

TUCOWS INC /PA/  
Form 10-K  
March 29, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO  
SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

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

Commission file number 0-28284

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## Tucows Inc.

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania  
(State or Other Jurisdiction of  
Incorporation or Organization)  
**96 Mowat Avenue**  
**Toronto, Ontario, Canada**  
(Address of Principal Executive Offices)

**23-2707366**  
(I.R.S. Employer  
Identification No.)

**M6K 3M1**  
(Zip Code)

Registrant's telephone number, including area code: **(416) 535-0123**  
Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class        | Name of Each Exchange on Which Registered |
|----------------------------|---|
| Common Stock, no par value | American Stock Exchange                   |

Securities registered pursuant to Section 12(g) of the Act:

**None**

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

## Edgar Filing: TUCOWS INC /PA/ - Form 10-K

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of June 30, 2006 (the last day of our most recently completed second quarter), the aggregate market value of the common stock held by non-affiliates of the registrant was \$54.3 million. Such aggregate market value was computed by reference to the closing sale price per share of \$0.96 as reported on the American Stock Exchange on such date. For purposes of making this calculation only, the registrant has defined affiliates as including all officers, directors, and beneficial owners of more than ten percent of the common stock of the Company. In making such calculation, the registrant is not making a determination of the affiliate or non-affiliate status of any holders of shares of the registrant's common stock.

The number of shares outstanding of the registrant's common stock as of March 26, 2007 was 74,698,221.

### DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the definitive Proxy Statement of Tucows Inc. to be used in connection with its 2007 Annual Meeting of Shareholders (the Proxy Statement), to be filed within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, are incorporated by reference into Part III of this Annual Report on Form 10-K to the extent provided herein. Except as specifically incorporated by reference herein, the Proxy Statement is not to be deemed filed as part of this Annual Report on Form 10-K.

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TUCOWS INC.  
 ANNUAL REPORT ON FORM 10-K  
 For Fiscal Year Ended December 31, 2006

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### Information Concerning Forward-Looking Statements

This Report on Form 10-K 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, 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 number of new, renewed and transferred-in domain names, the competition we expect to encounter as our business develops and competes in a broad range of Internet services, the effectiveness of our intellectual property protection, including our ability to license proprietary rights to network partners and to register additional trademarks and service marks, our belief that the market for domain name registration will trend upward gradually, our belief that it is more likely than not that net deferred assets will be realized; our expectations regarding our acquisition of the assets of Critical Path, Inc. and the equity of Mailbank.com Inc.; our expectations regarding the cost of compliance with Sarbanes-Oxley and our belief that, by increasing the number of applications and services we offer, we will be able to generate higher revenues. These statements are based on management's current expectations and are subject to a number of uncertainties and risks that could cause actual results to differ materially from those described in the forward-looking statements. Many factors affect our ability to achieve our objectives and to successfully develop and commercialize our services including:

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

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

The ability of vendors to continue to supply our needs;

Actions by our competitors;

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

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

Our ability to effectively manage our business;

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

Pending or new litigation; and

Factors set forth herein under the caption "Item 1A Risk Factors".

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. These statements are not guarantees of future performance.

We qualify all the forward-looking statements contained in this Form 10-K by the foregoing cautionary statements.

**PART I**

**ITEM 1. BUSINESS**

**Overview**

Tucows Inc., together with its consolidated subsidiaries, seeks to make the Internet easier and more effective for Internet users and to reduce complexity for its customers as they acquire, deliver or use Internet services.

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

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

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

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

**Products and Services**

We offer our services to our network of Service Providers and directly to end-users of the Internet. Our principal applications and services fall under two broad headings: Domain Registration and other Internet Services and Advertising and Other Services.

***Domain Registration and other Internet Services***

***Domain Registration Services***

Domain Registration Services encompass all of our product and service offerings related to the provisioning of domains, including the markets for expiring and secondary domain names. We offer wholesale and retail domain registration services for numerous generic top-level domains, or gTLDs, and country code top-level domains, or ccTLDs. Key components of our Domain Registration Services include:

- **Wholesale Domain Services.** Tucows Wholesale Domain Services are designed to enable Service Providers to register domains for their end-users using Tucows gTLD and ccTLD accreditations. Pricing is based on a per domain, per year charge. Tucows imposes no restrictions on the prices charged by Service Providers to their customers and offers this service through its open shared reseller system, or OpenSRS Platform, which is described below.
- **Hosted Registrar Services.** Hosted Registrar Services allow ICANN accredited registrars to use Tucows technical systems to process domain registrations with their accreditation. Hosted Registrar Services enable registrars to use a proven system without incurring the costs of building

their own technical infrastructure. Hosted Registrar Services also include professional service elements, including custom development, data management and systems administration. This service is offered through Tucows' open hosted reseller system, or OpenHRS platform, which is described below, and is offered as a fee-based service.

- **Retail Services.**

- **Domain Direct.** Tucows offers retail domain registration and other Internet services through Domain Direct at [www.domaindirect.com](http://www.domaindirect.com). These services are designed to enable consumers to establish an Internet presence using Domain Direct's control panel, which includes tools for domain registration, personalized email, domain forwarding, blogware and web hosting that allow customers to register, develop, use and manage their websites.

- **NetIdentity.** Tucows manages a domain name portfolio of surname-based domain names that we use to provide consumers with personalized email and web hosting services. These services enable consumers to subscribe for the use of a personalized, name-based email address, such as [john@smith.com](mailto:john@smith.com), or a similar personalized web address for blog or website purposes.

*Other Internet Services*

Other Internet services that we provide include email and anti-spam services, digital certificates, billing, provisioning and customer care software solutions, blogware and website building tools. We offer these services to our Service Providers on a private label basis so that the Service Providers may use their own brand name in selling Internet services to their end-users.

- **Messaging Email.** Our email service is a hosted service that provides email boxes that support post office protocol, or POP, Internet message access protocol, or IMAP, simple mail transfer protocol, or SMTP, and web-mail as methods of access and communication. Web-mail includes support for groupware functionality, including shared calendaring, tasks, notes and email boxes. An email forwarding service is also provided.

- **Anti-Spam.** Our email defense anti-spam service is a Tucows hosted service that provides spam, virus, content and attachment filtering, as well as Denial of Service, or DoS, attack prevention.

- **Digital Certificate Delivery.** Digital certificates are required to facilitate any online transaction or any exchange of sensitive information in a secure fashion. We have a partnership with GeoTrust to provide Service Providers with the ability to sell an array of digital certificates known as Secure Socket Layer, or SSL, certificates. Digital certificates consist of a public key and a private key. The public key is used to encrypt information and the private key is used to decipher the information, a process that is known as an SSL handshake. Digital certificates are issued using identity verification procedures and, in combination with the trusted third-party infrastructure standard in the Internet industry, are used to enable secure electronic transactions and to otherwise verify online identities. This verification occurs when a browser points to a secured domain; an SSL handshake authenticates the server and the client and establishes an encryption method and a unique session key. The Server and the client can then begin a secure session that guarantees message privacy and message integrity.

- **Billing Services, Provisioning and Customer Care Solutions.**

- **Platypus Billing System, or Platypus,** is a complete turnkey back-office solution for ISPs, Application Service Providers, or ASPs, web hosting companies and other companies that provide Internet services. Platypus handles billing, service provisioning, and customer account management. Web tools are provided so that customers can manage their customer accounts online.



- Wombat Help Desk System is a Platypus integrated Help Desk solution that provides total accountability for customer care needs. Wombat automatically routes, tracks and maintains customer care email and phone calls for optimal service desk performance.
- The Tucows Printing Service is an outsourced statement printing service offering to Platypus Billing System customers statement printing, folding, stuffing and postage metering services.
- **Blogware.** Blogware is a proprietary hosted weblog content management system that makes it easy for end users to share information, photographs and other interactive content online via their website. We believe that Blogware is the only hosted blog or weblog content management system that was built exclusively for Service Providers and that takes into account their specific needs, including the ability to brand the service, to create and administer trials of the service and to manage and administer the service across their customer bases. We manage the entire Blogware service and provisioning infrastructure, as well as ongoing application development on an outsourced basis.
- **Website Builder.** Our website builder tool enables end-users to create a website using an easy to use template based tool. We manage the infrastructure allowing Service Providers to present a private label product to their end-user customers without the development effort or overhead expenses that would be required to design and manage such a service on their own.

#### *Advertising and Other Services*

Advertising and other services include revenues attributable to our content business. We generate revenue directly from users of our website through selling advertising through the following channels:

- **Direct advertising on our website.** Our website, [www.tucows.com](http://www.tucows.com), is designed to provide customers with fast access to our extensive libraries of software and digital content and with help and information relating to the use of the Internet. We provide users with software for numerous platforms, including Windows, Macintosh, Linux, personal digital assistants, mobile/cellular and online services. The main libraries contain a total of over 40,000 titles. Our staff checks each title for spyware and viruses. We provide a public forum where individuals can review or comment on the software products. Most titles are rated on a scale of one to five, with five being the highest rating. Revenue is produced from our website through advertising and co-branding agreements. We do not generally enter into barter advertising agreements.
- **Direct Navigation Revenue.** We offer pay-per-click advertising on the pages of certain domains within our domain name portfolio. When a user types one of these domain names into the command line of the browser, they are presented with dynamically generated links which are pay-per-click advertising. Every time a user clicks on one of the links listed on a web page, it generates revenue for Tucows.
- **Our Author Resource Center.** Our Author Resource Center, or ARC, provides software developers who rely on us as a primary source of distribution with the tools to manage and promote their software on our website through advertising services, including keyword search placements, banners, promotional placements and premium data services to our large, technologically sophisticated audience. The advertising sales business model is based on both the amount charged to send a message to 1,000 receivers, or a cost-per-thousand, variable, and the amount charged when a user clicks on the advertisement, or a cost-per-click through, variable.

#### **Technology and Infrastructure**

We employ advanced software and hardware, combining internal expertise with industry standard technology to create a proprietary platform for the offering of our services. Our provisioning infrastructure





is a technical infrastructure that allows Service Providers to provide Internet services to their customers without having to make substantial investments in their own software or hardware. In 2000, our provisioning infrastructure was used primarily to provide domain registration services. Since then, a number of significant enhancements and architectural changes have been made to the infrastructure and its capabilities have been extended to the provisioning of additional Internet services, as previously discussed above.

The key components of our provisioning infrastructure are as follows:

- *Our OpenSRS Platform.* This platform acts as an interface between Service Providers, the Service Providers customers, third-party suppliers and our administration. Service Providers use the platform to provision services and recall and edit data with respect to already-provisioned services. To the extent permitted by the Service Providers business and technical infrastructure, the Service Providers customers can use the platform directly to manage their Internet services in an automated fashion. This includes the ability to add, delete, change and transfer domains. Third-party suppliers may have their services added to our OpenSRS platform, but also at our discretion and after a business evaluation has taken place. Our administrative staff use the OpenSRS platform to support Service Providers and their customers by accessing and, if appropriate, editing data about the provisioned services.
- Service Providers and end-users communicate with OpenSRS by any of the following means:
  - *Web Interfaces.* The OpenSRS Platform has web interfaces that allow Service Providers, end-users and our employees to access the OpenSRS platform from anywhere, at any time, in a secure fashion. The web interfaces, while unbranded, cannot be branded or otherwise customized.
  - *Application Programming Interfaces, or APIs.* The OpenSRS Platform has been designed to be rich in APIs. The APIs allow Service Providers to write software or web-based applications that perform at least substantially the same functions as would otherwise be available through the web interfaces, and often times with greater functionality. This is essentially how Service Providers brand or private-label our services. The existence of APIs enable Service Providers to write their own applications and fully integrate the provisioning of our services with the other services they provide on their websites. APIs also enable the Service Providers to create a web interface for their customers in which the management of our services is seamlessly integrated into the management of services that they provide.
  - *Open Source Client Code.* For Service Providers that do not want to write their own software or web-based applications using the APIs, we provide a set of written instructions, or Client Code, that Service Providers can install on their web servers to enable them to provision our services to their customers. Use of the Client Code is an efficient means of provisioning our services and, because the Client Code is open source, it gives the Service Provider flexibility in integrating and customizing the environment in which the services are provisioned and managed. Use of either the APIs or the Client Code for the provisioning of services allows the Service Provider to fully preserve their brand.
- *Our OpenHRS Platform.* We provide a hosted application to registrars that allows them to register domains using their own accreditation. This OpenHRS platform has been built using OpenSRS technology and is desirable for registrars because it relieves them of the burden of developing and maintaining their own domain registration infrastructure. Further, the OpenSRS infrastructure, upon which OpenHRS has been built, has already been tested through use in high demand,

real-world environments. This is a fee-based service, whereas OpenSRS is a transaction-based service.

#### **Downloadable Software Distribution Network Architecture**

We also manage an extensive network for distributing software and other digital content using proprietary software and standard hardware. The key elements of the accelerated content delivery network include central servers that we own and servers owned by Service Providers located at their facilities. Bandwidth and update times are minimized by utilizing mirroring software that sends compressed and incremental updates to local Service Providers and affiliates, which results in Service Providers' mirror sites being able to keep their libraries more current and provide customers with fresher content. Files are distributed among the mirror sites based on several proprietary algorithms that allow us to manage and host more files than could be maintained at any one location.

#### **Customer Service**

We seek to provide superior customer service by anticipating the technical requirements and business objectives of our Service Providers, such as customizable management of renewal processes, streamlining the process of adding additional services and providing solutions for dealing with the added administrative complexity of offering multiple services. We also provide our Service Providers with technical advice to help them understand how our applications and services can be customized for their particular needs. Service Providers may contact us by email or through our toll-free telephone number. An extensive library of frequently asked questions and answers is made available to all Service Providers through our website.

Our customer service team consists of trained technicians who draw on expertise throughout the organization to provide support in many languages and for an array of unique issues. These staff members handle general inquiries, investigate the status of orders and payments and answer technical questions about our applications and services. In response to customer inquiries, customer service representatives monitor site and network operations, refer complex problems to technical teams for resolution and make recommendations for future enhancements.

We pride ourselves on having developed a culture of customer service that pervades our entire organization. This can be attributed to the fact that we have always encouraged and provided easy means for our customers and resellers to communicate with anyone in the organization, as well as with each other. These communication avenues are monitored and utilized not only by support functions but also by our management.

We also use our own online discussion forums to communicate with our Service Providers. These forums have been used to discuss, among other things, suggestions or feedback on new features, marketing promotions and domain policy positions.

These forums are open to the public, which increases the level of scrutiny we face and the standard to which we are held. We believe that this, in turn, produces credibility with Service Providers. Problems that are raised in these forums are often solved by other Service Providers who have faced similar situations. This greatly increases the speed and breadth of responses the Service Provider is able to receive in a cost effective manner.

#### **Customers**

For the years ended December 31, 2006, 2005 and 2004, no single customer represented more than 10% of revenues.

### Competitive Conditions

The market for Internet services, including domain registrations, messaging, billing software and services, digital certificates, publishing, software and content distribution, and other Internet applications and services, is rapidly evolving and is highly competitive. Our competition may be divided into groups consisting of:

- domain registrars who market domains primarily on a retail basis, such as Network Solutions, Register.com, Yahoo and GoDaddy.com, and who compete with Service Providers for end-users;
- other domain registrars, such as eNom, Inc. and Melbourne IT, who market wholesale private label offerings to Service Providers;
- providers of billing software and services to telecommunications companies and Service Providers, such as Portal Software and Rodopi;
- providers of messaging services to Service Providers, such as Google, Microsoft, Postini and Everyone.net;
- providers of publishing services to Service Providers, such as Google, Xanga, Microsoft, Six Apart and CM4All; and
- providers of software downloads and other open source related content, such as CNET.

We expect to continue to experience significant competition from the competitors identified above, and, as our business develops and we compete in an increasingly broad range of Internet services, we expect to encounter competition from other providers of Internet services. Service Providers, Internet portals, web hosting companies, email hosting companies, outsourced application companies, country code registries and major telecommunication firms may broaden their service offerings to include outsourced domain registrations and other Internet applications and service solutions.

We believe that the primary competitive factors in our domain registration and downloadable software distribution businesses are:

- providing superior customer service by anticipating the technical requirements and business objectives of the Service Providers and providing them with technical advice to help them understand how our applications and services can be customized for their particular needs;
- providing cost savings over in-house solutions by relieving Service Providers of the expense of acquiring and maintaining hardware and software and the associated administrative burden;
- providing greater functionality and access to Internet applications and services, which in turn enables Service Providers to choose the application that best suit their end-users' needs;
- enabling Service Providers to better manage their relationships with their end-users;
- facilitating scalability through an infrastructure designed to support millions of transactions across millions of end-users; and
- our technology and infrastructure, consisting of advanced software and hardware that allows Service Providers to provide Internet services to their customers without having to make substantial investments in their own software or hardware.

Although we encounter pricing pressure in many markets in which we compete, we believe the effects of that pressure are mitigated by the fact that we deliver a high degree of value to our Service Providers through our business support practices and financial and technical integration.

We believe our status as a trusted supplier also allows us to mitigate the effects of this type of competition. We believe that the

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long-term relationships we have made with many Service Providers results in a sense of certainty that would not be available to the Service Provider through a competitor.

### **Intellectual Property**

We believe that we are well positioned in the content services and domain registration markets due in part to our highly recognized Tucows brand. Our success and ability to compete are dependent on our ability to develop and maintain the proprietary aspects of our brand name and technology. We rely on a combination of trademark, trade secret and copyright laws, as well as contractual restrictions, to protect our intellectual property rights.

We have registered the Tucows trademark in the United States, Canada and the European Union and will seek to register additional service marks and trademarks as appropriate.

We seek to limit disclosure of our intellectual property by requiring all employees and consultants with access to our proprietary information to execute confidentiality, non-disclosure and work-for-hire agreements. All of our employees are required to execute confidentiality and non-use agreements, which provide that any rights they may have in copyrightable works or patentable technologies accrue to us. Before entering into discussions with potential content providers and network partners about our business and technologies, we require these parties to enter into a non-disclosure agreement. If these discussions result in a license or other business relationship, we also generally require that the agreement containing the parties' rights and obligations include provisions for the protection of its intellectual property rights.

Effective trademark, service mark, copyright and trade secret protection may not be available in every country in which our services are or will be made available. We also expect to license proprietary rights such as trademarks or copyrighted material to network partners during planned national and international expansion.

### **Seasonality**

During the summer months and certain other times of the year, such as major holidays, Internet usage often declines. As a result, our websites may experience reduced user traffic. For example, our experience shows that new user registrations and site usage declines during the summer months and around the year-end holidays. Seasonality may also affect advertising and affiliate performance that could affect the performance of its websites. These seasonal effects could cause fluctuations in our financial results as well as our performance statistics reported and measured by leading Internet audience measurement services such as Media Metrix, Inc.

### **Trend Towards Outsourcing**

While Service Providers are capitalizing on the growth in Internet usage and the demand for new e-business applications and services, they also face significant competition from numerous other Service Providers offering similar applications and services. This has led to a greater focus on core competencies, as Service Providers are increasingly seeking to outsource non-core applications and services that they provide to their end-users. Outsourcing enables these Service Providers to focus better on their customer acquisition and retention efforts by eliminating the need to own, develop and support non-core applications in-house.

## Employees

We believe that one of our strengths is the quality and dedication of our people and the shared sense of being part of a team. We strive to maintain a work environment that fosters professionalism, excellence, diversity and cooperation among our employees. As of December 31, 2006, we had approximately 200 full time employees. None of our employees are currently represented by a labor union. We consider our relations with our employees to be good.

## Executive Officers of the Registrant

The following table sets forth specific information regarding our executive officers as of March 26, 2007.

| Name              | Age | Position(s)                           |
|-------------------|-----|---------------------------------------|
| Elliot Noss       | 44  | President and Chief Executive Officer |
| Michael Cooperman | 55  | Chief Financial Officer               |
| David Woroch      | 44  | Vice President, Sales                 |
| Alain Chesnais    | 50  | Vice President, Product Development   |
| Judith Fields     | 46  | Vice President, Operations            |
| Carla Goertz      | 49  | Vice President, Human Resources       |

**Elliot Noss** has served as our president and chief executive officer since May 1999 and served as vice president of corporate services for Tucows Interactive Limited, which was acquired by Tucows in May 1999, from April 1997 to May 1999.

**Michael Cooperman** has served as our chief financial officer since January 2000. From October 1997 to September 1999, Mr. Cooperman was the chief executive officer of Archer Enterprise Systems Inc., a developer of sales force automation software.

**David Woroch** has served as our vice president, sales since July 2001. From March 2000 to July 2001, Mr. Woroch served as our director of sales for North America. Before joining us, Mr. Woroch spent 13 years at IBM Canada in a variety of roles including sales, marketing, finance and strategic planning.

**Alain Chesnais** has served as our vice president, product development since July 2005. Before joining us, Mr. Chesnais held the position of director of software development programs at ATI Technologies Inc from April 2004 to July 2005. He held the position of vice president of engineering at TrueSpectra during the period of June 2000 to November 2003 and from May 1993 to June 2000; he held the position of director of engineering at Alias/Wavefront/TDI.

**Judith Fields** has served as our vice president, operations since July 2005. Prior to her promotion in July 2005, Ms. Fields held the position as our director of business systems since 2000. Prior to joining us Ms. Fields worked for Loblaw's Companies Limited from 1985 until 1999 where she held a variety of senior roles in both Information Services and Business Systems Development.

**Carla Goertz** has served as our vice president, human resources since August 2005. Before joining us Ms. Goertz held the position of director human resources at TechData Canada from April 2004 to July 2005. From November 2001 to July 2003, she held the position of vice president of human resources and administration for Castek Inc. Prior to joining Castek Inc. she held the role of vice president human resources at Systems Xcellence Inc.

The executive officers are elected or appointed by our board of directors to serve until the election or appointment and qualification of their successors or their earlier death, resignation or removal.





## Investor Information

Our web site address is [www.tucowsinc.com](http://www.tucowsinc.com). We make available through our web site, free of charge, copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after filing such material electronically or otherwise furnishing it to the SEC.

The information on the web site listed above is not and should not be considered part of this Annual Report on Form 10-K and is not incorporated by reference in this document.

We were incorporated in the Commonwealth of Pennsylvania in November 1992. Our executive offices are located at 96 Mowat Avenue, Toronto, Ontario, Canada M6K 3M1. Our telephone number is (416) 535-0123.

## ITEM 1A. RISK FACTORS

*Our business faces significant risks. Some of the following risks relate principally to our business and the industry and statutory and regulatory environment in which we operate. Other risks relate principally to the securities markets and ownership of our stock. The risks described below may not be the only risks we face. Additional risks that we do not yet know of or that we currently think are immaterial may also impair our business operations. If any of the events or circumstances described in the following risk factors actually occur, our business, financial condition or results of operations could suffer, and the trading price of our common stock could decline.*

### Risks Related to Our Business and Industry

*We may not be able to maintain or improve our competitive position and may be forced to reduce our prices because of strong competition in the market for Internet services generally and domain name registration in particular, which we expect will continue to intensify.*

The market for Internet services generally and domain registrations in particular is intensely competitive and rapidly evolving as participants strive to protect their current market share and improve their competitive position. Most of our existing competitors are also expanding the variety of services that they offer. These competitors include, among others, domain name registrars, website design firms, website hosting companies, Internet service providers, Internet portals and search engine companies, including Google, Microsoft, Network Solutions, VeriSign and Yahoo!. Competitors like Microsoft, Google and Yahoo!, as well as other large Internet companies, have the ability to offer these services for free or at a reduced price as part of a bundle with other service offerings. If these companies decide to devote greater resources to the development, promotion and sale of these new products and services, greater numbers of individuals and businesses may choose to use these competitors as their starting point for creating an online presence and as a general platform for running their online business operations. In particular, VeriSign may in the future decide to offer additional services that compete with our domain name registration services or other services. If VeriSign were to become a competitor of ours in our core business areas, VeriSign would likely enjoy a number of competitive advantages, including its position as the largest registry, as well as superior financial and operational resources and customer awareness within our industry.

In addition, other large competitors, in an attempt to gain market share, may also offer aggressive price discounts on the services they offer. These pricing pressures may require us to match these discounts in order to remain competitive, which would reduce our margins, or potentially cause us to lose customers altogether who decide to purchase these discounted services.

We also face significant competition from other existing registrars and the continued introduction of new registrars in the domain registration industry. As of February 28, 2007, ICANN had accredited 863 competitive registrars, including our company, to register domains in one or more of the gTLDs, though not all of these accredited registrars are operational. There are relatively few barriers to entry in this market and the continued introduction of competitive registrars and Service Providers into the domain registration industry and the rapid growth of some competitive registrars and Service Providers who have already entered the industry may make it difficult for us to maintain our current market share. Some of these registrars may have longer operating histories, greater name recognition, particularly in international markets, or greater resources than us. We expect that competition will increase in the near term and that our primary long-term competitors may not yet have entered the market. As a result, we may not be able to compete effectively.

As our business model is premised upon selling multiple services through our Service Providers, we have competed aggressively to attract new clients and retain existing customers. As a result of these actions, our average selling prices have fallen and we may be required, by marketplace factors or otherwise, to reduce, perhaps significantly, the prices we charge for our domain registration and related products and services. The decline in our average selling price has partially offset the impact of increased transaction volume on our revenue and profitability. The likelihood of further declines in our selling price will increase if our competitors who charge these reduced fees are able to maintain customer service comparable to ours. We may face continued pricing pressure in order to remain competitive, which would adversely impact our revenues and profitability. While we anticipate that the number of new, renewed and transferred-in domain registrations will incrementally increase, volatility in the market could result in our customers turning to other registrars, thereby impairing growth in the number of domains under our management and our ability to sell multiple services to such customers. Since our strategy is to expand the services we provide our customers, if we are unable to maintain our domain registrations, our ability to expand our business may be adversely effected.

