                        | 990,151       |
| Balances, June 30, 2016  | 10,422,453 | \$ 14,295,907 | \$ 2,234,541 | \$ 12,866,227 | \$ (119,301 )                  | \$ 29,277,374 |

On February 9, 2016, the Company announced that its Board of Directors had approved a stock buyback program to repurchase up to \$40 million of its common stock in the open market. Purchases will be made exclusively through the facilities of the NASDAQ Capital Market. The stock buyback program commenced on February 10, 2016 and will terminate on or before February 9, 2017. The Company repurchased 209,698 and 308,416 shares under this program for the three and six months ended June 30, 2016 for a total of \$5.0 million and \$7.2 million, respectively.

On February 11, 2015, the Company announced that its Board of Directors had approved a stock buyback program to repurchase up to \$20 million of its common stock in the open market. Purchases were made exclusively through the facilities of the NASDAQ Capital Market. The stock buyback program commenced on February 16, 2015 and was terminated on February 9, 2016. The Company did not repurchase any shares under this program during the six months ended June 30, 2016. The Company repurchased 25,413 and 239,502 shares under this program during the three and six months ended June 30, 2015 for a total of \$0.5 million and \$4.5 million, respectively.

On January 7, 2015, the Company announced that it successfully concluded the Tender Offer that was previously announced on December 8, 2014. Under the terms of the offer, for the six months ended June 30, 2015, the Company repurchased an aggregate of 193,907 shares of its common stock at a purchase price of \$18.50 per share, for a total of \$3.6 million, excluding transaction costs of approximately \$70,000. All shares purchased in the Tender Offer received the same price and all shares repurchased were immediately retired.





**14. Share-based payments****(a) Stock options**

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

Details of stock option transactions for the three months ended June 30, 2016 and June 30, 2015 are as follows:

|                                  | <b>Three months ended June 30,</b> |  | <b>Three months ended June 30,</b> |  |
|----------------------------------|------------------------------------|--|------------------------------------|--|
|                                  | <b>2016</b>                        |  | <b>2015</b>                        |  |
|                                  | <b>Number of shares</b>            | <b>Weighted average exercise price per share</b> | <b>Number of shares</b>            | <b>Weighted average exercise price per share</b> |
| Outstanding, beginning of period | 550,641                            | \$ 10.48   | 943,323                            | \$ 6.23  |
| Granted                          | 8,000                              | 23.37  | -                                  | -  |
| Exercised                        | (51,963 )                          | 3.52   | (112,656)                          | 2.66   |
| Forfeited                        | (4,088 )                           | 23.83  | (1,716 )                           | 13.15  |
| Expired                          | -                                  | -  | (1,875 )                           | 2.40   |
| Outstanding, end of period       | 502,590                            | 11.30  | 827,076                            | 6.69   |

Options exercisable, end of period 298,343 \$ 7.08 581,433 \$ 4.58

Details of stock option transactions for the six months ended June 30, 2016 and June 30, 2015 are as follows:

|                                    | <b>Six months ended<br/>June 30,<br/>2016</b> |  | <b>Six months ended<br/>June 30,<br/>2015</b> |  |
|------------------------------------|---|--|---|--|
|                                    | <b>Number<br/>of<br/>shares</b>               | <b>Weighted<br/>average<br/>exercise<br/>price<br/>per share</b> | <b>Number<br/>of<br/>shares</b>               | <b>Weighted<br/>average<br/>exercise<br/>price<br/>per share</b> |
| Outstanding, beginning of period   | 513,366                                       | \$ 9.24  | 976,062                                       | \$ 6.23  |
| Granted                            | 63,000  | 21.21  | 45,000  | 19.41  |
| Exercised                          | (63,537 )                                     | 3.72   | (187,653 )                                    | 2.92   |
| Forfeited                          | (9,489 )                                      | 17.23  | (4,458 )                                      | 12.46  |
| Expired                            | (750 )  | 3.76   | (1,875 )                                      | 2.40   |
| Outstanding, end of period         | 502,590                                       | 11.30  | 827,076                                       | 6.69   |
| Options exercisable, end of period | 298,343                                       | \$ 7.08  | 581,433                                       | \$ 4.58  |

As of June 30, 2016, the exercise prices, weighted average remaining contractual life and intrinsic values of outstanding options were as follows:

| Exercise price  | Options outstanding |   |   |                                       | Options exercisable |   |   |                                       |  |
|-----------------|---------------------|---|---|---------------------------------------|---------------------|---|---|---------------------------------------|--|
|                 | Number outstanding  | Weighted average exercise price per share | Weighted average remaining contractual life (years) | Aggregate intrinsic contractual value | Number exercisable  | Weighted average exercise price per share | Weighted average remaining contractual life (years) | Aggregate intrinsic contractual value |  |
| \$2.80 - 4.48   | 90,513              | \$ 2.97                                   | 1.3   | \$ 1,936,426                          | 90,513              | \$ 2.97                                   | 1.3   | \$ 1,936,426                          |  |
| \$5.52 - 8.92   | 178,177             | 6.63                                      | 2.9   | 3,158,294                             | 154,755             | 6.51                                      | 2.8   | 2,761,971                             |  |
| \$10.16 - 14.67 | 29,375              | 10.83                                     | 4.2   | 397,394                               | 10,625              | 12.02                                     | 3.9   | 131,144                               |  |
| \$15.51 - 19.95 | 132,775             | 17.35                                     | 5.1   | 930,368                               | 42,450              | 16.67                                     | 4.4   | 326,578                               |  |
| \$21.10 - 24.96 | 71,750              | 22.36                                     | 5.9   | 154,620                               | -                   | -   | -   | -                                     |  |
|                 | 502,590             | \$ 11.30                                  | 3.7   | \$ 6,577,102                          | 298,343             | \$ 7.08                                   | 2.6   | \$ 5,156,119                          |  |

Total unrecognized compensation cost relating to unvested stock options at June 30, 2016, prior to the consideration of expected forfeitures, was approximately \$1,336,707 and is expected to be recognized over a weighted average period of 2.1 years.

The Company recorded stock-based compensation of \$190,187 and \$390,415 for the three and six months ended June 30, 2016 and 2015 and \$124,605 and \$249,653 for the three and six months ended June 30, 2015, respectively.

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

## 15. Fair value measurement

ASC Topic 820, "Fair Value Measurements and Disclosures" establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either

directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides a summary of the fair values of the Company's derivative instrument assets and liabilities measured at fair value on a recurring basis at June 30, 2016:

|                                 | <b>June 30, 2016</b>     |                |              |                      |
|---------------------------------|--------------------------|----------------|--------------|----------------------|
|                                 | <b>Fair Value</b>        |                |              | <b>Assets</b>        |
|                                 | <b>Measurement Using</b> |                |              | <b>(Liabilities)</b> |
|                                 | <b>Level</b>             | <b>Level 2</b> | <b>Level</b> | <b>at Fair</b>       |
|                                 | <b>1</b>                 |                | <b>3</b>     | <b>value</b>         |
| Derivative instrument asset     | \$-                      | \$73,617       | \$ -         | \$ 73,617            |
| Derivative instrument liability | \$-                      | \$(294,170)    | \$ -         | \$(294,170 )         |

The following table provides a summary of the fair values of the Company's derivative instrument assets measured at fair value on a recurring basis as at December 31, 2015:

|                                 | <b>December 31, 2015</b> |                |              |                      |
|---------------------------------|--------------------------|----------------|--------------|----------------------|
|                                 | <b>Fair Value</b>        |                |              | <b>Assets</b>        |
|                                 | <b>Measurement Using</b> |                |              | <b>(Liabilities)</b> |
|                                 | <b>Level</b>             | <b>Level 2</b> | <b>Level</b> | <b>at Fair</b>       |
|                                 | <b>1</b>                 |                | <b>3</b>     | <b>value</b>         |
| Derivative instrument asset     | \$-                      | \$-            | \$ -         | \$-                  |
| Derivative instrument liability | \$-                      | \$(2,027,086)  | \$ -         | \$(2,027,086 )       |

