

TUCOWS INC /PA/
Form 10-Q
August 13, 2014

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, 2014

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 Incorporation or Organization)	(I.R.S. Employer Identification No.)

96 Mowat Avenue,

Toronto, Ontario M6K 3M1, Canada

(Address of Principal Executive Offices) (Zip Code)

(416) 535-0123

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes 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 12, 2014, there were 11,328,147 outstanding shares of common stock, no par value, of the registrant.

TUCOWS INC.

Form 10-Q Quarterly Report

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TRADEMARKS, TRADE NAMES AND SERVICE MARKS

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

	June 30, 2014 (unaudited)	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 14,164,518	\$ 12,418,888
Accounts receivable, net of allowance for doubtful accounts of \$130,472 as of June 30, 2014 and \$91,226 as of December 31, 2013	6,919,130	5,305,403
Inventory	481,140	309,686
Prepaid expenses and deposits	4,935,573	4,309,039
Prepaid domain name registry and ancillary services fees, current portion	46,379,230	44,209,591
Deferred tax asset, current portion (note 7)	1,250,468	1,081,526
Income taxes recoverable (note 7)	631,632	475,889
Total current assets	74,761,691	68,110,022
Prepaid domain name registry and ancillary services fees, long-term portion	12,090,838	11,838,579
Property and equipment	1,693,720	1,757,836
Deferred tax asset, long-term portion (note 7)	5,814,675	5,370,037
Intangible assets (note 5)	14,379,154	15,403,228
Goodwill	18,873,127	18,873,127
Total assets	\$ 127,613,205	\$ 121,352,829
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 3,185,060	\$ 2,361,481
Accrued liabilities	3,743,663	3,913,034
Customer deposits	4,487,871	4,500,946
Derivative instrument liability, (note 4)	59,077	491,098

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Loan payable (note 6)	5,358,333	6,300,000
Deferred revenue, current portion	57,609,511	54,379,719
Accreditation fees payable, current portion	505,645	473,811
Income taxes payable (note 7)	194,303	1,024,004
Total current liabilities	75,143,463	73,444,093
Deferred revenue, long-term portion	16,025,103	15,638,517
Accreditation fees payable, long-term portion	132,020	135,522
Deferred rent, long-term portion	88,359	75,979
Deferred tax liability, long-term portion (note 7)	5,108,500	5,141,500
Stockholders' equity (note 11)		
Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding	-	-
Common stock - no par value, 250,000,000 shares authorized; 11,240,992 shares issued and outstanding as of June 30, 2014 and 10,907,063 shares issued and outstanding as of December 31, 2013	13,513,124	11,859,267
Additional paid-in capital	29,138,165	28,632,311
Deficit	(11,505,358)	(13,329,379)
Accumulated other comprehensive income (loss)	(30,171)	(244,981)
Total stockholders' equity	31,115,760	26,917,218
Total liabilities and stockholders' equity	\$ 127,613,205	\$ 121,352,829
Commitments and contingencies (note 10)		

See accompanying notes to unaudited consolidated financial statements

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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net revenues (note 9)	\$35,588,001	\$31,173,357	\$69,990,395	\$61,158,379
Cost of revenues (note 9):				
Cost of revenues	24,736,004	23,007,506	49,052,643	45,085,405
Network expenses (*)	1,144,697	1,269,808	2,288,341	2,524,021
Depreciation of property and equipment	173,963	151,356	356,937	288,428
Amortization of intangible assets	-	35,910	-	71,820
Total cost of revenues	26,054,664	24,464,580	51,697,921	47,969,674
Gross profit	9,533,337	6,708,777	18,292,474	13,188,705
Expenses:				
Sales and marketing (*)	3,762,441	2,946,586	7,784,215	5,793,672
Technical operations and development (*)	1,107,532	748,137	2,197,430	1,881,967
General and administrative (*)	1,886,319	1,698,697	3,654,119	3,397,329
Depreciation of property and equipment	52,538	54,922	108,842	105,861
Amortization of intangible assets	219,030	219,030	438,060	438,060
Impairment of indefinite life intangible assets (note 5)	326,457	-	577,145	-
Loss on currency forward contracts (note 4)	96,545	146,639	647,916	381,277
Total expenses	7,450,862	5,814,011	15,407,727	11,998,166
Income from operations	2,082,475	894,766	2,884,747	1,190,539
Other income (expense):				
Interest expense, net	(69,348)	(93,428)	(143,181)	(192,790)
Total other income (expense)	(69,348)	(93,428)	(143,181)	(192,790)
Income before provision for income taxes	2,013,127	801,338	2,741,566	997,749
Provision for income taxes (note 7)	665,945	213,708	917,545	333,540
Net income	1,347,182	587,630	1,824,021	664,209