***Each registry and the ICANN regulatory body impose a charge upon the registrar for the administration of each domain registration. If these fees increase, this may have an impact upon our profits.***

Each registry typically imposes a fee in association with the registration of each domain. For example, the VeriSign registry presently charges a \$6 fee for each .com registration. ICANN charges a \$0.25 fee for each domain name registered in the TLDs that fall within its purview. We have no control over these agencies and cannot predict when they may increase their respective fees. In terms of the new registry agreement between ICANN and Verisign that was approved by the U.S. Department of Commerce on November 30, 2006, VeriSign will continue as the exclusive registry for the .com TLD and is entitled to increase the fee it receives for each .com domain name registration by 7% annually in any four of the six years through 2012, and potentially beyond that date. Any increase in these fees must either be included in the prices we charge to our Service Providers, imposed as a surcharge or must be absorbed by us. If we absorb such cost increases or if surcharges act as a deterrent to registration, we may find that our profits are adversely impacted by these third-party fees.

***We rely on our network of Service Providers to renew their domain registrations through us and to distribute our applications and services, and if we are unable to maintain these relationships or establish new relationships, our revenues will decline.***

The growth of our business depends on, among other things, our Service Providers' renewal of their customers' domain registrations through us. Service Providers may choose to renew their domains with other registrars or their registrants may choose not to renew and pay for renewal of their domains. This may reduce our Service Providers' number of domain name registration customers which in turn would drive up their customer acquisition costs and harm our operating results. If Service Providers decide, for

any reason, not to renew their registrations through us, it may in turn reduce the market to which our Service Providers could market our other higher-margin services, thereby further impacting our revenue and profitability and harming our operating results. Since our strategy is to expand the number of services we provide to our customers, any decline in renewals of domain name registrations that are not offset by new domain name registrations would likely have an adverse effect on our business and results of operations.

***We believe that companies operating on the Internet are facing a period of consolidation. In addition, some of our Service Providers may decide to seek ICANN accreditation. Both of these situations could reduce the number of our active Service Providers, in which case our revenues may suffer.***

If any of our competitors merge with one another, they will present a stronger combined force in the market and may attract the business of both existing and prospective Service Providers. Service Providers may opt to build their own technical systems and seek ICANN accreditation in order that they may process domain applications themselves. If a number of our customers decide to pursue this option, our sales will decrease.

***Our failure to secure agreements with country code registries or our subsequent failure to comply with the regulations of the country code registries could cause customers to seek a registrar that offers these services.***

The country code top-level domain, or ccTLD, registries require registrars to comply with specific regulations. Many of these regulations vary from ccTLD to ccTLD. If we fail to comply with the regulations imposed by ccTLD registries, these registries will likely prohibit us from registering or continuing to register domains in their ccTLD. Any failure on our part to offer domain registrations in a significant number of ccTLDs or in a popular ccTLD would cause us to lose a competitive advantage and could cause Service Providers to elect to take their business to a registrar that does offer these services.

***Our standard agreements may not be enforceable, which could subject us to liability.***

We operate on a global basis and all of our Service Providers must execute our standard agreements that govern the terms of the services we provide to our customers. These agreements contain provisions intended to limit our potential liability arising from the provision of services to our Service Providers and their customers, including liability resulting from our failure to register or maintain domains properly, from downtime or poor performance with respect to our Internet services, or for insecure or fraudulent transactions pursuant to which we have issued SSL certificates. As most of our customers purchase our services online, execution of our agreements by Service Providers occurs electronically or, in the case of our terms of use, is deemed to occur because of a user's continued use of the website following notice of those terms. We believe that our reliance on these agreements is consistent with the practices in our industry, but if a domestic, foreign or international court were to find that either one of these methods of execution is invalid or that key provisions of our services agreements are unenforceable, we could be subject to liability that has a material adverse effect on our business or we could be required to change our business practices in a way that increases our cost of doing business.

***Regulation could reduce the value of Internet domain names or negatively impact the Internet domain acquisition process, which could significantly impair the value attributable to our acquisitions of Internet domain names.***

The acquisition of expiring domain names for parked page commercialization, sale of names or acquisition of names for other uses, involves the registration of thousands of Internet domain names, both in the United States and internationally. We have and intend to continue to acquire previously-owned Internet domain names that have expired and have, following the period of permitted reclamation by their prior owners, been made available for sale. Furthermore, in addition to the names we acquired in our acquisition of Mailbank.com Inc., in June 2006, we have separately acquired and intend to continue to

acquire in the future other previously-owned Internet domain names. The acquisition of Internet domain names generally is governed by federal or international regulatory bodies. The regulation of Internet domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional requirements for previously-owned Internet domain names or modify the requirements for holding Internet domain names. As a result, we might not acquire or maintain names that contribute to our financial results in the same manner as we currently do. Because certain Internet domain names are important assets, a failure to acquire or maintain such Internet domain names could adversely affect our financial results and our growth. Any impairment in the value of these important assets could cause our stock price to decline.

*If we cannot obtain or develop additional applications and services that are appealing to our customers, we may remain dependent on domain registrations as a primary source of revenue and our net revenues may fall below anticipated levels.*

A key part of our long-term strategy is to diversify our revenue base by offering our Service Providers additional value-added products and services that address their evolving business needs. Although we have recently experienced increased sales for new products and services such as email and web certificates, our efforts to date have not resulted in substantial diversification. We cannot be sure that we will be able to license new applications and services at a commercially viable cost or at all, or that we will be able to cost-effectively develop the applications in-house. If we cannot obtain or develop these applications on a cost-effective basis and cannot expand the range of our service offerings, sales of our services may suffer as Service Providers turn to alternate providers that are able to more fully supply their business needs.

*As part of our diversification strategy, in January 2006 we acquired the hosted messaging business of Critical Path, Inc., a leading email services provider. The acquisition expands our presence in the email market but also increases our exposure in this volatile business.*

Factors that are likely to contribute to fluctuations in our operating results from provisioning hosted email services include:

- the demand for outsourced messaging services;
- our ability to attract and retain customers and provide customer satisfaction;
- the ability to upgrade, develop and maintain our systems and infrastructure and to effectively respond to the rapid technological changes in the messaging market;
- the budgeting and payment cycles of our existing and potential customers;
- the amount and timing of operating costs and capital expenditures relating to expansion of the messaging business; and
- the introduction of new or enhanced services by competitors.

In order to succeed in the hosted messaging business, our email product must remain competitive. We believe that some of the competitive factors affecting the market for hosted messaging services include:

- breadth of platform features and functionality of our offering and the sophistication and innovation of our competitors;
- scalability, reliability, performance and ease of expansion and upgrade;
- ease of integration with customers existing systems; and

- flexibility to enable customers to manage certain aspects of their systems and leverage outsourced services in other cases when resources, costs and time to market reasons favor an outsourced offering.

We believe competition will continue to be strong and further increase as our market attracts new competition, current competitors aggressively pursue customers, increase the sophistication of their offerings and as new participants enter the market. Many of our current and potential customers have longer operating histories, larger customer bases, greater brand recognition in the business and greater financial, marketing and other resources than we do. Any delay in our development and delivery of new services or enhancement of existing services would allow our competitors additional time to improve their product offerings and provide time for new competition to develop and market messaging services. Increased competition could result in pricing pressures, reduced operating margins and loss of market share, any of which could cause our financial results to decline.

***If we are unable to maintain our relationships with our customers, our revenue may decline.***

Our network of Service Providers are our principal source for distributing services. We also rely on our Service Providers to market, promote and sell our services. Our ability to increase revenues in the future will depend significantly on our ability to maintain our customer network, to sell more services through existing Service Providers and to develop our relationships with existing Service Providers by providing customer and sales support and additional products. Service Providers have no obligations to distribute our applications and services and may stop doing so at any time. If we are not able to maintain our relationships with Service Providers, our ability to distribute our applications and services will be harmed, and our revenue may decline.

With respect to our hosted eMail service, we rely on a limited number of customers for a high percentage of our revenues. The loss of one or several of these major customers, whether through termination of agreement, acquisition or bankruptcy, could have a significant impact on our revenues. Our agreements with our email customers typically have terms of one to three years often with automatic one-year renewals and can be terminated without cause upon certain notice periods that vary among our agreements and range from a period of 30 to 120 days notice.

***The international nature of our business exposes us to certain business risks that could limit the effectiveness of our growth strategy and cause our results of operations to suffer.***

Expansion into international markets is an element of our growth strategy. Introducing and marketing our services internationally, developing direct and indirect international sales and support channels and managing foreign personnel and operations will require significant management attention and financial resources. We face a number of risks associated with expanding our business internationally that could negatively impact our results of operations, including:

- management, communication and integration problems resulting from cultural differences and geographic dispersion;
- compliance with foreign laws, including laws regarding liability of online service providers for activities of customers and more stringent laws in foreign jurisdictions relating to the privacy and protection of third-party data;
- accreditation and other regulatory requirements to provide domain name registration, website hosting and other services in foreign jurisdictions;
- competition from companies with international operations, including large international competitors and entrenched local companies;

- to the extent we choose to make acquisitions to enable our international expansion efforts, the identification of suitable acquisition targets in the markets into which we want to expand;
- difficulties in protecting intellectual property rights in international jurisdictions;
- political and economic instability in some international markets;
- sufficiency of qualified labor pools in various international markets;
- currency fluctuations and exchange rates;
- potentially adverse tax consequences or an inability to realize tax benefits; and
- the lower level of adoption of the Internet in many international markets.

We may not succeed in our efforts to expand our international presence as a result of the factors described above or other factors that may have an adverse impact on our overall financial condition and results of operations.

***We currently license many third party technologies and may need to license further technologies which could delay and increase the cost of product and service developments***

We currently license certain technologies from third parties and incorporate them into certain of our services including email, anti-spam, anti-virus and web site publishing tools. The Internet services market is evolving and we may need to license additional technologies to remain competitive. We may not be able to license these technologies on commercially reasonable terms or at all. To the extent we cannot license necessary solutions, we may have to devote our resources to development of such technologies, which could delay and increase the cost of product and service developments overall.

In addition, we may fail to successfully integrate licensed technology into our services. These third party licenses may expose us to increased risks, including risks related to the integration of new technology and potential intellectual property infringement claims. In addition, an inability to obtain needed licenses could delay product and service development until equivalent technology can be identified, licensed and integrated. Any delays in services or integration problems could hinder our ability to attract and retain customers and cause our business and operating results to suffer.

***We depend on third parties for free and low cost web-based content.***

We access and provide web-based content for certain of our content notification and other sites. We access this content mainly by searching selected websites and then providing links to relevant content from the individual sites. Typically, we pay no fee, or a nominal fee, for accessing web-based content in this manner. Our ability to continue to use web-based content in this manner without cost, or for nominal fees, is fundamental to our goal of providing free, or low cost, content notification sites. If the market changes and owners begin to charge more significant fees for accessing material from their websites, we will incur additional expenses to provide the service or we may decide to no longer provide the service.

***Our advertising revenues may be subject to fluctuations.***

We believe that Internet advertising spending, as in traditional media, fluctuates significantly with economic cycles and during any calendar year, with spending being weighted towards the end of the year to reflect trends in the retail industry. Our advertisers can generally terminate their contracts with us at any time. Advertising spending is particularly sensitive to changes in general economic conditions and typically decreases when economic conditions are not favorable. A decrease in demand for Internet advertising could have a material adverse affect on our business, financial condition and results of operations.



***We may acquire companies or make investments in, or enter into licensing arrangements with, other companies with technologies that are complementary to our business and these acquisitions or arrangements could disrupt our business, cause us to require additional financing and dilute your holdings in our company.***

We may acquire companies, assets or the rights to technologies in the future in order to develop new or enhance existing services, to enhance our operating infrastructure, to fund expansion, to respond to competitive pressures or to acquire complementary businesses. Entering into these types of arrangements entails many risks, any of which could materially harm our business, including:

- the diversion of management's attention from other business concerns;
- the failure to effectively integrate the acquired technology or company into our business;
- the incursion of significant acquisition costs;
- the loss of key employees from either our current business or the acquired business; and
- the assumption of significant liabilities of the acquired company.

In addition, absent sufficient cash flows from operations, we may need to engage in equity or debt financings to secure additional funds to meet our operating and capital needs. We may not be able to secure additional debt or equity financing on favorable terms, or at all, at the time when we need that funding. In addition, even though we may have sufficient cash flow, we may still elect to sell additional equity or debt securities or obtain credit facilities for other reasons. If we raise additional funds through further issuances of equity or convertible debt securities, our existing shareholders could suffer significant dilution in their percentage ownership of our company, and any new equity securities we issue could have rights, preferences and privileges senior to those of holders of our common stock. Any debt financing secured by us in the future could involve restrictive covenants relating to our capital raising activities and other financial and operational matters, which might make it more difficult for us to obtain additional capital, to pay dividends and to pursue business opportunities, including potential acquisitions. In addition, if we decide to raise funds through debt or convertible debt financings, we may be unable to meet our interest or principal payments.

Any of the foregoing or other factors could harm our ability to achieve anticipated levels of profitability from acquired businesses or to realize other anticipated benefits of acquisitions. We may not be able to identify or consummate any future acquisitions on favorable terms, or at all. If we do effect an acquisition, it is possible that the financial markets or investors will view the acquisition negatively. Even if we successfully complete an acquisition, it could adversely affect our business.

***Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the innovation, creativity and teamwork fostered by our culture, and our business may be harmed.***

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity and teamwork. As our organization grows and we are required to implement more complex organizational management structures, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future success.

***Our business depends on a strong brand. If we are not able to maintain and enhance our brand, our ability to expand our customer base will be impaired and our business and operating results will be harmed.***

We believe that the brand identity we have developed has significantly contributed to the success of our business. We also believe that maintaining and enhancing the Tucows brand is critical to expanding our customer base. We anticipate that, as our market becomes increasingly competitive, maintaining and enhancing our brand may become increasingly difficult and expensive. Maintaining and enhancing our brand will depend largely on our ability to be a technology leader providing high quality products and



services, which we may not do successfully. To date, we have engaged in relatively little direct brand promotion activities. This enhances the risk that we may not successfully implement brand enhancement efforts in the future.

***If we fail to protect our proprietary rights, the value of those rights could be diminished.***

We rely upon copyright, trade secret and trademark law, confidentiality and nondisclosure agreements, invention assignment agreements and work-for-hire agreements to protect our proprietary technology, all of which offer only limited protection. We cannot ensure that our efforts to protect our proprietary information will be adequate to protect against infringement and misappropriation by third parties, particularly in foreign countries where laws or law enforcement practices may not protect proprietary rights as fully as in the United States and Canada.

We have licensed, and may in the future license, some of our trademarks and other proprietary rights to others. Third parties may also reproduce or use our intellectual property rights without seeking a license and thus benefit from our technology without paying for it. Third parties could also independently develop technology, processes or other intellectual property that are similar to or superior to those used by us. Actions by licensees, misappropriation of the intellectual property rights or independent development by others of similar or superior technology might diminish the value of our proprietary rights or damage our reputation.

The unauthorized reproduction or other misappropriation of our intellectual property rights, including copying the look, feel and functionality of our website could enable third parties to benefit from our technology without us receiving any compensation. The enforcement of our intellectual property rights may depend on our taking legal action against these infringing parties, and we cannot be sure that these actions will be successful.

Because of the global nature of the Internet, our websites can be viewed worldwide. However, we do not have intellectual property protection in every jurisdiction. Furthermore, effective trademark, service mark, copyright and trade secret protection may not be available in every country in which our services become available over the Internet. In addition, the legal standards relating to the validity, enforceability and scope of protection of intellectual property rights in Internet-related industries are uncertain and still evolving.

***We may not be able to realize the intended and anticipated benefits from our acquisitions of expiring domain names, which could affect the value of these acquisitions to our business and our ability to meet our financial obligations and targets.***

We may not be able to realize the intended and anticipated benefits that we currently expect from our acquisitions of expiring domain names. These intended and anticipated benefits include increasing our cash flow from operations, broadening our Internet service offerings and delivering services that strengthen our Service Provider relationships.

Factors that could affect our ability to achieve these benefits include:

- A significant amount of revenue attributed to our domain name assets comes from the provision of personalized email services and the generation of revenue from third party advertisements on parked pages. Some of our existing Service Providers who provide similar services may perceive this as a competitive threat and therefore may decide to terminate their agreements with us because of our recent acquisitions of a substantial number of expiring domain names.
- We will need to continue to acquire commercially valuable expiring domain names to grow our presence in the field of direct navigation. We will need to continuously improve our technologies to acquire valuable expiring domain names as competition in the marketplace for appropriate expiring

domain names intensifies. Our domain name acquisition efforts are subject to rules and guidelines established by registries which maintain Internet domain name registrations and other registrars who process and facilitate Internet domain name registrations. The registries and registrars may change the rules and guidelines for acquiring expiring domains in ways that may prove detrimental to our domain name acquisition efforts.

- The business of direct navigation is dependent on current technologies and user practices. If browser or search technologies were to change significantly, the practice of direct navigation may be altered to our disadvantage.

If the acquired assets are not integrated into our business as we anticipate, we may not be able to achieve the benefits of these acquired assets or realize the value paid for the asset acquisitions, which could materially harm our business, financial condition and results of operations.

*We may not be able to realize the intended and anticipated benefits from our acquisition of Mailbank.com Inc., which may impact the value of this acquisition to our business and our ability to meet our financial obligations and targets.*

In June 2006, the Company acquired Mailbank.com Inc., a provider of personalized email services and the owner of a large collection of surname domain addresses. We plan to use these assets to offer personalized Internet services directly to end-users through Domain Direct and through our channel of Service Providers as well as to generate income from the parked page of each domain address.

Factors that could affect our ability to achieve the intended benefits include:

- Our ability to market this new offering to our channel of Service Providers and their consequent interest in selling the personalized email service to their respective end users.
- Our ability to acquire additional surname based domain names in order to expand the portfolio to attract the greatest number of potential end users.

If the acquired assets are not integrated into our business as anticipated, we may not be able to achieve the intended benefits of these acquired assets or realize the value paid for the assets acquired, which could materially harm our business, financial condition and results of operations.

*We do not control the means by which end user access our web sites and material changes to current navigation practices or technologies or marketing practices could result in a material adverse effect on our business.*

The success of our parked pages business depends in large part upon the current end user tendency to type desired destinations directly into the web browser. End users employ this practice of direct navigation to access our web sites primarily through the following methods: directly accessing our web sites by typing descriptive keywords or keyword strings into the uniform resource locator (URL) address box of an Internet browser, accessing our web sites by clicking on bookmarked web sites and accessing our web sites indirectly through search engines and directories.

Each of these methods requires the use of a third party product or service, such as an Internet browser or search engine or directory. Internet browsers may provide alternatives to the URL address box to locate web sites, and search engines may from time to time change and establish rules regarding the indexing and optimization of web sites. Product developments and market practices for these means of access to our web sites are not within our control. We may experience a decline in traffic to our web sites if third party browser technologies or search engine methodologies and rules, including those affecting marketing efforts, are changed to our disadvantage.

***If the practice of direct navigation becomes less popular either as a result of evolving technologies or user practices, our ability to generate revenue from the practice of click through advertising may suffer.***

A significant amount of revenue generated from the commercialization of domain names owned by the Company is dependent on our agreements with third party providers. The monetization of these domain names is currently largely dependent on the paid listings allocated by these providers to the websites associated with our domain names. This allocation may depend on each provider's advertiser base, internal policies and other factors and determinations that may or may not be controlled by or known to us.

***We may experience unforeseen liabilities in connection with our domain name portfolio, including our acquisition of the Mailbank.com Inc. domain name portfolio, which could negatively impact our financial results.***

***The acquisition of Mailbank.com Inc. involved the acquisition of a portfolio of previously owned domain names. In addition, we are currently acquiring and intend to continue to acquire other previously owned domain names. In some cases, these acquired domain names may have trademark significance that is not apparent to us. As a result, we may face demands by third party trademark owners asserting infringement or dilution of their rights and seeking transfer of the domain names through the Uniform Domain Name Resolution Policy adopted by ICANN. We may also face actions from third-parties under national trademark or anti-competition legislation.***

We review each claim or demand on its merits and we intend to transfer any such previously owned domain names acquired by us to parties that have demonstrated a valid prior right. We cannot guarantee that we will be able to resolve all such disputes without litigation. The potential violation of third party intellectual property rights may subject us to unforeseen liabilities, including injunctions and claims for monetary damages.

***Once any infringement is detected, disputes concerning the ownership or rights to use intellectual property could be costly and time-consuming to litigate, may distract management from operating the business, and may result in us losing significant rights and our ability to operate all or a portion of our business.***

Claims of infringement of intellectual property or other rights of third parties against us could result in substantial costs. Third parties may assert claims of infringement of patents or other intellectual property rights against us concerning past, current or future technologies.

Content obtained from third parties and distributed over the Internet by us may result in liability for defamation, negligence, intellectual property infringement, product or service liability and dissemination of computer viruses or other disruptive problems. We may also be subject to claims from third parties asserting trademark infringement, unfair competition and violation of publicity and privacy rights relating specifically to domains. These claims may include claims under the *Anti-cybersquatting Consumer Protection Act*, or ACPA, which was enacted in the United States to curtail the registration of a domain that is identical or similar to another party's trademark or the name of a living person with the bad faith intent to profit from use of the domain.

These claims and any related litigation could result in significant costs of defense, liability for damages and diversion of management's time and attention. Any claims from third parties may also result in limitations on our ability to use the intellectual property subject to these claims unless we are able to enter into agreements with the third parties making these claims. If a successful claim of infringement is brought against us and we fail to develop non-infringing technology or to license the infringed or similar technology on a timely basis, we may have to limit or discontinue the business operations which used the infringing technology.

We rely on technologies licensed from other parties. These third-party technology licenses may infringe on the proprietary rights of others and may not continue to be available on commercially reasonable terms, if at all. The loss of this technology could require us to obtain substitute technology of lower quality or performance standards or at greater cost, which could increase our costs and make our products and services less attractive to customers.

***The law relating to the liability of online services companies for data and content carried on or disseminated through their networks is currently unsettled and could expose us to unforeseen liabilities.***

It is possible that claims could be made against online services companies under U.S., Canadian or foreign law for defamation, negligence, copyright or trademark infringement, or other theories based on data or content disseminated through their networks, even if a user independently originated this data or content. Several private lawsuits seeking to impose liability upon Internet service companies have been filed in U.S. and foreign courts. While the United States has passed laws protecting ISPs from liability for actions by independent users in limited circumstances, this protection may not apply in any particular case at issue. Our ability to monitor, censor or otherwise restrict the types of data or content distributed through our network is limited. Failure to comply with any applicable laws or regulations in particular jurisdictions could result in fines, penalties or the suspension or termination of our services in these jurisdictions. Our insurance may not be adequate to compensate or may not cover us at all in the event we incur liability for damages due to data and content carried on or disseminated through our network. Any costs not covered by insurance that are incurred as a result of this liability or alleged liability, including any damages awarded and costs of litigation, could harm our business and prospects.

***Privacy concerns relating to our technology could damage our reputation and deter current and potential users from using our services.***

From time to time, concerns have been expressed about whether our services compromise the privacy of our users and others. Concerns about our practices with regard to the collection, use, disclosure or security of personal information or other privacy-related matters, even if unfounded, could damage our reputation and operating results and expose us to litigation and possible liability, including claims for unauthorized purchases with credit card information, impersonation, or fraud claims and other claims relating to the misuse of personal information and unauthorized marketing purposes. While we strive to comply with all applicable data protection laws and regulations, as well as our own privacy policies, any failure or perceived failure to comply may result in proceedings or actions against us by government entities or others, which could potentially have an adverse effect on our business.

In addition, due to the fact that our services are web based, the amount of data we store for our users on our servers (including personal information) has been increasing. Any systems failure or compromise of our security that results in the release of our users' data could seriously limit the adoption of our services as well as harm our reputation and brand and, therefore, our business. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand the number of Internet services we offer.

A large number of legislative proposals pending before the United States Congress, various state legislative bodies and foreign governments concern data protection. In addition, the interpretation and application of data protection laws in Europe and elsewhere are still unsettled. We cannot guarantee that our current information-collection procedures and disclosure policies will be found to be in compliance with existing or future laws or regulations. If our policies and procedures are found not to be in compliance, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could in turn have a material effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

***Because we are required to recognize revenue for our services over the term of the applicable customer agreement, changes in our sales may not be immediately reflected in our operating results.***

We recognize revenue from our customers ratably over the respective terms of their agreements with us as required by GAAP. Typically, our domain name registration agreements have terms that range from one to ten years, and our website hosting agreements have annual or month-to-month terms. Accordingly, increases in sales during a particular period do not translate into immediate, proportional increases in revenue during that period, and a substantial portion of the revenue that we recognize during a quarter is derived from deferred revenue from customer agreements that we entered into during previous quarters. As a result, we may not generate net earnings despite substantial sales activity during a particular period, since we are not permitted under GAAP to recognize all of the revenue from these sales immediately, and because we are required to reflect a significant portion of our related operating expenses in full during that period. Conversely, the existence of substantial deferred revenue may prevent deteriorating sales activity from becoming immediately observable in our consolidated statement of operations.

In addition, we may not be able to adjust spending in a timely manner to compensate for any unexpected revenue shortfall, and any significant shortfall in revenue relative to planned expenditures could negatively impact our business and results of operations.

***Currency fluctuations may adversely affect us.***

Our revenue is primarily realized in U.S. dollars and a significant portion of our operating expenses is 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 financial exposure to certain foreign exchange fluctuations with the objective of neutralizing some 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. We do not account for these instruments as hedges in our consolidated financial statements.