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

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

### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains, in addition to historical information, forward-looking statements by us with regard to our expectations as to financial results and other aspects of our business that involve risks and uncertainties and may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as “may,” “should,” “anticipate,” “believe,” “plan,” “estimate,” “expect” and “intend,” and other similar expressions are intended to identify forward-looking statements. The forward-looking statements contained in this report include statements regarding, among other things, the competition we expect to encounter as our business develops and competes in a broader range of Internet services, the Company's foreign currency requirements, specifically for the Canadian dollar; Ting mobile and fixed Internet access subscriber growth and retention rates; our belief regarding the underlying platform for our domain services, our expectation regarding the trend of sales of domain names and advertising; our belief that, by increasing the number of services we offer, we will be able to generate higher revenues; the revenue that our parked page vendor relationships may generate in the future; the potential impact of current and pending claims on our business; our valuations of certain deferred tax assets; our expectation to collect our outstanding receivables, net of our allowance for doubtful accounts; our expectation regarding fluctuations in certain expense and cost categories; our expectations regarding our unrecognized tax; our expectations regarding cash from operations to fund our business; the impact of cancellations of or amendments to market development fund programs under which we receive funds, our expectation regarding our ability to manage realized gains/losses from foreign currency contracts; and general business conditions and economic uncertainty. These statements are based on management’s current expectations and are subject to a number of uncertainties and risks that could cause actual results to differ materially from those described in the forward-looking statements. Many factors affect our ability to achieve our objectives and to successfully develop and commercialize our services including:

Changes in the nature of key strategic relationships with our Mobile Virtual Network Operator ("MVNO") partners;

The effects of vigorous competition on a highly penetrated mobile telephony market, including the impact of competition on the price we are able to charge subscribers for services and devices and on the geographic areas served by our MVNO partner wireless networks;

Our ability to manage any potential increase in subscriber churn or bad debt expense;

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 attract and retain qualified personnel in our business;

• Our ability to effectively manage our business;

• The effects of any material impairment of our goodwill or other indefinite-lived intangible assets;

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

• Our ability to invest in the build-out of fiber networks into selected towns and cities to provide Internet access services to residential and commercial customers while maintaining the development and sales of our established services;

• Pending or new litigation; and

• Factors set forth herein under the caption “Item 1A Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.



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

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

## OVERVIEW

Our mission is to provide simple useful services that help people unlock the power of the Internet. We accomplish this by reducing the complexity our customers’ experience as they access the Internet (at home or on the go) or Internet services such as domain name registration, email, mobile telephony services and other Internet services. We are organized and managed based on two service offerings, Network Access Services and Domain Services, which are differentiated primarily by their services, the markets they serve and the regulatory environments in which they operate.

Our principal place of business is located in Canada. We report our financial results as two reportable operating segments, Network Access Services, which primarily derives revenue from the sale of retail mobile phones and services to individuals and small businesses, and Domain Services, which derives revenue from three distinct service offerings – Wholesale, Retail and Portfolio. Management regularly reviews our operating results on a consolidated basis, principally to make decisions about how we utilize our resources and to measure our consolidated operating performance. To assist us in forecasting growth and to help us monitor the effectiveness of our operational strategies, management regularly reviews revenue and cost of revenues for each of our service offerings in order to gain more depth and understanding of the key business metrics driving our business. Accordingly, we report Network Access Services and Domain Services revenue and cost of revenues separately.

For the three months ended June 30, 2016 and June 30, 2015, we reported revenue of \$47.5 million and \$42.9 million, respectively. For the three months ended June 30, 2016 and June 30, 2015, our Open SRS domain service offering accounted for 46% and 50% of our total revenue, respectively.

For the six months ended June 30, 2016 and June 30, 2015, we reported revenue of \$93.1 million and \$83.4 million, respectively. For the six months ended June 30, 2016 and June 30, 2015, our OpenSRS domain service offering

accounted for 46% and 51% of our total revenue, respectively.

### *Network Access Services*

Network Access Services derives revenue from the sale of retail mobile phones and services to individuals and small businesses through the Ting website, as well as from the provisioning of high speed Internet access, Internet hosting and network consulting services to customers in select cities in the United States. Ting provides customers with access to our provisioning and management tools to enable them, via the ting.com website, to purchase retail mobile phones and services nationally and fixed Internet access in select cities. Revenues are generated in the United States and are provided on a monthly basis with no fixed contract term. As of June 30, 2016, Ting managed mobile telephony services for approximately 144,000 subscribers and had approximately 227,000 devices under management.

Our primary distribution channel for Network Access Services is through our website, ting.com. We strive to meet or exceed our Network Access Service customers' needs by providing them with superior services, easy-to-use interfaces and proactive and attentive customer service.

### *Domain Services*

Domain Services include wholesale and retail domain name registration services, value added services and portfolio services. We earn revenues primarily from the registration fees charged to resellers in connection with new, renewed and transferred domain name registrations. In addition, we earn revenues from the sale of retail Internet domain name registration and email services to individuals and small businesses; and by making our portfolio of domain names available for sale or lease. Domain Services revenues are attributed to the country in which the contract originates, primarily Canada.

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

We believe that the underlying platforms for our services are among the most mature, reliable and functional reseller-oriented provisioning and management platforms in our industry, and we continue to refine, evolve and improve these services for both resellers and end-users. Our business model is characterized primarily by non-refundable, up-front payments, which lead to recurring revenue and positive operating cash flow.

Wholesale, primarily branded as OpenSRS, derives revenue from its Domain Service and from providing Value-Added Services. The OpenSRS Domain Service manages 14.8 million domain names under the Tucows ICANN registrar accreditation and for other registrars under their own accreditations. Value-Added Services include hosted email which provides email delivery and webmail access to millions of mailboxes, Internet security services, publishing tools and reseller billing services. All of these services are made available to end-users through a network of over 13,000 web hosts, Internet service providers (“ISPs”), and other resellers around the world. In addition, we also derive revenue from the bulk sale of domain names and advertising from the OpenSRS Domain Expiry Stream.

Retail, primarily our Hover website, derives revenues from the sale of domain name registration and email services to individuals and small businesses. Retail also includes our Personal Names Service – based on over 36,000 surname domains – that allows roughly two-thirds of Americans to purchase an email address based on their last name.

Portfolio generates advertising revenue from our domain name portfolio and from our advertising-supported website, [tucows.com](http://tucows.com). We also generate revenue by offering names in our domain portfolio for resale via our reseller network and other channels. In addition, we generate revenue from the payments for the sale of rights to gTLD strings under the New gTLD Program.

## **KEY BUSINESS METRICS**

We regularly review a number of business metrics, including the following key metrics, to assist us in evaluating our business, measure the performance of our business model, identify trends impacting our business, determine resource allocations, manage our operational cash flow, formulate financial projections and make strategic business decisions. The following are key business metrics:

### **Adjusted EBITDA**

Tucows reports all financial information required in accordance with United States generally accepted accounting principles (GAAP). Along with this information, to assist financial statement users in an assessment of our historical performance, we typically disclose and discuss a non-GAAP financial measure, adjusted EBITDA, on investor conference calls and related events that exclude certain non-cash and other charges as we believe that the non-GAAP information enhances investors' overall understanding of our financial performance.

We believe that the provision of this supplemental non-GAAP measure allows investors to evaluate the operational and financial performance of our core business using similar evaluation measures to those used by management. We use adjusted EBITDA to measure our performance and prepare our budgets. Since adjusted EBITDA is a non-GAAP financial performance measure, our calculation of adjusted EBITDA may not be comparable to other similarly titled measures of other companies; and should not be considered in isolation, as a substitute for, or superior to measures of financial performance prepared in accordance with GAAP. Because adjusted EBITDA is calculated before recurring cash charges, including interest expense and taxes, and is not adjusted for capital expenditures or other recurring cash requirements of the business, it should not be considered as a liquidity measure. See the Consolidated Statements of Cash Flows included in the attached financial statements. Non-GAAP financial measures do not reflect a comprehensive system of accounting and may differ from non-GAAP financial measures with the same or similar captions that are used by other companies and/or analysts and may differ from period to period. We endeavor to compensate for these limitations by providing the relevant disclosure of the items excluded in the calculation of adjusted EBITDA to net income based on U.S. GAAP, which should be considered when evaluating the Company's results. Tucows strongly encourages investors to review its financial information in its entirety and not to rely on a single financial measure.

Our current adjusted EBITDA definition excludes depreciation, amortization of intangible assets, income tax provision, interest expense, interest income, stock-based compensation, asset impairment, gains and losses from unrealized foreign currency transactions and infrequently occurring items. Gains and losses from unrealized foreign currency transactions removes the unrealized effect of the change in the mark-to-market values on outstanding unhedged foreign currency contracts, as well as the unrealized effect from the translation of monetary accounts denominated in non-U.S. dollars to U.S. dollars.