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Other comprehensive income (loss), net of tax	370,868	(260,941)	7,687	(446,726)
Unrealized income (loss) on hedging activities				
Net amount reclassified to earnings	59,409	-	207,123	-
Other comprehensive income (loss) net of tax of \$111,897 and \$133,761 for the three months ended June 30, 2014 and June 30, 2013, and \$224,137 and \$230,538 for the six months ended June 30, 2014 and June 30, 2013	430,277	(260,941)	214,810	(446,726)
Comprehensive income for the period	\$ 1,777,459	\$ 326,689	\$ 2,038,831	\$ 217,483
Basic earnings per common share (note 8)	\$0.12	\$0.06	\$0.16	\$0.07
Shares used in computing basic earnings per common share (note 8)	11,219,101	10,080,815	11,124,357	10,081,831
Diluted earnings per common share (note 8)	\$0.11	\$0.05	\$0.16	\$0.06
Shares used in computing diluted earnings per common share (note 8)	11,729,547	11,069,713	11,684,529	11,073,504
(*) Stock-based compensation has been included in operating expenses as follows:				
Network expenses	\$6,916	\$7,932	\$15,797	\$14,058
Sales and marketing	\$30,804	\$33,909	\$66,803	\$60,319
Technical operations and development	\$18,447	\$20,370	\$36,652	\$35,617
General and administrative	\$29,190	\$29,044	\$67,082	\$56,103

See accompanying notes to consolidated financial statements

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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Cash provided by:				
Operating activities:				
Net income for the period	\$1,347,182	\$587,630	\$1,824,021	\$664,209
Items not involving cash:				
Depreciation of property and equipment	226,501	206,278	465,779	394,289
Amortization of intangible assets	219,030	254,940	438,060	509,880
Impairment of indefinite life intangible asset	326,457	-	577,145	-
Deferred income taxes (recovery)	(415,246)	113,748	(758,477)	21,683
Excess tax benefits from share-based compensation expense	594,899	-	(418,901)	-
Amortization of deferred rent	9,168	4,372	12,380	9,876
Disposal of domain names	7,247	20,876	8,869	35,369
Loss (gain) on change in the fair value of forward contracts	(192,460)	114,846	(105,314)	565,987
Stock-based compensation	85,357	91,255	186,334	166,097
Change in non-cash operating working capital:				
Accounts receivable	(350,806)	(665,972)	(1,613,727)	(1,214,290)
Inventory	28,293	121,380	(171,454)	399,680
Prepaid expenses and deposits	(259,698)	635,193	(626,534)	296,895
Prepaid domain name registry and ancillary services fees	(606,215)	(341,273)	(2,421,898)	(1,382,987)
Income taxes recoverable	(133,242)	(2,789)	(566,543)	106,364
Accounts payable	(866,473)	1,797	803,942	607,721
Accrued liabilities	253,027	1,025,886	(169,371)	501,684
Customer deposits	16,054	273,851	(13,075)	(287,570)
Deferred revenue	867,445	557,152	3,616,378	1,976,736
Accreditation fees payable	(21,755)	(28,082)	28,332	15,917
Net cash (used in) / provided by operating activities	1,134,765	2,971,088	1,095,946	3,387,540
Financing activities:				
Proceeds received on exercise of stock options	130,782	279,685	1,041,863	318,194
Excess tax benefits from share-based compensation expense	-	-	1,013,800	-
Repurchase of common stock	-	-	(82,286)	(6,537,616)
Proceeds received on loan payable	-	-	-	5,200,000
Repayment of loan payable	(325,000)	(600,000)	(941,667)	(1,400,000)
Net cash provided by / (used in) financing activities	(194,218)	(320,315)	1,031,710	(2,419,422)
Investing activities:				

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Additions to property and equipment	(313,281)	(471,966)	(382,026)	(918,671)
Net cash used in investing activities	(313,281)	(471,966)	(382,026)	(918,671)
Increase (decrease) in cash and cash equivalents	627,266	2,178,807	1,745,630	49,447
Cash and cash equivalents, beginning of period	13,537,252	4,286,319	12,418,888	6,415,679
Cash and cash equivalents, end of period	\$14,164,518	\$6,465,126	\$14,164,518	\$6,465,126
Supplemental cash flow information:				
Interest paid	\$69,437	\$97,369	\$143,386	\$196,873
Income taxes paid, net	\$588,916	\$198,462	\$1,258,540	\$187,313
Supplementary disclosure of non-cash investing and financing activities:				
Property and equipment acquired during the period not yet paid for	\$19,637	\$4,864	\$19,637	\$4,864

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”, “Tu cows”, “we”, “us” or through similar expressions), together with our consolidated subsidiaries, is a global distributor of Internet services, including domain name registration, security and identity products through digital certificates, email and mobile telephony services on both a wholesale and retail basis.

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, 2014 and the results of operations and cash flows for the interim periods ended June 30, 2014 and 2013. 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, 2013 included in Tucows' 2013 Annual Report on Form 10-K filed with the SEC on March 18, 2014.