***If we do not maintain a low rate of credit card chargebacks, we will face the prospect of financial penalties and could lose our ability to accept credit card payments from customers, which would have a material adverse affect on our business, financial condition and results of operations.***

A substantial majority of our revenues originates from online credit card transactions. Under current credit card industry practices, we are liable for fraudulent and disputed credit card transactions because we do not obtain the cardholder's signature at the time of the transaction, even though the financial institution issuing the credit card may have authorized the transaction. Under credit card association rules, penalties may be imposed at the discretion of the association. Any such potential penalties would be imposed on our credit card processor by the association. Under our contract with our processor, we are required to reimburse our processor for such penalties. Our current level of fraud protection, based on our fraudulent and disputed credit card transaction history, is within the guidelines established by the credit card associations. However, we face the risk that one or more credit card associations may, at any time, assess penalties against us or terminate our ability to accept credit card payments from customers, which would have a material adverse affect on our business, financial condition and results of operations.

***Forecasting our tax rate is complex and subject to uncertainty.***

We are subject to income and other taxes in a number of jurisdictions and our tax structure is subject to review by both domestic and foreign tax authorities. We must make significant assumptions, judgments

and estimates to determine our current provision for income taxes, deferred tax assets and liabilities and any valuation allowance that may be recorded against our deferred tax assets. Although we believe that our estimates are reasonable, the ultimate determination of our tax liability is always subject to review by the applicable tax authorities. Any adverse outcome of such a review could have a negative effect on our operating results and financial condition in the period or periods for which such determination is made. Our current and future tax liabilities could be adversely affected by:

- international income tax authorities, including the Canada Revenue Agency and the U.S. Internal Revenue Service, challenging the validity of our arm's-length related party transfer pricing policies or the validity of our contemporaneous documentation.
- changes in the valuation of our deferred tax assets; or
- changes in tax laws, regulations, accounting principles or the interpretations of such laws.

*While we believe we have adequate internal control over financial reporting, we are required to evaluate our internal controls under Section 404 of the Sarbanes-Oxley Act of 2002. Any adverse results from such evaluation could result in a loss of investor confidence in our financial reports and have an adverse effect on the price of our shares of common stock.*

We are currently in the process of planning for the evaluation, documentation and testing of our internal control systems in order to permit our management to be in a position to report on our internal controls over financial reporting as of December 31, 2007 and our independent auditors to attest to, our internal controls over financial reporting as of December 31, 2008, as currently required by Section 404 of the Sarbanes-Oxley Act of 2002 ( Sarbanes-Oxley ). While we believe our internal control over financial reporting is effective and are currently planning for timely completion of such documentation, testing and evaluation, there can be no assurance that we will be able to comply with the requirements of Section 404 of Sarbanes-Oxley by December 31, 2007. We cannot be certain that we will be able to complete our evaluation, testing and any required remediation in a timely fashion. During the evaluation and testing process, if we identify one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that such internal control is effective. If we are unable to assert that our internal control over financial reporting is effective as of December 31, 2007 (or if our auditors are unable to assert that our management's report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls over financial reporting as of December 31, 2008), we could lose investor confidence in the accuracy and completeness of our financial reports, which would have a material adverse effect on our stock price. In addition, it could make it more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers. Staff at the Commission and the Public Company Accounting Oversight Board ( PCAOB ) (United States) have published for comment proposed changes to the current requirements which would generally have the effect, if adopted as proposed, of reducing the impact of section 404 on the Company. It is not possible to state if or when these proposals will be effective. Should the Commission and PCAOB not adopt the proposed changes, we anticipate that our costs relating to Sarbanes-Oxley will increase and become significant in future periods.

*New accounting pronouncements may require us to change the way in which we account for our operational, or business activities and may affect our ability to attract and retain employees.*

The Financial Accounting Standards Board, FASB, and other bodies that have jurisdiction over the form and content of our accounts are constantly discussing proposals designed to ensure that companies best display relevant and transparent information relating to their respective businesses. The effect of the pronouncements of FASB and other bodies may have the effect of requiring us to account for revenues and/or expenses in a different manner than at present. In particular, in accordance with SFAS No. 123R, from January 2006, we began recording a charge to earnings for the estimated fair value of employee stock

option grants. We have always regarded stock options as an important component of our employee compensation packages. We believe that stock options are an essential tool to link the long-term interests of our shareholders and our employees, especially executive management, and serve to motivate management to make decisions that will, in the long run, give the best returns to stockholders. These changes will adversely impact our operating results and may adversely affect our ability to attract and retain employees. In addition, regulations implemented by The American and Toronto Stock Exchanges require shareholder approval for most stock option plans, which could make it more difficult for us to grant options to employees in the future. To the extent that these or other new regulations make it more difficult or expensive to grant options to employees, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could adversely affect our business.

***Impairment of goodwill and other intangible assets would result in a decrease in earnings.***

Current accounting rules require that goodwill and other intangible assets with indefinite useful lives may no longer be amortized, but instead must be tested for impairment at least annually. These rules also require that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, the quarterly amortization expense is increased or decreased. We have substantial goodwill and other intangible assets, and we would be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. Any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

***We could suffer uninsured losses.***

Although we maintain general liability insurance, claims could exceed the coverage obtained or might not be covered by our insurance. While we typically obtain representations from our technology and content providers and contractual partners concerning the ownership of licensed technology and informational content and obtain indemnification to cover any breach of these representations, we still may not receive accurate representations or adequate compensation for any breach of these representations. We may have to pay a substantial amount of money for claims that are not covered by insurance or indemnification or for claims where the existing scope or adequacy of insurance or indemnification is disputed or insufficient.

***Current world events and economic trends may have a negative impact on our sales.***

Our sales are subject to risks arising from adverse changes in domestic and global economic conditions and fluctuations in consumer confidence and spending. As a result, our sales may decline as a result of factors beyond our control, such as war and terrorism. These events include ongoing armed conflicts and retaliatory terrorist attacks. Any of these events could cause consumer confidence and spending to decrease or result in increased volatility in the global markets and economy. If any of the foregoing events occur, our sales may decline and our business may be adversely affected.

*Our quarterly and annual operating results may fluctuate and our future revenues and profitability are uncertain.*

Our quarterly and annual operating results may fluctuate significantly in the future as a result of a variety of factors, many of which are outside of our control. Our quarterly and annual operating results may be adversely affected by a wide variety of factors, including:

- our ability to maintain revenue growth at current levels or anticipate a decline in revenue from any of our services;
- our ability to identify and develop new technologies or services and to commercialize those technologies into new services in a timely manner;
- the mix of our services sold during the quarter or year;
- our ability to make appropriate decisions which will position us to achieve further growth;
- concentrated capital expenditures in any particular period to support our growth or for other reasons;
- changes in our pricing policies or those of our competitors, changes in domain name fees charged to us by Internet registries or ICANN, or other competitive pressures on selling prices;
- our ability to identify, hire, train, motivate and retain highly qualified personnel, and to achieve targeted productivity levels;
- market acceptance of Internet services generally and of new and enhanced versions of our services in particular;
- our ability to establish and maintain a competitive advantage;
- the continued development of our global distribution channel and our ability to compete in multiple countries successfully as part of our sales and marketing strategy;
- the number and significance of service enhancements and new service and technology announcements by our competitors;
- our ability to identify, develop, deliver, and introduce in a timely manner new and enhanced versions of our current service offerings that anticipate market demand and address customer needs;
- changes in foreign currency exchange rates and issues relating to the conversion to the Canadian dollar;
- foreign, federal or state regulation affecting our business;
- our ability to continue to attract users to our website;
- our ability to attract software developers to participate in our Author Resource Center;
- our ability to continue to attract advertisers to place content on our website
- technical difficulties or other factors that result in system downtime;
- seasonality of the markets and businesses of our customers;



- news relating to our industry as a whole;
- our ability to enforce our intellectual property rights;
- our ability to manage internet fraud and information theft; and

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- the impact of the change in method used for the accounting of stock options.

Our operating expenses may increase. We base our operating expense budgets on expected revenue trends that are more difficult to predict in periods of economic uncertainty. We intend to continue our efforts to control discretionary spending; however, we will continue to selectively incur expenditures in areas that we believe will strengthen our position in the marketplace. If we do not meet revenue goals, we may not be able to meet reduced operating expense levels and our operating results will suffer. It is possible that in one or more future quarters, our operating results may be below our expectations and the expectations of public market analysts and investors. In that event, the price of our shares of common stock may fall.

#### **Risks Related To the Internet and Our Technology**

*Our business could be materially harmed if the administration and operation of the Internet no longer rely upon the existing domain system.*

The domain registration industry continues to develop and adapt to changing technology. This development may include changes in the administration or operation of the Internet, including the creation and institution of alternate systems for directing Internet traffic without the use of the existing domain system. Some of our competitors have begun registering domains with extensions that rely on such alternate systems. These competitors are not subject to ICANN accreditation requirements and restrictions. Other competitors have attempted to introduce naming systems that use keywords rather than traditional domains. The widespread acceptance of any alternative systems could eliminate the need to register a domain to establish an online presence and could materially adversely affect our business, financial condition and results of operations.

*The law relating to the use of and ownership in intellectual property on the Internet is currently unsettled and may expose us to unforeseen liabilities.*

There have been ongoing legislative developments and judicial decisions concerning trademark infringement claims, unfair competition claims and dispute resolution policies relating to the registration of domains. To help protect ourselves from liability in the face of these ongoing legal developments, we have taken the following precautions:

- Our standard registration agreement requires that each registrant indemnify, defend and hold us harmless for any dispute arising from the registration or use of a domain registered in that person's name; and
- Since December 1, 1999, we have required our Service Providers to ensure that all registrants are bound to the Uniform Domain Name Dispute Resolution Policy as approved by ICANN.

Despite these precautions, we cannot assure you that our indemnity and dispute resolution policies will be sufficient to protect us against claims asserted by various third parties, including claims of trademark infringement and unfair competition.

New laws or regulations concerning domains and registrars may be adopted at any time. Our responses to uncertainty in the industry or new regulations could increase our costs or prevent us from delivering our domain registration services over the Internet, which could delay growth in demand for our services and limit the growth of our revenues. New and existing laws may cover issues such as:

- pricing controls;
- the creation of additional generic top level domains and country code domains;
- consumer protection;

- cross-border domain registrations;
- trademark, copyright and patent infringement;
- domain dispute resolution; and
- the nature or content of domains and domain registration.

An example of legislation passed in response to novel intellectual property concerns created by the Internet is the Anti-Cybersquatting Consumer Protection Act or ACPA enacted by the United States government in November 1999. This law seeks to curtail a practice commonly known in the domain registration industry as cybersquatting. A cybersquatter is generally defined in the ACPA as one who registers a domain that is identical or similar to another party's trademark, or the name of another living person, with the bad faith intent to profit from use of the domain. The ACPA states that registrars may not be held liable for registration or maintenance of a domain for another person absent a showing of the registrar's bad faith intent to profit from the use of the domain. Registrars may be held liable, however, if they do not comply promptly with procedural provisions of the ACPA. For example, if there is litigation involving a domain, the registrar is required to deposit a certificate representing the domain registration with the court. If we are held liable under the ACPA, any liability could have a material adverse effect on our business, financial condition and results of operations.

*If Internet usage does not grow or if the Internet does not continue to expand as a medium for commerce, our business may suffer.*

Our success depends upon the continued development and acceptance of the Internet as a widely used medium for commerce and communication. Rapid growth in the uses of, and interest in, the Internet is a relatively recent phenomenon and its continued growth cannot be assured. A number of factors could prevent continued growth, development and acceptance, including:

- the unwillingness of companies and consumers to shift their purchasing from traditional vendors to online vendors;
- the Internet infrastructure may not be able to support the demands placed on it, and its performance and reliability may decline as usage grows;
- security and authentication issues may create concerns with respect to the transmission over the Internet of confidential information; and
- privacy concerns, including those related to the ability of websites to gather user information without the user's knowledge or consent, may impact consumers' willingness to interact online.

Any of these issues could slow the growth of the Internet, which could limit our growth and revenues.

*We believe that part of our growth will be derived from Service Providers in international markets and may suffer if Internet usage does not continue to grow globally.*

We believe that a major source of growth for Internet-based companies will come from individuals and businesses outside the United States where Internet access and use is currently less prevalent. A substantial number of our Service Providers are currently based outside the United States and we plan to grow our business in other countries. If Internet use in these jurisdictions does not increase as anticipated, our revenues may not grow as anticipated.

***We may be unable to respond to the rapid technological changes in the industry, and our attempts to respond may require significant capital expenditures.***

The Internet and electronic commerce are characterized by rapid technological change. Sudden changes in user and customer requirements and preferences, the frequent introduction of new applications and services embodying new technologies and the emergence of new industry standards and practices could make our applications, services and systems obsolete. The emerging nature of applications and services in the Internet application and services industry and their rapid evolution will require that we continually improve the performance, features and reliability of our applications and services. Our success will depend, in part, on our ability:

- to develop and license new applications, services and technologies that address the increasingly sophisticated and varied needs of our current and prospective customers; and
- to respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis.

The development of applications and services and other proprietary technology involves significant technological and business risks and requires substantial expenditures and lead-time. We may be unable to use new technologies effectively or adapt our internally developed technology and transaction-processing systems to customer requirements or emerging industry standards in a timely manner, or at all. Our internal development teams may also be unable to keep pace with new technological developments that affect the marketplace for our services. In addition, as we offer new services and functionality, we will need to ensure that any new services and functionality are well integrated with our current services, particularly as we offer an increasing number of our services as part of bundled suites. To the extent that any new services offered by us do not interoperate well with our existing services, our ability to market and sell those new services would be adversely affected and our revenue level and ability to achieve and sustain profitability might be harmed. Updating technology internally and licensing new technology from third parties may require us to incur significant additional capital expenditures.

***We could experience system failures and capacity constraints which could diminish our ability to effectively provide our services and could damage our reputation and harm our operating results.***

The availability of our services depends on the continuing operation of our information technology and communications systems. Any damage to or failure of our systems could result in interruptions in our service, which could reduce our revenues and profits, and damage our brand. Our systems are vulnerable to damage or interruption from earthquakes, terrorist attacks, floods, fires, power loss, telecommunications failures, computer viruses, computer denial of service attacks or other attempts to harm our systems. Some of our data centers are located in areas with a high risk of major earthquakes. Our data centers are also subject to break-ins, sabotage and intentional acts of vandalism, and to potential disruptions if the operators of these facilities have financial difficulties. Some of our systems are not fully redundant, and our disaster recovery planning cannot account for all eventualities. The occurrence of a natural disaster, a decision to close a facility without adequate notice or other unanticipated problems at our data centers could result in lengthy interruptions in our service.

***Our systems face security risks, and any compromise of the security of these systems could result in liability for damages and in lost customers.***

Our security systems may be vulnerable to unauthorized access by hackers or others, computer viruses and other disruptive problems. Someone who is able to circumvent security measures could misappropriate customer or proprietary information or cause interruptions in Internet operations. Internet and online service providers have in the past experienced, and may in the future experience, interruptions in service because of the accidental or intentional actions of Internet users, current and former employees or others.

We may need to expend significant capital and other resources to protect against the threat of security breaches or alleviate problems caused by breaches. Unauthorized persons may be able to circumvent the measures that are implemented in the future. Eliminating computer viruses and alleviating other security problems may require interruptions, delays or cessation of service to users accessing our websites and the web pages that deliver our content services. Repeated or substantial interruptions could result in the loss of customers and reduced revenues.

***Recent acquisitions have required the technical integration of several businesses into our existing operating platform. Our operations are becoming increasingly sophisticated and any failure in our ability to maintain and build upon our network architecture could have a materially negative impact on our ability to retain our customer base.***

Our acquisition of the hosted email and personalized email businesses earlier this year has necessitated the purchase of additional hardware and has required significant development of the company's network architecture. As a result of this acquisition, the Company's technical systems must manage significantly more data than they have in the past. Any failure in our ability to adapt our procedures or to manage these sophisticated new systems could have a material impact on our business.

***We may have difficulty scaling and adapting our existing architecture to accommodate increased traffic and technology advances or changing business requirements, which could lead to the loss of customers and cause us to incur additional expenses.***

To be successful, our network infrastructure must perform well and be reliable. The greater the user traffic and the greater the complexity of our services, the more computing power we will need. We have spent and expect to continue to spend substantial amounts on the purchase of new equipment to upgrade our technology and network infrastructure to enable it to handle increased traffic. This expansion is expensive and complex and could result in inefficiencies or operational failures. If we do not expand successfully, or if we experience inefficiencies and operational failures, the quality of our services and our customers' experience could decline. This could damage our reputation and lead us to lose current and potential customers. Cost increases, loss of traffic or failure to accommodate new technologies or changing business requirements could harm our operating results and financial condition.

***We rely on bandwidth providers, data centers and other vendors in providing services to our customers, and any failure or interruption in the services provided by these third parties could harm our ability to operate our business and damage our reputation.***

We rely on vendors, including data center and bandwidth providers in providing services to our customers. Any disruption in the network access or co-location services provided by these providers or any failure of these providers to handle current or increased volumes of use could significantly harm our business. Any financial or other difficulties our providers face may also have negative effects on our business. We exercise little control over these vendors, which increases our vulnerability to problems with the services they provide. We license technology and related databases to facilitate certain aspects of our data center and connectivity operations, including Internet traffic management services. We have experienced and expect to continue to experience interruptions and delays in service and availability for such elements. Any errors, failures, interruptions or delays in connection with these technologies and information services could harm our relationship with customers, adversely affect our brand and expose us to liabilities.

***Lack of consumer confidence in the security of on-line financial transactions could negatively impact our business.***

Consumers may not adopt online services if they are not confident that financial transactions over the Internet can be undertaken securely and confidentially. Although there is security technology currently available for online transactions, many Internet users may not use the Internet for commercial transactions because of security concerns. These concerns may be heightened by well-publicized security breaches of any Internet-related service, which could deter consumers from using our services provided by our solution. If consumers do not have confidence in the security for online services transactions that the current technologies provide, our revenue will not increase and may decrease.

***We may be accused of intellectual property infringement of the technology we have employed to support both our back end platform and the products and services we offer to and through our Service Providers and may be sued for damages caused by actual use of the platforms or products and services and we may be required to pay substantial damage awards.***

We seek to ensure that we have licensed or otherwise secured the necessary rights to use and offer for use all intellectual property relating to our platforms and the services we offer Service Providers through the platforms. Despite our efforts, we may be sued by third parties claiming rights in and to the technology we employ or by third parties who claim to have suffered as a result of any use, or inability to use, the platforms, products and services. If we are sued, defense of any such claims may require the resources of both our time and money. If a third-party is successful in its assertions, we may be required to pay damages that may have a material impact on our financial resources.

**Governmental and Regulatory Risks**

***Governmental and regulatory policies or claims concerning the domain registration system, and industry reactions to those policies or claims, may cause instability in the industry and disrupt our domain registration business.***

**ICANN Oversight of Domain Name Registration System**

Before 1999, Network Solutions managed the domain registration system for the .com, .net and .org domains on an exclusive basis under a cooperative agreement with the U.S. government. In November 1998, the U.S. Department of Commerce authorized ICANN to oversee key aspects of the domain registration system. ICANN has been subject to strict scrutiny by the public and by the government in the United States. For example, in the United States, Congress has held hearings to evaluate ICANN's selection process for new top level domains. In addition, ICANN faces significant questions regarding its financial viability and efficacy as a private sector entity. ICANN may continue to evolve both its long term structure and mission to address perceived shortcomings such as a lack of accountability to the public and a failure to maintain a diverse representation of interests on its board of directors. We continue to face the risks that:

- the U.S. or any other government may reassess its decision to introduce competition into, or ICANN's role in overseeing, the domain registration market;
- the Internet community or the U.S. Department of Commerce or U.S. Congress may refuse to recognize ICANN's authority or support its policies, which could create instability in the domain registration system;
- some of ICANN's policies and practices, and the policies and practices adopted by registries and registrars, could be found to conflict with the laws of one or more jurisdictions;

- ICANN may lose any one of the several claims pending against it in both the U.S. and international courts, in which case its credibility may suffer and its policies may be discredited;
- the terms of the registrar accreditation process could change in ways that are disadvantageous to us;
- ICANN and, under their proposed new registry agreement, VeriSign may impose increased fees received for each .com domain name registration;
- the terms of the registrar accreditation process could change in ways that are disadvantageous to us; and
- international regulatory bodies, such as the International Telecommunications Union or the European Union, may gain increased influence over the management and regulation of the domain registration system, leading to increased regulation in areas such as taxation and privacy.

If any of these events occur, they could create instability in the domain registration system. These events could also disrupt or suspend portions of our domain registration solution, which would result in reduced revenue.

#### **Governmental Regulation Affecting the Internet**

To date, government regulations have not materially restricted use of the Internet in most parts of the world. The legal and regulatory environment pertaining to the Internet, however, is uncertain and may change. New laws may be passed, existing but previously inapplicable laws may be deemed to apply to the Internet, or existing legal safe harbors may be narrowed, both by U.S. federal or state governments and by governments of foreign jurisdictions. These changes could affect:

- the liability of online service providers for actions by customers, including fraud, illegal content, spam, phishing, libel and defamation, infringement of third-party intellectual property and other abusive conduct;
- other claims based on the nature and content of Internet materials, such as pornography;
- user privacy and security issues;
- consumer protection;
- sales and other taxes, including the value-added tax of the European Union member states;
- characteristics and quality of services; and
- cross-border commerce.

The adoption of any new laws or regulations, or the application or interpretation of existing laws or regulations to the Internet, could hinder growth in use of the Internet and online services generally, and decrease acceptance of the Internet and online services as a means of communications, commerce and advertising. In addition, such changes in laws could increase our costs of doing business, subject our business to increased liability or prevent us from delivering our services over the Internet, thereby harming our business and results of operations.

*We may be subject to government regulation that may be costly and may interfere with our ability to conduct business.*

Although transmission of our websites primarily originates in Canada and the United States, the Internet is global in nature. Governments of foreign countries might try to regulate our transmissions or prosecute us for violations of their laws. Because of the increasing popularity and use of the Internet, federal, state and foreign governments may adopt laws or regulations in the future concerning commercial online services and the Internet, with respect to:

- user privacy;
- children;
- copyrights and other intellectual property rights and infringement;
- domains;
- pricing;
- content regulation;
- defamation;
- taxation; and
- the characteristics and quality of products and services.

Laws and regulations directly applicable to online commerce or Internet communications are becoming more prevalent. Laws and regulations such as those listed above or others, if enacted, could expose us to substantial liability and increase our costs of compliance and doing business.

#### **Risks Related to our Stock**

*We do not intend to declare dividends on our common stock in the foreseeable future.*

We anticipate that for the foreseeable future, our earnings, if any, will be retained for use in the business and that no cash dividends will be paid on our common stock. Declaration of dividends on our common stock will depend upon, among other things, future earnings, our operating and financial condition, our capital requirements and general business conditions.

*We are controlled by a limited number of principal shareholders, which may limit your ability to influence corporate matters.*

As of December 31, 2006, our four principal shareholders beneficially own approximately 40% of our shares of common stock. These shareholders could control the outcome of any corporate transaction or other matter submitted to our shareholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets, and also could prevent or cause a change in control. The interests of these shareholders may conflict with the interests of our other shareholders.

Third parties may be discouraged from making a tender offer or bid to acquire us because of this concentration of ownership.

*Our share price is volatile, which may make it difficult for shareholders to sell their shares of common stock when they want to, at an attractive price.*

Our share price has varied recently and the price of our common stock may decrease in the future, regardless of our operating performance. Investors may be unable to resell their common stock following periods of volatility because of the market's adverse reaction to this volatility.





The following factors may contribute to this volatility:

- actual or anticipated variations in our quarterly operating results;
- interruptions in our services;
- seasonality of the markets and businesses of our customers;
- announcements of new technologies or new services by our company or our competitors;
- our ability to accurately select appropriate business models and strategies;
- the impact that terrorist acts or military action may have on global economic conditions and the impact that this will have on our customers or business;
- the operating and stock price performance of other companies that investors may view as comparable to us;
- news relating to our industry as a whole; and
- news relating to trends in our markets.

The stock market in general, and the market for Internet-related companies in particular, including our company, has experienced extreme volatility. This volatility often has been unrelated to the operating performance of these companies. These broad market and industry fluctuations may cause the price of our shares of common stock to drop, regardless of our performance.

*Future sales of shares of common stock by our existing shareholders could cause our share price to fall.*

If our shareholders sell substantial amounts of shares of common stock in the public market, the market price of the shares of common stock could fall. The perception among investors that these sales will occur could also produce this effect.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

#### **ITEM 2. PROPERTIES**

We do not own any real property. Our principal administrative, engineering, marketing and sales office totals approximately 26,937 square feet and is located in Toronto, Ontario under a lease that expires on December 31, 2011. We also maintain offices of approximately 5,000 square feet in Flint, Michigan, approximately 4,000 square feet in Starkville, Mississippi and approximately 500 square feet in London, United Kingdom.

Substantially all of our computer and communications hardware is located at our facilities or at server hosting facilities in Toronto, Ontario, San Jose, San Francisco and Santa Clara, California, Denver, Colorado and London, England.

#### **ITEM 3. LEGAL PROCEEDINGS**

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



**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Tucows Annual Meeting of Shareholders was held on November 22, 2006. Holders of an aggregate of 75,732,220 shares of Tucows common stock at the close of business on October 10, 2006 were entitled to vote at the meeting, of which 55,908,361 were present in person or represented by proxy. At such meeting, Tucows shareholders voted as follows:

**Proposal 1.** To elect seven directors to serve until the 2007 Annual Meeting of Shareholders or until their respective successors shall have been duly selected and qualified.

| Nominee          | Votes For  | Votes Against | Votes Abstained |
|------------------|------------|---------------|-----------------|
| Allen Karp       | 53,123,454 |               | 2,784,907       |
| Elliot Noss      | 52,981,294 |               | 2,927,067       |
| Erez Gissin      | 53,118,011 |               | 2,790,350       |
| Eugene Fiume     | 53,120,416 |               | 2,787,945       |
| Jeffrey Schwartz | 53,117,899 |               | 2,790,462       |
| Lloyd Morrisett  | 53,064,266 |               | 2,844,095       |
| Stanley Stern    | 53,124,204 |               | 2,784,157       |

No other persons were nominated, or received votes, for election as directors at the 2006 Annual Meeting of Shareholders. There were no broker non-votes with respect to this proposal.