Our current adjusted EBITDA definition is the result of two revisions:

In response to the clarification guidance provided by the SEC Compliance & Disclosure Interpretations regarding Non-GAAP Measures, updated on May 17, 2016, we revised our definition of adjusted EBITDA to eliminate the adjustment for the effect of net deferred revenue. Prior to this quarter of 2016, our adjusted EBITDA definition included an adjustment which removed the effect of net deferred revenue, which comprised the change in deferred revenue, net of prepaid domain name registry and other Internet services fees.

As previously disclosed, in April 2016, as part of our assessment of our compensation program for 2016, we revised the definition of adjusted EBITDA to eliminate the adjustment for the effect of realized gains/losses from all foreign currency contracts, both hedged and unhedged as we believe we are able to manage realized gains/losses from all foreign currency contracts with proper planning and budgeting. We used this version of adjusted EBITDA definition in our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2016.

The current adjusted EBITDA definition will be used to assess Company performance for 2016 and future periods. In this Quarterly Report on Form 10-Q, unless otherwise indicated, “adjusted EBITDA” has the meaning set forth in the revised definition.

In accordance with the clarification guidance provided by the SEC Compliance & Disclosure Interpretations, Non-GAAP Measures updated on May 17, 2016, prior period Adjusted EBITDA amounts presented herein have been recast to reflect the above described revisions.

The following table reconciles net income to adjusted EBITDA (dollars in thousands):

|   | <b>Three months<br/>ended June 30,<br/>2016 2015<br/>(unaudited)</b> |         | <b>Six months<br/>ended June 30,<br/>2016 2015<br/>(unaudited)</b> |         |
|---|--|---------|--|---------|
| Net income for the period                                   | \$4,071  | \$2,285 | \$8,509  | \$5,119 |
| Depreciation of property and equipment                      | 428  | 342     | 848  | 601     |
| Amortization of intangible assets                           | 288  | 69      | 357  | 126     |
| Impairment of intangible assets                             | 4  | 38      | 25   | 50      |
| Interest expense, net                                       | 121  | 57      | 167  | 82      |
| Provision for income taxes                                  | 2,078  | 1,540   | 3,983  | 3,092   |
| Stock-based compensation                                    | 190  | 125     | 390  | 250     |
| Loss (gain) on foreign currency transactions <sup>(1)</sup> | (68 )  | (107 )  | (354 )   | 321     |
| Adjusted EBITDA   | \$7,112  | \$4,349 | \$13,925   | \$9,641 |

Loss (gain) on unrealized foreign currency transactions comprises of the Loss (gain) on change in the fair value of forward contracts and the Loss (gain) on foreign exchange revaluation of our foreign denominated monetary assets and liabilities. For three months ended June 30, 2016, the Company experienced a gain of less than \$0.1 million on change in fair value contracts compared to a gain of \$0.1 million for the three months ended June 30, 2015 as compared to a gain of \$0.3 million for the six months ended June 30, 2016 and a loss of \$0.1 million for the six months ended June 30, 2015. During the three and six months ended June 30, 2016 and 2015, we experienced gains on foreign exchange revaluation of our foreign denominated monetary assets and liabilities of less than \$0.1 million, respectively.

Adjusted EBITDA increased to \$7.1 million and \$13.9 million in the three and six months ended June 30, 2016 from \$4.3 million and \$9.6 million in the three and six months ended June 30, 2015, respectively. The increase in adjusted EBITDA from period to period was primarily driven by the growth in Ting mobile services.

### Network Access Services

|                                   | <b>June 30,<br/>2016<sup>(1)</sup> 2015<sup>(1)</sup></b> |         |
|-----------------------------------|---|---------|
| Ting subscribers under management | 144,000   | 113,000 |
| Ting devices under management     | 227,000   | 178,000 |

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

**Domain Services**

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

|   | <b>Three months ended</b>                             |                           | <b>Six months ended</b>                               |                           |
|---|---|---------------------------|---|---------------------------|
|   | <b>June 30,<br/>2016<sup>(1)</sup><br/>(in 000's)</b> | <b>2015<sup>(1)</sup></b> | <b>June 30,<br/>2016<sup>(1)</sup><br/>(in 000's)</b> | <b>2015<sup>(1)</sup></b> |
| Total new, renewed and transferred-in domain name registrations | 2,751   | 2,423                     | 5,103   | 4,878                     |

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

Domain names under management:

|  | <b>June 30,<br/>2016<sup>(1)</sup> 2015<sup>(1)</sup><br/>(in 000's)</b> |        |
|--|--|--------|
| Domain names under management:                           |  |        |
| Registered using the Tucows Registrar Accreditation      | 11,539   | 10,228 |
| Registered using our Resellers' Registrar Accreditations | 3,265  | 3,023  |
| Total domain names under management                      | 14,804   | 13,251 |

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

## **OPPORTUNITIES, CHALLENGES AND RISKS**

As a MVNO our Ting service is reliant on our Mobile Network Operators ("MNOs") providing competitive networks. Our MNOs each continue to invest in network expansion and modernization to improve their competitive positions. Deployment of new and sophisticated technology on a very large scale entails risks. Should they fail to implement, maintain and expand their network capacity and coverage, adapt to future changes in technologies and continued access to and deployment of adequate spectrum successfully, our ability to provide wireless services to our subscribers, to retain and attract subscribers and to maintain and grow our subscriber revenues could be adversely affected, which would negatively impact our operating margins.

Ting has also enjoyed rapid growth in its first four years of operation. Current competitive factors are however impacting Ting and the entire mobile telephony industry as both major carriers and other challenger brands have decreased prices and continue to launch new, lower-priced offerings. There is a risk that Ting will see a shrinking universe of potential customers that would save money using its services. In addition, our growth is being impacted as absolute churn is increasing, even as a relatively steady churn rate on a growing base. There is also a risk that Ting's cost structure, particularly the cost of goods paid to MNO partners, will make it increasingly difficult for Ting to compete in this landscape. While Ting will continue to aggressively compete and make investments in marketing initiatives and customer service, the above factors together with our larger subscriber base may make it difficult for us to continue to produce positive monthly net customer adds, which would have a material adverse effect on our business, financial condition and operating results.

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

Substantially all of our Domain Services revenue is derived from domain name registrations and related value-added services from wholesale and retail customers using our provisioning and management platforms. The market for wholesale registrar services is both price sensitive and competitive and is evolving with the introduction of New gTLDs, particularly for large volume customers, such as large web hosting companies and owners of large portfolios of domain names. We have a relatively limited ability to increase the pricing of domain name registrations without negatively impacting our ability to maintain or grow our customer base. Growth in our Domain Services revenue is dependent upon our ability to continue to attract and retain customers by maintaining consistent domain name registration and value-added service renewal rates and to grow our customer relationships through refining, evolving and improving our provisioning platforms and customer service for both resellers and end-users. In addition, we also generate revenue through pay-per-click advertising and the sale of names from our portfolio of domain names and through the OpenSRS Domain Expiry Stream. The revenue associated with names sales and advertising has recently experienced flat to declining trends due to the uncertainty around the implementation of ICANN's New gTLD



Program, lower traffic and advertising yields in the marketplace, which we expect to continue.

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

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

The communications industry continues to compete on the basis of network reach and performance, types of services and devices offered, and price.

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

## **Net Revenues**

### **Network Access Services**

#### *Mobile and Other Services*

We derive revenue from Ting's sale of retail mobile phones and services to individuals and small businesses nationally as well as providing fixed high speed internet access in select cities including Westminster, Maryland and Charlottesville, Virginia along with Internet hosting and network consulting services to customers in Charlottesville, Virginia. Ting provides customers with access to our provisioning and management tools to enable them, via the ting.com website, to purchase retail mobile phones and services nationally and fixed Internet access in select cities. Revenues are generated in the United States and are provided on a monthly basis with no fixed contract term.

### **Domain Services**

#### *Wholesale - OpenSRS Domain Service*

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

We receive revenues for each domain registration or other Internet service processed through our system by Service Providers. Our domain service revenue is principally comprised of registration fees charged to resellers in connection with new, renewed and transferred domain name registrations. The registration fee provides our resellers with access to our provisioning and management tools to enable them to register and administer domain names and access to additional services like WHOIS privacy and DNS (Domain Name System) services, enhanced domain name suggestion tools and access to our premium domain names. We earn fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to resellers and registrars on a monthly basis. Domain registrations are generally purchased for terms of one to ten years, with a majority having a one-year term. 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 years.