There have been no material changes to our significant accounting policies during the three months ended June 30, 2014 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

The Company recognizes the effects of events or transactions that occur after the balance sheet date but before financial statements are issued (“subsequent events”) if there is evidence that conditions related to the subsequent event existed at the date of the balance sheet date, including the impact of such events on management's estimates and assumptions used in preparing the financial statements. Other significant subsequent events that are not recognized in the financial statements, if any, are disclosed in the notes to the unaudited interim consolidated financial statements.

3. NEW ACCOUNTING POLICIES:

Recent Accounting Pronouncements Adopted

On July 18, 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (“ASU 2013-11”). ASU 2013-11 requires an entity to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction of a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward except as follows: to the extent a net operating loss carryforward, a similar tax loss or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable tax jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with a deferred tax asset. We adopted ASU 2013-11 in the quarter ending March 31, 2014 and the adoption did not have a material impact on our Condensed Consolidated Financial Statements.

On May 28, 2014, the FASB issued Accounting Standards Update 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09” or “new standard”). The new standard is effective for annual and interim periods beginning January 1, 2017, and early adoption is prohibited. ASU 2014-09 may be adopted by applying the provisions of the new standard on a retrospective basis to the periods included in the financial statements or on a modified retrospective basis which would result in the recognition of a cumulative effect of adopting ASU 2014-09 in the first quarter of 2017. We have not yet decided which implementation method we will adopt. The new standard replaces virtually all existing generally accepted accounting principles (“GAAP”) on revenue recognition and replaces them with a principles-based approach for determining revenue recognition using a new five step model. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 also includes new accounting principles related to the deferral and amortization of contract acquisition and fulfillment costs. We are studying the new standard and starting to evaluate and determine the impact the new standard will have on the timing of revenue recognition under our customer agreements and the amount of contract related costs that will be deferred. We cannot, however, provide any estimate of the impact of adopting the new

standard at this time.

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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 in its future cash flows related to a portion of payroll, rent and payments to a Canadian domain name registry supplier 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 from the acquisition date.

The Company has designated these transactions as cash flow hedges of forecasted transactions under ASC Topic 815 “Derivatives and Hedging” (“ASC Topic 815”). 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 or cash flows attributable to the risk of being hedged are expected to completely offset at inception and on an ongoing basis. Accordingly, quarterly 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, 2014, is recorded as derivative instrument liabilities.

As of June 30, 2014, the notional amount of forward contracts that the Company held to sell U.S. dollars in exchange for Canadian dollars was \$13.5 million, of which \$10.5 million met the requirements of ASC Topic 815 and were designated as hedges (June 30, 2013 - \$18.1 million of which \$15.1 million were designated as hedges). As of June 30, 2014, the Company has forward contracts with a notional amount of \$3.0 million, which are not accounted for as hedges. The change in fair value of \$0.2 million for these contracts is recorded on the statement of operations.

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, 2014, 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, 2014 Fair Value	December 31, 2013 Fair Value
		Asset	Asset
		(Liability)	(Liability)
Foreign currency forward contracts designated as cash flow hedges	Derivative instruments	\$ (45,886)	\$ (118,505)
Foreign currency forward contracts not designated as cash flow hedges	Derivative instruments	\$ (13,191)	\$ (372,593)
Total foreign currency forward contracts	Derivative instruments	\$ (59,077)	\$ (491,098)

Effects of derivative instruments on income and other comprehensive income (OCI) for the three months ended June 30, 2014 and June 30, 2013 are as follows:

Derivatives in Cash Flow	Amount of Gain or (Loss)	Location of Gain or (Loss) Reclassified	Amount of Gain or (Loss) Reclassified from	Location of	Amount of
				of	of
Hedging Relationship	Gain or (Loss)	Reclassified	from	Gain or (Loss)	Gain or (Loss)
				Recognized in	Recognized in
				Income on	Income on
				Derivative	Derivative
		Accumulated	Accumulated	(ineffective)	(ineffective)
	OCI on	OCI into	OCI into	Portion and	Portion and
	Derivative	Income	Income	Amount	Amount
	(Effective	(Effective	(Effective	Excluded from	Excluded from
	Portion)	Portion)	Portion)	Effectiveness	Effectiveness
				Testing)	Testing)
Foreign currency forward contracts for the three months ended June 30, 2014	\$ 430,277	Operating expenses	\$ (200,756)	—	—
		Cost of revenues	\$ (31,457)		
Foreign currency forward contracts for the three months ended June 30, 2013	\$ (260,941)	Operating expenses	\$ —	—	—
		Cost of revenues	\$ —		

Effects of derivative instruments on income and other comprehensive income (OCI) for the six months ended June 30, 2014 and June 30, 2013 are as follows:

Derivatives in Cash Flow Amount of Location of Amount of Location of

Hedging Relationship	Gain or (Loss)	Gain or (Loss) Reclassified	Gain or (Loss)	Gain or (Loss)
	Recognized in	from	from	Recognized in
	OCI on	Accumulated	Accumulated	Income on
	Derivative	OCI into	OCI into	Derivative
	(Effective	Income	Income	(ineffective
	Portion)	(Effective	(Effective	Portion
		Portion)	Portion)	and
				Amount
				Excluded
				from