**Proposal 2.** To consider and approve the adoption of the 2006 Equity Compensation Plan.

**Approve 2006 Equity Compensation Plan:**

| Votes For  | Votes Against | Votes Abstained |
|------------|---------------|-----------------|
| 22,865,048 | 3,153,632     | 69,921          |

There were 29,819,760 broker non-votes with respect to this proposal.

**Proposal 3.** To consider and approve the adoption of the second amendment and restatement of the Tucows Inc. bylaws to modernize our bylaws and to eliminate certain provisions of our existing bylaws.

**Approve Second Amended and Restated Bylaws:**

| Votes For  | Votes Against | Votes Abstained |
|------------|---------------|-----------------|
| 55,361,392 | 214,882       | 332,086         |

There was 1 broker non-votes with respect to this proposal.

**Proposal 4.** To ratify the appointment of KPMG LLP as our independent public accountants to audit our financial statements for the year ending December 31, 2006.

**Ratify KPMG LLP as our independent public accountants:**

| Votes For  | Votes Against | Votes Abstained |
|------------|---------------|-----------------|
| 55,675,897 | 198,988       | 33,475          |

There was 1 broker non-votes with respect to this proposal.



**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Price Range of Common Stock**

Our common stock trades on the American Stock Exchange under the symbol TCX. The following table sets forth the range of high and low sales prices for our common stock for the periods indicated.

| Year | Fiscal Quarter Ended | High | Low  |
|------|----------------------|------|------|
| 2006 | March 31, 2006       | 0.97 | 0.83 |
|      | June 30, 2006        | 0.98 | 0.79 |
|      | September 30, 2006   | 0.98 | 0.87 |
|      | December 31, 2006    | 0.95 | 0.80 |
| 2005 | March 31, 2005       | 1.23 | 0.67 |
|      | June 30, 2005        | 1.01 | 0.80 |
|      | September 30, 2005   | 1.16 | 0.89 |
|      | December 31, 2005    | 0.97 | 0.78 |

Our common stock was listed on the OTC Bulletin Board maintained by NASDAQ under the symbol TCOW through August 17, 2005. Our common stock began trading on the American Stock Exchange on August 18, 2005.

As of March 23, 2006, Tucows had 315 shareholders of record, which excludes shareholders whose shares are held in nominee or street name by brokers.

We have not declared or paid any cash dividends on our common stock during the fiscal years ended December 31, 2005 and December 31, 2006, and do not intend to do so in the foreseeable future.

**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth our selected consolidated financial data for the periods indicated. The financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements and related notes appearing elsewhere in this Annual Report on Form 10-K. The selected consolidated statement of operations data set forth below for the fiscal years ended December 31, 2006, 2005 and 2004 and the consolidated balance sheet data as of December 31, 2006 and 2005 are derived from our consolidated financial statements, which are included elsewhere in this Annual Report on Form 10-K. The selected consolidated statement of operations data set forth below for the fiscal years ended December 31, 2003 and 2002 and the consolidated balance sheet data as of December 31, 2004, 2003 and 2002 are derived from the audited consolidated financial statements that are not included in this Annual Report on Form 10-K, but have been previously filed with the SEC.

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The historical data is only a summary, and you should read it with our Management's Discussion and Analysis of Financial Condition and Results of Operations.

|   | <b>Year ended December 31,</b> |             |             |             |             |
|---|--------------------------------|-------------|-------------|-------------|-------------|
|   | <b>2006</b>                    | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>2002</b> |
| <b>Statement of Operations Data:</b>                          |                                |             |             |             |             |
| Net revenues  | \$ 65,030                      | \$ 48,517   | \$ 44,717   | \$ 37,195   | \$ 37,046   |
| Cost of revenues:   |                                |             |             |             |             |
| Cost of revenues:   | 41,535                         | 30,645      | 27,566      | 22,990      | 23,108      |
| Depreciation of property and equipment                        | 2,756                          | 752         | 739         | 1,148       | 1,851       |
| Amortization of intangible assets                             | 207                            |             |             |             |             |
| Total cost of revenues  | 44,498                         | 31,397      | 28,305      | 24,138      | 24,959      |
| Gross profit  | 20,532                         | 17,120      | 16,412      | 13,057      | 12,087      |
| Expenses:   |                                |             |             |             |             |
| Sales and marketing   | 5,986                          | 4,855       | 5,068       | 3,850       | 3,771       |
| Technical operations and development                          | 8,152                          | 5,628       | 4,549       | 3,935       | 3,726       |
| General and administrative                                    | 5,890                          | 4,346       | 4,108       | 3,998       | 4,523       |
| Depreciation of property and equipment                        | 223                            | 200         | 380         | 342         | 825         |
| Amortization of intangible assets                             | 670                            | 236         | 158         |             | 222         |
| Total expenses  | 20,921                         | 15,265      | 14,263      | 12,125      | 13,067      |
| Income (loss) from operations                                 | (389 )                         | 1,855       | 2,149       | 932         | (980 )      |
| Other income (expenses)                                       |                                |             |             |             |             |
| Interest income, net  | 110                            | 462         | 201         | 131         | 102         |
| Other income  | 2,347                          | 303         |             |             |             |
| Gain on disposal of Electric Library subscription assets      |                                |             |             |             | 1,847       |
| Gain on disposal of Liberty Registry Management Services Inc. |                                |             |             | 1,000       | 1,955       |
| Loss on disposal of Eklektix Inc.                             |                                |             |             |             | (44 )       |
| Write down of investment in bigchalk.com                      |                                |             |             |             | (1,013 )    |
| Total other income (expenses)                                 | 2,457                          | 765         | 201         | 1,131       | 2,847       |
| Income before provision for income taxes                      | 2,068                          | 2,620       | 2,350       | 2,063       | 1,867       |
| Recovery of income taxes                                      | (92 )                          | (152 )      | (3,150 )    |             |             |
| Net income for the year                                       | \$ 2,160                       | \$ 2,772    | \$ 5,500    | \$ 2,063    | \$ 1,867    |
| Basic and diluted income per common share                     | \$ 0.03                        | \$ 0.04     | \$ 0.08     | \$ 0.03     | \$ 0.03     |
| Shares used in computing basic income per common share        | 74,032,830                     | 69,077,329  | 66,079,104  | 64,626,429  | 64,626,429  |
| Shares used in computing diluted income per common share      | 76,489,381                     | 72,481,204  | 68,051,579  | 64,725,929  | 64,626,429  |

|  | <b>As of December 31,</b> |             |             |             |             |
|--|---------------------------|-------------|-------------|-------------|-------------|
|  | <b>2006</b>               | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|  | <b>(in thousands)</b>     |             |             |             |             |
| <b>Balance Sheet Data:</b>   |                           |             |             |             |             |
| Cash and cash equivalents (including restricted cash and short-term investments) | \$ 7,276                  | \$ 19,180   | \$ 14,375   | \$ 13,045   | \$ 9,782    |
| Working capital (deficit)  | (5,275 )                  | 9,044       | 4,033       | 2,202       | (1,066 )    |
| Total assets   | 84,665                    | 57,057      | 47,304      | 35,336      | 28,853      |
| Deferred revenue   | 45,137                    | 37,870      | 33,251      | 28,589      | 24,361      |
| Long-term obligations, net of current portion                                    | 6,000                     |             |             |             |             |
| Stockholders' equity (deficiency)  | 18,543                    | 13,092      | 7,457       | 866         | (1,360 )    |

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (MD&A)**

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes included elsewhere herein.

**OVERVIEW**

We provide Internet services and downloadable software through a global distribution network of more than 6,000 customers, or Service Providers, in more than 100 countries. We are an accredited registrar ICANN, and we generate revenue primarily through the provision of domain registration and other Internet services to Service Providers who offer such services to their own customers in a process known as wholesale distribution

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

**Net Revenues**

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

**Domain registration and other Internet services**

We generate revenues from the provision of Internet services on both a wholesale and retail basis. To date, the majority of net revenues has been derived from the sale of services provided as an accredited domain registrar. As of December 31, 2006, we offered registration services for the generic top-level domains, or gTLDs, .com, .net, .org, .info, .name .biz and .mobi and for the country code top-level domains, or ccTLDs .at, .be, .ca, .cc, .ch, .cn, .de, .dk, .es, .eu, .fr, .it, .nl, .tv, .uk, .us and .vc.

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

With respect to the sale of domain registrations, we earn registration fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to Service Providers and registrars on a monthly basis. Domain registrations are generally purchased for terms of one to ten years. Payments for the full term of all services, or billed revenue, are received at the time of activation of service and where appropriate are recorded as deferred revenue and are recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

Other Internet services currently consist of the sale of expiring domain names and digital certificates, billing, provisioning and customer care software solutions, hosted email and anti-spam services, blogware and website building tools which are used by our Service Providers to create bundles of Internet services for their end-users. We earn fees when a service is activated. Other Internet services are generally purchased for terms of one month to three years. Payments for domain registrations and other Internet services are for the full term of all services at the time of activation of service and where appropriate are recorded as deferred revenue and are recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.



On a retail basis, we offer Internet services directly to end-users through our Domain Direct division. These services include domain registration and other Internet services such as email, personalized email through our portfolio of surname-based domain names, blogware, hosting and website creation. Depending on the service offered, Domain Direct receives standard fees for its services that are published on its website. In addition, Domain Direct offers referral commissions based on a percentage of net registration revenues to participants in its affiliate program.

#### **Advertising and other revenue**

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

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

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

Advertising and other revenue is recognized ratably over the period in which it is presented.

#### **Critical Accounting Policies**

The following is a discussion of our critical accounting policies and methods. Critical accounting policies are defined as those that are both important to the portrayal of our financial condition and results of operations and are reflective of significant judgments and uncertainties made by management that may result in materially different results under different assumptions and conditions. Note 2 to the consolidated financial statements for the year ended December 31, 2006, or fiscal 2006 includes further information on the significant accounting policies and methods used in the preparation of our consolidated financial statements.

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

### Revenue recognition policy

We earn revenues from:

- Domain registration fees on both a wholesale and retail basis and other Internet services; and
- Advertising and other revenue.

With respect to the sale of domain registrations and other Internet services, we earn registration fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to Service Providers and registrars on a monthly basis. We also enter into revenue arrangements in which a Service Provider may purchase a combination of services (multiple element arrangements). When fair value exists for all elements, we allocate revenue to each element based on the relative fair value of each of the elements. Fair value is established by the price charged when that element is sold separately. For arrangements where fair value exists only for the undelivered elements, we defer the full value of the undelivered elements and recognize the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue, assuming all other criteria for revenue recognition have been met. Payments for the full term of all services, or billed revenue, are received at the time of activation of service and where appropriate are recorded as deferred revenue and are recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

Revenue from the sale of domain names, consists primarily of amounts earned for the transfer of rights to domain names that are currently under the Company's control. Collectibility of revenues generated is subject to a high level of uncertainty; accordingly revenues are recognized only as received.

We also generate advertising and other revenue through our online libraries of shareware, freeware and online services presented at our website, www.tucows.com, as well as from traffic and search sessions originating on our portfolio of domain names. Advertising and other revenue is recognized ratably over the period in which it is presented. To the extent that the minimum number of impressions we guarantee to customers is not met, we defer recognition of the corresponding revenues until the guaranteed impressions are achieved

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

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

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

### Product development costs

We account for the costs of computer software developed or obtained for internal use in accordance with the *American Institute of Certified Public Accountants Statement of Position 98-1: Accounting for the Cost of Computer Software Developed or Obtained for Internal Use*, as more fully described in Note 2 to our audited consolidated financial statements for Fiscal 2006. Our policy on capitalizing internally developed software costs determines the timing of its recognition of certain development costs. In addition, this policy

determines whether the cost is classified as development expense or depreciation of property and equipment. Management reassesses these judgments on an ongoing basis. Changes in management's assessment could impact the recognition of development costs in our accounts.

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

Our business acquisitions typically result in goodwill and other intangible assets, which affect the amount of future period amortization expense and possible impairment expense that we may incur. The determination of the value of such intangible assets requires management to make estimates and assumptions that affect our consolidated financial statements. We test goodwill for impairment in accordance with SFAS 142, which requires that we test goodwill, identifiable intangibles and long-lived assets for impairment at least annually and more frequently upon the occurrence of certain events, as defined by SFAS 142. We determine if the carrying value of intangibles, long-lived assets or goodwill are impaired based on a projected discounted cash flow model using a discount rate determined by management to be commensurate with the risk inherent in our current business model. Management will base its estimates in preparing the discounted cash flows on historical experience and on various other assumptions, including current market trends and developments, ongoing customer developments and general economic factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Indefinite-lived intangible assets are assessed for impairment on at least an annual basis or more often if events or circumstances warrant. These impairment tests involve the use of discounted cash flow analyses to assess the fair value of the indefinite-lived assets and the recoverability of the carrying value of these assets. These analyses involve estimates of future cash flows, estimated periods of use and applicable discount rates. If the fair values of these assets as determined above were less than the related carrying values, impairment losses would have been recognized, as applicable. Management has determined that there is no impairment of the carrying value of these surname domain names and direct navigation domain names at December 31, 2006.

The Company has chosen the end of its fiscal month of December as the date of its annual impairment test. In accordance with SFAS 142, goodwill is evaluated for impairment at the reporting unit level. While the CEO, who is the Company's chief operating decision maker, monitors the sales of various products, operations are managed and financial performance evaluated based upon the sales and production of multiple products employing common network costs, research and development resources, sales and administrative support, and facilities. This allows the Company to leverage its costs in an effort to maximize return. The Company believes that any allocation of such shared expenses to various products would be impractical and arbitrary and it currently does not make such allocations internally. As such, the Company considers itself a single reporting unit. In testing for a potential impairment of goodwill, the provisions of SFAS 142 require the application of a fair value based test at the reporting unit level. We performed the annual goodwill impairment test as of December 31, 2006, 2005 and 2004, and determined that goodwill was not impaired. In accordance with SFAS No. 144, Accounting for the impairment or disposal of long-lived assets ( SFAS 144 ), long-lived intangible assets with determinable economic life are tested for recoverability whenever events or circumstances indicate that their carrying amounts may not be recoverable. We determined that there were no events or circumstances that affected the recoverability of long-lived assets.

#### **Accounting for income taxes**

We account for income taxes under the asset and liability method in accordance with Statement of Financial Accounting Standards No. 109. Under the asset and liability method, we recognize deferred tax

assets or liabilities for the anticipated future tax effects of temporary differences between the financial statement basis and the tax basis of our assets and liabilities. We record a valuation allowance to reduce the net deferred tax assets when it is more likely than not that the benefit from the deferred tax assets will not be realized. In assessing the need for a valuation allowance, historical and future levels of income, expectations and risks associated with estimates of future taxable income and ongoing tax planning strategies are considered. In the event that it is determined that the deferred tax assets to be realized in the future would be in excess of the net recorded amount, an adjustment to the deferred tax asset valuation allowance would be recorded. This adjustment would increase income in the period such determination was made. Likewise, should it be determined that all or part of a recorded net deferred tax asset would not be realized in the future, an adjustment to increase the deferred tax asset valuation allowance would be charged to income in the period such determination would be made.

On a periodic basis, we evaluate the probability that our deferred tax asset balance will be recovered to assess its realizability. To the extent we believe it is more likely than not that some portion of our deferred tax assets will not be realized, we will increase the valuation allowance against the deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future taxable income. Our judgments regarding future profitability may change due to future market conditions, changes in U.S. or international tax laws and other factors. These changes, if any, may require possible material adjustments to these deferred tax assets, impacting net income or net loss in the period when such determinations are made.

### **Accounting for stock-based employee compensation**

On January 1, 2006, we adopted the fair value-based method for measurement and cost recognition of employee stock-based compensation arrangements under the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share-Based Payment* or SFAS 123R, using the modified prospective application transitional approach. Previously, we had elected to account for employee stock-based compensation using the intrinsic value method based upon Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* or APB 25 and related interpretations. The intrinsic value method generally did not result in any compensation cost being recorded for employee stock options since the exercise price was equal to the market value of the underlying shares on the date of grant.

Under the modified prospective application transitional approach, stock-based compensation is recognized for awards granted, modified, repurchased or cancelled subsequent to the date of adoption of SFAS 123R. In addition, stock-based compensation is recognized, subsequent to the date of adoption of SFAS 123R, for the remaining portion of unvested outstanding awards granted prior to the date of adoption. Prior periods have not been adjusted and we continue to provide pro forma disclosure as if it had accounted for employee share-based payments in all periods prior to the adoption of SFAS 123R in accordance with the fair value provisions of SFAS No. 123, *Accounting for Stock-based Compensation*, which is presented below.

We measure stock-based compensation costs on the grant date, based on the calculated fair value of the award. We have elected to treat awards with graded vesting as a single award when estimating fair value. Compensation cost is recognized on a straight-line basis over the employee requisite service period, which in our circumstance is the stated vesting period of the award, provided that total compensation cost recognized at least equals the pro rata value of the award that has vested. Compensation cost is initially based on the estimated number of options for which the requisite service is expected to be rendered. This estimate is adjusted to the vesting date once actual forfeitures are known.

Had we adopted the fair value-based method for accounting for stock-based compensation in all prior periods presented, the pro-forma impact on net income and net income per share would be as follows:

|   | Year ended December 31, |              |
|---|-------------------------|--------------|
|   | 2005                    | 2004         |
| Net income, as reported   | \$ 2,772,616            | \$ 5,500,338 |
| Add stock-based employee compensation expense included in reported net income, net of tax                                   |                         | 90,330       |
| Deduct total stock-based employee compensation expense determined under fair-value-based method for all rewards, net of tax | (357,523 )              | (413,151 )   |
| Net income, pro forma   | \$ 2,415,093            | \$ 5,177,517 |
| Earnings per common share, as reported  | \$ 0.04                 | \$ 0.08      |
| Earnings per common share, pro forma  | \$ 0.03                 | \$ 0.08      |

Refer to Note 8 Share-Based Payments in these consolidated financial statements for details of stock options and stock-based compensation cost recorded during fiscal 2006.

**RESULTS OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31, 2006 AS COMPARED TO THE YEAR ENDED DECEMBER 31, 2005**

**NET REVENUES**

The following table presents our revenues, by revenue source:

|  | Year ended December 31, |            |
|--|-------------------------|------------|
|  | 2006                    | 2005       |
| Domain name and other Internet services:         |                         |            |
| Domain names, excluding Domain Direct            | 44,144,229              | 37,984,645 |
| Other Internet services, including Domain Direct | 16,290,540              | 7,334,284  |
| Total domain name and other Internet services    | 60,434,769              | 45,318,929 |
| Advertising and other revenue                    | 4,594,721               | 3,198,110  |
|  | \$ 65,029,490           | 48,517,039 |
| Increase over prior period                       | \$ 16,512,451           |            |
| Increase percentage                              | 34                      | %          |

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

|  | Year ended December 31, |   |       |   |
|--|-------------------------|---|-------|---|
|  | 2006                    |   | 2005  |   |
| Domain name and other Internet services:         |                         |   |       |   |
| Domain names, excluding Domain Direct            | 67.8                    | % | 78.3  | % |
| Other Internet services, including Domain Direct | 25.1                    | % | 15.1  | % |
| Total domain name and other Internet services    | 92.9                    | % | 93.4  | % |
| Advertising and other revenue                    | 7.1                     | % | 6.6   | % |
|  | \$ 100.0                | % | 100.0 | % |

Total net revenues for Fiscal 2006 increased to \$65.0 million from \$48.5 million for the year ended December 31, 2005 or Fiscal 2005.

During Fiscal 2006, no customer accounted for more than 10% of total revenue, and one customer accounted for 13% of accounts receivable at December 31, 2006. Significant management judgment is

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

*Domain name and other Internet services*

Net revenues from domain name and other Internet services for Fiscal 2006 increased by \$15.1 million, or 33.3%, to \$60.4 million from \$45.3 million Fiscal 2005. This increase was primarily as a result of higher volumes from new and existing customers, as well as the additional revenue earned from the Hosted Messaging Assets we acquired from Critical Path in January 2006, and from the acquisition of the name-based domain assets from Mailbank.com, Inc. in June 2006, which both have been integrated into other Internet services and Advertising and other revenue streams.

During Fiscal 2006, the number of domain names that we processed increased by approximately 900,000 to approximately 4.9 million new, renewed and transferred-in domain name registrations, compared to Fiscal 2005. This increase was due primarily to the fact that we continued to compete aggressively to attract new clients and retain existing customers in order to protect our current market share and improve our competitive position. These actions have resulted in our average selling price declining, which has partially offset the impact of the increased transaction volume on our revenue and profitability. We may face continued pricing pressure in order to remain competitive, which would adversely impact our revenues and profitability.

The renewal rate for domain name registrations increased to approximately 73.7% for Fiscal 2006 compared to approximately 69.8% for Fiscal 2005.

During Fiscal 2006, revenue from domain names, excluding Domain Direct, comprised 67.8% of total revenue, compared to 78.3% for Fiscal 2005. This percentage decrease primarily resulted from the recognition of revenues from the newly acquired Hosted Messaging Assets. This resulted in revenue from other Internet services, including Domain Direct, increasing to 25.1% of total revenue Fiscal 2006 compared to 15.1% for Fiscal 2005.

While we anticipate that the number of new, renewed and transferred-in domain name registrations will incrementally increase, the volatility in the market could affect the growth of domain names under our management. During Fiscal 2006, the total number of domain names under our management increased by approximately 1.0 million to approximately 5.9 million, compared to Fiscal 2005. As of December 31, 2006, we provided provisioning services to ten registrars on a monthly basis, as compared to five registrars at December 31, 2005, which registrars use our technical systems to process domain registrations with their accreditation. As of December 31, 2006, we managed approximately 1.9 million domain names, compared to approximately 869,000 at December 31, 2005, on their behalf.

Deferred revenue from domain name registrations and other Internet services at December 31, 2006 increased in line with the increase in revenues to approximately \$45.1 million from approximately \$37.9 million at December 31, 2005.

*Advertising and other revenue*

Advertising and other revenue for Fiscal 2006 increased by \$1.4 million, or 43.8% to \$4.6 million from \$3.2 million for Fiscal 2005. This increase was primarily the result of the increase in number of third party advertisements on parked pages, amounting to \$1.2 million for Fiscal 2006.

During Fiscal 2006, revenue from advertising and other revenue comprised 7.1% of total revenue, compared to 6.6% for Fiscal 2005.

**COST OF REVENUES**

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

Cost of revenues for domain registrations represents the amortization of registry fees on a basis consistent with the recognition of revenues from our customers, namely ratably over the term in which we provide the service. Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered, and are recorded as prepaid domain registry fees. Costs of revenues for other Internet services consist of fees paid to third-party service providers and are recognized ratably over the periods in which the services are provided. We have minimal direct cost of revenues associated with our advertising and other revenues. Therefore, the gross profit margin on advertising revenue is approximately 100% and, accordingly, any increase or decrease in advertising and other revenue represents an increase or a reduction of our gross profit of approximately the same amount. Network costs include personnel and related expenses, including bandwidth and co-location expenses to support the supply of all of our services. Bandwidth and co-location expenses are composed primarily of communication and provisioning costs related to the management and support of our network.

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

|  | <b>Year ended December 31,</b> |             |
|--|--------------------------------|-------------|
|  | <b>2006</b>                    | <b>2005</b> |
| <b>Domain name and other Internet services:</b>  |                                |             |
| Domain names, excluding Domain Direct            | 31,678,898                     | 26,693,950  |
| Other Internet services, including Domain Direct | 4,230,782                      | 2,588,975   |
| Total domain name and other Internet services    | 35,909,680                     | 29,282,925  |
| Network, other costs                             | 5,625,283                      | 1,362,079   |
| Network, depreciation and amortization costs     | 2,962,904                      | 751,613     |
|  | \$ 44,497,867                  | 31,396,617  |
| Increase over prior period                       | \$ 13,101,250                  |             |
| Increase percentage                              | 42                             | %           |

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

|  | <b>Year ended December 31,</b> |   |             |   |
|--|--------------------------------|---|-------------|---|
|  | <b>2006</b>                    |   | <b>2005</b> |   |
| <b>Domain name and other Internet services:</b>  |                                |   |             |   |
| Domain names, excluding Domain Direct            | 71.2                           | % | 85.0        | % |
| Other Internet services, including Domain Direct | 9.5                            | % | 8.2         | % |
| Total domain name and other Internet services    | 80.7                           | % | 93.2        | % |
| Network, other costs                             | 12.6                           | % | 4.4         | % |
| Network, depreciation and amortization costs     | 6.7                            | % | 2.4         | % |
|  | \$ 100.0                       | % | 100.0       | % |

Cost of revenues for Fiscal 2006 increased by approximately \$13.1 million, or 42%, to \$44.5 million from \$31.4 million for Fiscal 2005, primarily as a result of the higher costs attributable to increased volumes of domain registrations and other Internet services of \$6.6 million and an increase in network costs of \$6.5 million. The increase in network costs was primarily the result of the additional labor, bandwidth and co-location costs required to manage the data centers of \$4.1 million, which includes \$513,000 of transitional costs relating to the transfer of operational knowledge from Critical Path Inc. employees, in connection with the acquisition of the Hosted Messaging Assets of Critical Path Inc.

Additional depreciation of \$2.0 million relating to information technology assets and increased amortization of \$200,000 relating to our acquisitions, also contributed to the increased cost of revenues. Additional network costs of \$162,000 were also incurred for travel to new co-location facilities and for other related miscellaneous expenses. The increase in cost of revenues as a percentage of total revenue was primarily the result of the proportionately greater network costs incurred to support and manage our expanded Internet service offerings, most notably our hosted email platform.