*Wholesale – OpenSRS Value-Added Services*

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

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

In addition, we provide billing, provisioning and customer care software solutions to ISPs through our Platypus billing software.

*Retail – Hover*

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

*Portfolio*

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

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

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

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

## Critical Accounting Policies

Preparation of our consolidated financial statements in accordance with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of certain assets, liabilities, revenues and expenses, as well as related disclosure of contingent assets and liabilities. There have been no material changes to the critical accounting policies and estimates as previously disclosed in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015, except for the adoption of Accounting Standard Update No. 2015-17, *Income Taxes (Topic 740)*, ASU No. 2015-16, *Business Combinations (Topic 805)*, No. 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* and Nos. 2015-03 and 2015-15, *Interest - Imputation of Interest (Subtopic 835-30)*. For further information on our critical accounting policies and estimates, see Note 2 to the consolidated financial statements appearing in Part I, Item 1 in this Quarterly Report on Form 10-Q.

**RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2016 AS COMPARED TO THE THREE AND SIX MONTHS ENDED JUNE 30, 2015**

**NET REVENUES**

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

|                                 | <b>Three months ended June 30,</b> |               | <b>Six months ended June 30,</b> |               |
|---------------------------------|------------------------------------|---------------|----------------------------------|---------------|
|                                 | <b>2016</b>                        | <b>2015</b>   | <b>2016</b>                      | <b>2015</b>   |
| <u>Network Access Services:</u> |                                    |               |                                  |               |
| Mobile Services                 | \$ 18,026,420                      | \$ 14,351,903 | \$ 34,970,490                    | \$ 26,911,135 |
| Other Services                  | 972,123                            | 1,066,066     | 1,867,185                        | 1,433,848     |
| Total Network Access Services   | 18,998,543                         | 15,417,969    | 36,837,675                       | 28,344,983    |
| <u>Domain Services:</u>         |                                    |               |                                  |               |
| Wholesale                       |                                    |               |                                  |               |
| Domain Services                 | 21,698,720                         | 21,286,863    | 42,969,585                       | 42,461,994    |
| Value Added Services            | 2,309,621                          | 2,355,837     | 4,612,054                        | 4,597,835     |
| Total Wholesale                 | 24,008,341                         | 23,642,700    | 47,581,639                       | 47,059,829    |
| Retail                          |                                    |               |                                  |               |
| Portfolio                       | 3,556,140                          | 3,009,465     | 6,970,772                        | 5,885,193     |
| Total Domain Services           | 903,357                            | 819,086       | 1,686,708                        | 2,067,048     |
|                                 | 28,467,838                         | 27,471,251    | 56,239,119                       | 55,012,070    |
|                                 | \$ 47,466,381                      | \$ 42,889,220 | \$ 93,076,794                    | \$ 83,357,053 |
| Increase over prior period      | \$ 4,577,161                       |               | \$ 9,719,741                     |               |
| Increase - percentage           | 11                                 | %             | 12                               | %             |

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

|  | <b>Three months ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|--|------------------------------------|-------------|----------------------------------|-------------|
|  | <b>2016</b>                        | <b>2015</b> | <b>2016</b>                      | <b>2015</b> |

Network Access Services:

|                               |      |      |      |      |
|-------------------------------|------|------|------|------|
| Mobile Services               | 38 % | 34 % | 38 % | 32 % |
| Other Services                | 2 %  | 2 %  | 2 %  | 2 %  |
| Total Network Access Services | 40 % | 36 % | 40 % | 34 % |

Domain Services:

|                      |      |      |      |      |
|----------------------|------|------|------|------|
| Wholesale            |      |      |      |      |
| Domain Services      | 46 % | 50 % | 46 % | 51 % |
| Value Added Services | 5 %  | 5 %  | 5 %  | 6 %  |
| Total Wholesale      | 51 % | 55 % | 51 % | 57 % |

|                       |      |      |      |      |
|-----------------------|------|------|------|------|
| Retail                |      |      |      |      |
| Portfolio             | 7 %  | 7 %  | 7 %  | 7 %  |
| Total Domain Services | 60 % | 64 % | 60 % | 66 % |

100% 100% 100% 100%

Total net revenues for the three months ended June 30, 2016 increased by \$4.6 million or 11% to \$47.5 million when compared to the three months ended June 30, 2015.

Total net revenues for the six months ended June 30, 2016 increased by \$9.7 million or 12% to \$93.1 million when compared to the six months ended June 30, 2015.

Deferred revenue increased to \$76.7 million at June 30, 2016 from \$74.3 million at June 30, 2015.

No customer accounted for more than 10% of total revenue during the three and six months ended June 30, 2016 and 2015. As at June 30, 2016, no customer accounted for more than 10% of accounts receivable and two customers accounted for 21% of accounts receivable as at June 30, 2015. Significant management judgment is required at the time revenue is recorded to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

### *Network Access Services*

Net revenues from Ting mobile phone equipment and services and the provisioning of high speed Internet access, Internet hosting and network consulting services for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015 increased by \$3.6 million or 23% to \$19.0 million. This increase primarily reflects the impact the larger Ting subscriber base is having on Ting mobile service revenue which grew by \$3.9 million to \$16.2 million as compared to the three months ended June 30, 2015. In addition, we generated \$1.0 million in provisioning high speed Internet access, Internet hosting and network consulting services during the three months ended June 30, 2016, a decrease of \$0.1 million when compared to the three months ended June 30, 2015 due to a decline in hosting and IT services revenues. Net revenues from Ting mobile phone equipment and services and the provisioning of high speed Internet access, Internet hosting and network consulting services for the six months ended June 30, 2016, as compared to the six months ended June 30, 2015 increased by \$8.5 million or 30% to \$36.8 million. This increase primarily reflects the impact the larger Ting subscriber base is having on Ting mobile service revenue which grew by \$7.9 million to \$31.3 million as compared to the six months ended June 30, 2015. Revenues generated from provisioning high speed Internet access, Internet hosting and network consulting services increased by \$0.4 million to \$1.9 million for the six months ended June 30, 2016 as compared to the six months ended June 30, 2015.

As of June 30, 2016, Ting had 144,000 subscribers and 227,000 mobile devices under its management compared to 113,000 subscribers and 178,000 devices under management as of June 30, 2015.

### *Wholesale*

During the three months ended June 30, 2016, domain services revenue increased by \$0.4 million or 2% to \$21.7 million when compared to the three months ended June 30, 2015. During the six months ended June 30, 2016, domain services revenue increased by \$0.5 million to \$43.0 million when compared to the six months ended June 30, 2015. These increases were due to the acquisition of the international reseller channel of Melbourne IT on April 1, 2016.

During the three months ended June 30, 2016, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed increased by 0.3 million to 2.8 million when compared to the three months ended June 30, 2015. During the six months ended June 30, 2016, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed increased by 0.2 million to 5.1 million when compared to the six months ended June 30, 2015. These increases were due to the acquisition of the international reseller channel of Melbourne IT on April 1, 2016



Domain services revenue and transaction volumes continue to be impacted by the ongoing migration of a few large customers, which have either been acquired by competitors or have become ICANN accredited registrars. These customers have been and will continue to move their domain management and domain transaction processing to their own accreditations and in-house systems. We expect that the number of new, renewed and transferred-in domain name registrations will continue to be impacted by future consolidation and decisions that large volume customers make with regard to acquiring their own accreditations. While we anticipate that the number of new, renewed and transferred-in domain name registrations will continue to incrementally increase as a result of new customers and the expansion in the number of new gTLDs in the long term, we expect the volatility of the above factors to affect the growth in the number of domain names that we manage.

As of June 30, 2016, total domains that we manage under our own accreditation increased by 1.3 million to 11.5 million when compared June 30, 2015. Including domains that we manage on behalf of other accredited registrars, total domains under management increased by 1.5 million to 14.8 million when compared to June 30, 2015. These increases were due to the acquisition of the international reseller channel of Melbourne IT on April 1, 2016

During the three months ended June 30, 2016, value added services revenue remained relatively flat at \$2.3 million when compared to the three months ended June 30, 2015. During the six months ended June 30, 2016, value added services revenue also remained relatively flat at \$4.6 million when compared to the six months ended June 30, 2015.

### ***Retail***

Net revenues from Retail for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015, increased by \$0.5 million, or 18%, to \$3.6 million. Net revenues from Retail for the six months ended June 30, 2016, as compared to the six months ended June 30, 2015, increased by \$1.1 million, or 18%, to \$7.0 million. These increases were largely due to the success that our retail marketing initiatives and improved websites are having on our ability to attract new customers and retain existing ones.

