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 (Do not check if a smaller reporting company)	Smaller reporting company

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

As of 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

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

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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

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:				

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION OF THE COMPANY:

Tucows Inc., a Pennsylvania corporation (referred to throughout this report as the “Company”, “Tucows”, “we”, “us” or through similar expressions), together with our consolidated subsidiaries, is a global distributor of Internet services, including domain name registration, security and identity products through digital certificates, 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.

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 June 30, 2014 Fair Value Asset (Liability)**	**As of December 31, 2013 Fair Value Asset (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)

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

Derivatives in Cash Flow Hedging Relationship	**Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)**	**Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)**	**Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)**	**Location of Gain or (Loss) Recognized in Income on Derivative (ineffective Portion and Amount Excluded from Effectiveness Testing)**	**Amount of Gain or (Loss) Recognized in Income on Derivative (ineffective Portion and Amount Excluded from Effectiveness 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**	**Amount of**

Hedging Relationship	Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)	Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Gain or (Loss) Recognized in Income on Derivative (ineffective Portion and Amount Excluded from Effectiveness Testing)	Gain or (Loss) Recognized in Income on Derivative (ineffective Portion and Amount Excluded from Effectiveness Testing)
Foreign currency forward contracts for the six months ended June 30, 2014	$ 214,810	Operating expenses	$ (506,138)	—	—
		Cost of revenues	$ (72,101)		
Foreign currency forward contracts for the six months ended June 30, 2013	$ (446,726)	Operating expenses	$ —	—	—
		Cost of revenues	$ —		

In addition to the above, for those foreign currency forward contracts not designated as hedges, the Company has recorded a loss of $0.1 million upon settlement and a gain of $0.2 million for the change in fair value of outstanding contracts for the three months ended June 30, 2014, in the consolidated statement of operations and comprehensive income. The Company has recorded a loss of $0.2 million upon settlement and a gain of $0.1 million for the change in fair value of outstanding contracts for the six months ended June 30, 2014, in the consolidated statement of operations and comprehensive income.

5. INTANGIBLE ASSETS:

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

A summary of acquired intangible assets for the three months ended June 30, 2014 is as follows:

	Technology 2 – 7 years	Brand 7 years	Customer relationships 4 – 7 years	Surname domain names indefinite life	Direct navigation domain names indefinite life	Total
Net book value, March 31, 2014	$ —	$181,240	$ 932,080	$11,856,948	$1,961,620	$14,931,888
Sales of domain names	—	—	—	(973)	(6,274)	(7,247)
Impairment of indefinite life intangible assets	—	—	—	(326,457)	—	(326,457)
Amortization expense	—	(43,410)	(175,620)	—	—	(219,030)
Net book value, June 30, 2014	$ —	$137,830	$ 756,460	$11,529,518	$1,955,346	$14,379,154

A summary of acquired intangible assets for the six months ended June 30, 2014 is as follows:

	Technology 2 – 7 years	Brand 7 years	Customer relationships 4 – 7 years	Surname domain names indefinite life	Direct navigation domain names indefinite	Total

					life		
Net book value, December 31, 2013	$ —	$224,650	$ 1,107,700	$12,096,712	$1,974,166	$15,403,228
Sales of domain names	—	—	—	(2,595)	(6,274)	(8,869)
Impairment of indefinite life intangible assets	—	—	—	(564,599)	(12,546)	(577,145)
Amortization expense	—	(86,820)	(351,240)	—	—	(438,060)
Net book value, June 30, 2014	$ —	$137,830	$ 756,460	$11,529,518	$1,955,346	$14,379,154

As of June 30, 2014, the accumulated amortization for the definite life intangibles was $5.5 million.

With regard to indefinite life intangible assets, as part of our normal renewal process during the three and six months ended June 30, 2014, we made an assessment that certain domain names acquired in the June 2006 acquisition of Mailbank.com Inc. should not be renewed and were allowed to expire. Accordingly, these domain names, with a book value of $0.3 million and $0.6 million, have been written off and recorded as impairment of indefinite life intangible assets during the three and six months ended June 30, 2014, respectively. No impairment was recorded on indefinite-life intangible assets during the three and six months ended June 30, 2013.

6. LOAN PAYABLE:

The Company has credit agreements (collectively the “Amended Credit Facility”) with the Bank of Montreal (the “Bank”) 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 Company 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.

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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. At June 30, 2014, the 2012 DLR Loan was fully repaid. At June 30, 2014, the outstanding balance under the 2012 DLRR Loan was $5.4 million, bearing interest at 5% per annum.

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, 2014, the Company held contracts in the amount of $13.5 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, 2014, 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 $3.6 million per year, which limit will be reviewed on an annual basis. As of June 30, 2014, the Company was in compliance with these covenants, and expects to be in compliance for the next twelve months.