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

During Fiscal 2006, direct cost of goods pertaining to domain names, excluding Domain Direct, comprised 71.2% of the cost of goods, compared to 85.0% for Fiscal 2005. During Fiscal 2006, direct cost of goods pertaining to other Internet services, including Domain Direct, comprised 9.5% of total cost of goods, compared to 8.2% for Fiscal 2005.

Amortization of intangible assets consists of amounts arising in connection with the acquisition of technology from each of the Boardtown Corporation in April 2004, the Hosted Messaging Business of Critical Path, Inc. in January 2006, and Mailbank.com Inc. in June 2006.

The technology purchased in connection with the acquisition of Boardtown Corporation is amortized on a straight-line basis over seven years, while the technology acquired in connection with each of the acquisitions of the Hosted Messaging Assets of Critical Path, Inc. and the in-house software of Mailbank.com Inc., is amortized on a straight-line basis over two years.

Prepaid domain registration and other Internet services fees at December 31, 2006 increased by approximately \$5.8 million, to approximately \$31.7 million from approximately \$25.9 million at December 31, 2005.

We expect network costs to increase as our network expands geographically and network activity increases.

## SALES AND MARKETING

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

|                            | Year ended December 31, |              |
|----------------------------|-------------------------|--------------|
|                            | 2006                    | 2005         |
| Sales and marketing        | \$ 5,985,907            | \$ 4,855,050 |
| Increase over prior period | \$ 1,130,857            |              |
| Increase percentage        | 23                      | %            |
| Percentage of net revenues | 9                       | % 10 %       |

Sales and marketing expenses Fiscal 2006 increased by approximately \$1.1 million, or 25%, to approximately \$6.0 million, compared to approximately \$4.9 million during Fiscal 2005.

The increase during Fiscal 2006 was primarily the result of additional people costs of \$1.2 million, including the cost of approximately \$53,000 relating to a severance payment, \$65,000 of stock-based compensation as a result of our adoption of SFAS 123R and the increase in staff needed to support our



expanded Hosted Messaging assets. In addition, in connection with our recent acquisition of our Hosted Messaging Assets, we incurred transitional costs in the amount of \$37,000 relating to knowledge transfer. The increase was also a result of additional travel costs of \$48,000 and additional marketing costs of \$49,000, as we continue to extend our sales and marketing reach. The increase in additional marketing costs was more than offset by the reversal of a contingency that was established for a marketing initiative but that is no longer required, amounting to \$238,000.

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

## TECHNICAL OPERATIONS AND DEVELOPMENT

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

|                                      | Year ended December 31, |           |      |           |
|--------------------------------------|-------------------------|-----------|------|-----------|
|                                      | 2006                    |           | 2005 |           |
| Technical operations and development | \$                      | 8,152,138 | \$   | 5,627,426 |
| Increase over prior period           | \$                      | 2,524,712 |      |           |
| Increase percentage                  |                         | 45        | %    |           |
| Percentage of net revenues           |                         | 13        | %    | 12        |
|                                      |                         |           |      | %         |

Technical operations and development expenses for Fiscal 2006 increased approximately \$2.5 million, or 45%, to approximately \$8.2 million from approximately \$5.6 million for Fiscal 2005.

The increase was primarily the result of people related costs, including contract and outside service costs, which increased by approximately \$2.3 million. Such increase reflects our ongoing commitment to enhance and extend our OpenSRS platform, as well as the additional resources required to develop and support our other Internet services, including our Hosted Messaging service. Included in this increase in people costs is \$679,000 of transitional costs incurred in connection with our acquisition of the Hosted Messaging Assets of Critical Path, relating to operational knowledge transfer from Critical Path employees, and \$40,000 of other expenses, primarily travel related expenses. Also included in the increase in technical operations and development expenses is approximately \$40,000 related to travel and other expenses.

In addition, for Fiscal 2006, we recorded \$92,000 of stock-based compensation as a result of our adoption of SFAS 123R effective January 1, 2006.

Capitalized personnel costs for employees directly related to the application development stage of development projects decreased by \$124,000 to \$204,000, compared to Fiscal 2005, which decrease also contributed to the increase in technical operations and development expenses Fiscal 2006.

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

**GENERAL AND ADMINISTRATIVE**

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

|                            | Year ended December 31, |              |   |   |
|----------------------------|-------------------------|--------------|---|---|
|                            | 2006                    | 2005         |   |   |
| General and administrative | \$ 5,890,123            | \$ 4,346,224 |   |   |
| Increase over prior period | \$ 1,543,899            |              |   |   |
| Increase percentage        | 36                      | %            |   |   |
| Percentage of net revenues | 9                       | %            | 9 | % |

General and administrative expenses for the year ended Fiscal 2006 increased by approximately \$1.5 million, or 36%, to \$5.9 million from \$4.3 million for Fiscal 2005.

The increase in general and administrative expenses is predominantly a result of increased people costs, including contract and outside service costs, of \$446,000 and a cost of approximately \$123,000 relating to a severance payment. The increase also resulted from \$132,000 of stock-based compensation as a result of our adoption of SFAS 123R.

During Fiscal 2006, professional fees increased by an amount of \$279,000, bank charges increased by an amount of \$172,000 predominantly as a result of the incremental credit card processing fees incurred as a result of the incremental credit card transactions as a result of our acquisition of Mailbank.com Inc in June 2006. In addition to these amounts, incremental public listing expenses, inclusive of registration and other regulatory filings, accounted for an increase of \$146,000 in general and administrative costs and increased facility costs amounted to \$119,000.

General and administrative costs increased by an additional \$273,000 for Fiscal 2006 as a result of increased costs incurred for business and state taxes, telephone, office supplies and travel expenses, as compared Fiscal 2005.

During Fiscal 2006, foreign exchange generated a gain of \$206,000, compared to a gain of \$221,000 for Fiscal 2005. The movement against the U.S. dollar and predominantly the Canadian dollar accounted for a gain of \$781,000 for the year ended December 31, 2006 compared to a gain of \$251,000 for the year ended December 31, 2005. This gain was offset by the impact of the fair value adjustment on unrealized foreign exchange forward contracts, which for the year ended December 31, 2006 was a net loss of approximately \$575,000, and for the year ended December 31, 2005, the impact was a net loss of approximately \$30,000.

These increases in general and administrative expenses for the year ended December 31, 2006 were offset by an amount of \$37,000 as a result of a decrease in the cost of insurance and a decrease in the provision for bad debts.

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

**DEPRECIATION OF PROPERTY AND EQUIPMENT**

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

|  | Year ended December 31, |            |   |   |
|--|-------------------------|------------|---|---|
|  | 2006                    | 2005       |   |   |
| Depreciation of property and equipment | \$ 223,131              | \$ 200,079 |   |   |
| Increase over prior period             | \$ 23,052               |            |   |   |
| Increase percentage                    | 12                      | %          |   |   |
| Percentage of net revenues             | 0                       | %          | 0 | % |

The decrease in depreciation for Fiscal 2006 compared to Fiscal 2005 was primarily due to certain of our older computer software being fully depreciated and not requiring replacement.

**AMORTIZATION OF INTANGIBLE ASSETS**

|                                   | Year ended December 31, |            |   |   |
|-----------------------------------|-------------------------|------------|---|---|
|                                   | 2006                    | 2005       |   |   |
| Amortization of intangible assets | \$ 669,476              | \$ 236,160 |   |   |
| Increase over prior period        | \$ 433,316              |            |   |   |
| Increase percentage               | 183                     | %          |   |   |
| Percentage of net revenues        | 1                       | %          | 0 | % |

Amortization of intangible assets consists of amounts arising in connection with the acquisition of Boardtown Corporation in April 2004, from the acquisition of the Hosted Messaging Business of Critical Path, Inc. in January 2006, and the acquisition of Mailbank.com Inc. in June 2006.

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

The customer relationships acquired in connection with the acquisition of the Hosted Messaging Assets of Critical Path, Inc. are amortized on a straight-line basis over five years.

In connection with the acquisition of Mailbank.com Inc., customers and customer relationships purchased are amortized on a straight-line basis over five years.

**OTHER INCOME**

|                              | Year ended December 31, |            |   |   |
|------------------------------|-------------------------|------------|---|---|
|                              | 2006                    | 2005       |   |   |
| Other income (expenses), net | \$ 2,457,551            | \$ 765,158 |   |   |
| Increase over prior period   | \$ 1,692,393            |            |   |   |
| Increase percentage          | 221                     | %          |   |   |
| Percentage of net revenues   | 4                       | %          | 2 | % |

In 2002, we assigned to an unrelated third party various patents which were acquired by us in the merger with Infonautics Corporation in 2001. In connection with the assignment of these patents, we retained the right to share in certain revenue relating to any cash flow received by such third party relating to the commercialization of these patents. As a result of this assignment, during Fiscal 2006, we recognized

\$2.3 million in other revenue. This amount was fully paid to us during the year. We do not expect to receive any additional revenue from this arrangement in the future.

Other income also includes interest income of \$365,000 Fiscal 2006, compared to \$463,000 for Fiscal 2005. Interest income is expected to decrease in future periods as we will have lower investment balances available, primarily as a result of the acquisitions we have made this year. As a result of the promissory notes issued in association with the acquisition of Mailbank.com Inc. in June 2006, we incurred an interest expense of \$255,000 during Fiscal 2006.

## INCOME TAXES

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

|                            | Year ended December 31, |               |
|----------------------------|-------------------------|---------------|
|                            | 2006                    | 2005          |
| Recovery of income taxes   | \$ (92,035 )            | \$ (151,975 ) |
| Decrease over prior period | \$ (59,940 )            |               |
| Decrease percentage        | (39 )%                  |               |
| Percentage of net revenues | (0 )%                   | (0 )%         |

We operate in various tax jurisdictions, and accordingly, our income is subject to varying rates of tax. Losses incurred in one jurisdiction cannot be used to offset income taxes payable in another. No provision for income taxes was recorded for Fiscal 2006 and 2005 because we had net operating losses to offset against our operating income. Our ability to use income tax loss carryforwards and future income tax deductions is dependant upon our operations in the tax jurisdictions in which such losses or deductions arise.

We are entitled to certain Canadian investment tax credits for qualifying research and development activities performed in Canada. During Fiscal 2006, we recorded a tax recovery, net of Canadian provincial taxes otherwise payable, in the amount of approximately \$92,000, representing the actual investment tax credit payment received from the Canadian authorities with respect to research and development undertaken in 2004.

During Fiscal 2005, we recorded a tax recovery, net of Canadian provincial taxes otherwise payable, in the amount of \$152,000, representing the actual investment tax credit received from the Canadian authorities with respect to research and development undertaken in 2001, 2002 and 2003.

**RESULTS OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31, 2005 AS COMPARED TO DECEMBER 31, 2004**

The following table presents our revenues, by revenue source:

|  | Year ended December 31, |            |
|--|-------------------------|------------|
|  | 2005                    | 2004       |
| Domain name and other Internet services:         |                         |            |
| Domain names, excluding Domain Direct            | 37,984,645              | 35,807,131 |
| Other Internet services, including Domain Direct | 7,334,284               | 5,692,656  |
| Total domain name and other Internet services    | 45,318,929              | 41,499,787 |
| Advertising and other revenue                    | 3,198,110               | 3,217,368  |
|  | \$ 48,517,039           | 44,717,155 |
| Increase over prior period                       | \$ 3,799,884            |            |
| Increase percentage                              | 8                       | %          |

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

|  | Year ended December 31, |   |       |   |
|--|-------------------------|---|-------|---|
|  | 2005                    |   | 2004  |   |
| Domain name and other Internet services:         |                         |   |       |   |
| Domain names, excluding Domain Direct            | 78.3                    | % | 80.1  | % |
| Other Internet services, including Domain Direct | 15.1                    | % | 12.7  | % |
| Total domain name and other Internet services    | 93.4                    | % | 92.8  | % |
| Advertising and other revenue                    | 6.6                     | % | 7.2   | % |
|  | \$ 100.0                | % | 100.0 | % |

Total net revenues for Fiscal 2005 increased to \$48.5 million from \$44.7 million for Fiscal 2004.

During Fiscal 2005, no customer accounted for more than 5% of billed revenue, and one customer accounted for 11% of accounts receivable at December 31, 2005. Subsequent to the year end, all of the amounts owed by this customer were collected. Significant management judgment is required at the time of recording of revenue to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

*Domain name and other Internet services*

Net revenues from domain name and other Internet services for Fiscal 2005 increased by \$3.8 million, or 9%, to \$45.3 million from \$41.5 million for Fiscal 2004, primarily as a result of increased volumes from new and existing customers, as well as the additional revenue earned as a result of the April 2004 acquisition of Boardtown Corporation. This increase occurred despite the fact that during Fiscal 2004, our revenue numbers included the recognition of deferred domain name revenue of approximately \$1.1 million that was recognized as a result of one of our resellers becoming an accredited registrar and transferring all of its domain names from our tag to its own tag. The impact of the transfer of these names, which included a large number of multiple year registrations, resulted in our having no future obligations in connection with these names. As a result, we recognized all deferred revenue previously recorded relating to these names during Fiscal 2004. The customer continues to be a customer of ours, using our OpenHRS platform for its registration needs.

During Fiscal 2005, the number of domain names that we processed increased by approximately 300,000 to approximately 4.0 million new, renewed and transferred-in domain name registrations, compared to Fiscal 2004. These increases were due primarily to the fact that we continued to compete aggressively to attract new clients and retain existing customers in order to protect our current market share and improve our competitive position. These actions have resulted in our average selling price declining, which has partially offset the impact of the increased transaction volume on our revenue and profitability. We may face continued pricing pressure in order to remain competitive, which would adversely impact our revenues and profitability.

The renewal rate for domain name registrations increased to approximately 70% for Fiscal 2005 compared to approximately 65% for Fiscal 2004.

During Fiscal 2005, revenue from domain names, excluding Domain Direct, comprised 78.3% of total revenue, compared to 80.1% for Fiscal 2004. During Fiscal 2005, revenue from other Internet services, including Domain Direct, comprised 15.1% of total revenue, compared to 12.7% for Fiscal 2004.

While we anticipate that the number of new, renewed and transferred-in domain name registrations will incrementally increase, the volatility in the market could affect the growth of domain names under our management. During Fiscal 2005, the total number of domain names under our management increased by approximately 500,000 to approximately 4.9 million, compared to Fiscal 2004. As of December 31, 2005 we provided provisioning services to five registrars on a monthly basis, as compared to six registrars at December 31, 2004, who use our technical systems to process domain registrations with their accreditation. As of December 31, 2005, we managed approximately 869,000 domain names, compared to approximately 316,000 at December 31, 2004, on their behalf.

Deferred revenue from domain name registrations and other Internet services at December 31, 2005 increased to approximately \$37.9 million from approximately \$33.3 million at December 31, 2004.

#### *Advertising and other revenue*

Advertising and other revenue for the years ended December 31, 2005 and 2004 remained flat at approximately \$3.2 million primarily due to the improved efficiency that users are experiencing in using our redesigned software download website that we completed during the second quarter of 2005.

During Fiscal 2005, revenue from advertising and other revenue comprised 6.6% of total revenue, compared to 7.2% for Fiscal 2004.

#### **COST OF REVENUES**

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

Cost of revenues for domain registrations represents the amortization of registry fees on a basis consistent with the recognition of revenues from our customers, namely ratably over the term of provision of the service. Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered, and are recorded as prepaid domain registry fees. Costs of revenues for other Internet services consist of fees paid to third-party service providers and are recognized ratably over the periods in which the services are provided. We have minimal direct cost of revenues associated with our advertising and other revenues. Therefore, the gross profit margin on advertising revenue is approximately 100% and, accordingly, any increase or decrease in advertising and other revenue represents an increase or a reduction of our gross profit of the same amount. Network costs include personnel and related expenses, including bandwidth and co-location expenses to support the supply of all our services. Bandwidth and co-location expenses are composed primarily of communication and provisioning costs related to the management and support of our network.

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

|  | Year ended December 31, |            |
|--|-------------------------|------------|
|  | 2005                    | 2004       |
| Domain name and other Internet services:         |                         |            |
| Domain names, excluding Domain Direct            | 26,693,950              | 24,273,535 |
| Other Internet services, including Domain Direct | 2,588,975               | 2,093,558  |
| Total domain name and other Internet services    | 29,282,925              | 26,367,093 |
| Network, other costs                             | 1,362,079               | 1,198,973  |
| Network, depreciation and amortization costs     | 751,613                 | 738,701    |
|  | \$ 31,396,617           | 28,304,767 |
| Increase over prior period                       | \$ 3,091,850            |            |
| Increase percentage                              | 11                      | %          |

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

|  | Year ended December 31, |   |       |   |
|--|-------------------------|---|-------|---|
|  | 2005                    |   | 2004  |   |
| Domain name and other Internet services:         |                         |   |       |   |
| Domain names, excluding Domain Direct            | 85.0                    | % | 85.8  | % |
| Other Internet services, including Domain Direct | 8.2                     | % | 7.4   | % |
| Total domain name and other Internet services    | 93.2                    | % | 93.2  | % |
| Network, other costs                             | 4.4                     | % | 4.2   | % |
| Network, depreciation and amortization costs     | 2.4                     | % | 2.6   | % |
|  | \$ 100.0                | % | 100.0 | % |

Cost of revenues for Fiscal 2005 increased by approximately \$3.1 million, or 11%, to \$31.4 million from \$28.3 million for Fiscal 2004, primarily as a result of the higher costs attributable to increased volumes of domain registrations and other Internet services of \$2.9 million and to the November 2004 change in nature of the ICANN accreditation fee. This increase was partly offset by the recognition of the non-cash prepaid cost of goods recorded during Fiscal 2004 of approximately \$800,000 that arose as a result of one of our resellers, as more fully described under Net Revenue above, becoming an accredited registrar and transferring all of its domain names from our tag to its own tag with the result that we no longer have any future obligations in connection with these names.

Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered. Registry fees are recorded as prepaid domain registry fees and are recognized ratably over the term of provision of the service. Other Internet service costs and ICANN accreditation transaction fees are generally paid either monthly or quarterly. Services provided over periods longer than one month are recognized ratably over the term of provision of the service. Effective November 1, 2004, ICANN's members voted to change the basis whereby registrars pay their variable accreditation fee to a transaction based fee of \$0.25 per domain year registered. As this fee is now being charged as a transaction fee, we are no longer expensing this fee to sales and marketing, but are allocating it to cost of goods sold and are recognizing it ratably over the term of provision of the service. We anticipate that cost of revenues will continue to increase in absolute dollars primarily as a result of continued growth in domain registration and other Internet services.

During Fiscal 2005, direct cost of goods pertaining to domain names, excluding Domain Direct, comprised 85.0% of total cost of goods, compared to 85.8% for Fiscal 2004. During Fiscal 2005, direct cost of goods pertaining to other Internet services, including Domain Direct, comprised 8.2% of total cost of goods, compared to 7.4% for Fiscal 2004.

Prepaid domain registration and other Internet services fees at December 31, 2005 increased by approximately \$3.8 million, to approximately \$25.9 million from approximately \$22.1million at December 31, 2004.

Cost of revenues includes the costs of network operations. These costs for Fiscal 2005 increased by \$13,000, or 2%, to \$752,000 from \$739,000 for Fiscal 2004, primarily as a result of additional people costs resulting from increased headcount and hours of operation, as well as increased network server maintenance and support contract costs.

The cost of network operations is comprised primarily of communication costs, equipment maintenance, and employee and related costs directly associated with the management and maintenance of the network.

## SALES AND MARKETING

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

|                            | Year ended December 31, |              |
|----------------------------|-------------------------|--------------|
|                            | 2005                    | 2004         |
| Sales and marketing        | \$ 4,855,050            | \$ 5,067,841 |
| Decrease over prior period | \$ (212,791 )           |              |
| Decrease percentage        | (4 )%                   |              |
| Percentage of net revenues | 10                      | % 11 %       |

Sales and marketing expenses during Fiscal 2005 decreased by approximately \$210,000, or 4%, to approximately \$4.9 million compared to approximately \$5.1 million during Fiscal 2004.

The decrease was primarily the result of a decrease in ICANN fees, which decreased by approximately \$490,000 due to this expense now being included under cost of goods sold (as discussed under Cost of revenues above).

In addition, personnel costs increased primarily as a result of additional personnel in sales and product management by approximately \$212,000. This increase was net of an amount of approximately \$198,000 recorded during Fiscal 2004 in connection with the 2004 At Risk incentive compensation plan. No accrual has been recorded for Fiscal 2005 as management has determined that we did not exceed the performance thresholds set by the compensation committee for senior managers and executive officers in our 2005 At Risk incentive compensation plan. This increase was also as a result of incremental expenses of approximately \$81,000 incurred during Fiscal 2005 as a result of additional marketing, supplies and other miscellaneous expenses. This was slightly offset by a decrease in travel expenses of approximately \$16,000 for Fiscal 2005 as a result of less travel undertaken during the year.

## TECHNICAL OPERATIONS AND DEVELOPMENT

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



## Institute of Certified Public Accountants Statement of Position 98-1, Accounting for the Costs of Computer Software

Developed or Obtained for Internal Use, costs incurred during the application development stage are capitalized and primarily include personnel costs for employees directly related to the development project. All other costs are expensed as incurred.

|                                      | Year ended December 31, |              |
|--------------------------------------|-------------------------|--------------|
|                                      | 2005                    | 2004         |
| Technical operations and development | \$ 5,627,426            | \$ 4,549,368 |
| Increase over prior period           | \$ 1,078,058            |              |
| Increase percentage                  | 24                      | %            |
| Percentage of net revenues           | 12                      | % 10         |

Technical operations and development expenses for Fiscal 2005 increased approximately \$1.1 million, or 24%, to approximately \$5.6 million from approximately \$4.5 million for Fiscal 2004.

The increase was primarily the result of people related costs including contract and outside service costs, which increased by approximately \$1.1 million (includes a cost of approximately \$100,000 relating to a severance payment) and reflects our ongoing commitment to enhance and extend our OpenSRS platform. No accrual was included under technical operations and development expenses during Fiscal 2005 for our 2005 At Risk incentive compensation plan as management has determined that we did not exceed the performance thresholds set by the compensation committee for senior managers and executive officers under the plan compared to approximately \$101,000 included for Fiscal 2004 under the 2004 At Risk incentive compensation plan. Also included in the increase in technical operations and development expenses is an increase of approximately \$75,000 related to travel and other expenses. These amounts were partly offset by a decrease in technical operations and development expenses due to a decrease in stock-based compensation of approximately \$70,000. This cost was incurred during Fiscal 2004, as a result of a change to the terms of the options granted to one of our former officers.

**GENERAL AND ADMINISTRATIVE**

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

|                            | Year ended December 31, |              |
|----------------------------|-------------------------|--------------|
|                            | 2005                    | 2004         |
| General and administrative | \$ 4,346,224            | \$ 4,107,981 |
| Increase over prior period | \$ 238,243              |              |
| Increase percentage        | 6                       | %            |
| Percentage of net revenues | 9                       | % 9          |

General and administrative expenses for Fiscal 2005 increased by approximately \$240,000, or 6%, to \$4.4 million from \$4.1 million for Fiscal 2004.

The increase in general and administrative expenses generally reflects the more sophisticated infrastructure needed to support the constantly evolving needs we experience as the size and scope of our business continues to grow. This resulted in increases in provision for doubtful accounts of approximately \$46,000, increases in facility costs of approximately \$111,000, and increases in public listing expenses, professional fees, telephone and supplies totaling approximately \$136,000 (includes an incremental cost of \$98,000 related to an outside management consultant). We also recorded a foreign exchange gain of

approximately \$221,000 for Fiscal 2005 compared to approximately \$432,000 for Fiscal 2004, reflecting the continued strengthening in the Canadian dollar.

These increases were partially offset by decreases in people costs, including contract and outside services of approximately \$89,000. This decrease in people costs reflects increases in people costs to support our growth being offset by our not including an accrual under general and administrative expenses during Fiscal 2005 for our 2005 At Risk incentive compensation plan as management has determined that we did not exceed the performance thresholds set by the compensation committee for senior managers and executive officers under the plan compared to approximately \$353,000 included for Fiscal 2004 under the 2004 At Risk incentive compensation plan. Directors and officers liability insurance, business and state taxes travel and other miscellaneous expenses also decreased by a total of approximately \$177,000 during Fiscal 2005 compared to Fiscal 2004.

#### DEPRECIATION OF PROPERTY AND EQUIPMENT

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

|  | Year ended December 31, |            |
|--|-------------------------|------------|
|  | 2005                    | 2004       |
| Depreciation of property and equipment | \$ 200,079              | \$ 380,033 |
| Decrease over prior period             | \$ (179,954 )           |            |
| Decrease percentage                    | (47 )%                  |            |
| Percentage of net revenues             | 0                       | % 1 %      |

The decrease in depreciation Fiscal 2005 compared to Fiscal 2004 was primarily due to certain of our older computer software being fully depreciated and not requiring replacement.

#### AMORTIZATION OF INTANGIBLE ASSETS

Amortization of intangible assets consists of amounts arising in connection with the acquisition of Boardtown Corporation in April 2004. The technology, brand and customer relationships purchased are amortized on a straight-line basis over seven years, while the non-competition agreements entered into with the former owners of Boardtown Corporation are amortized on a straight-line basis over three years.

|                                   | Year ended December 31, |            |
|-----------------------------------|-------------------------|------------|
|                                   | 2005                    | 2004       |
| Amortization of intangible assets | \$ 236,160              | \$ 157,760 |

#### OTHER INCOME

|                              | Year ended December 31, |            |
|------------------------------|-------------------------|------------|
|                              | 2005                    | 2004       |
| Other income (expenses), net | \$ 765,158              | \$ 200,501 |

Other income includes net interest income of approximately \$462,000 for the year ended December 31, 2005 and approximately \$201,000 for the year ended December 31, 2004.