### *Portfolio*

Net revenues from Portfolio for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015, increased by \$0.1 million to \$0.9 million.

Net revenues from Portfolio for the six months ended June 30, 2016, as compared to the six months ended June 30, 2015, decreased by \$0.4 million to \$1.7 million. This decrease primarily related to gains we recognized during the three months ended March 31, 2015 on the sale of our minority interest in .store, as a result of this contested domain being resolved through a confidential private auction.

## **COST OF REVENUES**

### **Network Access Services**

#### *Mobile and Other Services*

Cost of revenues for network access services includes the costs of provisioning mobile services (primarily our customers' voice, messaging, data usage provided by our MNOs), the costs of providing mobile phone hardware (the cost of mobile phone devices and SIM cards sold to our customers, order fulfillment related expenses, and inventory write-downs) as well as the costs for provisioning high speed Internet access (network access fees, software licenses), and any direct costs incurred in providing web hosting and IT consulting services.

### **Domains**

#### *Wholesale*

#### *OpenSRS Domain Service*

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

#### *Value-Added Services*

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

#### *Retail*

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

#### *Portfolio*

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

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



**Network expenses**

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

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

|  | <b>Three months ended June 30,</b> |              | <b>Six months ended June 30,</b> |              |
|--|------------------------------------|--------------|----------------------------------|--------------|
|  | <b>2016</b>                        | <b>2015</b>  | <b>2016</b>                      | <b>2015</b>  |
| <b><u>Network Access Services:</u></b>       |                                    |              |                                  |              |
| Mobile Services                              | \$9,380,533                        | \$7,996,331  | \$17,938,968                     | \$15,126,180 |
| Other Services                               | 528,957                            | 502,306      | 959,554                          | 717,614      |
| Total Network Access Services                | 9,909,490                          | 8,498,637    | 18,898,522                       | 15,843,794   |
| <b><u>Domain Services:</u></b>               |                                    |              |                                  |              |
| Wholesale                                    |                                    |              |                                  |              |
| Domain Services                              | 17,645,470                         | 17,744,966   | 35,288,241                       | 35,291,293   |
| Value Added Services                         | 451,604                            | 501,518      | 930,986                          | 1,037,650    |
| Total Wholesale                              | 18,097,074                         | 18,246,484   | 36,219,227                       | 36,328,943   |
| Retail                                       |                                    |              |                                  |              |
| Portfolio                                    | 1,639,755                          | 1,322,620    | 3,218,081                        | 2,543,120    |
| Total Domain Services                        | 19,940,171                         | 19,752,035   | 39,801,612                       | 39,228,252   |
| <b><u>Network Expenses:</u></b>              |                                    |              |                                  |              |
| Network, other costs                         | 1,404,826                          | 1,494,838    | 2,637,757                        | 2,716,934    |
| Network, depreciation and amortization costs | 362,452                            | 291,461      | 720,737                          | 495,027      |
|  | 1,767,278                          | 1,786,299    | 3,358,494                        | 3,211,961    |
|  | \$31,616,939                       | \$30,036,971 | \$62,058,628                     | \$58,284,007 |
| Increase over prior period                   | \$1,579,968                        |              | \$3,774,621                      |              |
| Increase - percentage                        | 5                                  | %            | 6                                | %            |

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

|  | <b>Three<br/>months<br/>ended June<br/>30,<br/>2016</b> |   | <b>2015</b> |   | <b>Six months<br/>ended June<br/>30,<br/>2016</b> |   | <b>2015</b> |   |
|--|---|---|-------------|---|---|---|-------------|---|
| <u>Network Access Services:</u>              |   |   |             |   |   |   |             |   |
| Mobile Services                              | 31  | % | 26          | % | 29  | % | 26          | % |
| Other Services                               | 2   | % | 2           | % | 2   | % | 1           | % |
| Total Network Access Services                | 33  | % | 28          | % | 31  | % | 27          | % |
| <u>Domain Services:</u>                      |   |   |             |   |   |   |             |   |
| Wholesale                                    |   |   |             |   |   |   |             |   |
| Domain Services                              | 56  | % | 59          | % | 57  | % | 60          | % |
| Value Added Services                         | 1   | % | 2           | % | 1   | % | 2           | % |
| Total Wholesale                              | 57  | % | 61          | % | 58  | % | 62          | % |
| Retail                                       |   |   |             |   |   |   |             |   |
| Portfolio                                    | 5   | % | 4           | % | 5   | % | 4           | % |
| Total Domain Services                        | 1   | % | 1           | % | 1   | % | 1           | % |
| <u>Network Expenses:</u>                     |   |   |             |   |   |   |             |   |
| Network, other costs                         | 3   | % | 5           | % | 4   | % | 5           | % |
| Network, depreciation and amortization costs | 1   | % | 1           | % | 1   | % | 1           | % |
|  | 4   | % | 6           | % | 5   | % | 6           | % |
|  | 100%  |   | 100%        |   | 100%  |   | 100%        |   |

Total cost of revenues for the three months ended June 30, 2016 increased by \$1.6 million, or 5%, to \$31.6 million when compared to the three months ended June 30, 2015. Total cost of revenues for the six months ended June 30, 2016 increased by \$3.8 million, or 6%, to \$62.1 million when compared to the six months ended June 30, 2015. This increase primarily resulted from the acquisition of the international reseller channel of Melbourne IT and the impact Ting's larger subscriber base has on network access service costs.

Prepaid domain registration and other Internet services fees as of June 30, 2016 increased to \$59.6 million from \$58.6 million as of June 30, 2015.

### *Network Access Services*

Cost of revenues from Ting mobile phone equipment and services and the provisioning of high speed Internet access, Internet hosting and network consulting services for the three months ended June 30, 2016, as compared to the three months ended June 30, 2015, increased by \$1.4 million or 17% to \$9.9 million. This increase primarily reflects the impact the larger Ting subscriber base is having on Ting mobile service cost of revenue which grew by \$1.6 million to \$7.6 million as compared to the three months ended June 30, 2015. In addition, we incurred costs of \$0.5 million in provisioning high speed Internet access, Internet hosting and network consulting services during the three months ended June 30, 2016, relatively flat when compared to the three months ended June 30, 2015.

Cost of revenues from Ting mobile phone equipment and services and the provisioning of high speed Internet access, Internet hosting and network consulting services for the six months ended June 30, 2016, as compared to the six months ended June 30, 2015, increased by \$3.0 million or 19% to \$18.9 million. This increase primarily reflects the impact the larger Ting subscriber base is having on Ting mobile service cost of revenue which grew by \$2.8 million to \$14.4 million as compared to the six months ended June 30, 2015. In addition, we incurred costs of \$1.0 million in provisioning high speed Internet access, Internet hosting and network consulting services during the six months ended June 30, 2016, an increase of \$0.3 million when compared to the six months ended June 30, 2015.

### *Wholesale*

Costs for Wholesale for the three months ended June 30, 2016 decreased slightly by \$0.1 million, or 1%, to \$17.6 million when compared to the three months ended June 30, 2015. Costs for Wholesale for the six months ended June 30, 2016 remained flat at \$35.3 million when compared to the six months ended June 30, 2015. Costs for Wholesale remained relatively flat year over year due to the increase associated with the acquisition of the international reseller channel of Melbourne IT on April 1, 2016 offset by the migration of a handful of large, low margin customers to their own accreditations and to a lesser extent higher registry rebates and favorable foreign exchange impacts.

### *Retail*

Costs for Retail for the three months ended June 30, 2016 increased by \$0.3 million, to \$1.6 million when compared to the three months ended June 30, 2015. Costs for Retail for the six months ended June 30, 2016 increased by \$0.7 million, to \$3.2 million when compared to the six months ended June 30, 2015. This increase resulted primarily from the increased cost of additional volume in Hover services.

***Portfolio***

Costs for Portfolio for the three and six months ended June 30, 2016 remained relatively flat at \$0.2 million and \$0.4 million, respectively, when compared to the three and six months ended June 30, 2015.

***Network Expenses***

Network costs for the three months ended June 30, 2016 remained relatively flat at \$1.8 million when compared to the three months ended June 30, 2015. Costs for Network Access Services for the six months ended June 30, 2016 increased by \$0.1 million, to \$3.4 million when compared to the six months ended June 30, 2015.