Scheduled principal loan repayments are as follows:

Remainder of 2014	$ 1,200,000
2015	1,558,333
2016	1,300,000
2017	1,300,000

7. INCOME TAXES

For the six months ended June 30, 2014, the Company recorded a provision for income taxes of $0.9 million on income before income taxes of $2.7 million, using an estimated effective tax rate for the fiscal year ending December 31, 2014 (“fiscal 2014”) adjusted for certain minimum state taxes. Comparatively, for the six months ended June 30, 2013, the Company recorded a provision for income taxes of $0.3 million on income before taxes of $1.0 million, using an estimated effective tax rate for its fiscal year ending December 31, 2013 (“fiscal 2013”).

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, 2014 and $0.3 million of total gross unrecognized tax benefit as of June 30, 2013, 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 decrease of $0.2 million from June 30, 2013 primarily relates to the finalization of prior year German income tax returns. 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, 2014 and December 31, 2013, respectively.

8. BASIC AND DILUTED EARNINGS PER COMMON SHARE:

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

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

	Three months ended June 30, 2014	Three months ended June 30, 2013	Six months ended June 30, 2014	Six months ended June 30, 2013
Numerator for basic and diluted earnings per common share:				
Net income for the period	$1,347,182	$587,630	$1,824,021	$664,209
Denominator for basic and diluted earnings per common share:				
Basic weighted average number of common shares outstanding	11,219,101	10,080,815	11,124,357	10,081,831
Effect of outstanding stock options	510,446	988,898	560,172	991,673

Diluted weighted average number of shares outstanding	11,729,547	11,069,713	11,684,529	11,073,504
Basic earnings per common share	$0.12	$0.06	$0.16	$0.07
Diluted earnings per common share	$0.11	$0.05	$0.16	$0.06

For the three months ended June 30, 2014, outstanding options to purchase 38,000 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, 2014, outstanding options to purchase 39,000 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 six months ended June 30, 2014, 6,092 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in March 2014, non of which occurred during the quarter ended June 30, 2014.

During the six months ended June 30, 2013, 1,028,530 common shares were repurchased and cancelled under the terms of a modified Dutch auction tender offer announced in December 2012.

During the six months ended June 30, 2013, 35,768 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in March 2013.

The computation of earnings per share and diluted earnings per share for the three and six months ended June 30, 2014 and 2013 include reductions in the number of shares outstanding due to these repurchases.

9. SEGMENT REPORTING:

(a) We are organized and managed based on two segments, which are differentiated primarily by their services, the markets they serve and the regulatory environments in which they operate. The two segments are Domain Services and Network Access Services and are described as follows:

1. 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.

2. Network Access Services - This segment derives revenue from the sale of retail mobile phones and services to individuals and small businesses through the Ting website. Revenues are generated in the United States.

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 margin 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, loss on disposition of property and equipment, amortization of intangibles, 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:

Three months ended June 30, 2014	**Domain Name Services**	**Network Access Services**	**Consolidated Totals**
Net Revenues	$27,328,156	$8,259,845	$35,588,001
Cost of Revenues	19,696,030	5,039,974	24,736,004
Gross Profit before network expenses	7,632,126	3,219,871	10,851,997
Network expenses			1,318,660
Gross Profit			9,533,337

Expenses:	
Sales and marketing	3,762,441
Technical operations and development	1,107,532
General and administrative	1,886,319
Depreciation of property and equipment	52,538
Amortization of intangibles	219,030
Write-off / impairment of indefinite life intangible assets	326,457
Loss on currency forward contracts	96,545
Income from operations	2,082,475
Other expenses, net	69,348
Income before provision for income taxes	$ 2,013,127

Six months ended June 30, 2014	Domain Name Services	Network Access Services	Consolidated Totals
Net Revenues	$55,018,398	$14,971,997	$69,990,395
Cost of Revenues	39,731,238	9,321,405	49,052,643
Gross Profit before network expenses	15,287,160	5,650,592	20,937,752
Network expenses			2,645,278
Gross Profit			18,292,474
Expenses:			
Sales and marketing			7,784,215
Technical operations and development			2,197,430
General and administrative			3,654,119
Depreciation of property and equipment			108,842
Amortization of intangibles			438,060
Write-off / impairment of indefinite life intangible assets			577,145
Loss on currency forward contracts			647,916
Income from operations			2,884,747
Other expenses, net			143,181
Income before provision for income taxes			$2,741,566