In 2002, we assigned to an unrelated third party (our Partner), various patents which were acquired by us in the merger with Infonautics in 2001. In connection with the assignment of these patents, we retained the right to a revenue share relating to any cash flow received by our Partner relating to the commercialization of these patents. As a result of this assignment, during Fiscal 2005, we recognized \$303,000 in other revenue. This amount was fully paid to us during the year. During Fiscal 2006, we

recognized \$2.3 million in other revenue as a result of this assignment. This amount was fully paid to us during 2006. We do not expect to receive any additional revenue share from this arrangement in the future.

**INCOME TAXES**

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

|                          | Year ended December 31, |                |
|--------------------------|-------------------------|----------------|
|                          | 2005                    | 2004           |
| Recovery of income taxes | \$ (151,975)            | \$ (3,150,432) |

We operate in various tax jurisdictions, and accordingly, our income is subject to varying rates of tax. Losses incurred in one jurisdiction cannot be used to offset income taxes payable in another. No provision for income taxes was recorded for Fiscal 2005 and 2004 because we had net operating losses to offset against our operating income. Our ability to use income tax loss carryforwards and future income tax deductions is dependant upon our operations in the tax jurisdictions in which such losses or deductions arise.

We are entitled to certain Canadian investment tax credits for qualifying research and development activities performed in Canada. During Fiscal 2005, we recorded a tax recovery, net of Canadian provincial taxes otherwise payable, in the amount of approximately \$152,000, representing the actual investment tax credit payment received from the Canadian authorities with respect to research and development undertaken in 2001, 2002 and 2003.

**Quarterly results**

The following table summarizes selected unaudited quarterly financial data for the past eight quarters:

**Tucows Inc.****Quarterly Results of Operations**

(Dollar amounts in U.S. dollars)

|  | <b>Three months ended<br/>March 31,<br/>2006<br/>(unaudited)</b> | <b>June 30,<br/>2006</b> | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2006</b> |
|--|--|--------------------------|-------------------------------|------------------------------|
| Net revenues   | \$ 15,287,120  | \$ 15,678,856            | \$ 16,864,320                 | \$ 17,199,194                |
| Income (loss) from operations                            | (733,461 )   | 135,691                  | 34,603                        | 174,015                      |
| Net income (loss) for the period                         | (156,964 )   | 226,353                  | 1,934,621                     | 156,424                      |
| Basic and diluted income per share                       | \$ 0.00  | \$ 0.00                  | \$ 0.03                       | \$ 0.00                      |
| Shares used in computing basic income per common share   | 71,980,393   | 72,527,662               | 75,706,078                    | 75,856,208                   |
| Shares used in computing diluted income per common share | 71,980,393   | 74,704,791               | 78,214,560                    | 78,186,255                   |
|  | <b>March 31,<br/>2005<br/>(unaudited)</b>                        | <b>June 30,<br/>2005</b> | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2005</b> |
| Net revenues   | \$ 11,801,706  | \$ 12,002,138            | \$ 12,054,796                 | \$ 12,658,399                |
| Income from operations                                   | 213,587  | 410,776                  | 665,463                       | 565,657                      |
| Net income for the period                                | 442,810  | 507,632                  | 788,218                       | 1,033,956                    |
| Basic and diluted income per share                       | \$ 0.01  | \$ 0.01                  | \$ 0.01                       | \$ 0.01                      |
| Shares used in computing basic income per common share   | 66,883,487   | 65,991,867               | 69,602,723                    | 71,898,247                   |
| Shares used in computing diluted income per common share | 71,604,368   | 68,744,679               | 73,145,627                    | 74,810,799                   |

**Liquidity and capital resources**

At December 31, 2006, our principal source of liquidity was cash, cash equivalents and short-term investments of approximately \$6.3 million compared to approximately \$19.1 million at December 31, 2005, a decrease of approximately \$12.8 million.

Net cash provided by operating activities for Fiscal 2006 was \$8.8 million, compared to \$4.1 million for Fiscal 2005. Operating activities, after adjustment for non-cash and other items including depreciation, amortization, change in the fair value of forward contracts and stock-based compensation of \$4.7 million, for Fiscal 2006 generated \$6.9 million. Changes in non-cash operating working capital provided an additional \$1.9 million. The increase in non-cash operating working capital primarily reflects changes in deferred revenue, which in turn is offset by changes in accounts receivable, accounts payable, accrued expenses, and prepaid domain name registry fees. The increase in accounts receivable resulted primarily from our recent acquisition of the Hosted Messaging Assets from Critical Path.

In October 2006, we migrated the email accounts acquired in the Mailbank.com Inc. transaction to our hosted email platform. As a result of service degradations experienced by these customers during the conversion process, we determined that it would be appropriate to extend the service period of all these customers by 90 days. Accordingly, this impacted the timing of renewal cash flow by 90 days and resulted in a decrease in cash flows of approximately \$600,000 during the quarter ended December 31, 2006. As this billed revenue would have been deferred and then recognized over the period that service is provided, our

current deferred revenue pertaining to these customers will be recognized over the extended period. The impact of this sales credit on recognized revenue is not expected to have a material impact in any reporting period.

Net cash used in investing activities was approximately \$18.0 million for Fiscal 2006. This resulted primarily from the cash amounts paid for the acquisition of Mailbank.com Inc. on June 19, 2006 for \$6.5 million and the purchase of the Hosted Messaging assets of Critical Path, Inc. for \$7.6 million on January 3, 2006. In addition, in connection with the acquisition of the Hosted Messaging Assets we placed an additional \$1.8 million into escrow to meet our obligation to pay additional cash payments to Critical Path Inc. if certain performance targets were met. As a result of performance targets being met, \$1 million was released from escrow in August 2006 and \$527,000 was released from escrow to Tucows and an additional \$95,532 was released from escrow in December 2006. In January 2007, the final \$90,050 was released from escrow and paid to Critical Path together with their share of interest earned on the monies in escrow.

In connection with the acquisition of Mailbank.com Inc. in June 2006, we issued two unsecured promissory notes, the first for \$6,000,000, bearing interest at 7% per annum, and the second for \$2,122,930, bearing interest at 9% per annum. Interest on the first note was payable quarterly in arrears, beginning October 1, 2006, with the principal payable on September 19, 2008. The second note was repaid in full by Tucows in August 2006, and primarily resulted in \$1.9 million of net cash used for financing activities for Fiscal 2006. This \$2.1 million repayment was partly offset by proceeds received on the exercise of stock options under our employee stock options plan in the amount of \$200,000.

We also invested \$4.6 million in property and equipment, primarily in Internet services infrastructure. These investments were made primarily for two reasons. First we wanted to position ourselves to take advantage of hosted email opportunities that materialized earlier than we expected, which investments included accelerating a successful re-architecture of our hosted email environment as well as the purchase of a significant number of additional hosted email licenses from Critical Path, Inc. Second, in response to a severe denial of service attack to which we were subject to in early May, which attack impacted a variety of the services on our network, we decided to both accelerate the timing of, and increase the investment in an improved Managed DNS infrastructure in order to better insulate ourselves against future attacks. Third, we experienced a significant increase in inbound spam and assessed that we needed to invest incrementally in our hosted email environment.

In addition, as of December 31, 2006 we held \$1.0 million in restricted cash as additional margin security against forward exchange contracts to which we are party.

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

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

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

**Subsequent event**

In February 2007, the Company purchased 1.5 million shares were purchased under the stock buyback program at \$0.87 per share.

**Off Balance Sheet Arrangements and Contractual Obligations**

We have not entered into any off balance sheet financial arrangements and have not established any special purpose entities as of December 31, 2006 nor have we guaranteed any debt or commitment of other entities. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. A summary of our contractual obligations and commercial commitments as of December 31, 2006 is presented in the table below. Purchase obligations include amounts committed under legally enforceable contracts or purchase orders.

| Contractual Obligations     | Total        | Payments due by period |              |            |                      |
|-----------------------------|--------------|------------------------|--------------|------------|----------------------|
|                             |              | Less than<br>1 year    | 1-3 years    | 3-5 years  | More than<br>5 years |
| Operating lease obligations | \$ 1,658,000 | \$ 352,000             | \$ 629,000   | \$ 677,000 | \$                   |
| Purchase obligations        | 2,290,000    | 1,240,000              | 1,029,000    | 21,000     |                      |
| Note payable                | 6,000,000    |                        | 6,000,000    |            |                      |
| Total                       | \$ 9,948,000 | \$ 1,592,000           | \$ 7,658,000 | \$ 698,000 | \$                   |

See additional discussion under Quantitative and Qualitative Disclosures about Market Risk in connection with the forward foreign exchange contracts that we entered into in December 2006.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We develop products in Canada and sell these products 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 at December 31, 2006.

Although we have a functional currency of U.S. dollars, a substantial portion of our fixed expenses are incurred in Canadian dollars. Our policy with respect to foreign currency exposure is to manage financial exposure to certain foreign exchange fluctuations with the objective of neutralizing some of the impact of foreign currency exchange movements. Accordingly, we have entered into foreign exchange forward contracts to mitigate the exchange rate risk on portions of our Canadian dollar exposure. These contracts, entered into in November 2006 will be utilized over the year ending December 31, 2007.

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

The impact of the fair value adjustment on unrealized foreign exchange forward contracts for Fiscal 2006 was a net loss of approximately \$575,000, and for Fiscal 2005, the impact was a net loss of approximately \$30,000, which is reflected on the consolidated statements of operations in general and administrative expenses. As of December 31, 2006, we had outstanding foreign currency forward contracts totaling \$20.4 million, with exchange rates varying from US\$1.00 to Cdn\$1.1250 to US\$1.00 to Cdn\$1.1362.

On November 14, 2006, Tucows entered into a series of forward foreign exchange contracts with a notional value of \$20.4 million, whereby \$850,000 is converted into Canadian dollars on a semi-monthly basis for the twelve months ended December 2007 at foreign exchange rates varying from U.S.\$1:Cdn\$1.1250 to U.S.\$1:Cdn\$1.1362.

We have performed a sensitivity analysis model for foreign exchange exposure over Fiscal 2006. 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 Fiscal 2006. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a decrease in net income for Fiscal 2006 of approximately \$1.8 million. There can be no assurances that the above projected exchange rate decrease will materialize. Fluctuations of exchange rates are beyond the actions to hedge or mitigate these risks.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our consolidated financial statements and supplementary data required by this item are attached to this Annual Report on Form 10-K beginning on page F-1.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

## **ITEM 9A. CONTROLS AND PROCEDURES**

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

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. We believe that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

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

No change in Tucows' internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **ITEM 9B. OTHER INFORMATION**

None.

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**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

All information required by this item but not set forth below is incorporated by reference to the Company's definitive proxy which will be filed with the Commission not later than 120 days after the close of the fiscal year covered by report.

**Code of Ethics**

We have adopted a Code of Ethics policy, known as the Ethics Policy for Senior Officers that applies to our Chief Executive Officer, Chief Financial Officer and Vice President, Finance. The Ethics Policy for Senior Officers is posted on our web site, [www.tucowsinc.com](http://www.tucowsinc.com). The Internet address for our web site is [www.tucowsinc.com](http://www.tucowsinc.com). The Ethics Policy for Senior Officers may be found at the Investors page on our web site. The information on our web site is not and should not be considered part of this Annual Report on Form 10-K and is intended to be an inactive textual reference only.

**ITEM 11. EXECUTIVE COMPENSATION**

Information required by this item is incorporated by reference to the Company's definitive proxy statement, which will be filed with the Commission not later than 120 days after the close of the fiscal year covered by this report.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information required by this item is incorporated by reference to the Company's definitive proxy statement, which will be filed with the Commission not later than 120 days after the close of the fiscal year covered by this report.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

Information required by this item is incorporated by reference to the Company's definitive proxy statement, which will be filed with the Commission not later than 120 days after the close of the fiscal year covered by this report.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information required by this item is incorporated by reference to Company's definitive proxy statement, which will be filed with the Commission not later than 120 days after the close of the fiscal year covered by this report.



**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

The following documents are filed as part of this Form 10-K:

1. **Financial Statements.** The financial statements listed in the accompanying index to consolidated financial statements are filed as part of this Form 10-K.
2. **Financial Statement Schedules.** Schedules are not submitted because they are not required or are not applicable, or the required information is shown in the consolidated financial statements or notes thereto.
3. **Exhibits.** The Exhibits listed below are filed or incorporated by reference as part of this Form 10-K. Where so indicated by footnote, exhibits which were previously filed are incorporated by reference. For exhibits incorporated by reference, the location of the exhibit in the previous filing is indicated in the footnotes below.

**Exhibit**

| <b>No.</b> | <b>Description</b>   |
|------------|--|
| 2.1        | Asset Purchase Agreement, dated as of December 14, 2005, between Critical Path and Tucows Inc. (Incorporated by reference to Exhibit 2.1 filed with Tucows' current report on Form 8-K, as filed with the Securities and Exchange Commission (the SEC) on December 19, 2005).              |
| 3.1        | Third Amended and Restated Articles of Incorporation of Tucows Inc. (Incorporated by reference to Exhibit 3.1 filed with Tucows' report on Form 8-K, as filed with the SEC on September 6, 2001).  |
| 3.2#       | Second Amended and Restated Bylaws of Tucows Inc.  |
| 10.1       | Stock Purchase Agreement, dated as of April 20, 2004, by and between Tucows Inc., Boardtown Corporation and the shareholders of Boardtown named therein (Incorporated by reference to Exhibit 2.1 filed with Tucows' report on Form 8-K, as filed with the SEC on May 11, 2004).           |
| 10.2       | Amendment to Stock Purchase Agreement, dated as of May 3, 2005, by and between Tucows Inc., Boardtown Corporation and the shareholders of Boardtown named therein (Incorporated by reference to Exhibit 10.1 filed with Tucows' report on Form 8-K, as filed with the SEC on May 5, 2005). |
| 10.3#      | 2006 Equity Compensation Plan.   |
| 10.4*      | Employment Agreement dated January 22, 2003 between Tucows.com Co. and Elliot Noss (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 28, 2004).                                |
| 10.5*      | Employment Agreement dated March 11, 2003 between Tucows.com Co. and Michael Cooperman (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 28, 2004).                            |
| 10.6*      | Employment Agreement dated March 11, 2003 between Tucows.com Co. and Supriyo Sen (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 28, 2004).                                  |
| 10.7*      | Employment Agreement dated March 11, 2003 between Tucows.com Co. and Graham Morris (Incorporated by reference to Exhibit 10.6 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 24, 2005).                                |

- 10.8 Lease between 707932 Ontario Limited and Tucows International Corporation, dated December 10, 1999 (Incorporated by reference to exhibit number 10.9 filed with Tucows annual report on Form 10-K for Fiscal 2001, as filed with the SEC on April 1, 2002).
- 10.9 Lease extension between 707932 Ontario Limited and Tucows Inc. and Tucows.com Co., dated September 4, 2004 (Incorporated by reference to Exhibit 10.5 filed with Tucows annual report on Form 10-K for Fiscal 2004, as filed with the SEC on March 23, 2005).
- 10.10\* Description of Tucows Fiscal 2004 At Risk Compensation Plan (Incorporated by reference to Exhibit 10.9 filed with Tucows annual report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 24, 2005).
- 10.11 Registrar Accreditation Agreement, effective as of June 25, 2005, by and between the Internet Corporation for Assigned Names and Numbers and Tucows.com Co. (Incorporated by reference to Exhibit 10.12 filed with Amendment No. 1 to Tucows registration statement on Form S-1 (Registration No. 333-125843), as filed with the SEC on July 7, 2005).
- 10.12 Registry-Registrar Agreement, dated as of October 4, 2001, by and between VeriSign, Inc. and Tucows Inc. (Incorporated by reference to Exhibit 10.13 filed with Amendment No. 1 to Tucows registration statement on Form S-1 (Registration No. 333-125843), as filed with the SEC on July 7, 2005).
- 21.1# Subsidiaries of Tucows Inc.
- 23.1# Consent of KPMG LLP.
- 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.

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\* Management or compensatory contract required to be filed pursuant to Item 15(c) of the requirements for Form 10-K reports.

# Filed herewith.

**INDEX TO FINANCIAL STATEMENTS**

**Consolidated Financial Statements of Tucows Inc.**

|   | Pages |
|---|-------|
| Consolidated Financial Statements of Tucows Inc.  | F-1   |
| <u>Report of Registered Independent Public Accounting Firm</u>  | F-2   |
| <u>Consolidated Balance Sheets as of December 31, 2006 and 2005</u>   | F-3   |
| <u>Consolidated Statements of Operations for the years ended December 31, 2006, 2005 and 2004</u>           | F-4   |
| <u>Consolidated Statements of Stockholders' Equity for the years ended December 31, 2006, 2005 and 2004</u> | F-5   |
| <u>Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004</u>           | F-6   |
| <u>Notes to Consolidated Financial Statements</u>   | F-7   |

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of Tucows Inc.:

We have audited the accompanying consolidated balance sheets of Tucows Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tucows Inc. as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the financial statements, the Company changed its method of accounting for stock-based compensation in 2006.

/s/ KPMG LLP  
Chartered Accountants  
Toronto, Canada  
February 7, 2007, except as to note 12,  
which is as of February 15, 2007

**Tucows Inc.**  
**Consolidated Balance Sheets**  
**(Dollar amounts in U.S. dollars)**

|   | December 31,<br>2006 | December 31,<br>2005 |
|---|----------------------|----------------------|
| <b>Assets</b>   |                      |                      |
| Current assets:   |                      |                      |
| Cash and cash equivalents   | \$ 6,256,392         | \$ 17,348,088        |
| Short-term investments  |                      | 1,771,569            |
| Restricted cash (note 11(c))  | 1,019,423            | 60,000               |
| Interest receivable   |                      | 39,574               |
| Accounts receivable, net of allowance for doubtful accounts of \$147,500 as of December 31, 2006 and \$51,250 as of December 31, 2005   | 2,969,997            | 1,439,329            |
| Prepaid expenses and deposits   | 2,394,627            | 1,999,820            |
| Prepaid domain name registry and ancillary services fees, current portion   | 22,168,558           | 18,175,988           |
| Deferred tax asset, current portion (note 9)  | 1,000,000            | 1,000,000            |
| Total current assets  | 35,808,997           | 41,834,368           |
| Prepaid domain name registry and ancillary services fees, long-term portion   | 9,511,341            | 7,701,939            |
| Deferred acquisition costs  |                      | 46,034               |
| Property and equipment (note 4)   | 5,647,532            | 1,542,671            |
| Deferred tax asset, long-term portion (note 9)  | 2,000,000            | 2,000,000            |
| Intangible assets (note 5)  | 18,554,436           | 1,006,080            |
| Goodwill (note 3)   | 12,094,817           | 1,951,067            |
| Investment (note 6)   | 353,737              | 353,737              |
| Cash held in escrow (note 3)  | 694,579              | 621,412              |
| Total assets  | \$ 84,665,439        | \$ 57,057,308        |
| <b>Liabilities and Stockholders' Equity</b>   |                      |                      |
| Current liabilities:  |                      |                      |
| Accounts payable  | \$ 2,867,814         | \$ 1,655,195         |
| Accrued liabilities   | 2,567,012            | 1,417,035            |
| Customer deposits   | 3,144,119            | 2,276,637            |
| Deferred revenue, current portion   | 31,658,081           | 26,790,166           |
| Accreditation fees payable, current portion   | 847,325              | 651,811              |
| Total current liabilities   | 41,084,351           | 32,790,844           |
| Deferred revenue, long-term portion   | 13,478,525           | 11,079,537           |
| Accreditation fees payable, long-term portion   | 163,988              | 94,785               |
| Promissory note payable (note 3(b))   | 6,000,000            |                      |
| Deferred tax liability (note 9)   | 5,396,000            |                      |
| Stockholders' equity (note 7)   |                      |                      |
| Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding  |                      |                      |
| Common stock - no par value, 250,000,000 shares authorized; 75,978,502 shares issued and outstanding as of December 31, 2006 and 71,945,303 shares issued and outstanding as of December 31, 2005 | 15,395,381           | 12,403,422           |
| Additional paid-in capital  | 50,359,906           | 50,061,866           |
| Deficit   | (47,212,712)         | (49,373,146)         |
| Total stockholders' equity  | 18,542,575           | 13,092,142           |
| Total liabilities and stockholders' equity  | \$ 84,665,439        | \$ 57,057,308        |
| Subsequent events (note 12)   |                      |                      |

See accompanying notes to consolidated financial statements

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

|  | Year ended December 31, |               |               |
|--|-------------------------|---------------|---------------|
|  | 2006                    | 2005          | 2004          |
| Net revenues (note 13)   | \$ 65,029,490           | \$ 48,517,039 | \$ 44,717,155 |
| Cost of revenues (note 13):  |                         |               |               |
| Cost of revenues (*)   | 41,534,963              | 30,645,004    | 27,566,066    |
| Depreciation of property and equipment                                 | 2,755,736               | 751,613       | 738,701       |
| Amortization of intangible assets                                      | 207,168                 |               |               |
| Total cost of revenues   | 44,497,867              | 31,396,617    | 28,304,767    |
| Gross profit   | 20,531,623              | 17,120,422    | 16,412,388    |
| Expenses:  |                         |               |               |
| Sales and marketing (*)  | 5,985,907               | 4,855,050     | 5,067,841     |
| Technical operations and development (*)                               | 8,152,138               | 5,627,426     | 4,549,368     |
| General and administrative (*)   | 5,890,123               | 4,346,224     | 4,107,981     |
| Depreciation of property and equipment                                 | 223,131                 | 200,079       | 380,033       |
| Amortization of intangible assets                                      | 669,476                 | 236,160       | 157,760       |
| Total expenses   | 20,920,775              | 15,264,939    | 14,262,983    |
| Income (loss) from operations  | (389,152 )              | 1,855,483     | 2,149,405     |
| Other income:  |                         |               |               |
| Interest income, net   | 110,525                 | 462,424       | 200,501       |
| Other income, net (note 10)  | 2,347,026               | 302,734       |               |
| Total other income   | 2,457,551               | 765,158       | 200,501       |
| Income before provision for income taxes                               | 2,068,399               | 2,620,641     | 2,349,906     |
| Recovery of income taxes (note 9)                                      | (92,035 )               | (151,975 )    | (3,150,432 )  |
| Net income for the year  | \$ 2,160,434            | \$ 2,772,616  | \$ 5,500,338  |
| Basic earnings per common share (note 2(o))                            | \$ 0.03                 | \$ 0.04       | \$ 0.08       |
| Shares used in computing basic earnings per common share (note 2(o))   | 74,032,830              | 69,077,329    | 66,079,104    |
| Diluted earnings per common share (note 2(o))                          | \$ 0.03                 | \$ 0.04       | \$ 0.08       |
| Shares used in computing diluted earnings per common share (note 2(o)) | 76,489,381              | 72,481,204    | 68,051,579    |

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

|                                      |           |    |          |
|--------------------------------------|-----------|----|----------|
| Cost of revenues                     | \$9,700   | \$ | \$       |
| Sales and marketing                  | \$64,900  | \$ | \$16,834 |
| Technical operations and development | \$91,700  | \$ | \$69,737 |
| General and administrative           | \$131,740 | \$ | \$3,759  |

See accompanying notes to consolidated financial statements

**Tucows Inc.****Consolidated Statements of Stockholders Equity****(Dollar amounts in U.S. dollars)**

|   | Common stock |               | Additional    | Deferred     |                 | Total         |
|---|--------------|---------------|---------------|--------------|-----------------|---------------|
|   | Number       | Amount        | paid in       | stock-based  | Deficit         | stockholders  |
|   |              |               | capital       | compensation |                 | equity        |
| Balances, December 31, 2003   | 64,626,429   | \$ 8,540,687  | \$ 49,992,129 | \$ (20,593)  | \$ (57,646,100) | \$ 866,123    |
| Exercise of stock options   | 1,834,275    | 726,050       |               |              |                 | 726,050       |
| Acquisition of Boardtown Corporation (note 3)                         | 356,546      | 274,540       |               |              |                 | 274,540       |
| Stock-based compensation (note 8)                                     |              |               | 69,737        |              |                 | 69,737        |
| Amortization of deferred stock-based compensation                     |              |               |               | 20,593       |                 | 20,593        |
| Net income for the year   |              |               |               |              | 5,500,338       | 5,500,338     |
| Balances, December 31, 2004   | 66,817,250   | 9,541,277     | 50,061,866    |              | (52,145,762)    | 7,457,381     |
| Exercise of stock options   | 771,555      | 300,870       |               |              |                 | 300,870       |
| Acquisition of Boardtown Corporation (note 3)                         | 1,066,075    | 986,600       |               |              |                 | 986,600       |
| Net proceeds received on issuance of common stock, net of issue costs | 3,290,423    | 1,574,675     |               |              |                 | 1,574,675     |
| Net income for the year   |              |               |               |              | 2,772,616       | 2,772,616     |
| Balances, December 31, 2005   | 71,945,303   | 12,403,422    | 50,061,866    |              | (49,373,146)    | 13,092,142    |
| Exercise of stock options   | 433,293      | 206,608       |               |              |                 | 206,608       |
| Acquisition of Boardtown Corporation (note 3)                         | 3,569        | 3,281         |               |              |                 | 3,281         |
| Acquisition of Mailbank.com Inc. (note 3)                             | 3,596,337    | 2,782,070     |               |              |                 | 2,782,070     |
| Stock-based compensation (note 8)                                     |              |               | 298,040       |              |                 | 298,040       |
| Net income for the year   |              |               |               |              | 2,160,434       | 2,160,434     |
| Balances, December 31, 2006   | 75,978,502   | \$ 15,395,381 | \$ 50,359,906 | \$           | \$ (47,212,712) | \$ 18,542,575 |