**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 non-personnel expenses include customer acquisition costs, advertising and other promotional costs.

|                            | <b>Three months ended</b> |             | <b>Six months ended June</b> |             |    |   |
|----------------------------|---------------------------|-------------|------------------------------|-------------|----|---|
|                            | <b>June 30,</b>           |             | <b>30,</b>                   |             |    |   |
|                            | <b>2016</b>               | <b>2015</b> | <b>2016</b>                  | <b>2015</b> |    |   |
| Sales and marketing        | \$5,435,033               | \$4,847,963 | \$10,720,657                 | \$8,647,138 |    |   |
| Increase over prior period | \$587,070                 |             | \$2,073,519                  |             |    |   |
| Increase - percentage      | 12                        | %           | 24                           | %           |    |   |
| Percentage of net revenues | 11                        | %           | 11                           | %           | 12 | % |
|                            |                           |             |                              |             | 10 | % |

Sales and marketing expenses for the three months ended June 30, 2016 increased by \$0.6 million, or 12%, to \$5.4 million when compared to the three months ended June 30, 2015. This increase related primarily to an increase of \$0.5 million in marketing expenditures largely to support and acquire Ting mobile and fixed Internet access subscribers, as well as increased workforce and travel related expenses of \$0.5 million primarily related to network access growth. The increase in workforce costs was partially offset by our recognizing a provision of \$0.4 million under our overachievement bonus program during the three months ended June 30, 2015, which was not repeated in fiscal 2016.

Sales and marketing expenses for the six months ended June 30, 2016 increased by \$2.1 million, or 24%, to \$10.7 million when compared to the six months ended June 30, 2015. This increase related primarily to an increase of \$1.7 million in marketing spend largely to support and acquire Ting mobile and fixed Internet access subscribers, as well as increased workforce and travel related expenses of \$0.8 million primarily related to network access growth. The increase in workforce costs was partially offset by our recognizing a provision of \$0.5 million under our overachievement bonus program during the six months ended June 30, 2015, which was not repeated in fiscal 2016.

**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, network access services, email, retail, domain portfolio and other Internet services, as well as to distribute our digital content services. All technical operations and development costs are expensed as incurred.

|                                      | <b>Three months ended</b> |             | <b>Six months ended June</b> |             |   |   |   |   |
|--------------------------------------|---------------------------|-------------|------------------------------|-------------|---|---|---|---|
|                                      | <b>June 30,</b>           |             | <b>30,</b>                   |             |   |   |   |   |
|                                      | <b>2016</b>               | <b>2015</b> | <b>2016</b>                  | <b>2015</b> |   |   |   |   |
| Technical operations and development | \$998,651                 | \$1,189,276 | \$2,175,011                  | \$2,303,471 |   |   |   |   |
| Decrease over prior period           | \$(190,625)               |             | \$(128,460 )                 |             |   |   |   |   |
| Decrease - percentage                | (16                       | )%          | (6                           | )%          |   |   |   |   |
| Percentage of net revenues           | 2                         | %           | 3                            | %           | 2 | % | 3 | % |

Technical operations and development expenses for the three and six months ended June 30, 2016 decreased slightly to \$1.0 million and \$2.2 million when compared to the three and six months ended June 30, 2015. This decrease was largely attributable to workforce related costs, primarily through our recognizing a provision of \$0.1 million under our overachievement bonus program during the three and six months ended June 30, 2015 that was not repeated.

## 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, foreign exchange and other general corporate expenses.

|                            | <b>Three months ended</b> |             | <b>Six months ended June</b> |             |   |   |   |   |
|----------------------------|---------------------------|-------------|------------------------------|-------------|---|---|---|---|
|                            | <b>June 30,</b>           |             | <b>30,</b>                   |             |   |   |   |   |
|                            | <b>2016</b>               | <b>2015</b> | <b>2016</b>                  | <b>2015</b> |   |   |   |   |
| General and administrative | \$2,926,608               | \$2,750,466 | \$5,331,535                  | \$5,218,488 |   |   |   |   |
| Increase over prior period | \$176,142                 |             | \$113,047                    |             |   |   |   |   |
| Increase - percentage      | 6                         | %           | 2                            | %           |   |   |   |   |
| Percentage of net revenues | 6                         | %           | 6                            | %           | 6 | % | 6 | % |

General and administrative expenses for the three months ended June 30, 2016 increased by \$0.2 million, or 6%, to \$2.9 million when compared to the three months ended June 30, 2015. This increase was primarily the result of professional fees, credit card processing fees, stock-based compensation and travel increasing by \$0.5 million, primarily to support the growth of network access services when compared to the three months ended June 30, 2015 being partially offset by workforce related costs decreasing by \$0.3 million. This decrease in workforce related costs was largely attributable to our recognizing a provision of \$0.4 million under our overachievement bonus program during the three months ended June 30, 2015, which was not repeated in fiscal 2016. During the three months ended June 30, 2016 and 2015, we experienced gains on foreign exchange revaluation of our foreign denominated monetary assets and liabilities of less than \$0.1 million.



General and administrative expenses for the six months ended June 30, 2016 increased by \$0.1 million, or 2%, to \$5.3 million when compared to the six months ended June 30, 2015. This increase was primarily the result of professional fees, credit card processing fees, facilities and stock-based compensation increasing by \$0.7 million, primarily to support the growth of network access services when compared to the three months ended June 30, 2015 being partially offset by workforce related costs decreasing by \$0.3 million. This decrease in workforce related costs was largely attributable to our recognizing a provision of \$0.5 million under our overachievement bonus program during the three months ended June 30, 2015, which was not repeated in fiscal 2016. In addition, these increases were also partially offset by our recognizing, during the six months ended June 30, 2016, a gain on foreign exchange revaluation of our foreign denominated monetary assets and liabilities of \$0.1 million compared to a loss of \$0.2 million during the six months ended June 30, 2015.

## DEPRECIATION OF PROPERTY AND EQUIPMENT

|  | Three months<br>ended June 30, |          | Six months ended<br>June 30, |           |   |   |
|--|--------------------------------|----------|------------------------------|-----------|---|---|
|  | 2016                           | 2015     | 2016                         | 2015      |   |   |
| Depreciation of property and equipment | \$76,922                       | \$62,022 | \$150,190                    | \$121,284 |   |   |
| Increase over prior period             | \$14,900                       |          | \$28,906                     |           |   |   |
| Increase - percentage                  | 24                             | %        | 24                           | %         |   |   |
| Percentage of net revenues             | 0                              | %        | 0                            | %         | 0 | % |

Depreciation costs remained relatively flat at \$0.1 million and \$0.2 million for the three and six months ended June 30, 2016 and June 30, 2015, respectively.

## AMORTIZATION OF INTANGIBLE ASSETS

|                                   | Three months<br>ended June 30, |          | Six months ended<br>June 30, |           |   |   |
|-----------------------------------|--------------------------------|----------|------------------------------|-----------|---|---|
|                                   | 2016                           | 2015     | 2016                         | 2015      |   |   |
| Amortization of intangible assets | \$276,918                      | \$56,997 | \$333,915                    | \$110,212 |   |   |
| Increase over prior period        | \$219,921                      |          | \$223,703                    |           |   |   |
| Increase - percentage             | 386                            | %        | 203                          | %         |   |   |
| Percentage of net revenues        | 1                              | %        | 0                            | %         | 0 | % |

Amortization of intangible assets for the three and six months ended June 30, 2016, consists of amounts arising in connection with the acquisition of the acquisition of EPAG Domainservices GmbH ("EPAG") in July 2011, the acquisition of the BRI Group in February 2015 and the acquisition of the international reseller channel of Melbourne IT on April 1, 2016.

Network rights, brand and customer relationships acquired in connection with the acquisitions of EPAG, the BRI Group and Melbourne IT are amortized on a straight-line basis over seven years.

#### IMPAIRMENT OF INDEFINITE LIFE INTANGIBLE ASSETS

|   | <b>Three months ended</b> |             | <b>Six months ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2016</b>               | <b>2015</b> | <b>2016</b>             | <b>2015</b> |
| Impairment of indefinite life intangible assets | \$3,894                   | \$37,805    | \$24,879                | \$50,298    |
| Decrease over prior period                      | \$(33,911)                |             | \$(25,419)              |             |
| Decrease - percentage                           | (90)                      | )%          | (51)                    | )%          |
| Percentage of net revenues                      | 0                         | %           | 0                       | %           |

As part of our normal renewal process during the three and six months ended June 30, 2016 we assessed that certain domain names acquired in the June 2006 acquisition of Mailbank.com Inc. should not be renewed and should be allowed to expire. Accordingly, these domain names, with a book value of \$3,894 and \$24,879 respectively, have been written off and recorded as an impairment of indefinite life intangible assets. During the three and six months ended June 30, 2015, domain names with a book value of \$37,805 and \$50,298 respectively, were written off and recorded as an impairment of indefinite life intangible assets.