Three months ended June 30, 2013	Domain Name Services	Network Access Services	Consolidated Totals
Net Revenues	$27,439,382	$3,733,975	$31,173,357
Cost of Revenues	20,067,878	2,939,628	23,007,506
Gross Profit before network expenses	7,371,504	794,347	8,165,851
Network expenses			1,457,074
Gross Profit			6,708,777
Expenses:			
Sales and marketing			2,946,586
Technical operations and development			748,137
General and administrative			1,698,697
Depreciation of property and equipment			54,922
Amortization of intangibles			219,030
Loss on currency forward contracts			146,639
Income from operations			894,766
Other expenses, net			93,428
Income before provision for income taxes			$801,338

Six months ended June 30, 2013

	Domain Name Services	Network Access Services	Consolidated Totals
Net Revenues	$55,076,140	$6,082,239	$61,158,379
Cost of Revenues	40,035,792	5,049,613	45,085,405
Gross Profit before network expenses	15,040,348	1,032,626	16,072,974
Network expenses			2,884,269
Gross Profit			13,188,705
Expenses:			
Sales and marketing			5,793,672
Technical operations and development			1,881,967
General and administrative			3,397,329
Depreciation of property and equipment			105,861
Amortization of intangibles			438,060
Loss on currency forward contracts			381,277
Income from operations			1,190,539
Other expenses, net			192,790
Income before provision for income taxes			$997,749

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

	Three months ended June 30,		Six months ended June 30,	
	2014	**2013**	**2014**	**2013**
Domain Services:				
Wholesale				
Domain Services	$21,503,086	$21,800,101	$43,152,040	$43,696,001
Value Added Services	2,395,726	2,559,427	4,999,331	5,248,117
Total Wholesale	23,898,812	24,359,528	48,151,371	48,944,118
Retail	2,540,538	2,001,354	4,924,601	3,919,798
Portfolio	888,806	1,078,500	1,942,446	2,212,224
Total Domain Services	27,328,156	27,439,382	55,018,418	55,076,140
Network Access Services:				
Ting	8,259,845	3,733,975	14,971,977	6,082,239
Total Network Access Services	8,259,845	3,733,975	14,971,977	6,082,239
	$35,588,001	$31,173,357	$69,990,395	$61,158,379

During the three and six months ended June 30, 2014 and 2013, no customer accounted for more than 10% of total revenue. As at June 30, 2014, one customer accounted for 12% of accounts receivable, while as at June 30, 2013, no customer accounted for more than 10% of accounts receivable.

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

	Three months ended June 30,		Six months ended June 30,	
	2014	**2013**	**2014**	**2013**
Domain Services:				
Wholesale				
Domain Services	$17,809,325	$18,484,667	$36,044,540	$36,938,969
Value Added Services	563,011	520,456	1,103,733	1,082,494
Total Wholesale	18,372,336	19,005,123	37,148,273	38,021,463
Retail	1,110,659	833,327	2,126,075	1,583,923
Portfolio	213,035	229,428	456,890	430,406
Total Domain Services	19,696,030	20,067,878	39,731,238	40,035,792

Network Access Services:				
Ting	5,039,974	2,939,628	9,321,405	5,049,613
Total Network Access Services	5,039,974	2,939,628	9,321,405	5,049,613
Network Expenses:				
Network, other costs	1,144,697	1,269,808	2,288,341	2,524,021
Network, depreciation and amortization costs	173,963	187,266	356,937	360,248
Total Network Expenses	1,318,660	1,457,074	2,645,278	2,884,269
	$26,054,664	$24,464,580	$51,697,921	$47,969,674

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

	June 30, 2014	**December 31, 2013**
Canada	$1,184,101	$1,292,425
United States	464,442	453,223
Germany	45,177	12,188
	$1,693,720	$1,757,836

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

	June 30, 2014	**December 31, 2013**
Canada	$55,900	$271,300
Germany	838,390	1,061,050
	$894,290	$1,332,350

(f) The following is a summary of the Company’s deferred tax asset, net of valuation allowance, by geographic region:

	June 30, 2014	December 31, 2013
Canada	$7,065,143	$6,451,563
	$7,065,143	$6,451,563

10. COMMITMENTS AND CONTINGENCIES:

The Company is involved in various legal claims and lawsuits in connection with its ordinary business operations. The Company intends to vigorously defend these claims. While the final outcome with respect to any actions or claims outstanding or pending as of June 30, 2014 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.

11. STOCKHOLDERS' EQUITY:

The following unaudited table summarizes stockholders' equity transactions for the three month period ended June 30, 2014:

	Common stock		Additional paid in capital	Deficit	Accumulated Other Comprehensive Income	Total stockholders' equity
	Number	Amount				
Balances, March 31, 2014	11,192,884	$13,301,296	$29,133,854	$(12,852,540)	$ (460,448)	$29,122,162
Exercise of stock options	48,108	211,828	(81,046)	—	—	130,782
Stock-based compensation	—	—	85,357	—	—	85,357
Net income for the period	—	—				