See accompanying notes to consolidated financial statements

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

|  | <b>Year ended December 31,</b> |               |               |
|--|--------------------------------|---------------|---------------|
|  | <b>2006</b>                    | <b>2005</b>   | <b>2004</b>   |
| <b>Cash provided by (used in):</b>   |                                |               |               |
| <b>Operating activities:</b>   |                                |               |               |
| Net income for the year  | \$ 2,160,434                   | \$ 2,772,616  | \$ 5,500,338  |
| <b>Items not involving cash:</b>   |                                |               |               |
| Depreciation of property and equipment   | 2,978,867                      | 951,692       | 1,118,734     |
| Amortization of intangible assets  | 876,644                        | 236,160       | 157,760       |
| Unrealized change in the fair value of forward contracts   | 574,762                        | 30,119        | (88,743 )     |
| Stock-based compensation   | 298,040                        |               | 90,330        |
| Deferred income taxes  |                                |               | (3,000,000 )  |
| <b>Change in non-cash operating working capital:</b>   |                                |               |               |
| Interest receivable  | 39,574                         | (39,574 )     |               |
| Accounts receivable  | (1,475,715 )                   | (328,247 )    | (546,762 )    |
| Prepaid expenses and deposits  | 141,897                        | 126,763       | (1,333 )      |
| Prepaid domain name registry and ancillary services fees   | (5,801,972 )                   | (3,804,225 )  | (3,732,942 )  |
| Accounts payable   | 745,581                        | 171,652       | (148,751 )    |
| Accrued liabilities  | 44,828                         | (1,271,703 )  | 403,404       |
| Customer deposits  | 867,482                        | 29,375        | 77,772        |
| Deferred revenue   | 7,102,935                      | 4,618,723     | 4,661,788     |
| Accreditation fees payable   | 264,716                        | 570,297       | 176,299       |
| Cash provided by operating activities  | 8,818,073                      | 4,063,648     | 4,667,894     |
| <b>Financing activities:</b>   |                                |               |               |
| Proceeds received on exercise of stock options   | 206,608                        | 300,870       | 726,050       |
| Net proceeds received on issuance of common stock, net of issue costs  |                                | 1,574,675     |               |
| Repayment of note payable  | (2,122,930 )                   |               |               |
| Cash (used in) provided by financing activities  | (1,916,322 )                   | 1,875,545     | 726,050       |
| <b>Investing activities:</b>   |                                |               |               |
| Additions to property and equipment  | (4,607,774 )                   | (1,477,126 )  | (1,034,709 )  |
| Investment in short-term investments   | 1,771,569                      | (1,771,569 )  |               |
| Decrease (increase) in restricted cash being margin security against forward exchange contracts (note 10(c)) | (959,423 )                     | 400,398       | (327,898 )    |
| Deferred acquisition costs   |                                | (46,034 )     |               |
| Acquisition of Mailbank.com Inc., net of cash acquired   | (6,486,732 )                   |               |               |
| Acquisition of Hosted Messaging Assets, net of cash acquired   | (7,552,320 )                   |               |               |
| Acquisition of Boardtown Corporation, net of cash acquired   | (85,599 )                      |               | (2,019,510 )  |
| Decrease (increase) in cash held in escrow   | (73,168 )                      | 388,238       | (1,009,650 )  |
| Cash used in investing activities  | (17,993,447 )                  | (2,506,093 )  | (4,391,767 )  |
| Increase in cash and cash equivalents  | (11,091,696 )                  | 3,433,100     | 1,002,177     |
| Cash and cash equivalents, beginning of year   | 17,348,088                     | 13,914,988    | 12,912,811    |
| Cash and cash equivalents, end of year   | \$ 6,256,392                   | \$ 17,348,088 | \$ 13,914,988 |
| <b>Supplemental cash flow information:</b>   |                                |               |               |
| Interest paid  | \$ 254,502                     | \$ 300        | \$ 166        |
| <b>Supplementary disclosure of non-cash investing and financing activities:</b>                              |                                |               |               |
| Common stock issued on the acquisition of Boardtown Corporation  | \$ 3,281                       | \$ 986,600    | \$ 274,540    |
| Common stock issued on the acquisition of Mailbank.com Inc.  | \$ 2,782,070                   | \$            | \$            |
| Promissory note payable on the acquisition of Mailbank.com Inc.  | \$ 6,000,000                   | \$            | \$            |

See accompanying notes to consolidated financial statements



**Tucows Inc.**  
**Notes to Consolidated Financial Statements**  
**(Dollar amounts in U.S. dollars)**

**1. Organization of the Company:**

The Company is a global distributor of Internet services, including domain name registration, security and identity products through digital certificates and email, through its global Internet-based distribution network of Internet Service Providers, web hosting companies and other providers of Internet services to end-users.

**2. Significant accounting policies:**

These financial statements are stated in U.S. dollars, except where otherwise noted. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America.

*(a) Basis of consolidation*

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated on consolidation.

Investments over which the Company is unable to exercise significant influence, are recorded at cost and written down only when there is evidence that a decline in value that is other than temporary has occurred.

*(b) Use of estimates*

The preparation of the Consolidated Financial Statements in accordance with U.S. GAAP necessarily requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to amounts recognized for or carrying values of revenues, bad debts, investments, goodwill, intangible assets, income taxes, contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances at the time they are made. Under different assumptions or conditions, the actual results will differ, potentially materially, from those previously estimated. Many of the conditions impacting these assumptions and estimates are outside of the Company's control.

*(c) Cash and cash equivalents*

All highly liquid investments, with an original term to maturity of three months or less at the date of acquisition, are classified as cash equivalents.

*(d) Property and equipment*

Property and equipment are stated at cost, net of accumulated amortization. Amortization is provided on a straight-line basis so as to amortize 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       | 100                | % |
| Furniture and equipment | 20                 | % |
| Leasehold improvements  | Over term of lease |   |

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

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. An impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. If such assets are considered 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 asset.

*(e) Intangible assets*

Intangible assets, comprising technology, brand value, customer relationships and non-compete arrangements related to the acquisition of Boardtown Corporation in April 2004, the acquisition of the Hosted Messaging Business of Critical Path, Inc. in January 2006 and the acquisition of Mailbank.com Inc. in June 2006, are being amortized on a straight-line basis over periods of three, five or seven years.

The Company reviews the carrying values of its intangible assets for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss would be recognized when the estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. If such assets are considered impaired, the amount of the impairment loss recognized is measured as the amount by which the carrying value for 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 asset.

Intangible assets, which represent surname domain names and direct navigation domain names related to the acquisitions of Mailbank.com Inc. in June 2006, have an indefinite life and as such are not being amortized. Management has determined that there is no impairment of the carrying value of these surname domain names and direct navigation domain names at December 31, 2006.

Indefinite-lived intangible assets are assessed for impairment on at least an annual basis or more often if events or circumstances warrant. These impairment tests involve the use of discounted cash flow analyses to assess the fair value of the indefinite-lived assets and the recoverability of the carrying value of these assets. These analyses involve estimates of future cash flows, estimated periods of use and applicable discount rates. If the fair values of these assets as determined above were less than the related carrying values, impairment losses would have been recognized, as applicable. Management has determined that there is no impairment of the carrying value of these surname domain names and direct navigation domain names at December 31, 2006.

*(f) Goodwill*

Goodwill represents the excess of the purchase price over the fair values of net identifiable assets acquired. In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, the Company does not amortize goodwill but is required to evaluate goodwill annually or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Absent triggering factors during the year, the Company conducts its goodwill assessment in the fourth quarter to correspond with its measurement planning cycle. Impairment is tested at the reporting unit level by comparing the reporting unit's carrying amount to its fair value. The fair values of the reporting units are estimated using discounted cash flows based on historical experience and on various other

**Tucows Inc.**

**Notes to Consolidated Financial Statements (Continued)**

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

assumptions, including current market trends and developments. To the extent a reporting unit's carrying amount exceeds its fair value, an impairment of goodwill exists. Impairment is measured by comparing the fair value of goodwill, determined in a manner similar to a purchase price allocation, to its carrying value.

*(g) 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 Service Providers 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. Registration fee revenues are net of any promotional rebates as the Company has a continuing obligation to provide services to customers throughout the registration period. 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.

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

The Company also generates advertising and other revenue through its online libraries of shareware, freeware and online services presented on its website. Advertising 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 reserves 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 reserves 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 reserves may be required.

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**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

*(h) Deferred revenue*

Deferred revenue primarily relates to the unearned portion of revenues received in advance related to the unexpired term of registration fees from domain name registrations and other Internet services, net of external commissions. Revenue received in advance of the provision of services from advertising and Sleuth search technology is deferred and recognized in the month that the services are provided.

*(i) Accreditation fees payable*

Accreditation fees relate to the unpaid portion of accreditation fees paid to ICANN in connection with the registration of Generic Top-Level Domains.

*(j) Prepaid domain name registry fees*

Prepaid domain name registry and other Internet services fees represent amounts paid to registries, and country code domain name operators for updating and maintaining the registries, as well as to suppliers of other Internet services. Domain name registry and other Internet services fees are recognized on a straight-line basis over the life of the contracted registration term.

*(k) Translation of foreign currency transactions*

The Company's functional currency is the United States dollar. Monetary assets and liabilities of the Company and of its wholly owned subsidiaries that are denominated in foreign currencies are translated into United States dollars at the exchange rates prevailing at the balance sheet dates. Non-monetary assets and liabilities are translated at the historical exchange rates. Transactions included in operations are translated at the average rate for the year. Foreign exchange gains amounting to \$780,512, \$250,714, and \$343,506 have been recorded in operating expenses in the consolidated statements of operations during the years ended December 31, 2006, 2005 and 2004, respectively.

The Company follows Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS 133 ), as amended. SFAS 133, as amended, establishes accounting and reporting standards for derivative instruments and hedging activities. The Company has not complied with the documentation standards required for its forward foreign exchange contracts to be accounted for as hedges under SFAS 133 and has, therefore, accounted for such forward foreign exchange contracts at their fair values with a (loss)/gain recorded in the consolidated statements of operations of \$(574,762), \$(30,119) and \$88,743 for the years ended December 31, 2006, 2005 and 2004, respectively, equal to the change in the fair value of such contracts. The fair value of the forward foreign exchange contracts is included in accrued liabilities in the consolidated balance sheet at December 31, 2006 and is included in prepaid expenses in the consolidated balance sheet at December 31, 2005.

*(l) Product development costs*

Product development costs are expensed as incurred. The Company accounts for the costs of computer software developed or obtained for internal use in accordance with Statement of Position ( SOP ) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use . Under this SOP, costs that are incurred in the preliminary stage of software development are expensed as incurred. Costs incurred during the application and development stage are capitalized and generally

**Tucows Inc.**

**Notes to Consolidated Financial Statements (Continued)**

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

include external direct costs of materials and services consumed in the development and payroll and payroll-related costs for employees who are directly associated with the development project. Costs incurred in the post implementation and operation stage are expensed as incurred. The Company capitalized \$204,100, \$328,300 and \$338,500 during the years ended December 31, 2006, 2005 and 2004, respectively, of such costs relating to the development of internal use software. The capitalized costs of computer software developed for internal use are amortized on a straight-line basis over one year from the date the software is put into use.

*(m) Income taxes*

Under the asset and liability method of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ( SFAS 109 ), deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under SFAS 109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of operations in the year that includes the enactment date. A valuation allowance is recorded if it is not more likely than not that some portion of or all of a deferred tax asset will be realized.

The Company is entitled to earn investment tax credits ( ITCs ), which are credits related to specific qualifying expenditures as prescribed by Canadian Income Tax legislation. These ITCs relate primarily to research and development expenses. The ITCs are recognized once the Company has reasonable assurance that the amounts will be realized.

*(n) Stock-based compensation*

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123(R)), which requires companies to recognize in the statement of operations all share-based payments to employees, including grants of employee stock options, based on their fair value. The statement eliminates the ability to account for share-based compensation transactions, as the Company formerly did, using the intrinsic value method as prescribed by Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees.

The Company adopted FAS 123(R) using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006. The consolidated financial statements as of and for Fiscal 2006 reflect the impact of adopting FAS 123(R). In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of FAS 123(R). See Note 8 for further details.

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the consolidated statement of operations during 2006 included compensation expense for stock-based payment awards granted prior to, but not yet vested as of, January 1, 2006 based on the grant date fair value estimated in accordance with the pro forma provisions of FAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosures (FAS 148) and compensation expense for the stock-based payment awards granted subsequent to December 31, 2005, based on the grant date fair value

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

estimated in accordance with FAS 123(R). As stock-based compensation expense recognized in the statement of operations for 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. FAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

*(o) Earnings per common share*

Basic earnings per common share has been calculated on the basis of income for the year divided by the weighted average number of common shares outstanding during each year. Diluted earnings per share gives effect to all dilutive potential common shares outstanding at the end of the year had been issued, converted or exercised at the later of the beginning of the year or their date of issuance. In computing diluted income per share, the treasury stock method is used to determine the number of shares assumed to be purchased from the conversion of common stock equivalents or the proceeds of exercises of options.

The following table reconciles the numerators and denominators of the basic and diluted earnings per common share computation:

|  | Year ended<br>December 31, 2006 | Year ended<br>December 31, 2005 | Year ended<br>December 31, 2004 |
|--|---------------------------------|---------------------------------|---------------------------------|
| Numerator for basic and diluted earnings per common share:   |                                 |                                 |                                 |
| Income for the year  | \$ 2,160,434                    | \$ 2,772,616                    | \$ 5,500,338                    |
| Denominator for basic and diluted earnings per common share: |                                 |                                 |                                 |
| Basic weighted average number of common shares outstanding   | 74,032,830                      | 69,077,329                      | 66,079,104                      |
| Effect of stock options                                      | 2,456,551                       | 3,403,875                       | 1,972,475                       |
| Diluted weighted average number of shares outstanding        | 76,489,381                      | 72,481,204                      | 68,051,579                      |
| Basic earnings per common share                              | \$ 0.03                         | \$ 0.04                         | \$ 0.08                         |
| Diluted earnings per common share                            | \$ 0.03                         | \$ 0.04                         | \$ 0.08                         |

Options to purchase 513,311 shares of common stock were outstanding during 2006 (2005 : 105,510; 2004 : 864,310) but were not included in the computation of diluted income per common share because the options' exercise price was greater than the average market price of the common shares. The options which expire in years 2006 to 2015 were still outstanding at the end of 2006.

*(p) Concentration of credit risk*

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents, short-term investments, accounts receivable and forward foreign exchange contracts. Cash equivalents and restricted cash consist of deposits with major commercial banks, the maturities of which are three months or less from the date of purchase. With respect to accounts receivable, the Company performs periodic credit evaluations of the financial condition of its customers and typically does not require collateral from them. The counterparty to the forward foreign exchange contracts is a major commercial bank which management believes does not represent a significant credit

**Tucows Inc.**

**Notes to Consolidated Financial Statements (Continued)**

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

risk. Management assesses the need for allowances for potential credit losses by considering the credit risk of specific customers, historical trends and other information. No customer accounted for more than 10% of revenue in 2006, 2005 or 2004. One customer accounted for 13% of accounts receivable at December 31, 2006, one customer accounted for 11% of accounts receivable at December 31, 2005, and two customers accounted for 27% of accounts receivable at December 31, 2004. All of these accounts receivable have been collected.

*(q) Fair values of financial assets and financial liabilities*

The carrying values of cash and cash equivalents, short-term investments, restricted cash, interest receivable, accounts receivable, accounts payable, accreditation fees payable and accrued liabilities approximate their fair values due to the relatively short periods to maturity of the instruments.

As the funds in escrow include interest to December 31, 2006 and are due to be released from escrow in January and April 2007, the fair value of the cash held in escrow approximates its fair value.

Interest rates that are currently available to the Company for issuance of long-term debt with similar terms and remaining maturities are used to estimate the fair value of the Company's promissory note. The estimated fair value of the Company's promissory note at December 31, 2006 was \$6,352,000, compared to a carrying amount of \$6,000,000, exclusive of accrued interest of \$257,658.

*(r) Comprehensive income*

The Company follows Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income (SFAS 130). This statement requires companies to classify items of their comprehensive income by their nature in the financial statements and display the accumulated balance of other comprehensive income separately from deficit and additional paid-in capital in the equity section of the balance sheet. There was no difference between net income and comprehensive income for the years ended December 31, 2006, 2005 and 2004.

*(s) Segment reporting*

The Company follows Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131), which establishes standards for reporting information about operating segments in annual financial statements. It also establishes standards for related disclosures about products and services, geographic areas and major customers. The Company operates in one business segment.

The Company's revenues are attributed to the country in which the contract originates, primarily Canada. Revenues from domain names issued from the Toronto, Canada location are attributed to Canada because it is impracticable to determine the country of the customer.

The Company's assets are located in Canada, United States and United Kingdom (see note 13 (c)).

*(t) Reclassifications*

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

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

*(u) Recent accounting pronouncements*

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( *FIN48* ). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes that a company should use a more-likely-than-not recognition threshold based on the technical merits of the tax position taken. Tax positions that meet the more-likely-than-not recognition threshold should be measured in order to determine the tax benefit to be recognized in the financial statements. FIN 48 is effective in fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 on its consolidated results of operations and financial condition.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The guidance requires public companies to quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement as material, when all relevant quantitative and qualitative factors are considered. The guidance in SAB 108 is effective for the Company beginning in the fourth quarter of 2006. The adoption of SAB 108 did not have a material effect on the Company's Consolidated Financial Statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 ( *SFAS 157* ), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Earlier adoption is permitted, provided the company has not yet issued financial statements, including for interim periods, for that fiscal year. We are currently evaluating the impact of SFAS 157, but do not expect the adoption of SFAS 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 ( *SFAS 159* ), *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for us on January 1, 2008. We are currently evaluating the impact of adopting SFAS 159 on our financial position, cash flows, and results of operations.

**3. Business acquisitions:**

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

To expand our presence in the email market, on January 3, 2006, Tucows.com Co., one of the Company's wholly owned subsidiaries, completed the purchase of all of the Hosted Messaging Assets from Critical Path, Inc. for a purchase price of \$6.25 million in cash. An additional \$1.75 million of consideration was held in escrow, and was payable by Tucows, contingent on certain future customer orders being renewed through October 2006.



**Tucows Inc.****Notes to Consolidated Financial Statements (Continued)****(Dollar amounts in U.S. dollars)**

During Fiscal 2006, \$1,132,836 of the monies in escrow were released to Critical Path as certain customers renewed their contracts in accordance with the terms of the escrow agreement, while \$527,114 was released from escrow to Tucows as one of the renewing customers did not meet all of the contingent requirements. The amount of \$90,050 remaining in escrow at December 31, 2006, which excludes interest earned to date, was released and paid to Critical Path in January 2007 and reflected as additional goodwill in fiscal 2007.

The total aggregate consideration paid for the Hosted Messaging Assets amounted to \$7,598,355, and is composed of:

- \$6,086,031 being \$6,250,000 paid in cash, less \$163,969 receivable paid by Critical Path during 2006
- \$1,132,836 released from escrow in 2006
- \$379,487 of transaction costs (inclusive of \$46,034 paid in 2005).

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

|                                     |    |           |           |
|-------------------------------------|----|-----------|-----------|
| Prepaid expenses and deposits       | \$ | 570,704   |           |
| Property and equipment              |    | 2,040,000 |           |
| Intangible assets                   |    |           |           |
| Customer and customer relationships |    | 1,071,000 |           |
| Technology                          |    | 154,000   |           |
| Goodwill                            |    | 3,982,248 |           |
| Total assets acquired               |    |           | 7,817,952 |
| Accruals                            |    | 55,628    |           |
| Deferred Revenue                    |    | 163,969   |           |
| Total liabilities                   |    |           | 219,597   |
| Purchase price                      | \$ |           | 7,598,355 |

Intangible assets relate to acquired technology and customer relationships, and are being amortized over their respective useful lives of 2 and 5 years.

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

On June 19, 2006, Tucows (Delaware) Inc., one of the Company's wholly owned subsidiaries, acquired all of the issued and outstanding shares of Mailbank.com Inc. (doing business as NetIdentity). Tucows plans to use these assets to offer personalized Internet services directly to end-users through Domain Direct and through its channel of Service Providers as well as to generate income from the parked page of each domain address. The total aggregate consideration amounting to \$18,034,850 is composed of:

- \$6,085,305, paid in cash at closing, and \$655,830, paid in cash subsequent to the closing date,
- \$2,877,070, being the fair value of 3,596,337 shares of Tucows common stock (which amount does not take into account \$95,000 of expenses associated with the issuance of shares),
- \$6,000,000 unsecured promissory note due to the former shareholders of Mailbank.com Inc., repayable with accrued interest on June 19, 2008,

**Tucows Inc.****Notes to Consolidated Financial Statements (Continued)****(Dollar amounts in U.S. dollars)**

- \$2,122,930 unsecured promissory note that was repaid to the former shareholders of Mailbank.com Inc. with accrued interest at the rate of 9% per annum on August 19, 2006,
- \$198,715 of transaction costs.

The promissory notes payable are both due to the former shareholders of Mailbank.com Inc.

The unsecured promissory note amounting to \$6,000,000 and bears simple interest at the rate of 7% per annum. The interest on the promissory note is payable quarterly in arrears, beginning October 1, 2006. The principal, together with any unpaid interest is due on June 19, 2008. Tucows may prepay this promissory note in full or in part without any premium or penalty. This promissory note is shown as a non-current liability on the consolidated balance sheet as at December 31, 2006. The accrued interest payable as of December 31, 2006 amounting to \$222,658 is included in accrued liabilities.

Mark Cuban, who on June 19, 2006 was an 8.5% shareholder of the Company, was also a significant shareholder of Mailbank.com Inc., with holdings of approximately 22.8%. Rawleigh H. Ralls, IV, who on June 19, 2006 was a 1% shareholder of the Company, held approximately 35.4% of Mailbank.com Inc. Both Mr. Cuban and Mr. Ralls were signatories to the Mailbank.com Inc. merger agreement and separately voted to approve the adoption of the merger agreement, the merger itself and other related transactions.

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

|                                     |    |            |            |
|-------------------------------------|----|------------|------------|
| Cash and cash equivalents           | \$ | 453,118    |            |
| Accounts receivable                 |    | 54,953     |            |
| Prepaid expenses and deposits       |    | 43,508     |            |
| Property and equipment              |    | 51,683     |            |
| Intangible assets:                  |    |            |            |
| Customer and customer relationships |    | 2,800,000  |            |
| Surname domain names                |    | 12,100,000 |            |
| Direct navigation domain names      |    | 2,100,000  |            |
| Acquired software                   |    | 200,000    | 17,200,000 |
| Goodwill                            |    | 6,072,624  |            |
| Total assets acquired               |    |            | 23,875,886 |
| Accounts payable                    |    | 82,768     |            |
| Accrued liabilities                 |    | 457,268    |            |
| Deferred tax liability              |    | 5,396,000  |            |
| Total liabilities                   |    |            | 5,936,036  |
| Purchase price                      |    |            | 17,939,850 |
| Share issuance costs                |    |            | 95,000     |
| Total aggregate consideration       | \$ |            | 18,034,850 |

Intangible assets relate to acquired technology and customer relationships, which are being amortized over their respective useful lives of 2 and 5 years, as well as to surname and direct navigation domain names, which have an indefinite life and as such are not being amortized.

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

**c. Acquisition of Boardtown Corporation:**

On April 27, 2004, the Company finalized the acquisition of 100% of the outstanding capital stock of Boardtown Corporation ( Boardtown ) for total purchase consideration of up to \$4.0 million.

The total aggregate consideration paid until December 31, 2006 amounting to \$3,397,262 is comprised of:

- \$2,000,000 paid in cash during 2004;
- \$274,540 (based on Tucows Inc. s average share price for the two days before and two days after April 21, 2004, the date of the announcement of the transaction, of \$0.77 per share for 356,546 Tucows Inc. shares);
- \$986,600, representing the value of 1,066,075 shares of common stock released from escrow in 2005,
- \$88,880, representing the value of 3,281 shares of common stock and cash of \$85,599 released from escrow in 2006, and
- \$47,242 of transaction costs.

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

|   |              |
|---|--------------|
| Current assets (including cash of \$27,732) | \$ 110,440   |
| Property and equipment                      | 52,861       |
| Intangible assets including:                |              |
| Technology                                  | \$ 540,000   |
| Brand                                       | 170,000      |
| Customer relationships                      | 500,000      |
| Non-compete agreements                      | 190,000      |
| Goodwill                                    | 2,039,947    |
| Current liabilities                         | (205,986 )   |
|   | \$ 3,397,262 |

During 2005, the Company and the shareholders of Boardtown agreed that the shareholders of Boardtown had met certain of the performance milestones in which additional purchase consideration is contingent upon. Accordingly 1,066,075 shares of common stock were released from escrow to the shareholders of Boardtown. The release of the above shares has been recorded as additional goodwill within the consolidated balance sheets, in the amount of \$986,600. In addition, as the net cash flow from existing operations performance milestone was not satisfied, the \$400,000 of the cash contingent consideration was returned to the Company.

During 2006, the Company and the shareholders of Boardtown agreed that the shareholders of Boardtown had met certain of the performance milestones in which additional purchase consideration is contingent upon. Accordingly the remaining 3,569 shares of common stock as well as cash in the amount of \$85,599 were released from escrow to the shareholders of Boardtown. The release of the above shares and cash has been recorded as additional goodwill within the consolidated balance sheets, in the amount of \$88,880.

**Tucows Inc.****Notes to Consolidated Financial Statements (Continued)****(Dollar amounts in U.S. dollars)**

At December 31, 2006, \$555,000 of the contingent consideration, inclusive of accrued interest, remained in the Boardtown escrow account. To the extent that the performance milestones pertaining to renewing or converting potential support customers are met by April 2007, this additional consideration will be released from escrow and its fair value will be recorded as additional goodwill at the time when the obligation becomes determinable.

Intangible assets relate to acquired technology and brand, which are being amortized over their respective useful lives of 7 years, as well customer relationships and non-compete agreements, which are being amortized over their respective useful lives of 5 years.