**LOSS (GAIN) ON CURRENCY FORWARD CONTRACTS**

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

|   | <b>Three months ended<br/>June 30,</b> |             | <b>Six months ended June<br/>30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2016</b>                            | <b>2015</b> | <b>2016</b>                          | <b>2015</b> |
| (Gain) loss on currency forward contracts | \$ (8,711 )                            | \$ 25,227   | \$ (119,468)                         | \$ 329,251  |
| Decrease over prior period                | \$ (33,938)                            |             | \$ (448,719)                         |             |
| (Decrease) /increase - percentage         | (135 )%                                |             | (136 )%                              |             |
| Percentage of net revenues                | (0 )%                                  | 0 %         | (0 )%                                | 0 %         |

As of June 30, 2016, we have entered into certain forward exchange contracts that do not comply with the requirements of hedge accounting to meet a portion of our future Canadian dollar requirements through December 2016. The impact of the fair value adjustment on outstanding contracts resulted in a net gain of \$28,978 for the three months ended June 30, 2016 compared to a net gain of \$0.1 million for the three months ended June 30, 2015. In addition, the impact of the fair value adjustment on outstanding contracts resulted in a realized loss upon settlement of currency forward contracts of \$20,267 for the three months ended June 30, 2016 and a net loss of \$0.1 million for the three months ended June 30 2015.

The impact of the fair value adjustment on outstanding contracts for the six months ended June 30, 2016 was a net gain of \$0.3 million, compared to a net loss of \$0.1 million for the six months ended June 30, 2015. In addition, the impact of the fair value adjustment on outstanding contracts was increased by a realized loss upon settlement of currency forward contracts of \$0.2 million for the six months ended June 30, 2016, compared to a net loss of \$0.3 million during the six months ended June 30, 2015.

At June 30, 2016, our balance sheet reflects a net derivative instrument liability of \$0.3 million, as well as a net derivative instrument asset of \$0.1 million, as a result of our existing foreign exchange contracts.

**OTHER INCOME AND EXPENSES**

|                             | <b>Three months ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|-----------------------------|------------------------------------|-------------|----------------------------------|-------------|
|                             | <b>2016</b>                        | <b>2015</b> | <b>2016</b>                      | <b>2015</b> |
| Other income (expense), net | \$8,292                            | \$(57,402)  | \$90,940                         | \$(82,177)  |
| Decrease over prior period  | \$65,694                           |             | \$173,117                        |             |
| Decrease - percentage       | 114                                | %           | 211                              | %           |
| Percentage of net revenues  | 0                                  | % (0 )%     | 0                                | % (0 )%     |

Other income during the three months ended June 30, 2016 was \$8,292 and \$0.1 million for the six months ended June 30, 2016, compared to other expenses of \$0.1 million and \$0.1 million, respectively, for the three and six months ended June 30, 2015. Other income primarily consists of the amortization of a \$1.5 million Joint Marketing Agreement commencing in November 2015, which was partially offset by interest we incur in connection with our credit facility with the Bank of Montreal (as discussed below).

## INCOME TAXES

|   | <b>Three months ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|---|------------------------------------|-------------|----------------------------------|-------------|
|   | <b>2016</b>                        | <b>2015</b> | <b>2016</b>                      | <b>2015</b> |
| Provision for income taxes              | \$2,077,633                        | \$1,540,096 | \$3,983,363                      | \$3,091,789 |
| Increase in provision over prior period | \$537,537                          |             | \$891,574                        |             |
| Increase - percentage                   | 35                                 | %           | 29                               | %           |
| Effective tax rate                      | 33.8                               | % 40.3      | % 31.9                           | % 37.7      |

For the three months ended June 30, 2016, we recorded a provision for income taxes of \$2.1 million on income before income taxes of \$6.1 million, using an estimated effective tax rate for Fiscal 2016 adjusted for certain minimum state taxes. Comparatively, for the three months ended June 30, 2015, we recorded a provision for income taxes of \$1.5 million on income before taxes of \$3.8 million, using an estimated effective tax rate for the 2015 fiscal year.

For the six months ended June 30, 2016, we recorded a provision for income taxes of \$4.0 million on income before income taxes of \$12.5 million, using an estimated effective tax rate for Fiscal 2016 adjusted for certain minimum state taxes. Comparatively, for the six months ended June 30, 2015, we recorded a provision for income taxes of \$3.0 million on income before taxes of \$8.2 million, using an estimated effective tax rate for the 2015 fiscal year.

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

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

We had approximately \$0.1 million of total gross unrecognized tax benefit as of June 30, 2016 and as of December 31, 2015, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes. We recognize accrued interest and penalties related to income taxes in income tax expense. We did not have significant interest and penalties accrued at June 30, 2016 and December 31, 2015, respectively.

#### **OTHER COMPREHENSIVE INCOME (LOSS)**

To mitigate the impact of the change in fair value of our foreign exchange contracts on our financial results, in October 2012 we began applying hedge accounting for the majority of the contracts we need to meet our Canadian dollar requirements on a prospective basis.

The impact of the fair value adjustment on outstanding hedged contracts for the three months ended June 30, 2016 was a net gain in other comprehensive income of \$27,264. The impact of the fair value adjustment on outstanding hedged contracts for the three months ended June 30, 2015 was a net loss in other comprehensive income of \$38,046. The impact of the fair value adjustment on outstanding hedged contracts for the six months ended June 30, 2016 was a gain of \$0.6 million compared to a net loss of \$1.0 million for the six months ended June 30, 2015.

The net amount reclassified to earnings during the three months ended June 30, 2016 was a loss of \$0.1 million compared to a loss of \$0.4 million during the three months ended June 30, 2015. The net amount reclassified to earnings during the six months ended June 30, 2016 was a loss of \$0.4 million compared to a loss of \$0.8 million during the six months ended June 30, 2015.



|                             | <b>Three months ended</b> |             | <b>Six months ended June</b> |              |
|-----------------------------|---------------------------|-------------|------------------------------|--------------|
|                             | <b>June 30,</b>           |             | <b>30,</b>                   |              |
|                             | <b>2016</b>               | <b>2015</b> | <b>2016</b>                  | <b>2015</b>  |
| Comprehensive income (loss) | \$ 106,631                | \$ 333,909  | \$ 990,151                   | \$ (210,883) |
| Decrease over prior period  | \$ (227,278)              |             | \$ 1,201,034                 |              |
| Decrease - percentage       | (68                       | )%          | 570                          | %            |
| Percentage of net revenues  | 0                         | % 1         | % 1                          | % (0 )%      |

## LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2016, our cash and cash equivalents balance decreased by \$1.8 million to \$5.9 million when compared to December 31, 2015. Our principal uses of liquidity during the six months ended June 30, 2016 resulted from our repurchasing 308,416 of our shares for \$7.2 million through our open market stock buyback that commenced on February 9, 2016, the acquisition of the international reseller channel Melbourne IT for total consideration and transaction costs of \$6.2 million, continued investment in property and equipment of \$1.8 million and \$0.4 million in principal repayments on the 2012 DLRR Loan. These uses of funds were partly offset by cash provided by operating activities of \$7.7 million and the proceeds from a \$6.0 million draw on the 2012 DLR Loan to fund the Melbourne IT reseller channel acquisition.

We have credit agreements (collectively the “Amended Credit Facility”) with the Bank of Montreal which provide us with access to a demand loan revolving facility (the “2012 DLR Loan”) and a demand loan revolving reducing facility (the “2012 DLRR Loan”) that provide for a \$14 million, five-year revolving credit facility, a \$3.5 million treasury risk management facility and a \$1.0 million operating demand loan. As at June 30, 2016, the balance under the 2012 DLR Loan was \$6.0 million and the balance under the 2012 DLRR Loan was \$3.1 million. Both of these financing arrangements remain available to fund future operations of the Company, with no set expiration date.

In accordance with the terms of the demand loan facilities, repayment of advances under the 2012 DLR Loan consist of interest only payments at U.S. Base Rate plus 1.25%, made monthly in arrears, and prepayment is permitted without penalty.

The Amended Credit Facility provides for a \$3.5 million settlement risk line to assist us with hedging Canadian dollar exposure through foreign exchange forward contracts and/or currency options. Under the terms of the Amended Credit Facility, we may enter into such agreements at market rates with terms not to exceed 18 months. As of June 30, 2016, we held contracts in the amount of \$11.0 million to trade U.S. dollars in exchange for Canadian dollars.

The Amended Credit Facility contains customary events of default and affirmative and negative covenants and restrictions, including certain financial maintenance covenants such as a maximum total funded debt to EBITDA ratio and a minimum fixed charge ratio. As of June 30, 2016, we were in compliance with all our covenants.

### *Cash Flow from Operating Activities*

Net cash provided by operating activities during the six months ended June 30, 2016 was \$7.7 million, as compared to \$5.2 million during the six months ended June 30, 2015.

Net income, after adjusting for non-cash charges, during the six months ended June 30, 2016 was \$10.3 million. Net income included non-cash charges and recoveries of \$1.8 million such as depreciation, amortization, impairment of indefinite life intangible asset, stock-based compensation, unrealized gains on currency forward contracts, other income, and an expense for deferred tax. In addition, changes in our working capital used \$2.6 million. Positive contributions of \$7.4 million from movements in income taxes payable, deferred revenue and customer deposits were offset by \$10.0 million utilized in changes from accounts receivables, inventories, prepaid expenses and domain registry fees, accounts payables and accrued liabilities.

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

Net cash outflows from financing activities during the six months ended June 30, 2016 totaled \$1.5 million as compared to cash outflows of \$3.1 million during the six months ended June 30, 2015. Net cash outflows of \$7.2 million resulted from repurchasing 308,416 of our shares during the six months through our open market stock buyback that commenced on February 9, 2016, principal repayments of \$0.4 million relating to the 2012 DLRR Loan and payment of \$0.1 million for credit facility renegotiation costs. These cash outflows were partially offset by an inflow of \$6.0 million resulting from an advance on the 2012 DLR loan to fund the acquisition of the international reseller channel from Melbourne IT Limited and a \$0.3 million inflow from the net impact of exercise of stock options.

### ***Cash Flow from Investing Activities***

Investing activities during the six months ended June 30, 2016 used net cash of \$8.1 million as compared to generating \$4.9 million during the six months ended June 30, 2015.

On April 1st, 2016, the Company acquired the international reseller channel from Melbourne IT Limited for consideration of \$6.0 million, excluding legal and registry related transaction costs of \$0.2 million. The consideration was funded through a \$6.0 million draw on the 2012 DLR loan on March 31, 2016.

In addition, the Company invested \$1.8 million in property and equipment, primarily to support the continued expansion of our fiber footprint.

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

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

There are currently no material understandings, commitments or agreements regarding the acquisition of other businesses.

#### **Off-Balance Sheet Arrangements**

As of June 30, 2016, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

#### **Contractual Obligations**

In our Annual Report on Form 10-K for the year ended December 31, 2015, we disclosed our contractual obligations.

As of June 30 2016, there have been no other material changes to those contractual obligations outside the ordinary course of business.

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

We develop products in Canada and sell these services in North America and Europe. Our sales are primarily made in U.S. dollars, while a major portion of expenses are incurred in Canadian dollars. Our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our interest income is sensitive to changes in the general level of Canadian and U.S. interest rates, particularly since the majority of our investments are in short-term instruments. Based on the nature of our short-term investments, we have concluded that there is no material interest rate risk exposure as of June 30, 2016. We are also subject to market risk exposure related to changes in interest rates under our Amended Credit Facility. We do not expect that any changes in interest rates will be material; however, fluctuations in interest rates are beyond our control. We will continue to monitor and assess the risks associated with interest expense exposure and may take additional actions in the future to mitigate these risks.

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

At June 30, 2016 we had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

| <b>Maturity date</b>    | <b>Notional<br/>amount<br/>of U.S. dollars</b> | <b>Weighted<br/>average<br/>exchange rate<br/>of<br/>U.S. dollars</b> | <b>Fair value</b> |
|-------------------------|--|---|-------------------|
| July - September 2016   | 6,002,500                                      | 1.2554  | (190,264 )        |
| October - December 2016 | 4,952,500                                      | 1.2885  | (30,289 )         |
|                         | \$ 10,955,000                                  | 1.2703  | \$ (220,553 )     |

As of June 30, 2016 we had \$11.0 million of outstanding foreign exchange forward contracts which will convert to CDN \$13.9 million. Of these contracts, \$9.3 million met the requirements for hedge accounting (as of June 30, 2015, of \$24.0 million such contracts, \$20.4 million were designated as hedges).

We have performed a sensitivity analysis model for foreign exchange exposure over the three months ended June 30, 2016. The analysis used a modeling technique that compares the U.S. dollar equivalent of all expenses incurred in Canadian dollars, at the actual exchange rate, to a hypothetical 10% adverse movement in the foreign currency exchange rates against the U.S. dollar, with all other variables held constant. Foreign currency exchange rates used were based on the market rates in effect during the three months ended March 31, 2016. 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 June 30, 2016 of approximately \$0.6 million. There can be no assurances that the above projected exchange rate decrease will materialize. Fluctuations of exchange rates are beyond our control. We will continue to monitor and assess the risk associated with these exposures and may take additional actions in the future to hedge or mitigate these risks.

### Credit Risk

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

doubtful accounts based on historical experience and our expectation of future losses.

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

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

Our management, including our Chief Executive Officer and Chief Financial Officer, performed an evaluation of our disclosure controls and procedures as required by Rule 13a-15(e) and 15d-15(e) under the Exchange Act. The evaluation was performed to determine whether 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 Exchange Act 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. Based on the evaluation as of June 30, 2016 management has concluded that our disclosure controls and procedures were effective.

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

During the six months ended June 30, 2016, there have not been any changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II.**

**OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

In addition to the other information set forth in this Quarterly Report, you should also carefully consider the risk factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015, 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. There have been no material changes to these risk factors. The risks described in our Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition or operating results.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Issuer Purchase of Equity Securities

| <b>Period</b> | <b>Total Number<br/>of<br/>Shares<br/>Purchased</b> | <b>Average<br/>Price<br/>Paid Per<br/>Share</b> | <b>Total Number<br/>of<br/>Shares<br/>Purchased as<br/>part of</b> | <b>Maximum<br/>Number of<br/>Shares (or<br/>Approximate<br/>Dollar Value)</b> |
|---------------|---|---|--|---|
|---------------|---|---|--|---|



|         |   |                |         |          | <b>Publically<br/>Announced<br/>Plans or<br/>Programs</b> | <b>that may yet be<br/>purchased<br/>under<br/>the Plans or<br/>Programs</b> |
|---------|---|----------------|---------|----------|---|--|
| April 1 | - | April 30, 2016 | —       | —        | —   | —  |
| May 1   | - | May 31, 2016   | 90,339  | \$ 23.62 | 90,339  | \$ 35,685,735  |
| June 1  | - | June 30, 2016  | 119,359 | 24.03    | 119,359   | 32,819,743   |
|         |   |                | 209,698 | \$ 23.84 | 209,698   | \$ 32,819,743  |

On February 9, 2016, the Company announced that its Board of Directors has approved a stock buyback program to repurchase up to \$40 million of its common stock in the open market. Purchases will be made exclusively through the facilities of the NASDAQ Capital Market. The stock buyback program commenced on February 10, 2016 and will terminate on or before February 9, 2017.

#### **Item 4. Mine Safety Disclosures**

Not applicable.

**Item 6. Exhibits**

(a) Exhibits.

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
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| 31.1               | Chief Executive Officer's Rule 13a-14(a)/15d-14(a) Certification *  |
| 31.2               | Chief Financial Officer's Rule 13a-14(a)/15d-14(a) Certification *  |
| 32.1               | Chief Executive Officer's Section 1350 Certification †  |
| 32.2               | Chief Financial Officer's Section 1350 Certification †  |
| 101.INS            | XBRL Instance *   |
| 101.SCH            | XBRL Taxonomy Extension Schema *  |
| 101.CAL            | XBRL Taxonomy Extension Calculation *   |
| 101.DEF            | XBRL Taxonomy Extension Definition *  |
| 101.LAB            | XBRL Taxonomy Extension Labels *  |
| 101.PRE            | XBRL Taxonomy Extension Presentation *  |

\* 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: August 8, 2016 TUCOWS INC.

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

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

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