**d. Goodwill:**

Goodwill consists of the following:

|   | <b>Boardtown<br/>Corporation</b> | <b>Hosted Messaging<br/>Assets of<br/>Critical Path</b> | <b>Mailbank.com<br/>Inc.</b> | <b>Total</b>  |
|---|----------------------------------|---|------------------------------|---------------|
| Balances, December 31, 2003   | \$                               | \$  | \$                           | \$            |
| Acquisition of Boardtown Corporation April 2004                         | 964,467                          |   |                              | 964,467       |
| Balances, December 31, 2004   | 964,467                          |   |                              | 964,467       |
| Released from escrow during the year                                    | 986,600                          |   |                              | 986,600       |
| Balances, December 31, 2005   | 1,951,067                        |   |                              | 1,951,067     |
| Acquisition of Hosted Messaging Assets of<br>Critical Path January 2006 |                                  | 2,849,411   |                              | 2,849,411     |
| Acquisition of Mailbank.com Inc. June 2006                              |                                  |   | 6,072,623                    | 6,072,623     |
| Released from escrow during the year                                    | 88,880                           | 1,132,836   |                              | 1,221,716     |
| Balances, December 31, 2006   | \$ 2,039,947                     | \$ 3,982,247  | \$ 6,072,623                 | \$ 12,094,817 |

**e. Pro forma Results of Operations (unaudited) :**

The results of operations of the Hosted Messaging Assets from Critical Path, Inc acquired on January 3, 2006 and the results of Mailbank.com Inc. acquired on June 19, 2006 have been included in the consolidated statement of operations for Fiscal 2006 since their respective dates of acquisition. Unaudited pro forma results of operations for Fiscal 2006 are included below. Such pro forma information assumes that the above acquisitions had occurred as of January 1, 2006 and is presented in accordance with our accounting policies. This summary is not necessarily indicative of what our results of operations would have been had the Hosted Messaging Assets from Critical Path, Inc and Mailbank.com Inc. been consolidated entities during such periods, nor does it purport to represent results of operations for any future periods.

|  | <b>Year ended<br/>December 31, 2006<br/>(in thousands)</b> | <b>Year ended<br/>December 31, 2005<br/>(in thousands)</b> |
|--|--|--|
| Net revenues                           | \$ 66,754  | \$ 62,076  |
| Net income (loss) for the period       | \$ 1,325   | \$ (6,933 )  |
| Basic earnings (loss) per common share | \$ 0.02  | \$ (0.10 )   |

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
(Dollar amounts in U.S. dollars)

**4. Property and equipment:**

Property and equipment consist of the following:

|                                      | <b>December 31,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|--------------------------------------|------------------------------|------------------------------|
| Computer equipment                   | \$ 9,567,806                 | \$ 4,573,457                 |
| Computer software                    | 8,546,413                    | 6,528,216                    |
| Furniture and equipment              | 992,505                      | 929,824                      |
| Leasehold improvements               | 634,582                      | 626,081                      |
|                                      | <b>19,741,306</b>            | <b>12,657,578</b>            |
| Less:                                |                              |                              |
| Accumulated amortization             | 13,963,774                   | 10,984,907                   |
| Write-down of property and equipment | 130,000                      | 130,000                      |
|                                      | <b>14,093,774</b>            | <b>11,114,907</b>            |
|                                      | <b>\$ 5,647,532</b>          | <b>\$ 1,542,671</b>          |

**5. Intangible assets:**

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

Acquired intangible assets consist of the following:

| <b>Amortization period</b>                                    | <b>Technology<br/>2 - 7 years</b> | <b>Brand<br/>7 years</b> | <b>Customer<br/>relationships<br/>4 - 7 years</b> | <b>Non-compete<br/>agreements<br/>3 years</b> | <b>Surname<br/>domain names<br/>indefinite life</b> | <b>Direct<br/>navigation<br/>domain names<br/>indefinite life</b> | <b>Total</b>  |
|---|-----------------------------------|--------------------------|---|---|---|---|---------------|
| Acquisition of Boardtown Corporation in 2004                  | \$ 540,000                        | \$ 170,000               | \$ 500,000  | \$ 190,000                                    | \$  | \$  | \$ 1,400,000  |
| Amortization expense  | (51,320 )                         | (16,480 )                | (47,800 )   | (42,160 )                                     |   |   | (157,760 )    |
| Net book value,<br>December 31, 2004                          | 488,680                           | 153,520                  | 452,200   | 147,840                                       |   |   | 1,242,240     |
| Amortization expense  | (77,160 )                         | (24,240 )                | (71,400 )   | (63,360 )                                     |   |   | (236,160 )    |
| Net book value,<br>December 31, 2005                          | 411,520                           | 129,280                  | 380,800   | 84,480  |   |   | 1,006,080     |
| Acquisition of the Hosted Messaging Assets from Critical Path | 154,000                           |                          | 1,071,000   |   |   |   | 1,225,000     |
| Acquisition of Mailbank.com, Inc.                             | 200,000                           |                          | 2,800,000   |   | 12,100,000  | 2,100,000   | 17,200,000    |
| Amortization expense  | (207,168 )                        | (24,240 )                | (581,876 )  | (63,360 )                                     |   |   | (876,644 )    |
| Net book value,<br>December 31, 2006                          | \$ 558,352                        | \$ 105,040               | \$ 3,669,924                                      | \$ 21,120                                     | \$ 12,100,000                                       | \$ 2,100,000  | \$ 18,554,436 |

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

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 ending<br/>December 31,</b> |
|-------|-------------------------------------|
| 2007  | 1,145,124                           |
| 2008  | 993,996                             |
| 2009  | 947,004                             |
| 2010  | 947,004                             |
| 2011  | 321,308                             |
| Total | \$ 4,354,436                        |

**6. Investment:**

The Company holds a 7% interest in Afilius, Limited ( Afilius ), a private company, which is a consortium of 18 domain name registrars.

**7. Public Offering:**

In August 2005, the Company completed a public offering whereby 3,290,423 shares of common stock (which includes the underwriters over-allotment of 2,889,250 shares) were issued and received net proceeds of \$1,574,675 (after underwriters fees of \$177,683 and related offering expenses of \$1,209,023).

As part of the offering, certain existing shareholders of the Company, disposed of 21,823,827 shares of the Company common stock and received net proceeds of \$18,462,958 (after underwriters fees of \$1,178,487). The Company did not receive any proceeds from the sale of the shares sold by the selling shareholders.

**8. Stock Option Plans:**

The Company's 1996 Stock Option Plan was established for the benefit of the employees, officers, directors and certain consultants of the Company. The maximum number of common stock which may be set aside for issuance under the Plan was 11,150,000 shares, provided that the Board of Directors of the Company has the right, from time to time, to increase such number subject to the approval of the stockholders of the Company when required by law or regulatory authority. Generally, options issued under the Plan vest over a four-year period. The 1996 Compensation Equity Plan expired on February 25, 2006; no options were issued from this plan after that date.

On November 22, 2006, the Shareholders of the Company approved the implementation of the Company's 2006 Equity Compensation Plan, which serves as a successor to the 1996 Stock Option Plan. The Company's 2006 Equity Compensation Plan has been established for the benefit of the employees, officers, directors and certain consultants of the Company. The maximum number of common stock which have been set aside for issuance under the Plan is 5,000,000 shares. Generally, options issued under the Plan vest over a four-year period and have a term not exceeding seven years.

**Tucows Inc.****Notes to Consolidated Financial Statements (Continued)****(Dollar amounts in U.S. dollars)**

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model, consistent with the provisions of SFAS No. 123R and SAB No. 107. 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 stock. 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 Tucows Inc. common stock at the date of grant.

The fair value of stock options granted during the years ended December 31, 2006, 2005 and 2004 was estimated using the following assumptions:

|   | Year ended December 31, |         |         |   |
|---|-------------------------|---------|---------|---|
|   | 2006                    | 2005    | 2004    |   |
| Volatility  | 121.0                   | % 120.3 | % 132.4 | % |
| Risk-free interest rate   | 4.5                     | % 3.8   | % 3.2   | % |
| Expected life (in years)  | 6.3                     | 4.0     | 4.0     |   |
| Dividend yield  |                         | %       | %       | % |
| The weighted average grant date fair value for options issued, with the exercise price equal to market value on the date of grant | \$ 0.83                 | \$ 0.69 | \$ 0.50 |   |

Details of stock option transactions are as follows:

|                                  | Year ended<br>December 31, 2006 |  | Year ended<br>December 31, 2005 |  | Year ended<br>December 31, 2004 |  |
|----------------------------------|---------------------------------|--|---------------------------------|--|---------------------------------|--|
|                                  | Number of<br>shares             | Weighted<br>average<br>exercise price<br>per share | Number of<br>shares             | Weighted<br>average<br>exercise price<br>per share | Number of<br>shares             | Weighted<br>average<br>exercise price<br>per share |
| Outstanding, beginning of year   | 6,497,387                       | \$ 0.51  | 7,497,586                       | \$ 0.49  | 8,665,755                       | \$ 0.69  |
| Granted                          | 293,000                         | 0.92   | 228,875                         | 0.88   | 1,479,250                       | 0.61   |
| Exercised                        | (433,293 )                      | 0.48   | (771,555 )                      | 0.39   | (1,834,275 )                    | 0.40   |
| Forfeited                        | (269,402 )                      | 0.64   | (450,019 )                      | 0.54   | (392,735 )                      | 0.40   |
| Expired                          | (117,500 )                      | 0.70   | (7,500 )                        | 4.69   | (420,409 )                      | 5.58   |
| Outstanding, end of year         | 5,970,192                       | \$ 0.52  | 6,497,387                       | \$ 0.51  | 7,497,586                       | \$ 0.49  |
| Options exercisable, end of year | 5,289,618                       | \$ 0.50  | 5,324,655                       | \$ 0.50  | 5,211,809                       | \$ 0.48  |

The stock options expire at various dates through 2016.

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

As of December 31, 2006, the exercise prices, weighted average remaining contractual life of outstanding options and intrinsic values 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 value | Number exercisable | Weighted average exercise price per share | Aggregate intrinsic value |
| \$0.26 - \$0.36 | 588,215             | \$ 0.35                                   | 7.1   | \$ 293,918                | 501,975            | \$ 0.35                                   | \$ 251,629                |
| \$0.37 - \$0.50 | 3,523,738           | \$ 0.38                                   | 3.9   | \$ 1,639,833              | 3,523,738          | \$ 0.38                                   | \$ 1,639,833              |
| \$0.52 - \$0.91 | 1,539,095           | \$ 0.71                                   | 7.0   | \$ 239,397                | 1,140,324          | \$ 0.74                                   | \$ 145,335                |
| \$0.93 - \$5.94 | 319,144             | \$ 1.45                                   | 7.8   | \$                        | 123,581            | \$ 2.25                                   | \$                        |
|                 | 5,970,192           | \$ 0.52                                   |   | \$ 2,173,148              | 5,289,618          | \$ 0.50                                   | \$ 2,036,797              |

Total unrecognized compensation cost relating to unvested stock options at December 31, 2006, prior to the consideration of expected forfeitures, is approximately \$365,000 and is expected to be recognized over a weighted average period of 2.6 years.

The total intrinsic value of options exercised during the years ended December 31, 2006, 2005 and 2004 was \$171,000, \$462,000 and \$530,000, respectively. Cash received from the exercise of stock options during the years ended December 31, 2006, 2005 and 2004 was \$207,000, \$301,000 and \$726,000 respectively.

As a result of the adoption of SFAS 123R on January 1, 2006, the Company recorded stock-based compensation amounting to \$298,040 for the year ended December 31, 2006. No stock-based compensation was recorded for the year ended December 31, 2005, while stock-based compensation amounting to \$69,737 was recorded for the year ended December 31, 2004, as a result of modification of the terms of certain options granted to a former employee.

Had we adopted the fair value-based method for accounting for stock-based compensation in all prior periods presented, the pro-forma impact on net income and net income per share would be as follows:

|   | Year ended December 31, |              |
|---|-------------------------|--------------|
|   | 2005                    | 2004         |
| Net income, as reported   | \$ 2,772,616            | \$ 5,500,338 |
| Add stock-based employee compensation expense included in reported net income, net of tax                                   |                         | 90,330       |
| Deduct total stock-based employee compensation expense determined under fair-value-based method for all rewards, net of tax | (357,523 )              | (413,151 )   |
| Net income, pro forma   | \$ 2,415,093            | \$ 5,177,517 |
| Earnings per common share, as reported  | \$ 0.04                 | \$ 0.08      |
| Earnings per common share, pro forma  | \$ 0.03                 | \$ 0.08      |

Amortization of deferred stock-based compensation amounted to nil for the years ended December 31, 2006 and December 31, 2005, and \$20,593 for Fiscal 2004.



**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

**9. Income taxes:**

The provision for income taxes differs from the amount computed by applying the statutory Federal income tax rate of 35% to the income before provision for income taxes as a result of the following:

|  | Year ended<br>December 31, 2006 | Year ended<br>December 31, 2005 | Year ended<br>December 31, 2004 |
|--|---------------------------------|---------------------------------|---------------------------------|
| Income for the year before provision for income taxes  | \$ 2,068,000                    | \$ 2,621,000                    | \$ 2,350,000                    |
| Computed expected tax expense  | \$ 724,000                      | \$ 917,000                      | \$ 822,000                      |
| Increase (reduction) in income tax expense resulting from:   |                                 |                                 |                                 |
| State income taxes   | 62,000                          | 79,000                          | 75,000                          |
| Permanent differences  | 315,000                         | 35,000                          | 132,000                         |
| ITCs recovered   | (128,000 )                      | (252,000 )                      | (150,000 )                      |
| Other  | (269,000 )                      | (192,000 )                      | (660,000 )                      |
| Change in beginning of the year balance of the valuation allowance allocated to income tax expense | (796,000 )                      | (739,000 )                      | (3,369,000 )                    |
| Recovery of income taxes   | \$ (92,000 )                    | \$ (152,000 )                   | \$ (3,150,000 )                 |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets as of December 31, 2006 and 2005 are presented below:

|  | December 31,<br>2006 | December 31,<br>2005 |
|--|----------------------|----------------------|
| Deferred tax assets:                         |                      |                      |
| Net operating losses carried forward         | \$ 4,608,000         | \$ 5,710,000         |
| Deferred revenue                             | 5,122,000            | 4,210,000            |
| Reserves                                     | 466,000              | 142,000              |
| Capital losses                               |                      | 45,000               |
| Amortization                                 | 6,917,000            | 8,068,000            |
| Total gross deferred tax assets              | 17,113,000           | 18,175,000           |
| Less valuation allowance                     | (14,113,000 )        | (15,175,000 )        |
| Net deferred tax assets                      | \$ 3,000,000         | \$ 3,000,000         |
| Deferred income tax asset, current portion   | \$ 1,000,000         | \$ 1,000,000         |
| Deferred income tax asset, long-term portion | 2,000,000            | 2,000,000            |
|  | \$ 3,000,000         | \$ 3,000,000         |
| Deferred tax liabilities:                    |                      |                      |
| Indefinite life intangible assets            | \$ (5,396,000 )      | \$                   |

**Tucows Inc.****Notes to Consolidated Financial Statements (Continued)****(Dollar amounts in U.S. dollars)**

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the years in which those temporary differences become deductible. Management considers projected future taxable income, uncertainties related to the industry in which the Company operates, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods which the deferred tax assets are deductible, management believes it is appropriate to record a valuation allowance in the amount of \$14.1 million at December 31, 2006 and a valuation allowance in the amount of \$15.2 million at December 31, 2005.

The valuation allowance decreased from \$15,175,000 at December 31, 2005 to \$14,113,000 at December 31, 2006. Of the \$14,113,000 valuation allowance, \$266,000 is attributable to acquired deferred tax assets of acquisitions for which any subsequent reduction of this valuation allowance would be applied first to reduce goodwill and then intangible assets of the acquired entity.

As of December 31, 2006, the Company had approximately \$12,127,000 of losses available to reduce future years U.S. taxable income which expire on various dates between 2020 and 2021. In order to utilize the total gross deferred tax assets, the Company would have to earn taxable income of approximately \$45.0 million.

**10. Other income:**

In 2002, we assigned to an unrelated third party (our Partner), various patents which were acquired by us in the merger with Infonautics in 2001. In connection with the assignment of these patents, we retained the right to a revenue share relating to any cash flow received by our Partner relating to the commercialization of these patents. As a result of this assignment, during the year ended December 31, 2006, we recognized \$2.3 million in other revenue. This amount was fully paid to us during the year. We do not expect to receive any additional revenue share from this arrangement in the future.

**11. Commitments and contingencies:**

(a) The Company has several non-cancelable lease and purchase obligations primarily for general office facilities and equipment that expire over the next five years. Future minimum payments under these agreements are as follows:

|            |              |
|------------|--------------|
| 2007       | \$ 1,591,000 |
| 2008       | 835,000      |
| 2009       | 824,000      |
| 2010       | 353,000      |
| 2011       | 344,000      |
| Thereafter |              |

(b) In the normal course of operations, the Company is subject to various lawsuits and other claims. The Company believes that the outcome of any of the outstanding claims would not result in a material effect on the Company's financial position.

**Tucows Inc.****Notes to Consolidated Financial Statements (Continued)****(Dollar amounts in U.S. dollars)**

(c) To manage its exposure to foreign exchange rate fluctuations, the Company has entered into a series of forward foreign exchange contracts whereby amounts of \$850,000 are converted into Canadian dollars on a semi-monthly basis from January 2007 to December 2007 at foreign exchange rates varying from 1.1362 to 1.1250. The notional principal of the outstanding contracts at December 31, 2006 is \$20.4 million. As margin security against these contracts, the Company has placed \$1.02 million into secured term deposits, which mature on a monthly basis in line with the contracts and has been reflected as restricted cash on the consolidated balance sheet as at December 31, 2006.

**12. Subsequent events:**

In January 2007, our Board of Directors approved a stock buyback program, whereby during the period February 16, 2007 to February 18, 2008, the Company may repurchase up to 5,698,398 common shares of Tucows either through the facilities of the America Stock Exchange or the Toronto Stock Exchange.

In February 2007, the Company purchased 1.5 million shares were purchased under the stock buyback program at \$0.87 per share.

**13. Supplemental information:**

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

|  | <b>Year ended December 31,</b> |               |               |
|--|--------------------------------|---------------|---------------|
|  | <b>2006</b>                    | <b>2005</b>   | <b>2004</b>   |
| Domain names, excluding Domain Direct            | \$ 44,144,229                  | \$ 37,984,645 | \$ 35,807,131 |
| Other internet services, including Domain Direct | 16,290,540                     | 7,334,284     | 5,692,656     |
|  | 60,434,769                     | 45,318,929    | 41,499,787    |
| Advertising and other revenue                    | 4,594,721                      | 3,198,110     | 3,217,368     |
|  | \$ 65,029,490                  | \$ 48,517,039 | \$ 44,717,155 |

During the years ended December 31, 2006 and 2005, no customer accounted for more than 10% of total revenue. During the year ended December 31, 2006 one customer accounted for 13% of accounts receivable, while during the year ended December 31, 2005, one customer accounted for 11% of accounts receivable.

**Tucows Inc.**  
**Notes to Consolidated Financial Statements (Continued)**  
**(Dollar amounts in U.S. dollars)**

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

|  | Year ended December 31, |               |               |
|--|-------------------------|---------------|---------------|
|  | 2006                    | 2005          | 2004          |
| Domain names, excluding Domain Direct            | \$ 31,678,898           | \$ 26,693,950 | \$ 24,273,535 |
| Other internet services, including Domain Direct | 4,230,782               | 2,588,975     | 2,093,558     |
|  | 35,909,680              | 29,282,925    | 26,367,093    |
| Network, other costs                             | 5,625,283               | 1,362,079     | 1,198,973     |
| Network, depreciation and amortization costs     | 2,962,904               | 751,613       | 738,701       |
|  | \$ 44,497,867           | \$ 31,396,617 | \$ 28,304,767 |

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

|                | Year ended December 31, |              |              |
|----------------|-------------------------|--------------|--------------|
|                | 2006                    | 2005         | 2004         |
| Canada         | \$ 2,521,328            | \$ 1,502,596 | \$ 831,182   |
| United States  | 3,045,236               | 40,075       | 186,055      |
| United Kingdom | 80,968                  |              |              |
|                | \$ 5,647,532            | \$ 1,542,671 | \$ 1,017,237 |

(d) Valuation and qualifying accounts:

|  | Balance at beginning year | Charged to (recovered) costs and expenses | Write-offs during year | Balance at end of year |
|--|---------------------------|---|------------------------|------------------------|
| <b>Allowance for doubtful accounts</b>             |                           |   |                        |                        |
| 2006   | \$ 51,250                 | \$ 96,250                                 | \$                     | \$ 147,500             |
| 2005   | 25,000                    | \$ 26,250                                 | \$                     | \$ 51,250              |
| 2004   | 30,000                    | (5,000 )                                  |                        | 25,000                 |
| <b>Valuation allowance for deferred tax asset:</b> |                           |   |                        |                        |
| 2006   | \$ 15,175,000             | \$ (1,062,000 )                           | \$                     | \$ 14,113,000          |
| 2005   | 15,914,000                | (739,000 )                                |                        | 15,175,000             |
| 2004   | 19,283,000                | (3,369,000 )                              |                        | 15,914,000             |

**EXHIBIT INDEX**

**Exhibit**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 2.1        | Asset Purchase Agreement, dated as of December 14, 2005, between Critical Path and Tucows Inc. (Incorporated by reference to Exhibit 2.1 filed with Tucows' current report on Form 8-K, as filed with the Securities and Exchange Commission (the SEC) on December 19, 2005).   |
| 3.1        | Third Amended and Restated Articles of Incorporation of Tucows Inc. (Incorporated by reference to Exhibit 3.1 filed with Tucows' report on Form 8-K, as filed with the SEC on September 6, 2001).   |
| 3.2#       | Second Amended and Restated Bylaws of Tucows Inc.   |
| 10.1       | Stock Purchase Agreement, dated as of April 20, 2004, by and between Tucows Inc., Boardtown Corporation and the shareholders of Boardtown named therein (Incorporated by reference to Exhibit 2.1 filed with Tucows' report on Form 8-K, as filed with the SEC on May 11, 2004).  |
| 10.2       | Amendment to Stock Purchase Agreement, dated as of May 3, 2005, by and between Tucows Inc., Boardtown Corporation and the shareholders of Boardtown named therein (Incorporated by reference to Exhibit 10.1 filed with Tucows' report on Form 8-K, as filed with the SEC on May 5, 2005).  |
| 10.3#      | 2006 Equity Compensation Plan.  |
| 10.4*      | Employment Agreement dated January 22, 2003 between Tucows.com Co. and Elliot Noss (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 28, 2004).   |
| 10.5*      | Employment Agreement dated March 11, 2003 between Tucows.com Co. and Michael Cooperman (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 28, 2004).   |
| 10.6*      | Employment Agreement dated March 11, 2003 between Tucows.com Co. and Supriyo Sen (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 28, 2004).   |
| 10.7*      | Employment Agreement dated March 11, 2003 between Tucows.com Co. and Graham Morris (Incorporated by reference to Exhibit 10.6 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 24, 2005).   |
| 10.8       | Lease between 707932 Ontario Limited and Tucows International Corporation, dated December 10, 1999 (Incorporated by reference to exhibit number 10.9 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2001, as filed with the SEC on April 1, 2002).   |
| 10.9       | Lease extension between 707932 Ontario Limited and Tucows Inc. and Tucows.com Co., dated September 4, 2004 (Incorporated by reference to Exhibit 10.5 filed with Tucows' annual report on Form 10-K for Fiscal 2004, as filed with the SEC on March 24, 2005).  |
| 10.10*     | Description of Tucows Fiscal 2004 At Risk Compensation Plan (Incorporated by reference to Exhibit 10.9 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 24, 2005).  |
| 10.11      | Registrar Accreditation Agreement, effective as of June 25, 2005, by and between the Internet Corporation for Assigned Names and Numbers and Tucows.com Co. (Incorporated by reference to Exhibit 10.12 filed with Amendment No. 1 to Tucows' registration statement on Form S-1 (Registration No. 333-125843), as filed with the SEC on July 7, 2005). |

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- 10.12 Registry-Registrar Agreement, dated as of October 4, 2001, by and between VeriSign, Inc. and Tucows Inc. (Incorporated by reference to Exhibit 10.13 filed with Amendment No. 1 to Tucows registration statement on Form S-1 (Registration No. 333-125843), as filed with the SEC on July 7, 2005).
  - 21.1# Subsidiaries of Tucows Inc.
  - 23.1# Consent of KPMG LLP.
  - 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.
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\* Management or compensatory contract required to be filed pursuant to Item 15(c) of the requirements for Form 10-K reports.

# Filed herewith.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

TUCOWS INC.

By:

/s/ ELLIOT NOSS

Elliot Noss

Name: Elliot Noss

Title: *Chief Executive Officer and President*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons of behalf of the registrant and in the capacities and on the dates indicated.

| <b>Signature</b>                              | <b>Title</b>   | <b>Date</b>    |
|---|--|----------------|
| /s/ ELLIOT NOSS<br>Elliot Noss                | President, Chief Executive Officer<br>(Principal Executive Officer) and Director | March 28, 2007 |
| /s/ MICHAEL COOPERMAN<br>Michael Cooperman    | Chief Financial Officer (Principal Financial<br>and Accounting Officer)          | March 28, 2007 |
| /s/ STANLEY STERN<br>Stanley Stern            | Director   | March 28, 2007 |
| /s/ EUGENE FIUME<br>Eugene Fiume              | Director   | March 28, 2007 |
| /s/ EREZ GISSIN<br>Erez Gissin                | Director   | March 28, 2007 |
| /s/ LLOYD N. MORRISSETT<br>Lloyd N. Morrisett | Director   | March 28, 2007 |
| /s/ JEFFREY SCHWARTZ<br>Jeffrey Schwartz      | Director   | March 28, 2007 |
| /s/ ALLEN KARP<br>Allen Karp                  | Director   | March 28, 2007 |